The Monetary Banana Peel

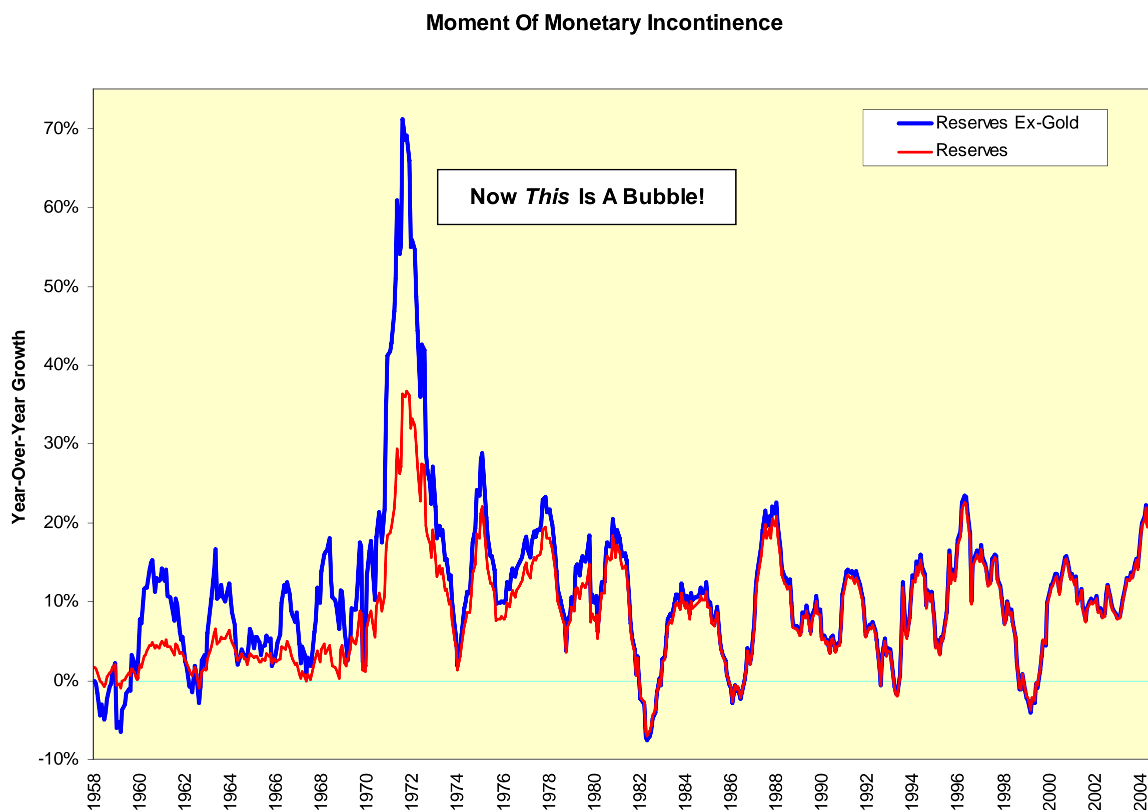
Few things in life are more enjoyable than debating grand themes. Any fool can take out the garbage, but it takes a sage, someone with metaphysical underpinnings and not a few chemical imbalances, to debate the meaning of existence and just what the heck has been going on in the bond market.

Such a smoke-blowing detour into the improvable was promised last week; the question posed was whether economists' and central bankers' compasses are as broken today as they were in the early 1970s. That epochal time in global economic history encompassed the collapse of the post-World War II Bretton Woods system of fixed exchange rates and the creation of something called Special Drawing Rights (SDRs, sometimes referred to contemptuously as "paper gold" by those who like to refer to things contemptuously).

Very briefly, SDRs were fiat reserves created in 1970 to augment countries' reserve balances held at the International Monetary Fund. These SDRs were valued against a basket of currencies. Countries whose currency was under attack could swap their SDR reserves out and buy their own currency on the open market. Periodically, those who love silly proposals trot out the idea of pricing commodities such as crude oil in a similar basket of currencies, but as discussed in January 2004, these proposals never get off the ground and for good reason.

Liquid Enough For You?

The reason any of this matters is inflation is a monetary phenomenon. The problem with the creation of SDRs, the abandonment of the gold standard and the eventual acceptance of floating exchange rates was no central bank knew how to manage the money supply in such an environment. This is not an idle statement. The IMF publishes, with their usual complete lack of timeliness – the last data point available is May 2004 – data on global reserves. Consider the year-over-year growth rates of total reserves and reserves ex-gold.



The early 1970s saw reserve growth rates in excess of 60% between May and November 1971, with August 1971 topping out at 71.1%. That was the month of Richard Nixon's ill-advised decision to devalue the dollar relative to gold, to impose import surcharges and to devalue the dollar relative to key currencies.

