

## Interest Rates: Think Central Banks in Control? Think Again. What do the Fed, European Central Bank and Reserve Bank of Australia have in common? Answer: They don't control interest rates.

By Vadim Pokhlebin  
Tue, 18 Aug 2009 10:45:00 ET



The conventional wisdom says low interest rates are key to boosting economic growth. Conversely, higher rates make borrowing more expensive and supposedly slow down an "overheating economy."

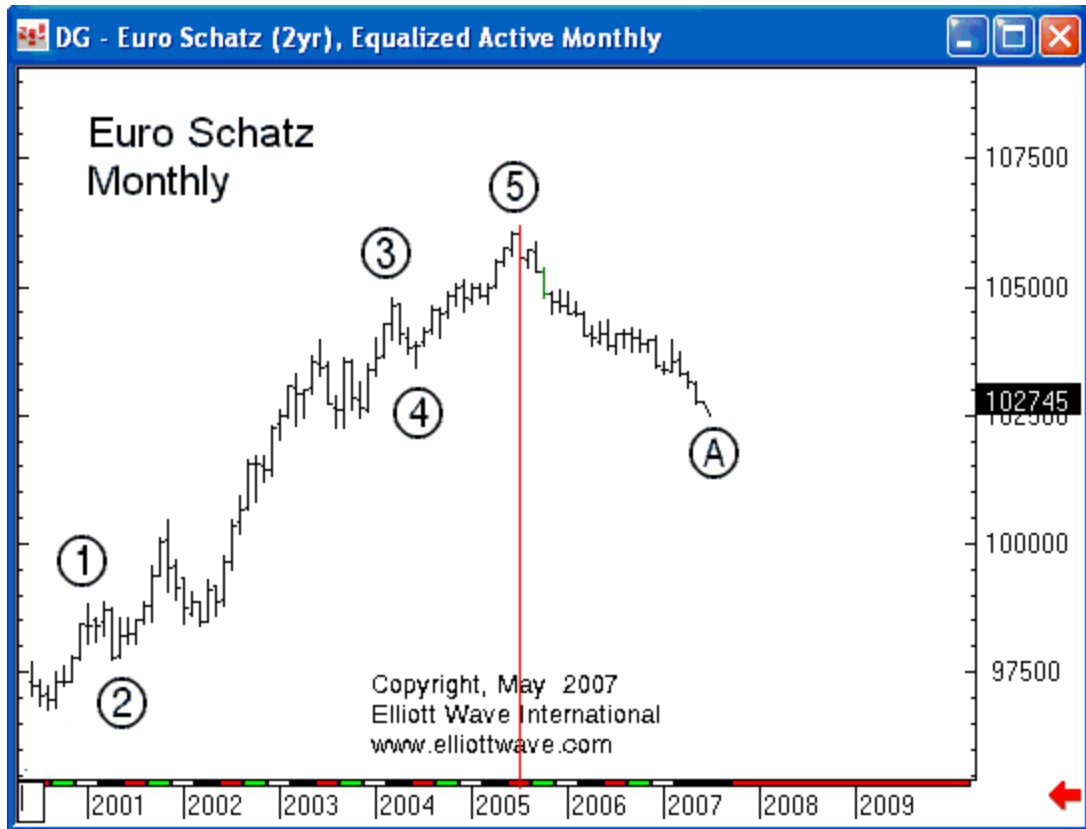
To raise or lower interest rates is the single most important tool through which central banks' "potent directors" are said to control our economic future. They carefully watch economic indicators, goes the thinking, and deftly adjust interest rates accordingly.

If you believe that, what you will read next will come as a shock: Central banks are no more in control of interest rates than they are of the weather. Three examples prove this point.

