Short-Term Interest Rates No Longer Unexpectedly Low

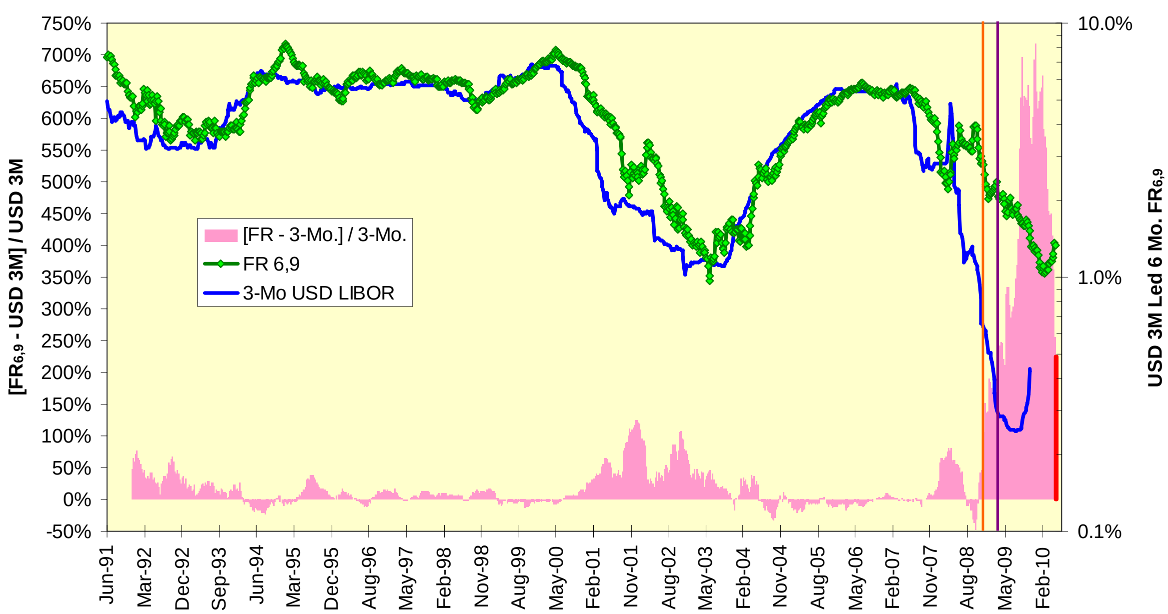
Sometimes I think you can fool all of the people all of the time, but most of the time most of the people cannot be fooled all of the time, especially at times like these. Which brings us to the theory of rational expectations, which holds only unexpected changes in monetary policy can affect real employment and output. If the changes are expected, the yield curve and the exchange value of the currency have adjusted in anticipation thereof and the only result should be a change in inflation expectations.

Like a lot of economic theories, it gives its advocates plenty of time to practice their tap-dancing as they explain why, once again, it did not work as advertised, but it is still a useful construct for explaining why monetary policy is so often ineffectual.

Thanks to the forward rate structure of interest rate markets, we can get a good read on what the market was expecting. If we take the forward rate of LIBOR between six and nine months ($FR_{6,9}$); that is, the rate at which we can lock in borrowing for three months starting six months from now, we have the market's hedgeable measure of where rates will be. I cannot emphasize strongly enough this is not an interest rate forecast, but a rate at which two parties can do business and presumably both make a profit given this locked-in rate. This can be compared to what the actual three month rate was six months later.

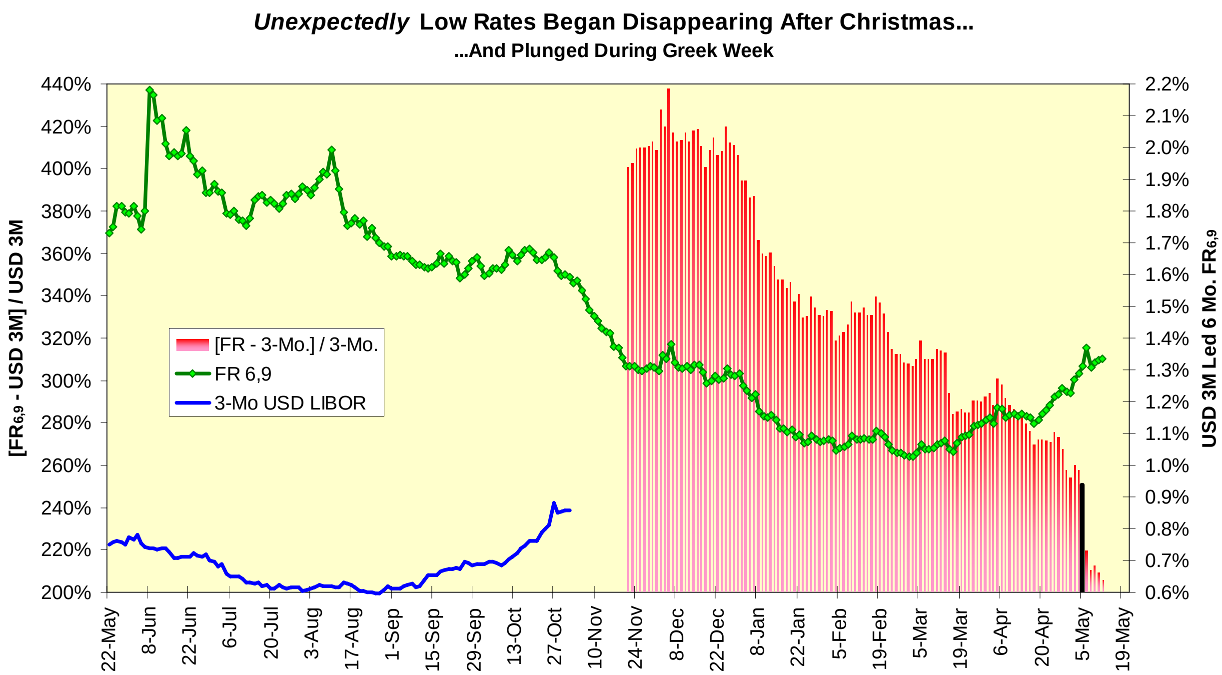
That "expectations gap" is depicted in the roseate columns below. The December 2008 and March 2009 dates when the U.S. first went to zero interest rates and quantitative easing, respectively, are marked with orange and violet vertical lines; the last datum is highlighted with a bright red column.

The High Bias Of U.S. Forward Rates Is Collapsing



Please note how high the expectations gap rose to in 2009. The market was genuinely surprised by how low short-term interest rates fell and for how long they remained there. But you cannot fool all of the people all of the time, especially when they won't get fooled again. The $FR_{6,9}$ began rising in early March and three-month LIBOR led six months is coming right up behind it. A rational person, not to be confused with an adherent of the rational expectations theory, would say low short-term interest rates have been absorbed into the expectational structure of financial markets and therefore should have no further effect on real activity, only on expected inflation. Who are we to disagree with rational people?

If we shorten up the time horizon and move from weekly to daily frequency, we see just how quickly the expectation gap has disappeared. Please note how it fell precipitously on the May 6, 2010 flash crash day, marked with a black column, as forward LIBOR jumped. It seems as if banks do not trust each other as much as they did, and while we are a long ways away from the credit crunch of late 2008, we can kiss the glory days of ultra-low TED spreads goodbye.



All of this is consistent with recent observations on how quantitative easing does not help stock and bond markets much in the countries engaging in the practice; this applies to the newest member of the club, the Eurozone, as well. All of the people eventually catch on all of the time when they feel they are being defrauded.