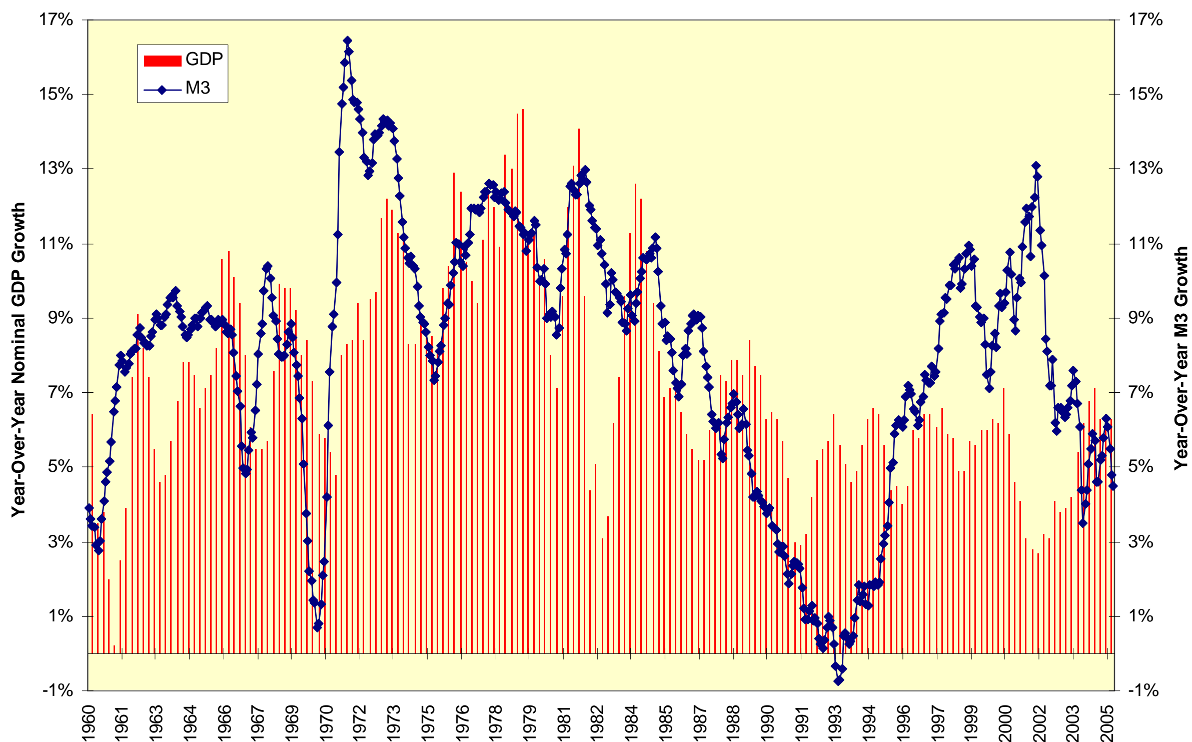
This singular burst of monetary mismanagement led to a decade of economic woes, including stagflation, the first two oil shocks, the worst recession since World War II and wage and price controls.

Are We In Reverse?

