Central Banks: Send Out The Clowns

Cato, the Roman statesman, concluded every speech with the exhortation *Delenda est Carthago* ("Carthage must be destroyed"). Whether he ever tired of this repetition is unrecorded, but your loyal correspondent, who has been harping on the dangers of central bank excesses and improvisations, is tiring of banging on the same drum. But bang we must: The European Central Bank's (ECB) out-of-the-blue rate cut this past week and the bond market's horrendous reaction thereto serve as yet one more piece of evidence that this globe ain't big enough for both of us: *Delenda est medio banci*.

Before you roll your eyes and think, "what a nut case," consider the following two provisions. The first, from Article I, Section 8, Paragraph 5 of the U.S. Constitution states "The Congress shall have power... To coin Money, regulate the Value thereof, and of foreign coin, and fix the Standard of Weights and Measures." That sounds pretty clear as to who has the ultimate authority over monetary policy. The second is from Article 2 of the Statute of the European System of Central Banks, "... the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community... " There's not much ambiguity there, either.

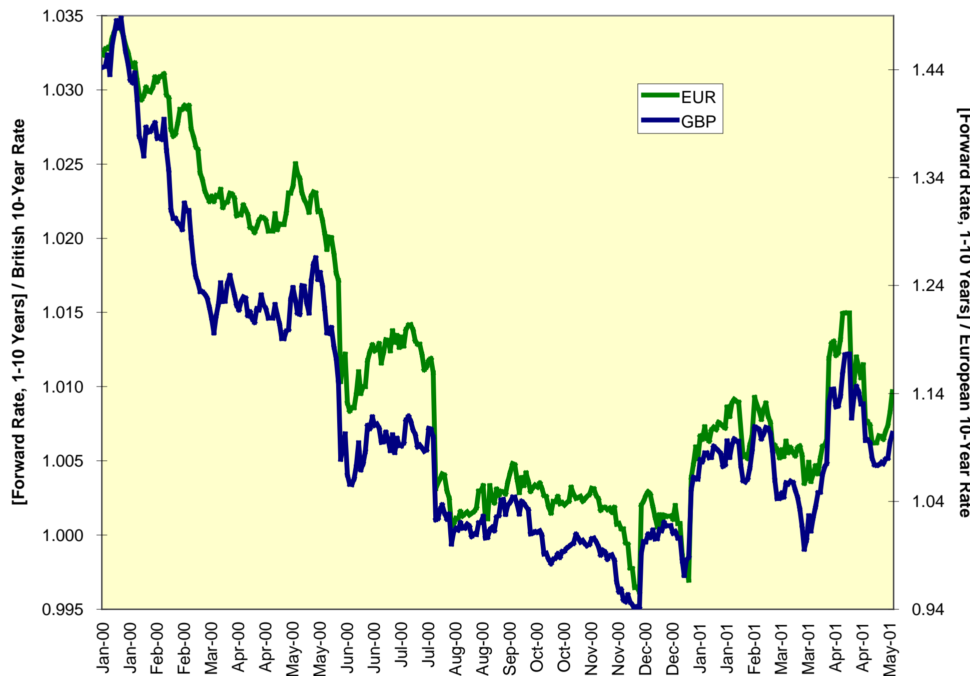
Unsurprisingly, these exercises in free-form monetary policy have had deleterious consequences for the respective economies, for equity markets, and now for bond markets. Should the ECB open the monetary taps now in the face of rising price trends in Europe, they will risk a major bear market in bonds. The European CPI rose 2.6% in March 2001, the tenth consecutive month in which the CPI exceeded the goal of 2.0%, and their money supply is growing at a 5% annual clip, as compared to a real annual growth in GDP of 2.96%.

Is it the job of politicians and central bankers to please bondholders? Yes: Stable bond yields imply stable inflationary expectations, lower planning risks for businesses, and greater inducements for risk-taking by both investors and entrepreneurs. We should have learned this lesson from both sides during the 1970s and 1990s. The relative performance of European and British financial markets today drive the lesson home one more time.

Crossing The Channel

One theme expressed in these pages has been how well markets take care of themselves in the absence of central bank direction. Since the start of 2001, the Bank of England has lowered its base lending rate three times, from 6.0% to 5.25%, while the ECB has moved only once in lowering its rate from 4.75% to 4.5%. Yet since January 2000, when comparable data became available, the shapes of the two yield curves have been strikingly parallel even as central bank policies have diverged. Once again we'll use the ratio of the forward rate from one to ten years, the rate at which you can lock in borrowing over that horizon, to the ten-year rate itself as a measure of the yield curve.