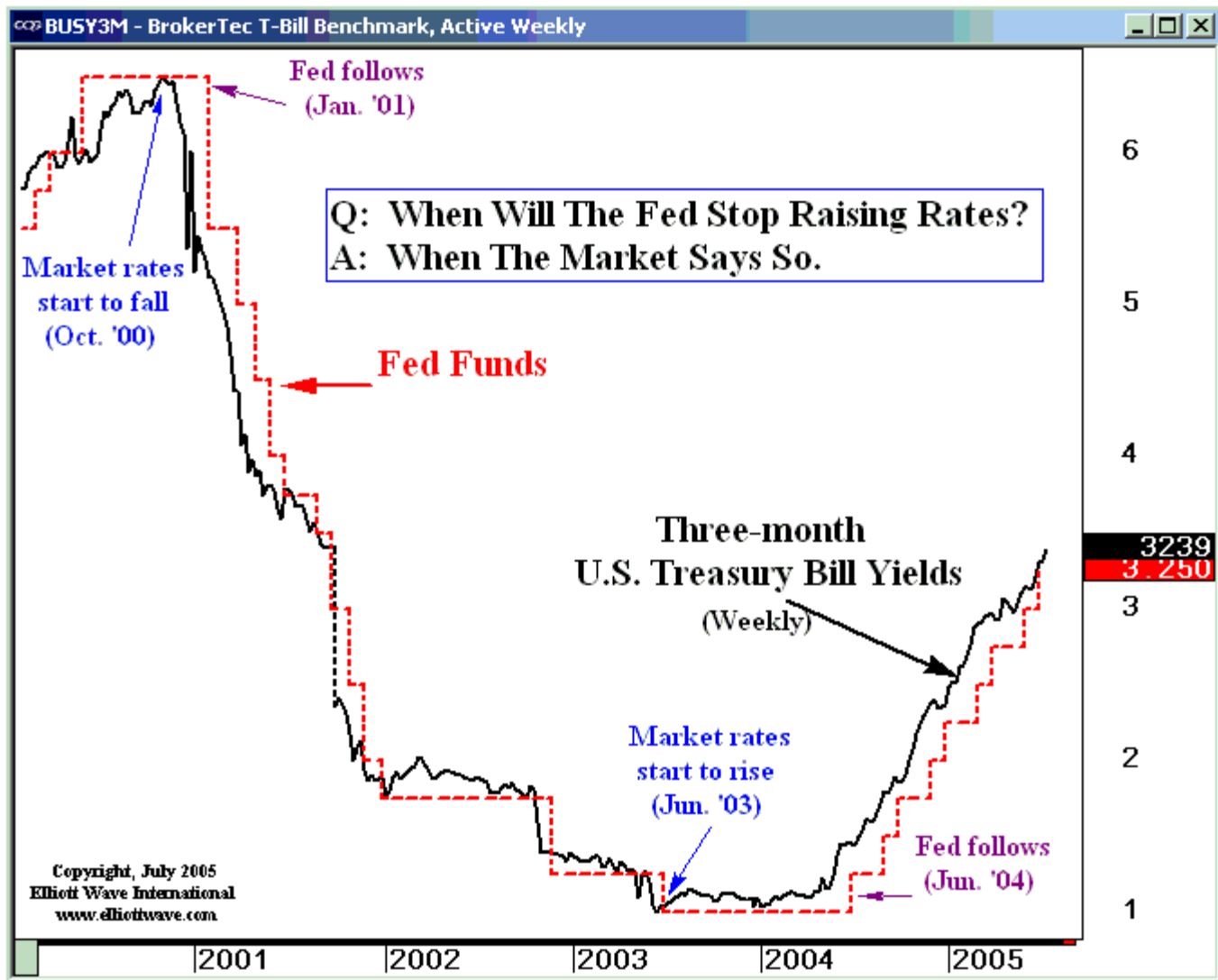
Before the European Central Bank started raising rates in late 2005, rumors that a hike was coming had been flying for months. No one knew exactly when it would happen. Neither did we here at Elliott Wave International. But we did know it was imminent -- because of one indicator with a long history of predicting central banks' interest rates decisions: bond yields.

Bond yields change daily, and central banks don't control them: Yields (and prices) are set by the bond market. And if you observe the timing of central banks' interest rates decisions, you will notice that usually, bankers don't lead the bond market -- they only react to what it dictates.

Here is a chart of the Euro Schatz, Germany's 2-year bond, Europe's U.S. Treasury Note equivalent. (Copied from EWI's [intensive Interest Rate Specialty Service](#); chart modified for this article.) See the vertical red line? That's the point when the Schatz price topped (yields bottomed and began to rise). As you can see, German bonds topped in July 2005, but the ECB only began raising interest rates several months later:



