

Understanding Volatility: How central banks influence market volatility

Central banks wield significant influence over financial markets through their monetary policy decisions and it's important for investors to understand how these policies can affect market volatility.

Let's look at how economic catalysts like central bank policies can create ripple effects in the share market movements.

The role of central banks

Central banks, such as the Reserve Bank of Australia, the Federal Reserve in the United States, the European Central Bank (ECB), and the Bank of England, play a crucial role in managing a country's monetary policy. Their primary objectives often include controlling inflation, managing employment levels, and ensuring economic stability. Central banks use various tools to influence the economy, including adjusting interest rates, conducting open market operations, and implementing quantitative easing (QE).

1. Interest rates

One of the most powerful tools available to central banks is the adjustment of interest rates. Lowering interest rates typically encourages borrowing and spending, as loans become cheaper. This can stimulate economic growth, leading to potential increases in corporate earnings and stock prices. Conversely, raising interest rates makes borrowing more expensive, which can dampen spending and slow economic growth, resulting in lower stock prices.

Example: In December 2015, the Federal Reserve in the US raised the federal funds rate for the first time since the financial crisis of 2008. This decision sent ripples through the stock market, with initial volatility following the announcement. However, the long-term effect was a gradual increase in interest rates, which eventually led to concern among investors about slowing economic growth.

2. Open market operations

Open market operations involve the buying and selling of government securities in the open market to regulate the money supply. When a central bank buys securities, it injects liquidity into the banking system, encouraging lending and investment. Selling securities has the opposite effect, pulling liquidity from the market.

Example: During the COVID-19 pandemic, the Federal Reserve implemented aggressive open market operations, purchasing large quantities of government and mortgage-backed securities to provide liquidity and stabilise financial markets. This move helped prevent a major financial crisis, leading to a significant rebound in the stock market.

3. Quantitative Easing (QE)

QE is an unconventional monetary policy tool used when traditional methods, like lowering interest rates, become ineffective (usually when rates approach zero). Central banks purchase longer-term securities to lower interest rates and increase the money supply, encouraging borrowing and spending.

Example: The Federal Reserve launched its first QE program in response to the 2008 financial crisis, purchasing trillions of dollars in assets. This unprecedented move had immediate effects on the stock market, propelling it to recover from the recession and signaling a return of investor confidence.

Identifying economic catalysts

But what is it that central banks tend to look at before making their policy decision? Here are some key indicators to watch:

1. Inflation rates

Inflation is a critical consideration for central banks. Rising inflation often leads to increased interest

rates, while low inflation may result in rate cuts. Investors should pay attention to key inflation metrics, such as the Consumer Price Index (CPI) and Producer Price Index (PPI).

2. Unemployment rates

Central banks often respond to labor market conditions. High unemployment rates may prompt rate cuts to stimulate growth, while low unemployment may lead to tightening monetary policy to prevent overheating.

3. Gross Domestic Product (GDP)

GDP is a primary indicator of economic health. Strong GDP growth may encourage central banks to raise interest rates to curb potential inflation, while weak growth could prompt stimulus measures.

4. Consumer and business confidence indices

Consumer confidence indices such as the Westpac-Melbourne Consumer Sentiment Index gauge economic sentiment. High confidence can lead to increased spending, prompting central banks to tighten policies. Conversely, low confidence might lead to stimulative measures.

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