

The Major Euro Crosses

Here's an unanswerable question: How will future economic historians regard those countries in Europe who chose to remain outside of the euro? Several of the non-participants, such as Denmark and Norway, have currencies not considered to be amongst the "majors." Other non-participants, principally Eastern European states such as Poland and Hungary, hope to be participants some day.

Two non-participants have currencies commonly regarded as majors and have remained outside of the euro, the United Kingdom and Switzerland. Neither is expected to join anytime in the foreseeable future, the British for cultural reasons and the Swiss to maintain their vaunted neutrality. Both cross-rates, the British pound per euro (BPEU) and Swiss franc per euro (SFEU), are critical to the economic success and financial stability of both countries. A visit to either, where retail prices are posted in euros (and dollars) alongside pound and franc prices, confirms this immediately.

The consolidation of twelve currencies into the euro removed 66 different currency pairs, $(12^2-12)/2$, from the interbank market. We will pass on the question whether the world is a better or worse place in the absence of Finnish markka / Portuguese escudo cross-traders, but we will note the combined absence of all these cross-rate trades did lead to a pronounced drop in global currency volatility (see "Currency Trends and Volatility," November 2006).

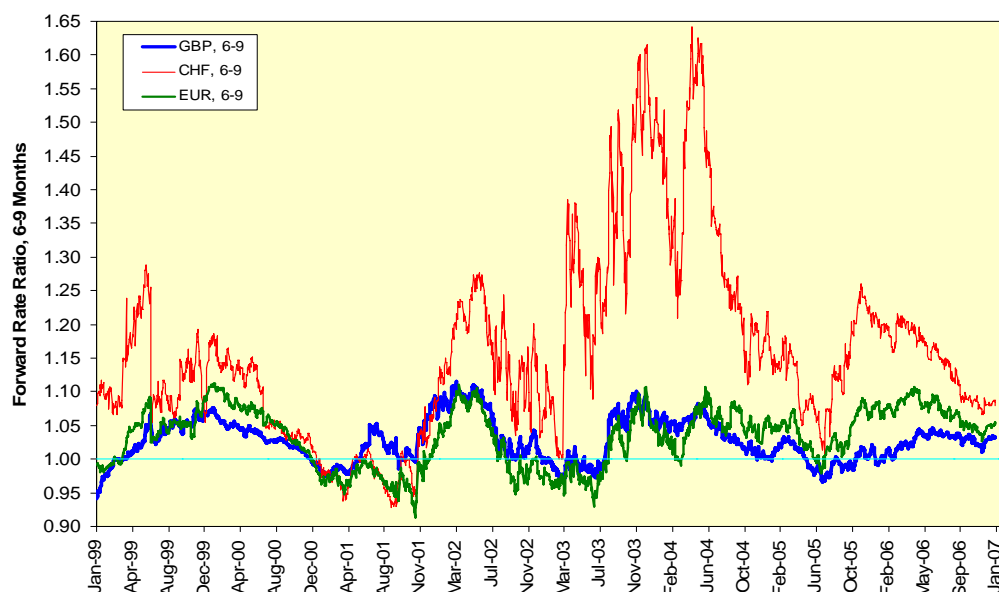
The BPEU and SFEU are the two principal trades remaining within the euro bloc, the currency world's counterpoint to the U.S. dollar bloc (see "The Dollar Index and 'Firm' Exchange Rates," December 2005). How have they behaved, what drives them and what information can we derive from their movements?

Non-Parallel Universes

The differential interest rate expectations between two currencies always are an excellent starting point for examining their currency cross-rate. The key metric for a currency is the forward rate ratio (FRR) between six and nine months; this is the rate at which we can lock in borrowing for three months beginning six months from now. This FRR today provides us with a tradable interest rate expectation applicable to the decision whether to roll a three-month non-deliverable forward for another three months starting three months from now. The more a FRR exceeds 1.00, the steeper the yield curve is over that segment and by extension the looser that country's monetary policy is.

While the Swiss long have enjoyed a reputation for fiscal probity, they have been as willing as anyone to engage in monetary stimulus in recent years. If we compare the FRRs for the euro (EUR), British pound (GBP) and Swiss franc (CHF) since the January 1999 advent of the EUR, we see how the Bank of England (BOE) and the European Central Bank (ECB) have stayed close together in the monetary policies. The largest exception was in late 2005 and early 2006 when the ECB maintained a looser monetary policy than did the BOE.