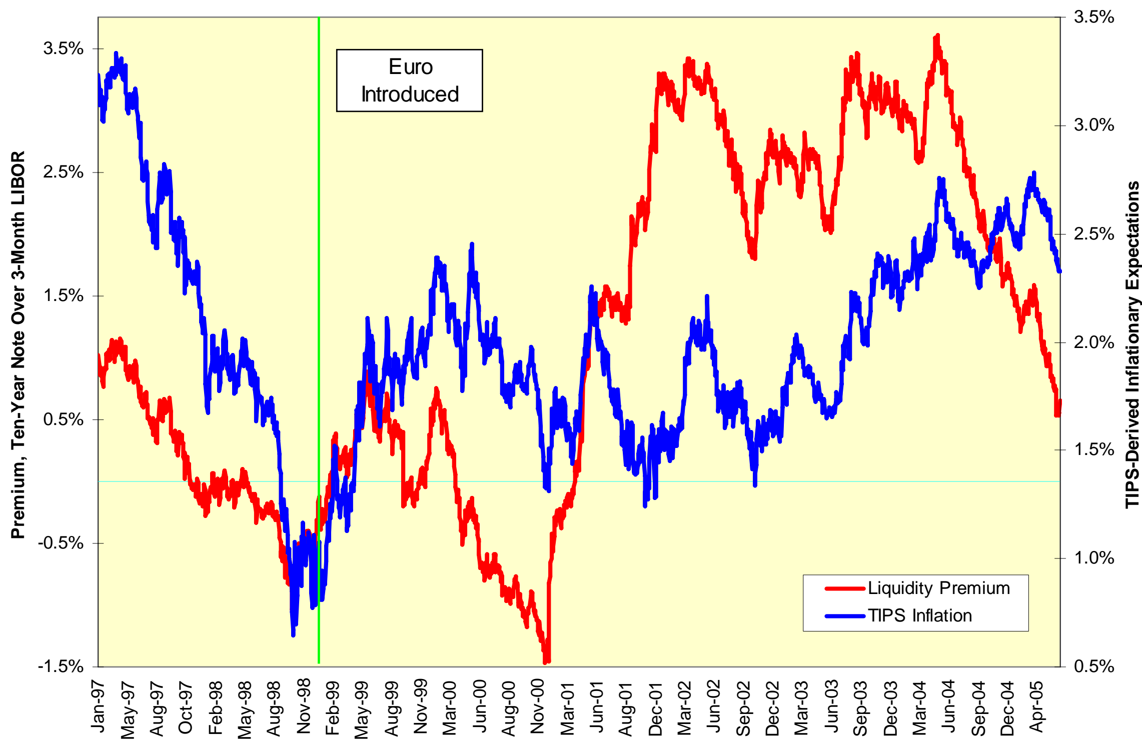
Now, fellow deep-thinkers, let's pull on the old tweed jackets and ponder whether the world's central banks face a somewhat inverse image of 35 years ago. Just as no one had experience in managing the money supply in a floating exchange rate environment, no one really has experience in managing the end of the floating exchange rate era. I will provide my own "he said *what*" here: The floating exchange rate is over, done, *finis*, singing in the choir eternal, pining for the fjords and other lame Monty Python references. We have a dollar bloc consisting of the U.S., China, various East Asian exporters and a few Latin American countries on a rotating basis. We have a euro bloc dissolving in front of our eyes into whatever intermediate form it chooses to take, and that is pretty much it.

The blocs create monetary management problems. As noted here as far back as January 2004, the dollar weakness and ballooning current account deficit then underway paradoxically supported U.S. financial markets by mandating a capital surplus.

The maintenance of these currency blocs may produce some interesting side effects, two of which will be discussed here. The first is massive capital inflows from Asian central banks and elsewhere overwhelm the Federal Reserve's ability to manage the level of free reserves in the U.S. banking system. Ever since Paul Volcker threw in the towel on trying to hit money supply targets, the Federal Reserve has focused on the federal funds rate. Capital inflows may depress interest rates below where they would be if our external balances were more, um, balanced, and that may serve to depress money supply growth. We can argue endlessly whether money matters or even if we can measure it properly, but it is clear the growth rate of the money supply relative to the growth rate of the economy is out of kilter. Despite the low interest rates and concomitant asset price inflation of recent years, M3 growth is both below that of nominal GDP growth and falling for the first time since the late 1980s.



The second effect of currency bloc management is a reduction in the currency risk premium demanded by investors for long-term bonds. The bitter experience of the 1970s was that the liquidity premium, or spread between long and short-term rates, had to compensate both for inflation and for the currency risk undertaken. Shortly after the introduction of the euro in 1999, the relationship between expected inflation as measured by the spread between nominal ten-year notes and ten-year TIPS and the liquidity premium of ten-year notes over three-month LIBOR diverged.



The present relationship suggests that investors are willing to accept a lower liquidity premium for bonds than inflation expectations would warrant. This is an irrational response unless we consider two other attributes of bonds. The first is that in the absence of inflationary expectations, the convexity, or rate at which a bond's duration changes with respect to yield, of a long bond should make the yield curve inverted. Convexity is valuable, and investors should be willing to accept a lower yield in exchange therefor.

The second is expectations for currency stability should have the same depressing effect on the liquidity premium as lower inflationary expectations. The capital inflows required to maintain both stability within the dollar bloc and between the dollar and euro blocs constitute an implied free put option on bonds. Once again, investors should be willing to accept a lower nominal yield in exchange for this externally financed put option.

What conundrum?

Dial D For Destiny

The fear that the Federal Reserve and its fellow central banks may make an unwitting policy error – and generals famously fight the last war – was expressed here last week. The probability of an over-tightening is increased by the collective inexperience in managing global monetary conditions as we return to a de facto fixed exchange rate regime and as capital market innovations make central banks' tool increasingly ineffective.

The swiftness and enduring impact of the 1970 errors have been lost somehow in the collective memory. Those errors were made with the best of intentions but isn't that always the case for a tragedy? Today the Federal Reserve is trying, with the best of intentions, to unwind its 2001-2004 stimulus. They have no clue as to how do this, and so we may be destined to repeat in reverse the errors of 35 years ago.