

MARKET CONSTRAINTS ON CENTRAL BANK POLICY

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Although I cannot speak as an economist, I can perhaps offer some comments from the perspective of a trader. Having spent nearly every day for the past 15 years evaluating markets and trading in them, I have been part of the process that has transformed world capital markets. This transformation is worth discussing for a moment or two before going on to some observations about market pricing and constraints on monetary policy.

Emergence of Global Financial Markets

In the years immediately following the abandonment of Bretton Woods, there were few sophisticated traders of foreign exchange, and even fewer who simultaneously monitored the real yields available on government instruments around the world. And even if there had been such traders, transactions would have been extraordinarily difficult to carry out. There were no futures contracts on foreign fixed-income instruments; arbitrage in the cash markets was virtually precluded by regulation and practice; and information on monetary and macroeconomic phenomena was difficult to acquire quickly and systemically, plus most market participants were not prepared to do so in any case. In contrast, today 200,852 Reuters screens are used worldwide by thousands of market participants who analyze international monetary phenomena on a continuous, 24-hour real-time basis. We can monitor futures contracts on German short-term and long-term interest rates, French rates, British rates, Japanese rates, Australian rates, New Zealand rates, Canadian rates, and even Spanish rates. U.S. interest rates trade 24 hours a day throughout

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the world. Equities index contracts are traded in the United States, the United Kingdom, Germany, France, Japan, Switzerland, and elsewhere.

The growth of a class of market participants, capable of evaluating and responding quickly, has been even more important. In 1975, few traders would have known how to evaluate German or Japanese monetary operations, for example, even if those traders had the technical means to observe them. Today, if the Bundesbank sneezes, the international trading community is ready with "gesundheit." We sit at our screens 24 hours a day (collectively) watching for announcements about the size of open-market operations in Japan or about the level of reserves in the system, and we look at every German repurchase for signs of policy changes. Every move of the central bank or of treasury officials in a major world economy is scrutinized with care and some measure of expertise.

Rapidity of Price Discovery

The development of this human capital, this ability of capital markets to process and evaluate monetary policies, has altered the character of price discovery, making it more rapid and more decisive. Let me offer two examples from the U.S. market. I remember the mid- and late-1970s in the United States when the 30-year bond just refused to go down despite months, even years, of negative real interest rates. As a trader, I remember trying regularly to sell the U.S. bond week after week as inflation numbers and monetary aggregates were published suggesting that U.S. inflation was bad and getting worse. Yet yields refused to budge over 8 percent. Bond buyers would emerge on every dip in prices. They remained confident that inflation could not be as bad as it looked, despite the consistent trend of bad inflation numbers. Only after two years of solid buying of bonds at these negative real interest rates did bond yields finally take off, reaching, as we know, 14 percent by 1981.

The experience of the United States during 1989 and 1990, on the other hand, was surely no repeat of the pattern of the 1970s. In 1989 and 1990, the Fed's ease in short-term rates was no guarantee of lower long bond yields. On the contrary, each monetary ease was preceded and followed by an extensive debate on whether the Fed was moving prematurely to ease—conditional on views about prospective inflation. On two occasions, Fed ease was followed by significantly higher yields in the long bond. After the Fed ease of December 20, 1989, long bond yields rose 15 basis points within the week and 120 basis points within four months (from 7.81 percent

to 9 percent). Simultaneously, the dollar dropped five pfennigs against the Deutsche mark in the week following that ease. The Fed easing was not resumed until long bond yields had retreated from their 9 percent peak and the dollar had stabilized—a period of seven months. The next Fed ease was also greeted with skepticism by the market. Yields on long bonds rose by 10 basis points after the Fed ease of 25 basis points on July 13, 1990.

Significance of the New Market Discipline on Fed Policy

I must offer a few words of caution about the significance of the new market discipline on the conduct of monetary policy. The idea that markets “know everything”—that policymakers can base their decisions on what the markets “know”—is a fallacy. It is true that markets have become more efficient at reflecting quickly in pricing any perceived consequences for financial assets of changes in monetary policy, business conditions, and political factors. But these price movements cannot be accepted naively as a guide to policy. First, market expectations can simply be wrong; and second, forward prices are artifacts of expectations and arbitrage that, taken together, create a forward price that may be only a distant cousin of the market’s “true” expectations.

Consider the case of Germany in 1989–90. In September 1989, before the fall of the Berlin Wall, yields on German 10-year bonds were 6.8 percent; in February, they were 9 percent. The markets demanded 220 basis points in yield within five months, with most of the upward movement in interest rates taking place in one month. Yields rose from 7.5 percent at the start of 1990 to 9 percent by February. During the several years before 1990, Germany’s measured inflation varied between zero and 3 percent. Observed inflation during 1990 remained between 2 percent and 3 percent. Yet the markets quickly demanded a rise in real interest rates of two full percentage points.

Despite a great deal of market “move” operating to drive a wedge between forward prices and *ex post* actual prices, some policy realities are driven by market behavior. Central banks that heed and, better still, anticipate market reactions are likely to be rewarded with lower interest rates. Consider the Bank of Japan in the period following the Iraqi invasion of Kuwait. With oil prices nearly doubling and the threat of an oil shock creating imported inflation, the BOJ preemptively raised the discount rate by 75 basis points on August 30, 1990, and guided short rates from 7.5 percent to 8.5

percent in just six weeks. These moves convinced markets that the BOJ would not tolerate a repetition of the disastrous experience of the mid-1970s when the central bank accommodated the oil shock. With the Japanese central bank moving ahead of market expectations, the long bond yield quickly peaked at 7.8 percent (from 7.0 percent on August 1 to 7.8 percent on September 30) and moved steadily down to 6.25 percent in February 1991. Simultaneously, the currency strengthened from 150 yen per dollar in early August to 125 in mid-October and has subsequently remained in the 125 to 135 range, even as apprehension over a shooting war rose in the months leading to the allied campaign in January 1991.

The BOJ's experience contrasts with the American experience where the Fed began pushing down short-term interest rates in December 1989, with federal funds trading at 8.50 percent and the 30-year bond trading at 7.92 percent. By February 1991, the federal funds rate was about 6.25 percent, the long bond yielded nearly 8 percent, and the dollar fell about 8.5 percent against the yen. Notwithstanding the wisdom of the Fed's decision to seek a soft landing with lower short-term interest rates, the result of a 225 basis point cut in the federal funds rate has been a slight increase in long-term borrowing costs. Fourteen months after a preemptive ease, long-term rates were marginally higher in the United States; whereas six months after Japan's preemptive tightening, long-term interest rates dropped over 160 basis points.

Conclusion

The growth of efficiency of global capital markets over the past decade and a half has had a desirable—and predictable—side effect for central banks. The markets now reward more generously and more rapidly with lower borrowing costs—in both real and nominal terms—those governments whose central banks act convincingly to counter inflation. The painful corollary, of course, is that the markets will punish more severely and rapidly those central banks that say they are committed to fighting inflation but act otherwise. Perhaps this is progress. Perhaps the daily action of global capital markets, as disorderly and messy as those markets sometimes seem, has produced a public good in the form of lower inflation and lower real capital costs for countries whose central banks understand how markets work.