The Great Swiss Monetary Divergence



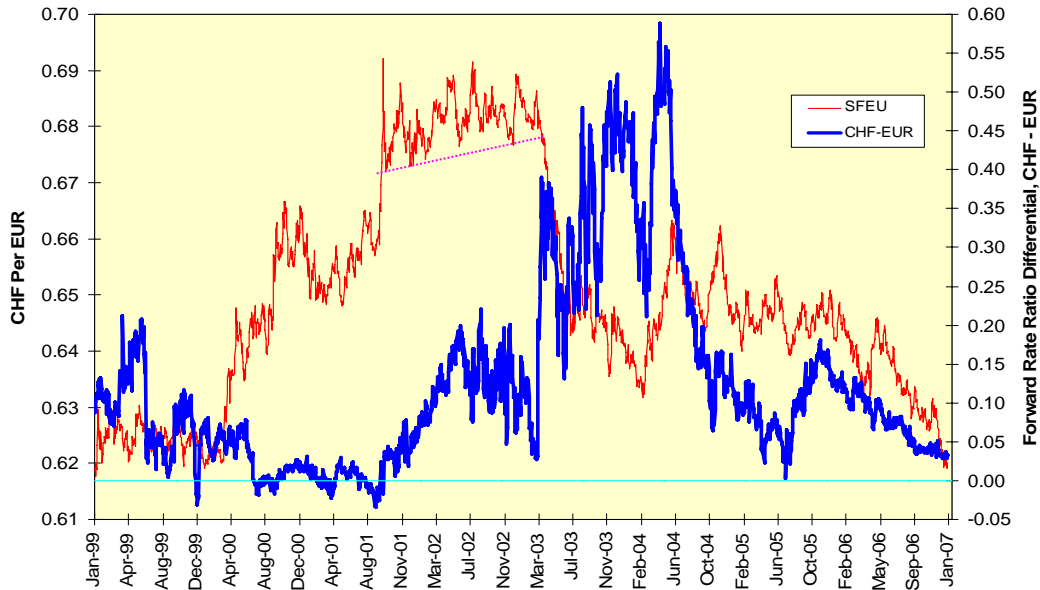
Not so for the Swiss National Bank (SNB). Their reduction in their target LIBOR from 75 to 25 basis points in March 2003 – three months before the Federal Reserve cut the federal funds rate to 1% - propelled their FRR higher and well over comparable levels in the U.K and the Eurozone. Their increase in target LIBOR in June 2004 to 50 basis points matched the Federal Reserve’s move in timing and size, and it started a very rapid change in their FRR.

Swiss-Euro Cross

Any discussion of the EUR’s long-term history has to be mindful of one non-economic reason for its weakness in 2000-2001, and that is the sale of legacy currencies hidden from the various national tax collectors prior to the introduction of cash euros in 2002. This so-called “mattress trade” made the SFEU unnaturally strong during those years.

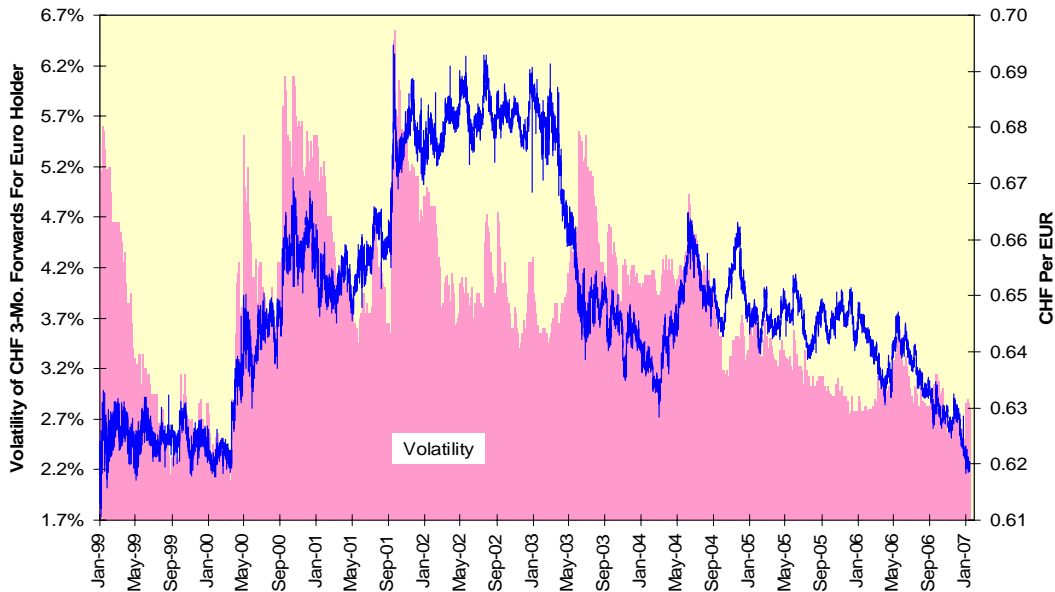
We can compare relative monetary policies in two countries by the difference in their FRRs. A country whose FRR is greater than another’s has a looser monetary policy and all else held equal should see its currency weaken. All else seldom is held equal, however. The Swiss FRR has exceeded its Eurozone counterpart since late 2001, but it did not break its trend support (dashed line) until the March 2003 Swiss rate cut. The SFEU then collapsed under the weight of looser Swiss monetary policy, and that weakness persisted through late 2006 even though the Swiss FRR is flattening relative to the Eurozone FRR. It will take a renewed tightening of Swiss monetary policy to change this.

