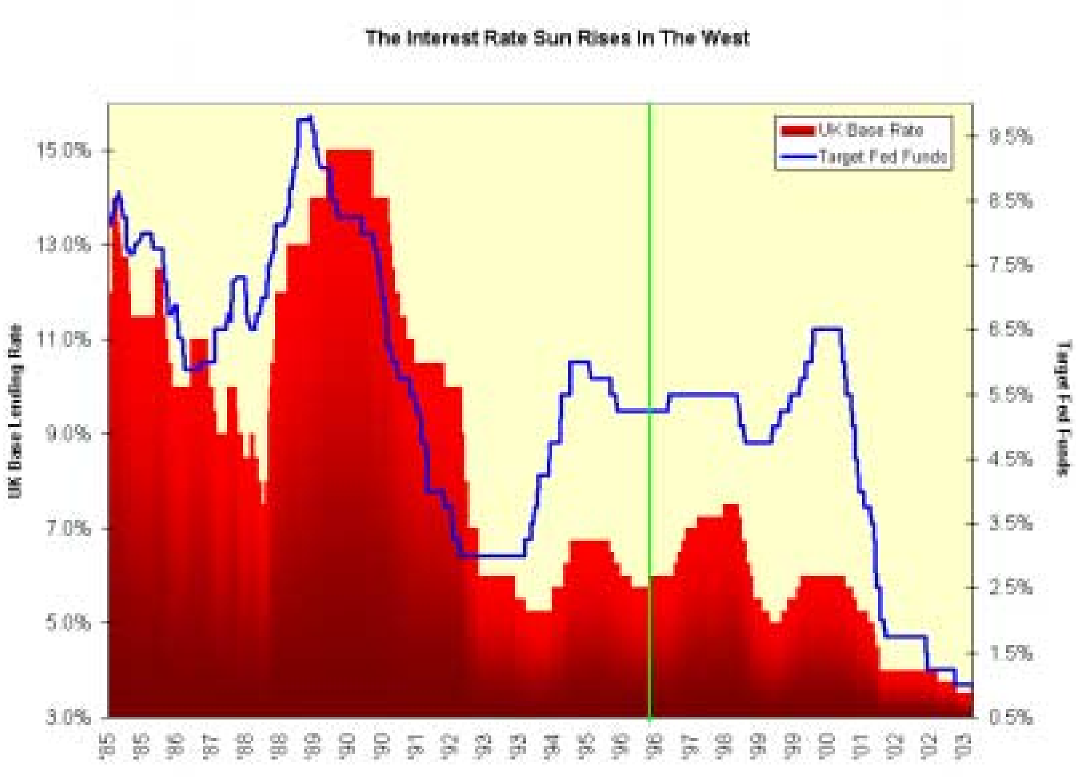
The British Are Coming! Buy Them Now

The announcements last week by the Bank of England (BOE) and the Reserve Bank of Australia - our fellow Anglophone coalition members in the Iraq War - that they were increasing their benchmark interest rates were greeted by some here in the U.S. as a warning signal. Surely this meant the Federal Reserve would have to follow suit and raise the federal funds rate itself. After all, when the Bundesbank was in its heyday as the 800-pound gorilla of European central banking, it used to send out the Bank of Belgium or some other nonesuch to lead the way.

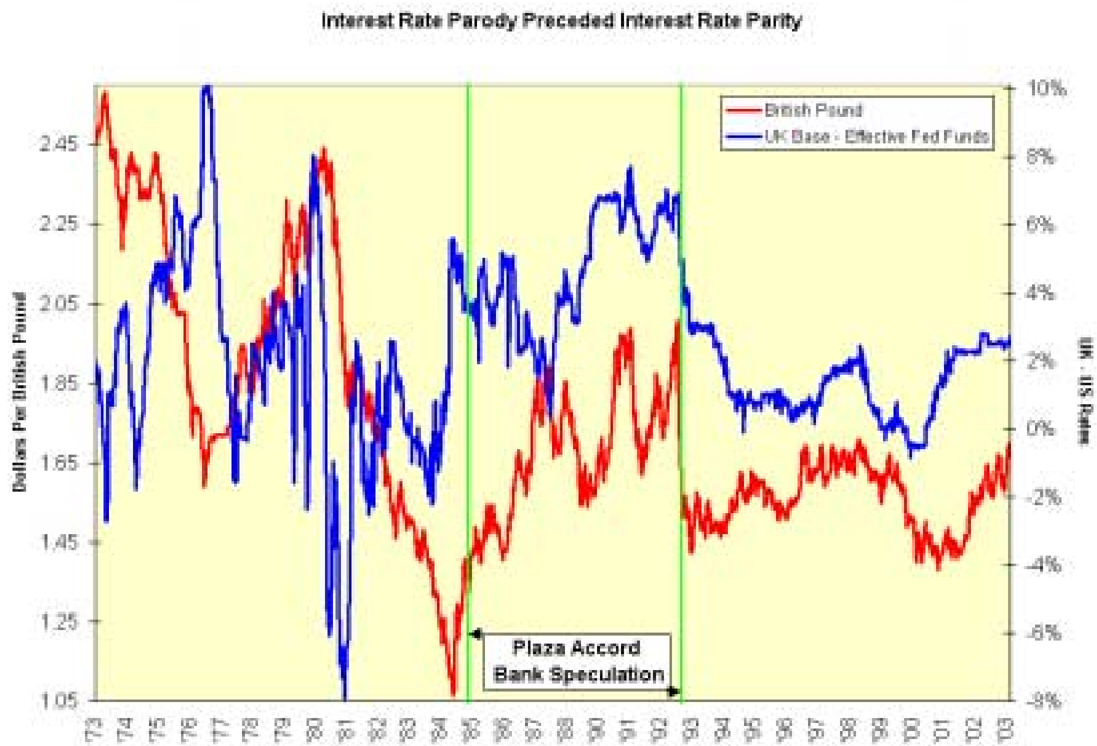
Let's place the Australian decision to one side, not out of any particular disdain for our friends Down Under who have given us Elle McPherson and Nicole Kidman on one hand and Steve Irwin and Dire Straits on the other, but rather in recognition their economy is linked to Asia more than to anything in the Atlantic basin. Now let's take a look at whether the Bank of England has been a stalking horse for the Federal Reserve in since 1985, when the Federal Reserve series of federal funds rate targets begins.