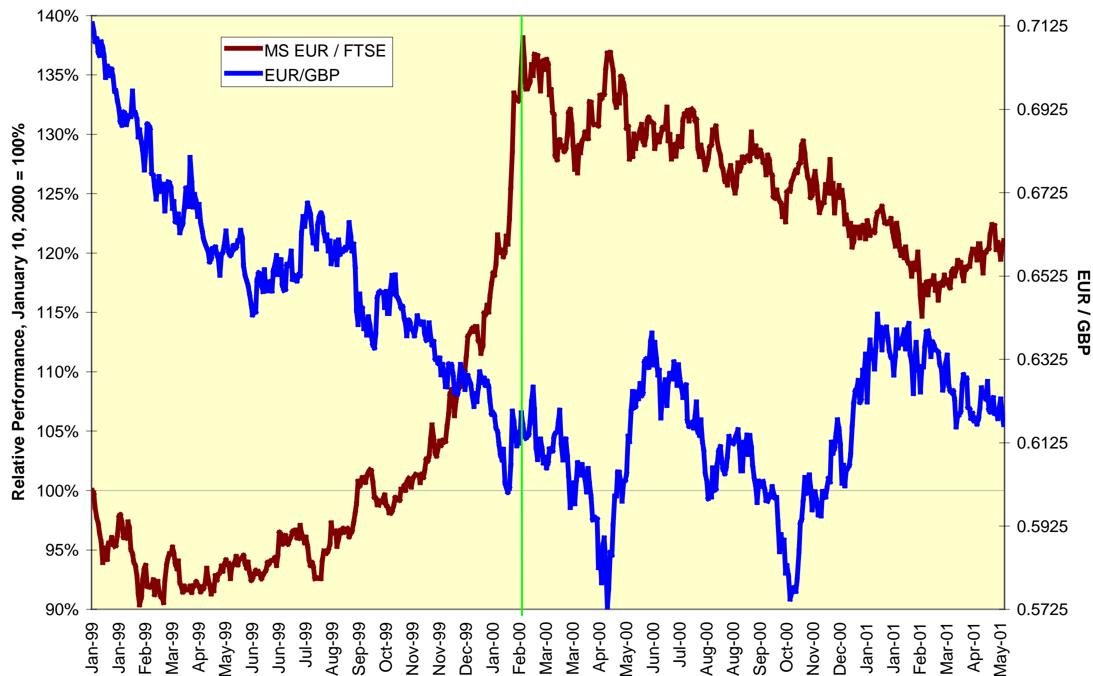
Interest Rate Expectations In Europe And Britain



While the shapes of the two yield curves have been parallel, their volatilities have been quite different, as evidenced by the different scales. The British (GBP) curve has remained quite flat throughout the period; the ratio of forward rates to ten-year rates has hovered just over 1.00. The European (EUR) curve flattened from a very steep shape in early 2000, when forward rates were more than 40% higher than ten-year rates, to an inversion by the end of November 2000. The flattening of the euro curve came in response to the currency's weakness. The EUR has struggled as much against the GBP as it has against the dollar; the key resistance on this cross rate has been .6425, just as key resistance against the dollar has emerged near .9300.

Equity Market Consequences

The European bond market's greater volatility and the never-ending misadventures of the EUR itself have taken their toll on the Continent's stock markets relative to the British FTSE index. If we compare the relative performance of the Morgan Stanley Euro index (MSER) and the FTSE, we see how the shot higher during the 1999-2000 tech stock boom, even as the EUR/GBP cross rate eroded steadily. It wasn't until the persistently steep EUR yield curve increased inflationary expectations and drove the EUR down to new lows that the FTSE started to outperform, as forecast here in February 2000 (see "A Tale Of Twelve Cities").



The return toward a steeper EUR yield curve, if that is in fact what the ECB is driving toward, will perpetuate EUR weakness, maintain underperformance of European equities, and expand the risk premium for holding European bonds. It's almost hard to imagine that one group could cause so much damage in such a short period of time; there's a reason why no one ever tried to run a central bank by international committee before.

This column warned (see "The Dangerous Dance of Central Banks," June 2000) of the dangers of ad hoc policy construction by the Bank of Japan as well as the Federal Reserve and the ECB. Is the world a better place today than it was a year ago? Is your portfolio larger? Let's fix this before it gets worse.