Differential Interest Rate Expectations Between CHF And EUR



Will this happen anytime soon? The message from the cross-rate options market is, “No.” The cost of buying options on the CHF has declined steadily for EUR holders since the 2003 rate cut. We can interpret this as saying EUR holders who have borrowed the CHF and swapped it into EUR have no fear of the CHF strengthening anytime soon. Of course, the very same CHF borrowers are increasing the risk of the underinsured event, a sudden rise in the CHF, happening by creating a path of greatest anxiety in that direction.

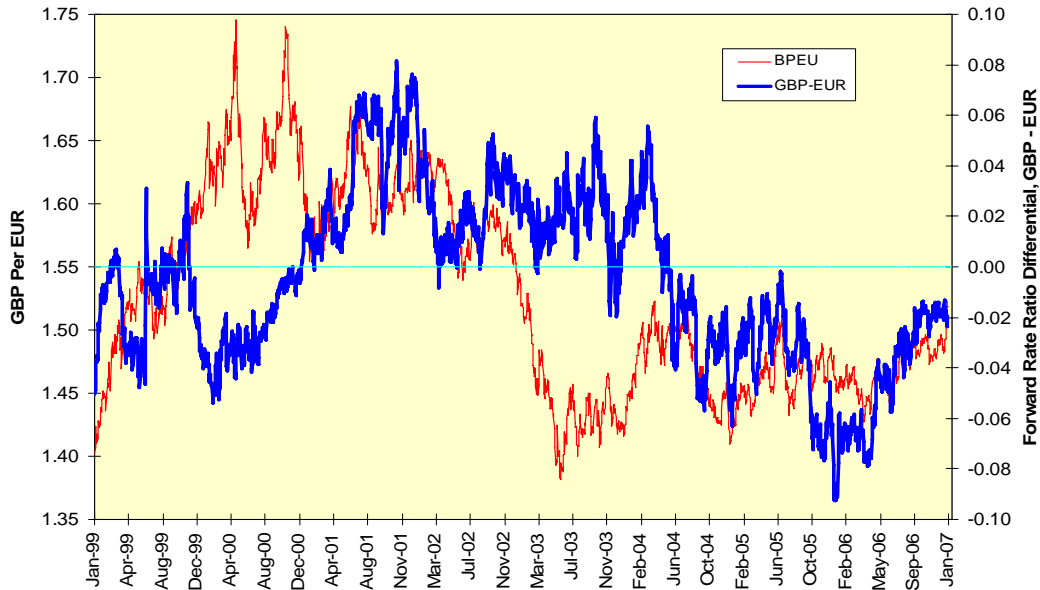
The CHF / EUR Cross-Rate



Pound-Euro Cross

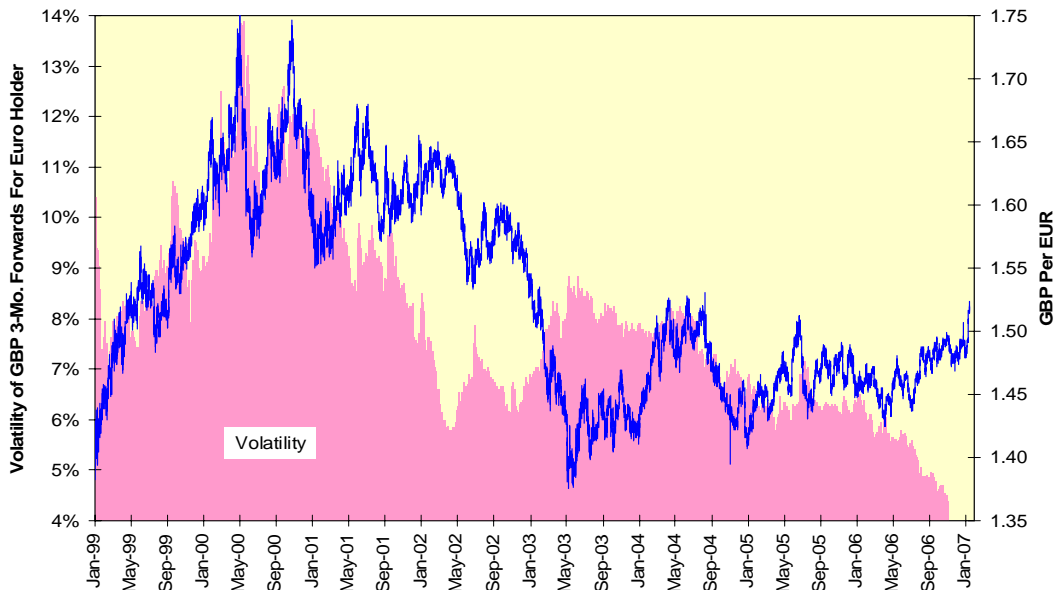
The FRR relationship between the GBP and the EUR has been markedly different than the CHF-EUR FRR relationship. Once the mattress trade ended and the FRR differential remained over zero into mid-2004, the BPEU rate fell as expected. After mid-2004, British monetary policy tightened relative to that of the Eurozone and the FRR differential fell into negative territory. However, the BPEU rate remained in a trading range rather than strengthen. And while the FRR differential remained negative, it was far from static; it fell sharply into the start of 2006 and then rebounded rapidly thereafter, all without a material and noticeable effect on the BPEU rate.

