Central Bank Confusion And Coordination

The American electorate has been wise enough over the past three decades to, more often than not, split its ticket. This never reflected radical moderation so much as it did a form of risk management, an extension of the checks and balances so wisely written into the Constitution by the Founders.

The same principle of policy diversification extends globally amongst the various finance ministers and central banks. Sometimes their policies are disparate; the Federal Reserve's manic rate-cutting of 2001-2003 was not matched by the other major central banks, nor was the Bank of Japan's similar charge toward 0% in the 1990s matched elsewhere.

At other times, policies are coordinated with little success. The 1987 stock market crash was preceded by two years of central bank coordination to drive the dollar lower, and the final leg of the world's equity boom in the late 1990s was preceded by more choreographed rate-cuts.

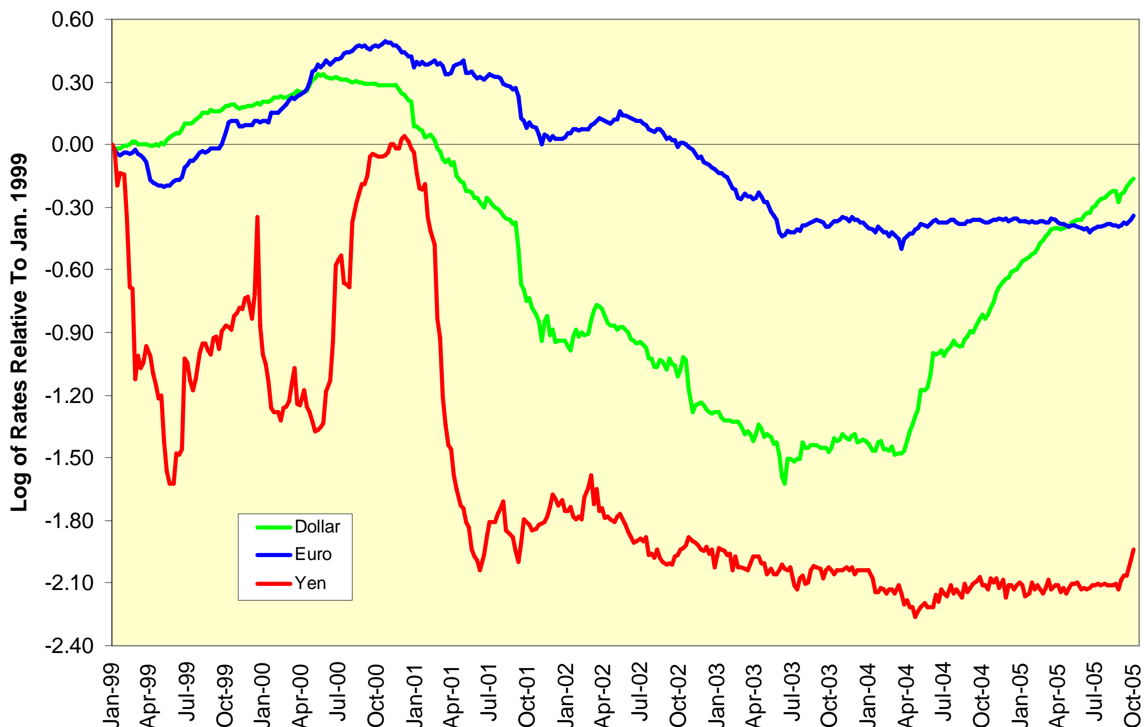
None of this argues for gratuitous non-coordination, however. We only need to recall how the Federal Reserve's rate cuts of the early 1990s were matched by the Bundesbank's rate increases designed to forestall inflation in the newly unified Germany; this set of policies at cross-purposes helped precipitate both a weak dollar and the September 1992 collapse of the British pound. I warned back in June 2000 of the risks posed then by diverging monetary policies.

United We Stand. Or Fall

The statement made by European Central Bank president Jean-Claude Trichet last week that the ECB stood ready to raise interest rates to prevent an acceleration of inflation brings the ECB on board with the Federal Reserve and the Bank of Japan. Just as the Federal Reserve had been more aggressive in cutting rates in recent years, it has been more aggressive in raising them since mid-2004.

Let's compare the relative movements of six-month LIBOR rates for the dollar, the euro and the yen. These rates incorporate current base lending rates set by central banks plus short-term policy perceptions. The chart below compares these rates on a logarithmic scale to their January 1999 levels extant at the euro's introduction.

