Interest rate shock could kick-start stock exchange

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Norges Bank surprised most experts by cutting the interest rate by as much as 1.75 percentage points during the final interest rate meeting in 2008. Surprise interest rate changes like this, so-called interest rate shocks, can cause major changes in stock prices.

Professors Hilde C. Bjørnland and Kai Leitemo of BI Norwegian School of Management have conducted an extensive study of the interaction between U.S interest rate decisions and the stock market (S&P 500) over a 20-year period from 1983 to 2002.

The results of the study are now being published in the venerable international science periodical Journal of Monetary Economics.

Interest rate increase slows down stock exchange

”A surprise interest rate cut of one percentage point can send stock prices up by seven to nine percent,” says Bjørnland, professor of economics at BI Norwegian School of Management. This is a stronger link than in other similar analyses of data from the US.

Similarly, a surprise interest rate increase will be not be well received by the stock market, and can trigger a stock price fall of seven to nine percent.

So it is not surprising that interest rate decisions by Norges Bank are followed with great interest, not only by journalists and people with large mortgages, but also players in the finance markets.

However, not all interest rate changes have this effect on stock prices. This is valid only for unexpected interest rate changes. An expected increase in interest rates will already be taken into account in stock prices, and as such, not affect them.

“Our analysis of the U.S. data indicates that 40 percent of the interest rate changes over this 20-year period came as a surprise to the market. This indicates that changes to the interest rate significantly affect stock prices,” Bjørnland says.

However, she stresses that these are only temporary effects. In the long term, stock prices are mainly influenced by the company’s productivity.

Stock prices can affect interest rates

But it is not only surprise changes to interest rates which can have an impact on the stock market. In a similar manner, surprise changes in the stock market can affect the interest rate market.

A surprise stock price drop of ten percent could result in an immediate interest rate cut of 0.40 percent, according to the study. Over the course of six months, a drop in stock prices could cause interest rates to be cut by a full percentage point.

The Bjørnland/Leitemo study differs from previous studies in that it to a greater degree looks at the interdependence between interest rate decisions by the central bank and movements in the stock market.

Source: BI Norwegian School of Management