Differential Interest Rate Expectations Between GBP And EUR



And just as the volatility of CHF forwards fell continuously after early 2003, the volatility of GBP forwards has fallen since late 2000, interrupted only by a May 2002-May 2003 rebound. EUR holders appear convinced the trading range will persist as if ordained by some semi-official policy.

The GBP / EUR Cross-Rate

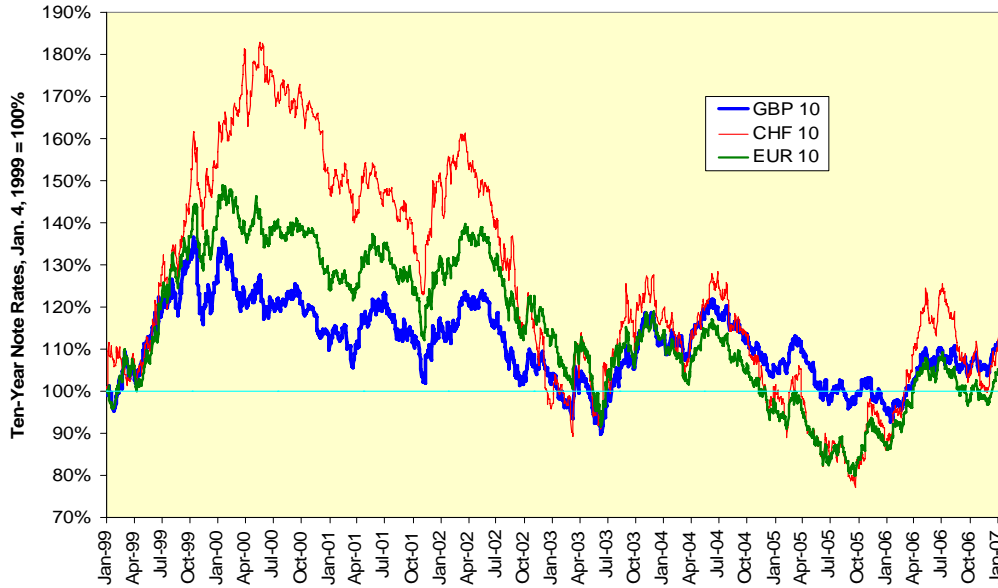


Capital Market Horizon

Currency exchange rates are more than simple interest rate differentials. Two other factors come into play, one relevant here and none not particularly relevant. Trade flows between the United Kingdom, Switzerland and the Eurozone are not in the sort of persistent imbalance seen, say, in the U.S.-China or U.S.-Japan bilateral market. We can dismiss this as a major factor in exchange rates out of hand.

The relevant factor is returns in capital markets. If we index the yields to maturity on Swiss, British and Eurozone ten-year notes since the January 1999 advent of the EUR, we find there were wide differences well into mid-2002. Those differences widened slightly in 2005 as British yields remained firm and the British short-term FRR increased relative to that for the EUR, but then converged once more. By late 2006, yields at the ten-year horizon had converged. If returns on capital are similar and the mobility of labor and other factors of production throughout Europe is high, why should currency exchange rates be volatile on either a realized or an implied forward basis?

Bond Yields Have Converged



The harmonic convergence of asset returns, currency volatility and monetary policies creates something of a virtuous cycle in European markets. The convergence of asset returns and parallel monetary policies reduce currency volatility. This reduced volatility in turn reduces the liquidity premium bond investors must demand to protect themselves against currency volatility. Yield curves around the world have flattened in part because of this factor.

The whole state of affairs is rather extraordinary: In a nominally floating exchange-rate world, the construction of the EUR led to a de facto return to the stable exchange rates prevailing prior to the dissolution of Bretton Woods in the late 1960s and early 1970s. This “firm” exchange rate environment, predicted here in December 2005, is in fact coming to pass.