Stimulus and interest rates – where are we heading from here?

Saxo Bank Research Note **3 Nov. 2009** **Research Analyst Robin Bagger-Sjöbäck**

UK: So far, the Bank of England (BoE) has devoted some £175 billion to the Asset Purchase Facility program, mainly intended to buy gilts. As of now, £174.8 billion has been spent (£172.8 billion on gilts, equivalent to 13% of GDP) and expectations for the BoE minutes this Thursday (Nov 5th) are that the program will be extended yet again, probably with another £50 billion. We believe such an extension will steady gilt yields and flatten out the yield curve, while sterling ought to lose some ground again.

France: In the early days of the crisis, France made clear that it did not want to take the same path as the US, which allegedly focuses more on long term stimuli effects, but instead concentrate more on the short term and try to boost employment and aggregate demand without delay. The majority of the committed funds in the $37 billion stimulus package (1.4% of GDP) will be distributed between direct state investments and helping businesses enhance their cash-flows. Mr. Devedjian, the minister in charge of the French stimulus package, has stated that all projects that are allocated money from the fund must begin in 2009 in order to garner rapid results. The aim is to have distributed 75%, or $27.8 billion, before the end of 2009.

Germany: So far the two stimulus packages enacted by Angela Merkel (total $104 billion) were intended to spur the German economy throughout 2009 and 2010. The results are somewhat mixed, with the last unemployment number unexpectedly decreasing to 8.1%, while both consumer confidence and retail sales worsened in August. At the beginning of Merkel's second term in office as Chancellor, she signed another bill committing $36 billion to make room for income and corporate tax relief between 2011 and 2013, taking the total government outlays to 4% of GDP. The expectation is that Germany's total budget shortfall in 2010 now amounts to over €130 billion (€7.4 billion in 2008), meaning that they will break the 3% of GDP limit set by the EU for overall budget deficits .

Japan: Japan unveiled several stimulus packages (during Q4 '08 and early '09) which came to a total of $157.8 billion or 3.6% of GDP. The main objective of the scheme was to purchase corporate debt in the open market. The Bank of Japan (BoJ) said last week that it will discontinue purchases of corporate debt by the end of the year (as originally planned) and replace it with an extension of unlimited collateral-backed lending until the end of March 2010.

China: "The beast in the east" was relatively quick to introduce its $586 billion stimulus program (15% of GDP) in November 2008, a program which focuses mostly on housing, infrastructure investments and tax cuts. As regulations on mortgage lending have eased considerably, property values have sky-rocketed, as have equities in both mainland China and Hong Kong. The very rapid asset appreciation has left some economists fretting that a large chunk of the stimulus money intended for house purchases has flowed into the stock market instead, feeding an asset bubble. Chinese officials said in November 2008 when the spending program was introduced that it was designed for the coming 24 months, i.e. exit is planned for November 2010.

Conclusion: the various stimulus packages and an easy money stance on the part of central banks around the world have succeeded in slowing down the deterioration of the world economy and have boosted asset prices globally as the markets price in an economic recovery. Countries like Norway and Australia have even felt enough of the recovery impulse to spur central banks there to already begin tightening monetary policy. Nevertheless, most major economies will need to see how well they can survive without the "life support" provided by desperately low interest rates, hefty stimulus measures, and even quantitative easing. It is increasingly clear that governments and central banks are gearing up for so-called "exit strategies" from the easy money policies enacted to deal with the risks of a financial meltdown as we head into the New Year.

Interest rate expectations indicate that the UK, Switzerland, Sweden, Japan, US and Canada will be the last to exit stimulus and near zero-interest-rate-policy commitments (see chart).

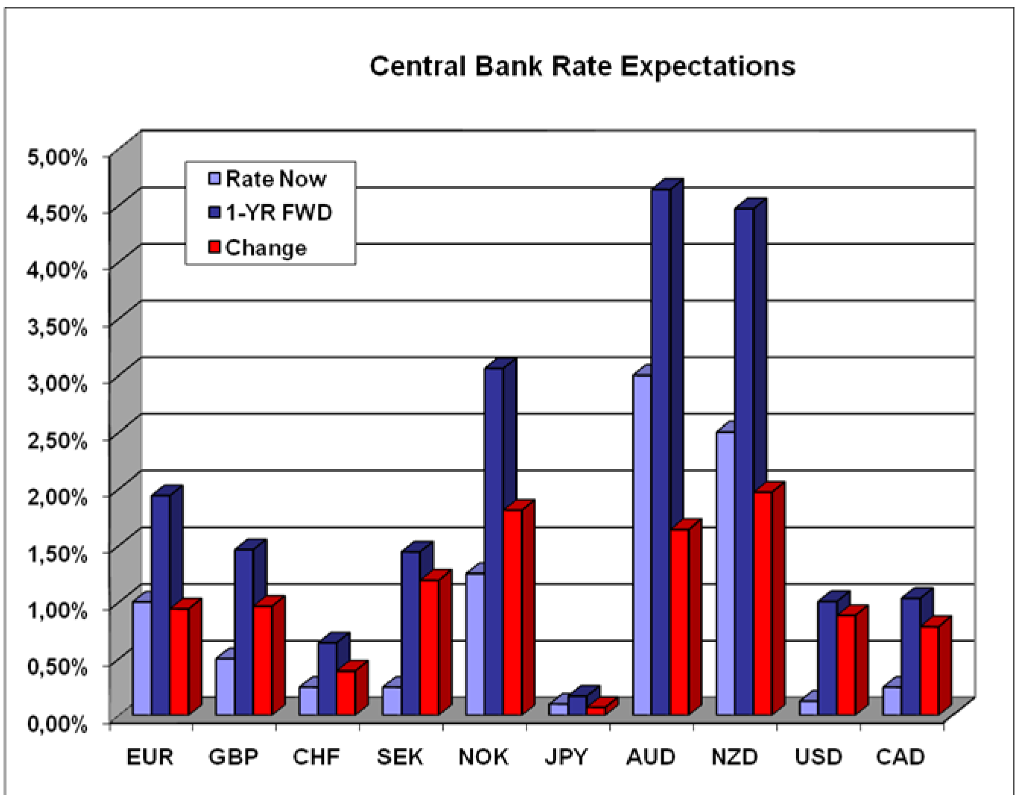

Chart: The chart above shows the current policy rate for the G-10 currencies, the market's expectation for the policy rate a year from now, and the net change between the two. We have already seen Australia's RBA and Norges Bank increasing rates to 3.50% (+50 bps) and 1.50% (+25 bps) respectively in the last month. New Zealand's RBNZ and the ECB are the next most hawkish central banks, according to the market, while the BoJ is expected to maintain its virtual zero for the whole duration.

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