Macro & Microeconomics

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Impact of Monetary Policy changes on the Stock Market

Monetary policy has received a wide interest among the investor community. In simple terms, monetary policy is the process where a central bank of a country controls the supply of money in the economy. To spur the economic growth, the government can decide to review its monetary policies. The nature of the relationship between monetary policies and the stock market is currently a highly debatable topic. Although the relation between the stock market and interest rates is indirect, they tend to move in the opposite direction. These policies mostly include the Central bank decreasing its interest rates and lowering deposit-reserve ratios for banks. This paper provides a brief review of changes in the monetary policies and their impact on the stock market

The intention of monetary policies is to encourage economic growth, curb inflation, and keep in check price stability. Typical monetary policies have either expansion attributes or contraction attributes. In expansion attributes, there is an increase in the money supply in the economy more abruptly than normal. Expansion monetary policies are used in the economic slowdown to try to reduce unemployment rates by availing cheap credit; this capital finances the company's expansion growth (Atkeson, Chari & Kehoe, 2009). Contraction monetary policies reduce the money supply in the economy, and their use is to curb inflation.

An increase in the interest rates will reduce the availability of capital and the cost of capital will be high. If investors have a view that a company is making less profit due to high debt expenses or spends less on growth expansion, then the amount in future profits will drop. This will result in a drop in the company’s stock prices. The high interest rates also restrict the appetite for risk and make it relatively expensive to secure stocks. Another negative impact of high interest on the stock market is that it makes other financial investments such as bonds and securities more attractive. This diverts the investment capital from the stock market.

A reduction in the interest rates, on the other hand, avails capital to businesses, which will have the capacity to finance their expansion at a cheaper rate. This increases their potential for future earnings. Other factors being equal this will increase the company's stock price.

Currently, the People's Bank of China announced a cut in rates for the fourth time within seven months. This was applied to ease the stock stampede that resulted in a 20% loss of its stock market capitalization, and in order to assure and still keep the investors' confidence. This cutting of rates also brings speculation of more easing of policies to come. Investors see this as an opportunity as the easing will lead to a conducive environment of business, meaning more future earnings, which in turn leads to high stock prices. This policy will increase interest in the Chinese stock market and investors will pile up stocks, ultimately leading to an increase in the market capitalization. This monetary policy will also help keep a check on sharp fluctuations in the stock market.

Overall, two key factors affect stock market prices in relation to interest rates and monetary policies. According to North & Caes (2012), they include:

a) Speculation that future interest rates will increase – this leads to a decrease in stock prices.

b) Speculation that future earnings will increase – this leads to an increase in stock prices.

In conclusion, changes in the monetary policies have a significant impact on the stock market. Knowledge of the workings of monetary policies in the economy and their effects on the stock market can be of great help to investors. It can guide them in strategizing their portfolios to maximize the benefits from policy changes and increase returns.

References

Atkeson, A., Chari, V., & Kehoe, P. (2015). *Sophisticated monetary policies*. Cambridge, Mass.: National Bureau of Economic Research.