In a word, no. With a minor exception, October 1996, when the BOE increased its base lending rate from 5.75% to 6.00%, there is no evidence of the BOE leading the Federal Reserve in any sustained move. For the sake of completeness, the 100 basis point increase, from 10% to 11% in the base lending rate in October 1986 preceded a series of increases in the fed funds rate, but the BOE rescinded that increase in March 1987.

In For A Penny, In For A Pound

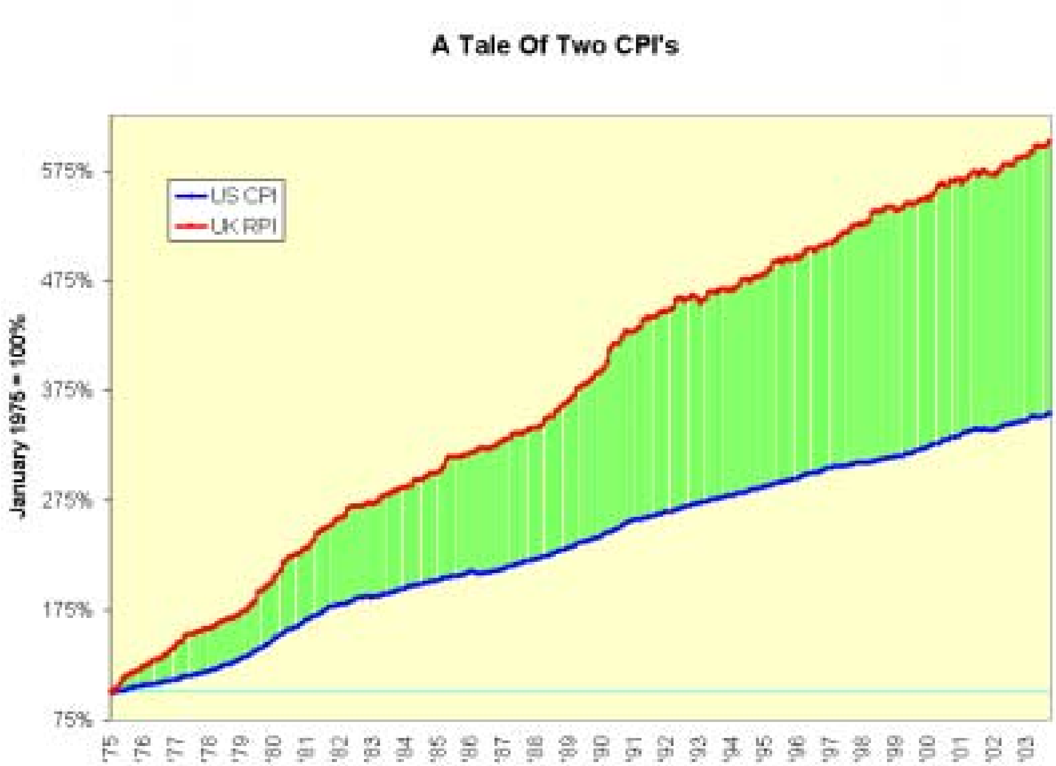
The BOE has faced a different set of constraints over the years than has the Fed. While American monetary policy has a primarily inward focus defined both in the Full Employment Act of 1946 and in the Humphrey-Hawkins Act of 1978, British monetary policy has had a primarily external focus defined by the evolution of pan-European exchange rate agreements. The BOE's target, more often than not in the three decades of flexible exchange rates, has been the exchange value of the pound more than price stability or some notional growth target for the economy.



