

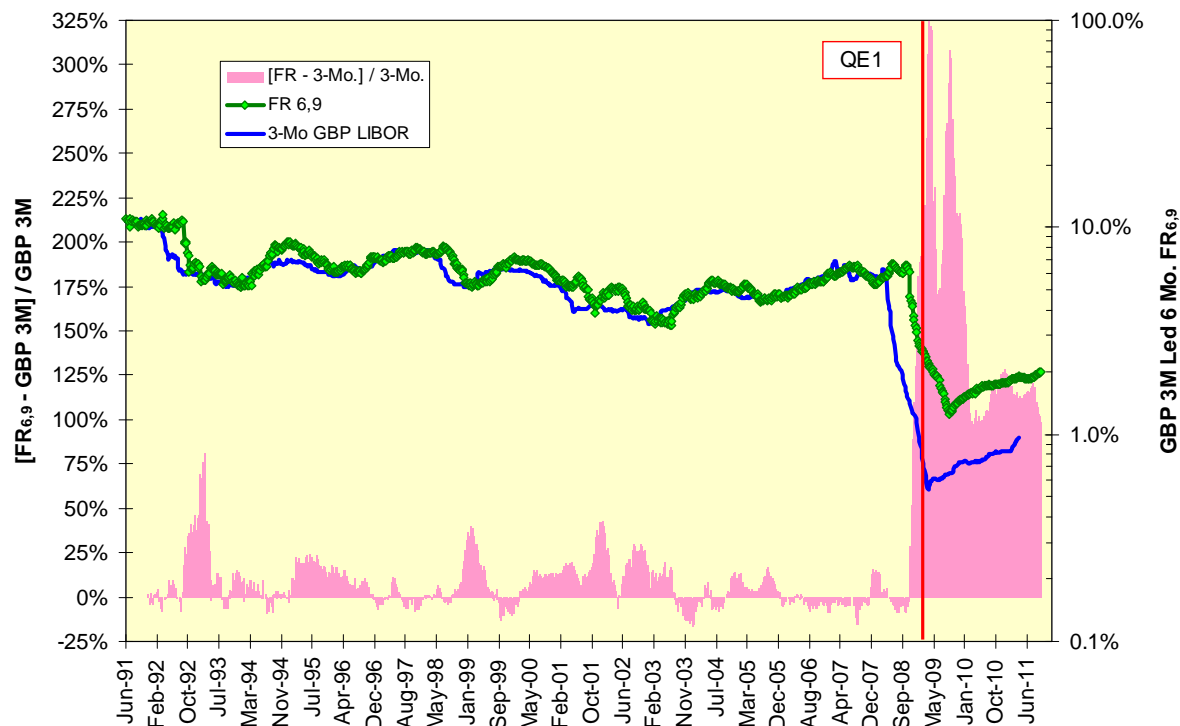
QE2 Under Queen Elizabeth II

A Scottish Nationalist reading the title might be tempted to correct me by noting the present Queen Elizabeth may be the second Elizabeth to occupy the throne of England but only the first to occupy the throne of the United Kingdom. They still take these things seriously; I saw last week Prime Minister Cameron sent out a note to all of the leaders of former British colonies about permitting princesses to accede to the throne in line with their brothers.

Regardless, the Bank of England has decided to throw more money after more money in Her Majesty's Silly Service by embarking on a program to buy more Gilt (yes, guilt-free; we got that out of the way). Just as in the [case of the U.S.](#) and our beloved Federal Reserve, the British are starting to believe these low short-term rates are going to be part of the landscape for a while.

