The British Are Coming!

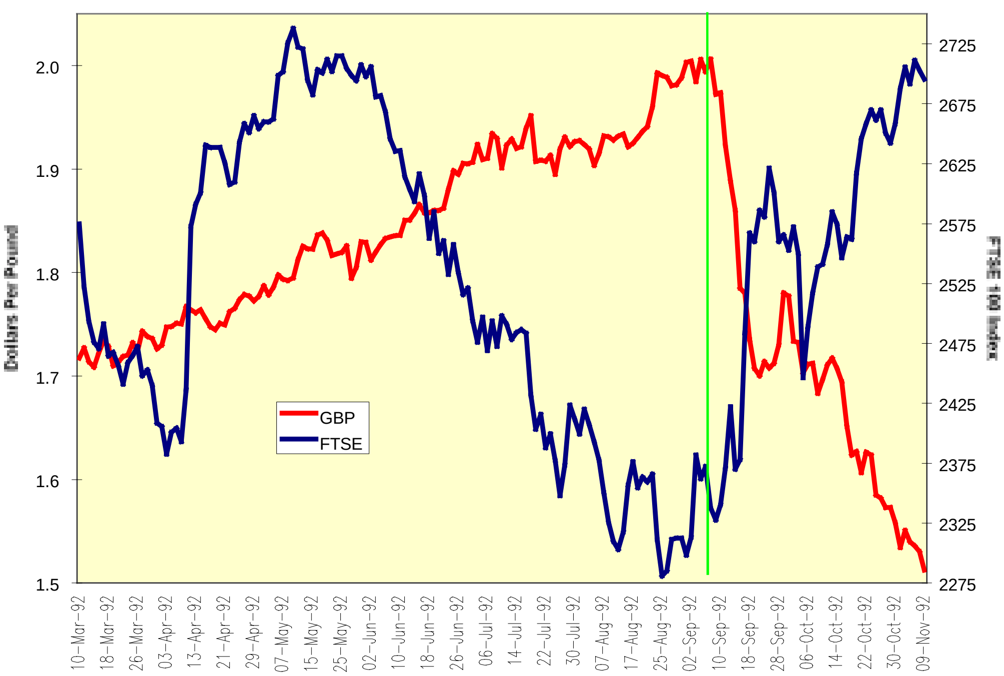
Being wrong is one thing, staying wrong is another. All nations have a searing economic experience they never wish to repeat. Germany has a phobia of inflation; the U.S. has one of the Great Depression, Japan fears a return to its 1980's bubble economy, and the British are determined not to repeat the policies leading to the currency disaster of September 1992.

Those Who Study History...

Given last Thursday's 25 basis point rate cut by the Bank of England, a cut not matched by the European Central Bank, (motto: If we can do it wrong, we will) a brief history lesson is offered. The reunification of Germany in 1991 involved exchanging the virtually worthless ostmarks of the former East Germany for West German deutsche marks on a one-for-one basis. This expanded the German money supply by the quantity of ostmarks exchanged, and triggered a round of rate increases by the Bundesbank, Germany's central bank, to forestall inflation. Other European countries were compelled to follow suit in order to keep their currencies in a tight band against the mark within the European Monetary System. George Soros and others bet the Bank of England, Swedish Riksbank, etc., would have to relent eventually. They did, and their currencies collapsed promptly.

Did this produce a massive capital outflow? Hardly: The Financial Times index, the FTSE, started to rally out of a bear market shortly before the pound collapsed. The further down the pound went between in September and October 1992, the more the FTSE rallied. The key, of course, was lower, more rational, interest rates.