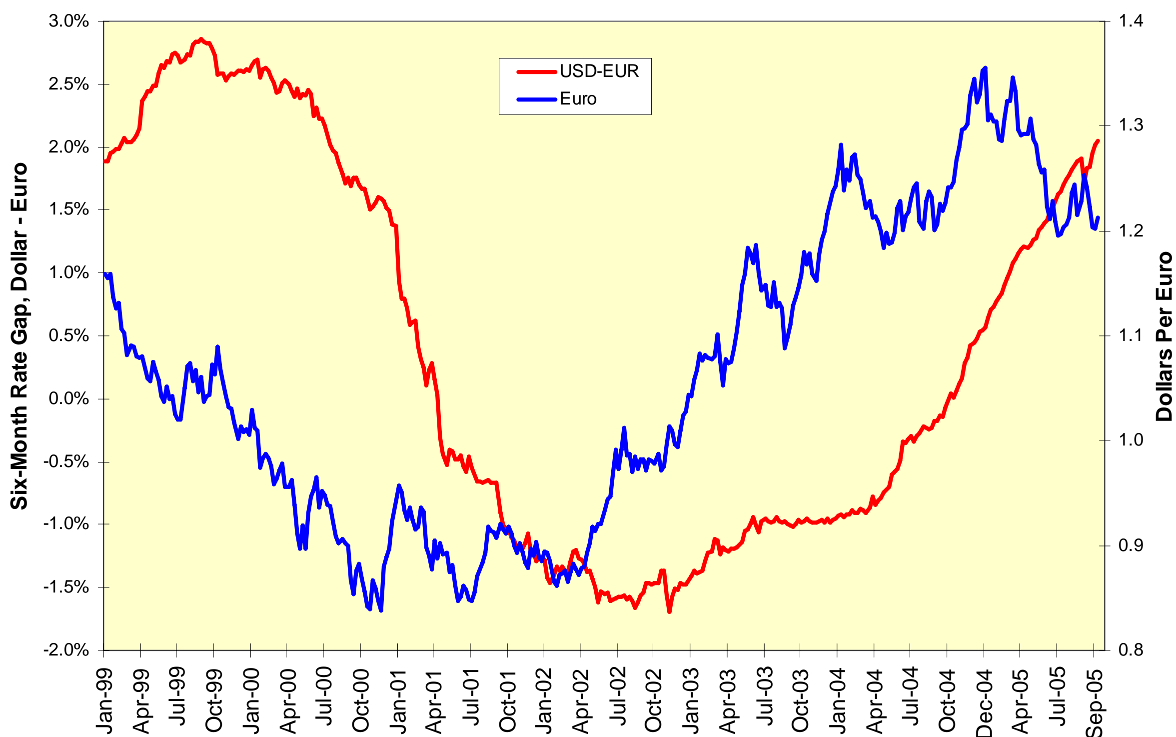
Room To Rise For Short-Term Rates



One of the interesting aspects of this comparison is how none of the major six-month LIBORs are at January 1999 levels; this has been true since November 2002. Both euro-LIBOR and yen-LIBOR are substantially below those levels and despite recent turns higher have yet to move in parallel to dollar-LIBOR. There is room to rise for all of these interest rates and, more important, there is room for the dollar's rate advantage to narrow. Should this affect the currency and equity markets?

On a relative basis, not necessarily: As discussed here in May 2004, there is much more to analyzing currency movements than a simple rate comparison. We have to look at the comparative asset returns and inflation expectations between the two currency zones. Otherwise, we can get a distorted picture of how markets operate. The examples below will be limited to the euro; the yen is affected by too many extraneous factors to produce a clean comparison.

A glance at the chart below might tempt us into believing the euro-dollar exchange rate moves nine months or more in advance of the six-month LIBOR differentials between the two zones. In practice, whatever long lead and lag times we may wish to tease from the data are irrelevant. The currency markets instantly capitalize to the extreme any and all information that may affect the expected rate gap. That certainly was case with the euro and its 1.7% rally last week following Trichet's statement.