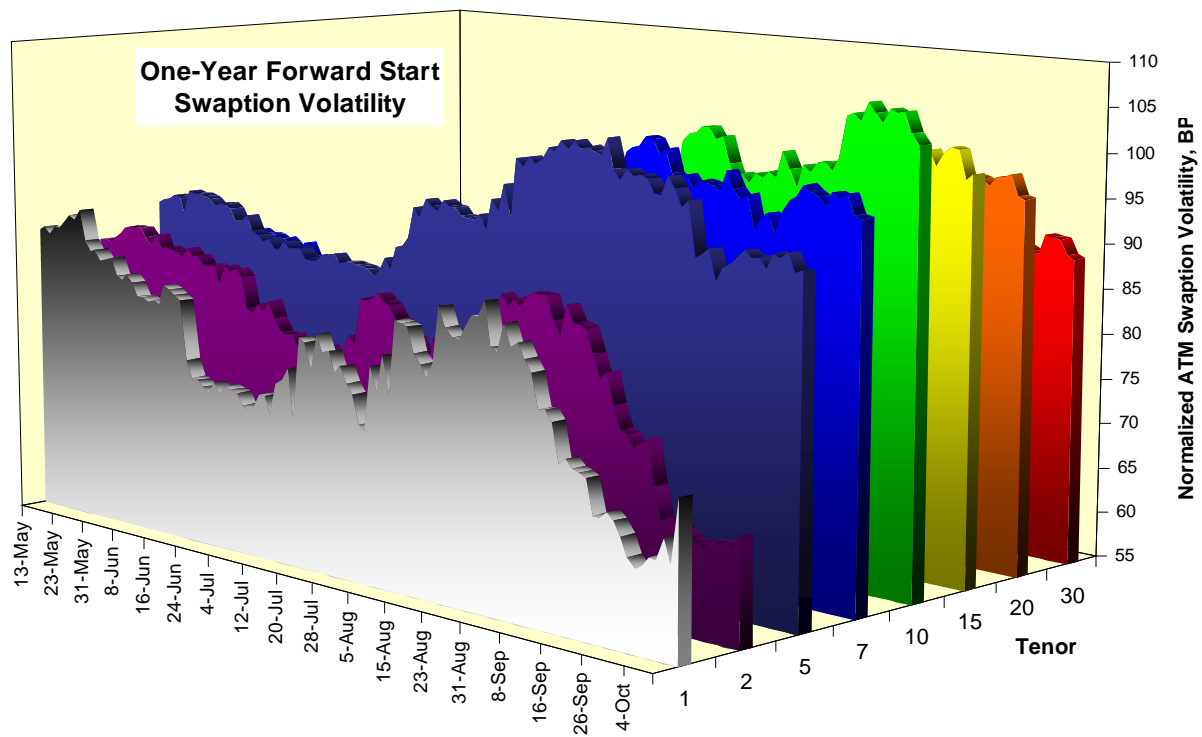
One way to illustrate this is by depicting how expectations for British three-month rates starting six months from now match up to those three-month rates when the time comes. That gap between the forward rate and the actual rate measures the extent to which the market was fooled by the central bank. A high gap, illustrated with the roseate columns, corresponds to actual interest rates being below expectations; if the gap is declining, the market is becoming inured to the idea of low rates for the foreseeable future. That gap is declining now.

The High Bias Of U.K. Forward Rates Declining



A second way of illustrating this is in the swaption market, last discussed in the American context in [September](#). A swaption is an option to enter the fixed-rate leg of an interest rate swap. Higher swaption volatility reflects a stronger belief rates will rise by expiration; lower volatility indicates a willingness of the paying party to remain floating and risk higher interest rates.

Here the answer is a little less direct than in the LIBOR comparison. Swaption volatility for one- and two-year swaps starting a year from now began declining at the start of August, but that decline has ended. Restated, the Bank of England has yet to duplicate the Federal Reserve's credibility in jamming interest rates lower. The Mother Country could learn a new trick or two.



The real question, of course, is why anyone thinks any of this will work. We have blown through two rounds of money-printing, have [twisted the yield curve](#) to the benefit of Uncle Sam and no one else and may be ready to start printing again. Japan has been banging on this drum for years, and Switzerland has tried it in various forms. If the Bank of England is trying to help British banks by squeezing their interest rate margins, the banks should plead with them to stop. The money would best be used to recapitalize the banks directly without damaging everyone else with lower rates and all of the distortions they produce.

Einstein defined insanity as doing the same thing over and over and expecting different results. If this sounds like an apt description of central banking in our era, it is.