The interest rate parity model of exchange rates, which never operates perfectly for a variety of reasons, holds that changes in the spot rate between two currencies should be a function of the interest rate spread between them. This means a central bank can target the exchange rate or its interest rates, but not both simultaneously. If the exchange rate is the target, then interest rates become volatile, and that is exactly the British experience between 1973 and the Plaza Accord of 1985. It was only after the debacle of September 1992, when European central banks gambled their taxpayers' money against the likes of George Soros that interest rates became more of a focus for the BOE and interest rate parity began to operate.

Labor Pains

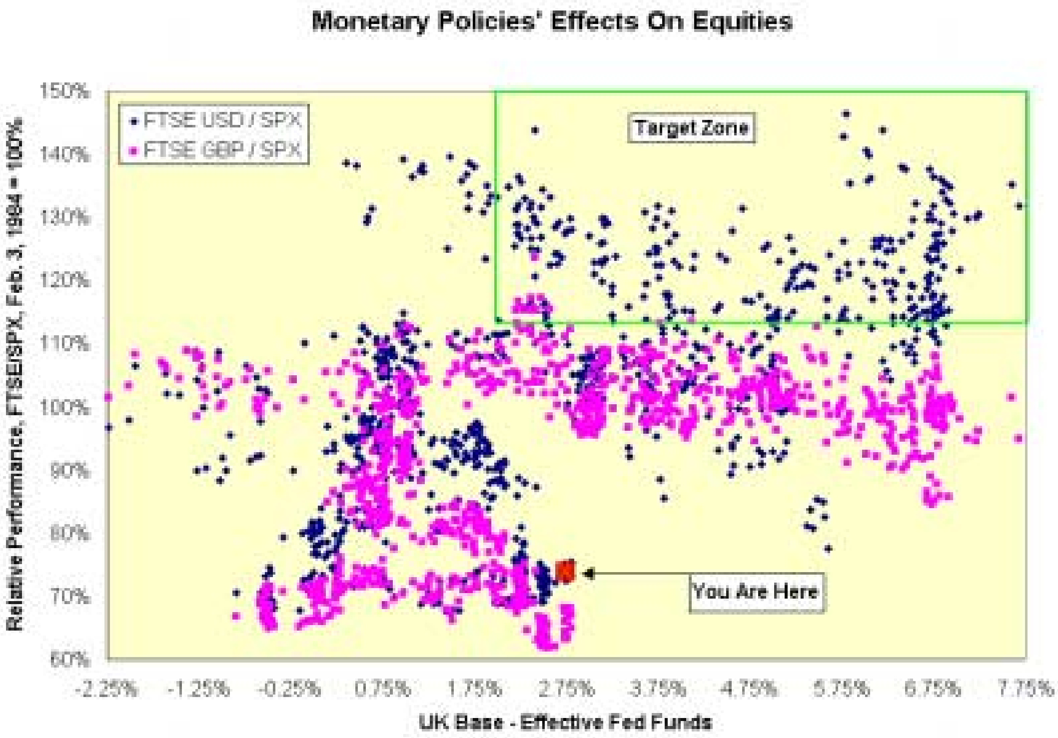
The frictional costs of currency and interest rate volatility in the U.K. were compounded by the residue of the social welfare state erected by the Labor Party - a group for whom the exhortation "please shut up" represents an excessive use of the word "please" - to push British inflation well over American levels. If we re-index the U.S. Consumer Price Index and the British Retail Price index to the latter's start in January 1975, we can see that British consumer prices have risen 1.7 times as fast as their American counterparts.



The BOE has to keep this relatively poor performance on maintaining price stability in mind, especially now that they face two larger central banks, the Federal Reserve and the always-good-for-a-few-laughs European Central Bank. The Fed is on record as favoring a slow return to higher interest rates; the ECB similarly has signaled their intent to keep rates low in the face of a sluggish Continental economy.

A small move higher in the base lending rate now by the BOE could strengthen the pound and reduce inflationary pressures in the U.K.

Playing FTSE
If the BOE is going to get out in front of the Fed, will American investors be presented with an opportunity in British equities? We can compare the relative performance of the FTSE 100 to the S&P 500 as a function of the interest rate spread between British base lending rates and American effective fed funds rates since February 1984. The relative performance measured in pounds is uninteresting. However, if we express the FTSE's performance in dollars, we find a very large target zone of outperformance by the FTSE at interest rate spreads larger than today's.



The reason for this relationship is simple and direct: As the British economy firms, the BOE responds by raising rates, which now translates into a stronger pound. An American investor gets both a currency gain and a stock gain relative to the U.S. market. A direct position in FTSE 100 futures accomplishes achieves this exposure; for those who prefer an equity to a future, the iShares MSCI United Kingdom index fund may be more suitable.