ECB MONETARY POLICY NORMALIZATION AND EFFECTS ON INSURANCE COMPANIES INVESTMENTS

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US MONETARY POLICY FOLLOWING THE APPOINTMENT OF NEW FED CHAIRMAN

- New Chairman of FED Jerome Powell took over the position from Janet Yellen February 5th 2018.
- The key question of actors on financial markets is if the FED will continue the policy of gradual increase of interest rates or if it will give up such interest rate pattern.
- At the beginning of 2018 FED forecasted that interest rates will be raised three times (0,25 basis points each) to reaching 2,00 to 2,25%. Based on 30 Day Federal Funds Futures, as a predictive tool, investors expected that the first increase would take place during the FOMC meeting March 20-21st. This did happen.
- According to the forecasts of investment banks in US that were published the end of March 2018 FED could raise its federal funds rate during 2018 not three but four times to the level of 2,50%.

US MONETARY POLICY FOLLOWING THE APPOINTMENT OF NEW FED CHAIRMAN

- Gradual increase of FED interest rates would provide for little support to USD.
- Following the short-term recovery at the beginning of February, one could expect the weakening of US dollar against EUR.
- The reasons for that include the existence of both budget deficit and balance of payments deficit in US that will probably cause additional sales of USD by investors.
- During the last five years USD/EUR exchange rate recorded significant fluctuations. According to the estimates of investment banks US dollar is overvalued and vulnerable to drop in value by 10% on the long run.
- This is due to the increasing budget deficit of US during the Q1 of 2018 by 11% compared to the Q1 in 2017 and record high increase in balance of payments deficit to USD 50 billion in December 2017. Trump’s administration aims at further weakening o USD to stimulate US exports and further increase of US real GDP

PROSPECTS OF NORMALIZING ECB MONETARY POLICY

- Opposite to the expectations of increasing key interest rates by FED in 2018, researchers of investment banks across the world do not expect the changes of ECB key interest rates in 2018.
- ECB will continue its quantitative easing program to encourage real GDP growth and approach targeted inflation rate which is below but close to 2%.
- The first increase of key interest rates could take place in March 2019

IMPLICATIONS OF DIVERGNET MONETARY POLICY OF THE FED AND ECB ON INVESTMENT ENVIRONMENT FOR INSURERS

- Insurers could benefit via higher economic growth in developed countries which would encourage economic growth in small open economies.
- Normalization of ECB interest rates will slow the decline in investment yields.
- High volatility of USD/EUR exchange rate and shares on markets will negatively impact the return rates of insurers.
- Relatively high yields on government bonds of non-EU countries such as Serbia will have an impact in the opposite direction

IMPLICATIONS OF DIVERGNET MONETARY POLICY OF THE FED AND ECB ON INVESTMENT ENVIRONMENT FOR INSURERS

Figure 5. US Dollar to Euro in the last five years
(25 March 2013 – 24 March 2018)

Source: https://www.xe.com/currencycharts/?from=USD&to=EUR&view=5Y, 24.03.2018.

IMPLICATIONS OF DIVERGNET MONETARY POLICY OF THE FED AND ECB ON INVESTMENT ENVIRONMENT FOR INSURERS

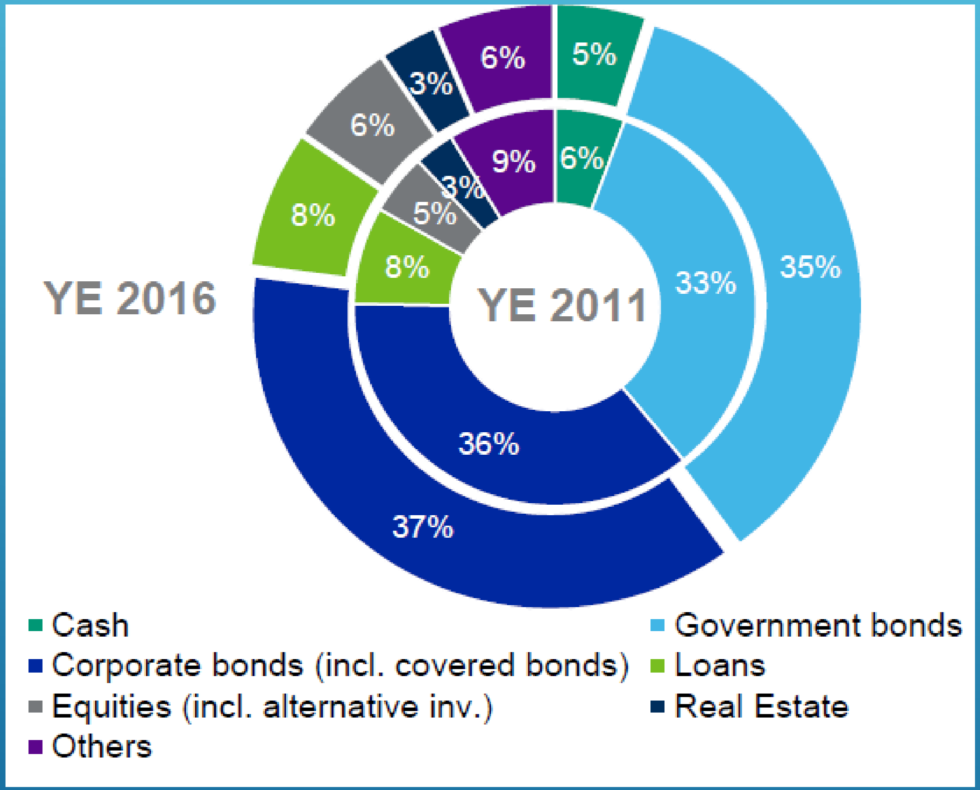
- As presented in Figure 7 European Insurers' asset mix remains broadly stable in 2016, compared with 2011. In its structure the most important assets include:

  - corporate bonds (including covered bonds) with 37% and 36%, respectively; and

  - government bonds with 35% and 33%, respectively.

IMPLICATIONS OF DIVERGNET MONETARY POLICY OF THE FED AND ECB ON INVESTMENT ENVIRONMENT FOR INSURERS

Figure 7. European Insurers' asset mix in 2011 and 2016



Source: Moody's Investors Services (2017). Insurance –Europe, November 23, http://www.actuarialpost.co.uk/downloads/cat_1/Moodys-Insurance%20Outlook-EMEA.pdf, p. 17, 16.03.2018.

IMPLICATIONS OF DIVERGNET MONETARY POLICY OF THE FED AND ECB ON INVESTMENT ENVIRONMENT FOR INSURERS

- Obviously due to the very small yields on bonds especially government bonds the insurance companies would be under pressure to invest in riskier types of assets with possibly lower liquidity.
- On the other hand, difficulties in sourcing such a type of assets will significantly limit the speed of changes in portfolio structure of insurance companies at least in the near future.