Year 1, number 1, november 2007

FINANCIAL INSIGHTS

The current state of the financial world by Prof. Dr. J. Sijben

Capgemini Financial Services offers, in cooperation with Prof. Dr. Jacques Sijben, quarterly a view at the current development at the Global financial world. Prof. Sijben is a specialist in Monetary Economics and lectures this at the Tias Business School in Tilburg.

Interest rate outlook for 2008

Prof. Dr. Jacques J. Sijben

Interest has long played an important role, not only in economic science but also in financial practice. Examples include interest as a cost of capital for business, interest on mortgage loans (construction sector), interest charges in the government budget and finally interest as a transmission link in monetary policy (central bank).

Looking back, it can be observed that since the beginning of the 1980s, when long-term interest rates were over 10%, the international financial landscape has changed dramatically and inflation and inflation expectations have declined sharply. Moreover, macroeconomic stability has increased since the 1990s, strengthening optimism among investors. As a result, capital market interest rates have fallen sharply. Since 2000, long-term rates in both the United States and the Eurozone have been below 5% each year, and in Japan (deflation) even lower than 2%.

Although from June 2004 the Federal Reserve gradually raised short-term or money market interest rates (previously 1%) to 5.25% in June 2005, long-term rates remained relatively low, completely contrary to the expectations theory. In the spring, He believed it was caused by the following factors.

First, due to the credible anti-inflation policies of the politically independent central banks, inflation expectations were anchored at a low, stable level (2%). In addition, investors had an optimistic view of the macroeconomic outlook, leading to a sharp fall in the risk-term premium. Investors' risk perception is very cyclically sensitive (psychology), as a result of which boom-bust cycles (asset bubbles) can arise in asset markets. Increasing international competition (globalisation) and the emerging markets in Asia (low wages) also put downward pressure on inflation in Western countries. This development was accompanied by generous financing of the sizeable US current account deficit ($880 billion) by the central banks in Asia. They invest the intervention dollars in US government bonds, thereby keeping US interest rates "artificially" low. Bernanke talks of a "savings glut" in Asia. Finally, the pension funds' investment switch from equities to long-term bonds, following the bursting of the ICT bubble in 2000, put downward pressure on long-term interest rates.

tions with regard to US house prices in recent years, which ultimately led to a housing bubble. Increasing numbers of families were spurred to buy a home and take advantage of the continuing boom in the housing market with a view to spending the surplus value in the near future. Since the middle of 2006, the overheated housing market has cooled, and in July of this year it led, entirely unexpectedly, to a global credit crisis.

An assessment of the interest rate trend in 2008 must take due account of continuing macroeconomic uncertainty up to the middle of 2008. First, assuming there is a substantial weakening of growth in America (no recession), the risk-term premium will rise. Risk aversion among investors has increased sharply since July of this year, taking the risk premium back to a more "normal" level. As a result, long-term interest rates will rise, and share prices will move higher only gradually, albeit with volatility.

It is also critically important how the central banks react in this uncertain macroeconomic environment over the next few quarters. Following the liquidity injections in August, the intensification of the credit crisis prompted the ECB to pause its rate hikes on 6 September (4%), although the inflation risk is strong in Europe (upward wage pressure and higher oil prices). By contrast, the Fed, with its dual mandate, rightly gave priority to economic growth on 18 September. By cutting interest early by 50 basis points to 4.75%, Bernanke hopes to avoid a credit crunch and a recession. It is obvious that the interest rate trend in 2008 will be determined by developments in the economy and inflation in the next few quarters. A relatively high oil price (currently above $80) and a further weakening of the dollar against the euro (1.40-1.45), perhaps even moving towards 1.50, will further increase inflation pressure in the United States, partly due to the low unemployment. The interest-damping effect of Asian financing will continue for the time being, while the decline of the dollar will slightly improve the current account deficit. As a result, together with a higher risk-term premium, long-term interest rates will rise overall towards 5%-5.5%. Depending on the macroeconomic newsflow, short-term interest rates will be cut further to 4.25% or even 4%.

In Europe, due to a smaller interest rate gap compared to the US, the euro will continue to appreciate. That will put downward pressure on both inflation and long-term interest rates (4.5%-4.75%). On the other hand, in the absence of a recession in the US, the inflation risk (wage trend) will rise, as a result of which short-term interest rates will be raised to 4.25%.

I believe that from the middle of 2008 the negative effect of the credit crisis will have worn off and a gradual recovery will begin in the US. The Fed will then provisionally keep its policy on hold and the dollar will strengthen slightly. The yield curve will steepen. In Europe, despite criticism from politicians, the ECB will decide in this scenario to raise short-term rates towards 4.25%-4.5%, leading to a flattening of the yield curve (long-term rates 4.5%-5%)

2 October 2007.

Colophon
Financial Insights is a publication of Capgemini Nederland B.V. No part of this publication may be reproduced and/or published by means of printing, photocopying or any other manner without the permission of Capgemini.

Information
If you require any further information about the subjects or our services, please do not hesitate to contact Johan Kerkhoff, Financial Services Strategy Director