The Importance Of Proper Currency Valuation

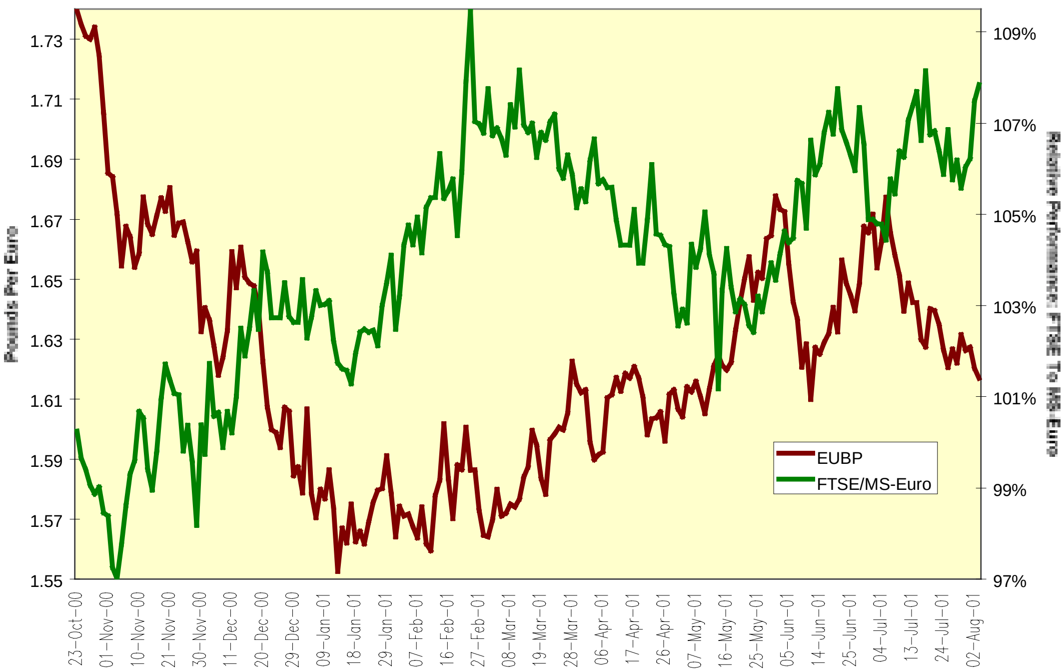


... Have A Chance Of Learning Something

The British rate cut, which was announced at 0700 EDT, ignited a rally in the S&P 500 futures prior to Thursday's opening; this rally was dashed at 0745 EDT when the ECB announced it was standing pat. The S&P 500 futures never traded higher than that point on either Thursday or Friday, as seen in the tick chart below. Why the anti-globalization protestors never turn their sights on the world's central banks is beyond me; these guys can destroy a planet faster than anything this side of the Death Star.

Will the British markets be rewarded for their foresight? If we regard the pound/euro cross-rate (EUBP) weakening as a measure of success, the process has begun already. The EUBP fell from 1.74 in October 200 to 1.552 at the start of 2001. It has encountered stiff resistance at 1.677, and is about to break horizontal support at 1.617. As was the case in 1992, the weaker pound seems like a catalyst for higher equity valuations in London. We can compare the relative performance of the FTSE and the Morgan Stanley Euro Index (MS-Euro) from October 23, 2000 to the EUBP, and get a very clear picture of the currency-equity relationship in Europe.

History Repeats Itself



Nothing here should be construed as an argument for competitive devaluation as the pathway to prosperity. It's not the absolute level of any currency, the dollar included, that is of importance to stock and bond markets, it's the sense that the currency's level is proper. If the Bank of England and the Chancellor of the Exchequer (is that a cool title, or what?) decided to weaken the pound to enhance the competitive position of British exporters, the markets would react negatively. More importantly, it would recall the competitive raising of tariffs in the 1930's that served to deepen and prolong the Great Depression.

Finally, it's important to note the Bank of England isn't doing anything heroic as much as the European Central Bank is continuing to disappoint those hoping for, just one time, a dollop of common sense. The forward curve in euro money markets is inverted, which is prima facie evidence of a tight monetary policy. ECB President Wim Duisenberg, this century's candidate for the Sphinx Without A Riddle award, must be ignoring what everyone else sees, and that is recessionary pressure in the euro zone. Why Tony Blair would want the UK to abandon the pound in favor of this buffoonery is quite a mystery.

Recommendation For U.S. Policy

The U.S. dollar has weakened quickly over the past month, dropping from 120.9 on July 5, to 116.14 on August 3. While nothing is certain, the fall appears likely to continue for some time to come. What should our policy makers do? The answer, pure and simple, is keep their mouths tightly closed. The notion that we're actively debauching the dollar will unsettle markets, and the notion that we would "defend" it via higher interest rates would be unwelcome as well. Stocks frequently have rallied in the face of a weaker dollar; this was true in 1986-1987 and again in 1995. Above all, silence is golden.

In the meantime, let's look to the U.K. for a momentary dose of good judgment and sound policy. Any country with a 101 year-old Queen Mother who can get away with those hats must be doing something right.