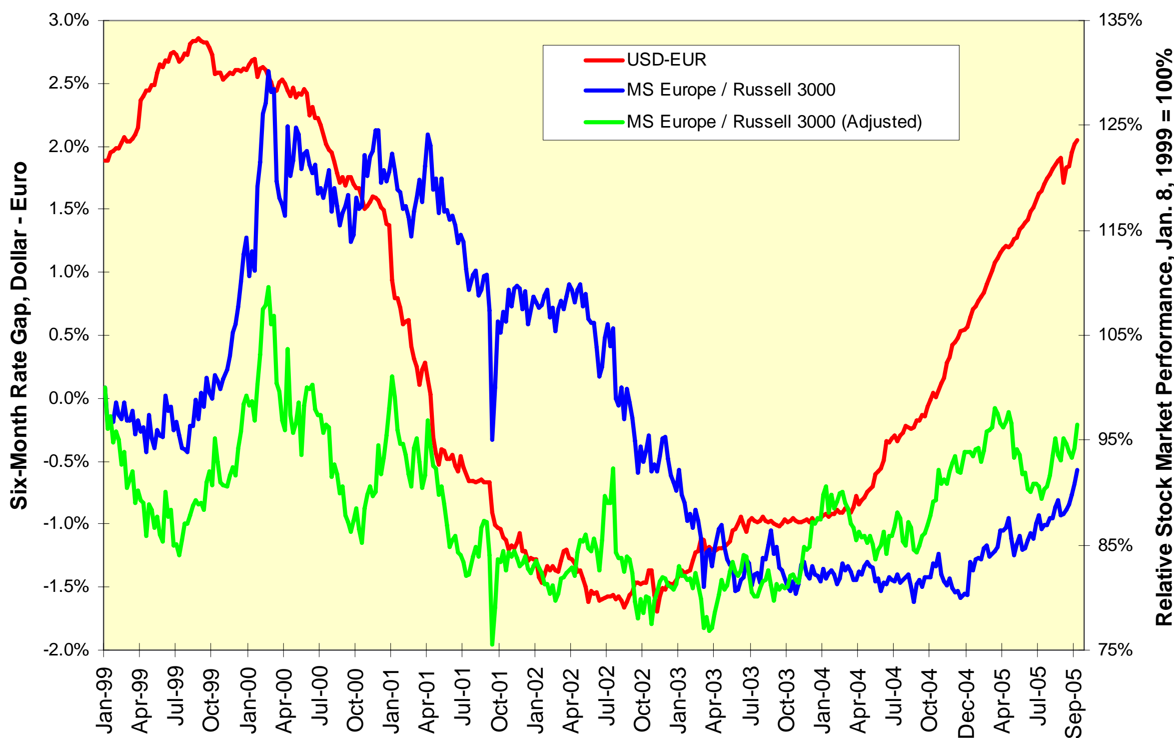
Relative Stock Market Performance

Now let's look at the relative performance of the Eurozone stock market as measured by the Morgan Stanley Euro Index to the American market as measured by the Russell 3000 to the six-month LIBOR gap. The relative performance of the two stock indices can be depicted on both a nominal and a currency-adjusted basis; the latter represents the gains and losses an unhedged American investor would see.

The relative returns to American investors in European markets have advanced in recent months on both an adjusted and an unadjusted basis even as the rate gap between the dollar and the euro grew. We could argue rates were rising faster in the U.S. by virtue of a stronger economic performance and higher asset returns in the U.S. In addition, the Federal Reserve's increasingly apparent resolution to fight inflation, something the ECB signed onto only last week, does indeed create a better investment climate.

Absolute And Relative

We only have one episode in the euro's short history of a prolonged period of euro rates rising faster than dollar rates, the two-year period between mid-2000 and mid-2002. This rate gap occurred within the context of the global bear market in equities and was driven more by the Federal Reserve's rate-cutting than anything the ECB did.



American investors fared better – if we wish to include losing less money in Europe than in the United States as "faring better" – by holding European stocks during this period. This is a relative measure; the absolute returns were negative in both markets.

Now that the world's central banks are in apparent agreement on the need to raise rates and fight inflation, should we expect the European markets to start outperforming their American counterparts on the basis of a narrowing rate gap alone? And, even more important than this relative basis, can we state in advance whether rising global short-term rates will be sufficient to stall all equity markets?

The answers to both questions are maddeningly indeterminate. The inflation now being combated is the culmination of several years of monetary ease. The Federal Reserve eased more and has been tightening more, and these actions produced both the 2002-2004 rally in the euro and its weakness relative to the dollar in 2005. If the market senses the ECB is further behind the curve on inflation and will either stay that way or start raising rates too fast, the European markets will suffer on both an absolute and a relative basis.

If we go through the various policy combinations, we start to conclude the best course of action for the Federal Reserve is to stay on its measured pace and for the ECB to start talking this talk in its various languages. That is the only form of policy coordination that will benefit all markets. Is this asking a lot of the central banks? Yes, but as Benjamin Franklin noted, they had best hang together or else they surely will hang separately.