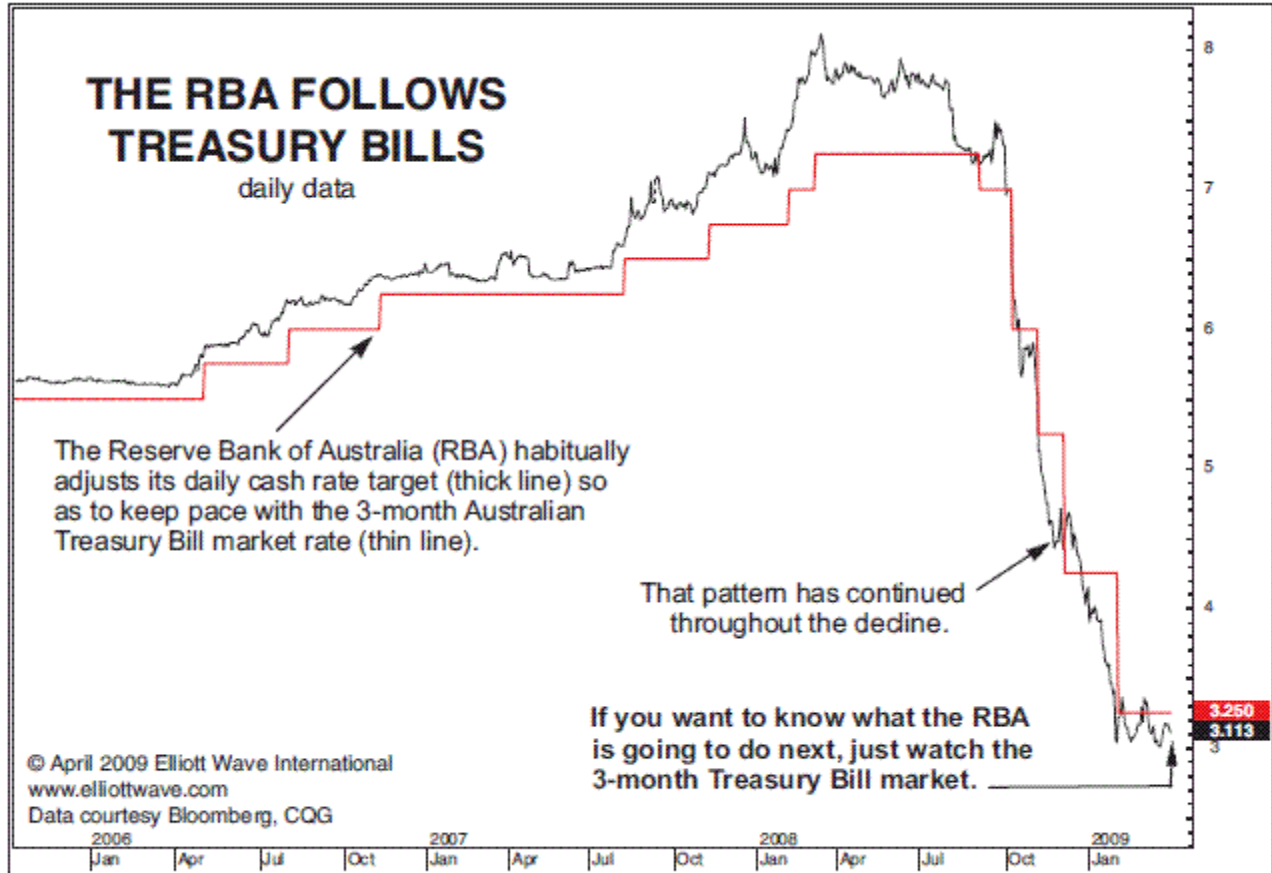
Below is a chart our [Mon.-Wed-Fri. Short Term Update](#) subscribers will recognize. It compares the timing of the U.S. Federal Reserve Bank's interest rates decisions with the U.S. Treasury Bills yields. Again, it's clear that the bank follows the bond market:



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Finally, here is a chart of the 3-month Australian Treasury Bills our [Asian-Pacific Financial Forecast](#) subscribers saw in the April issue, with the editor's note:



"...the cash target rate set by Australia's central bank, the Reserve Bank of Australia (RBA), appear to follow those in 3-month Australian Treasury Bills. After decisive moves up in T-bills from 2006 to early 2008, for example, the RBA faithfully raised its target. T-bills have since led the RBA during the financial crisis of the past year. In fact, the record indicates that the RBA almost always follows T-bills over time."

Now that you know that the Fed and its overseas counterparts are a step behind the markets, is it really a surprise that they came up powerless against the 58% drop in the DJIA and other global stock indexes?

**And more importantly: Do you really believe central bankers can prevent another crash?**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a5MX8Y3f1NfQ>

## Bond Bears Dumping Two-Year Treasuries Defy History (Update2)

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By Oliver Biggadike and Daniel Kruger



Aug. 24 (Bloomberg) -- Bond investors that drove two-year Treasuries down on Aug. 21 by the most since early June after Federal Reserve Chairman Ben S. Bernanke said the economy is "beginning to emerge" from recession may find themselves wishing they had held onto the securities.

While the comments sparked speculation that the central bank may soon raise borrowing costs as growth resumes, history shows the Fed is likely to keep its benchmark interest rate at a record low for a year or more. Policy makers didn't boost rates after the 2001 **recession** until 12 months into the recovery, while it was 17 months following the 1991 economic contraction.

"It's going to be very difficult for the Federal Reserve to raise rates simply because there's no inflation," said **Michael Cheah**, who manages \$2 billion in bonds at SunAmerica Asset Management in Jersey City, New Jersey. "The two-year at a yield of 1 percent is an excellent yield," said Cheah, who has been buying the securities.