Today Europe, Tomorrow The World

What's the euro worth? Before you punch in the symbol for the euro-dollar exchange rate into your nearest quote screen, consider what you would be providing. If I turned the question around and asked you to tell me what the dollar is worth, you would have a similar and related problem. You could give me a group of single-currency pair quotes, the price of an asset such as gold or an index such as the dollar index (DXY) or the International Monetary Fund's Special Drawing Rights.

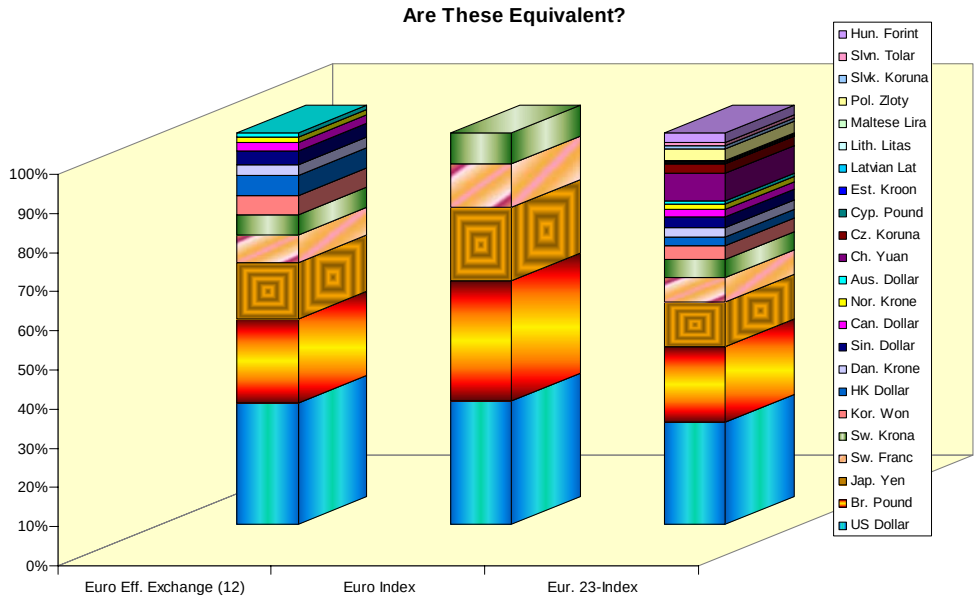
Each approach is imperfect. No single-currency quote pair would tell the same story, especially if it was for a relatively minor currency such as the Mexican peso or South African rand. However, no one in Laredo or El Paso, Texas, would regard the peso as minor, and anyone in the gold or diamond mining industries would feel the same about the rand. Is gold a fixed asset, the immutable and celestially perfect star around which mortal detritus orbits, to paraphrase the sentiments of the ardent gold bugs, or is gold just another commodity swept up in a bubble, as suggested here last December?

This leaves, for better or worse, the basket approach to saying what a currency is worth, at least on a relative basis. The DXY has served this role admirably as an analytic measure for three decades and as the basis for futures and options for two decades. As we move ever-closer to what I termed here last June a "firm" exchange rate environment, one characterized by dollar and euro blocs, it would be useful to have a parallel to the DXY. In this way we could express the euro as a multilateral, not as a bilateral, quote.

Simpler Is Better

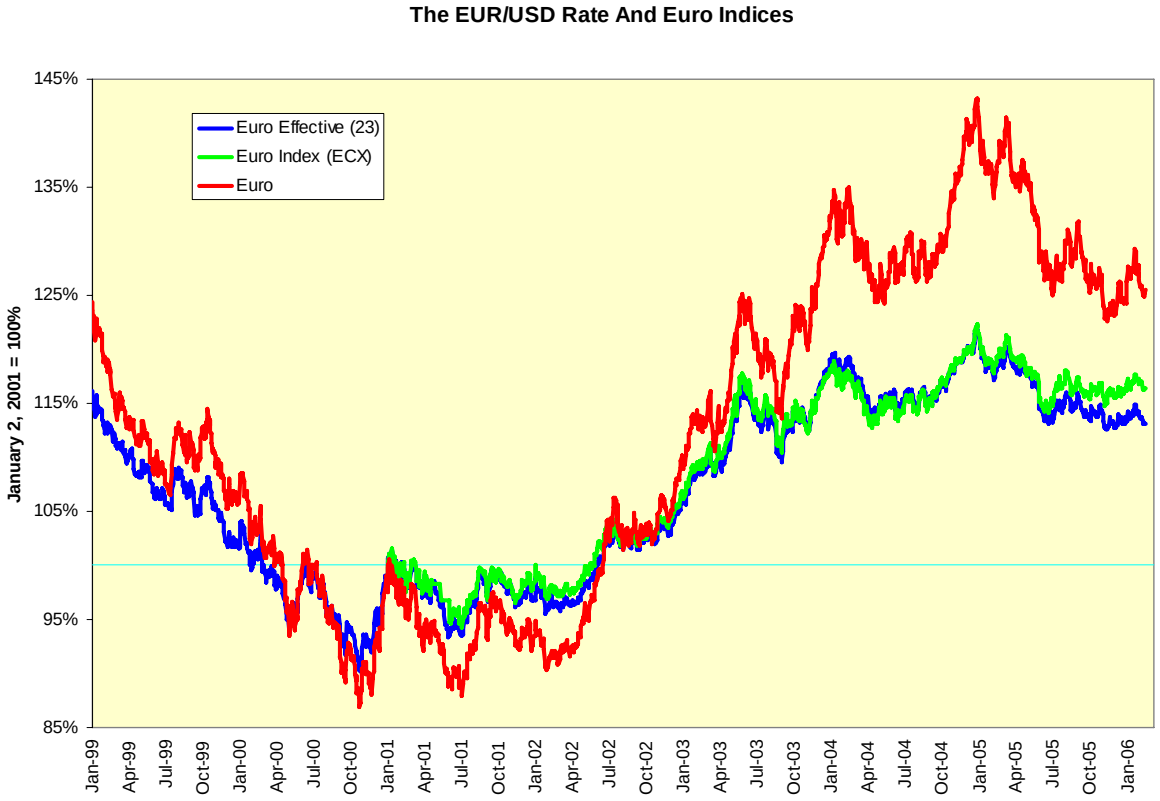
Of course, one we agree on an indexation approach, we run into the problem of how to assemble the index, how to weight the index, what to include in the index, etc. Think of all the indices in your investing life; each claims to be the best, but you have no single way of making that determination. The European Central Bank created a 12-currency Euro Effective Exchange Rate index, but stopped publishing that index in October 2005 in favor of a 23-currency index.

This latter index looks like European political correctness run amok. In includes the small-weight currencies of countries on the European periphery such as Latvia, Lithuania, Estonia, Malta, the non-Euro Scandinavian currencies and non-European trading partners such as Hong Kong, Singapore and Korea. Basically, if your currency is a dollar or crown of some kind, you are in the index.



The problem with this index is it has too many members whose currencies are too closely correlated with other to make the distinctions meaningful. More important for currency traders, the cumulative bid-ask spreads on 23 different currencies, not all of them deep and liquid, would make trading this index too expensive.

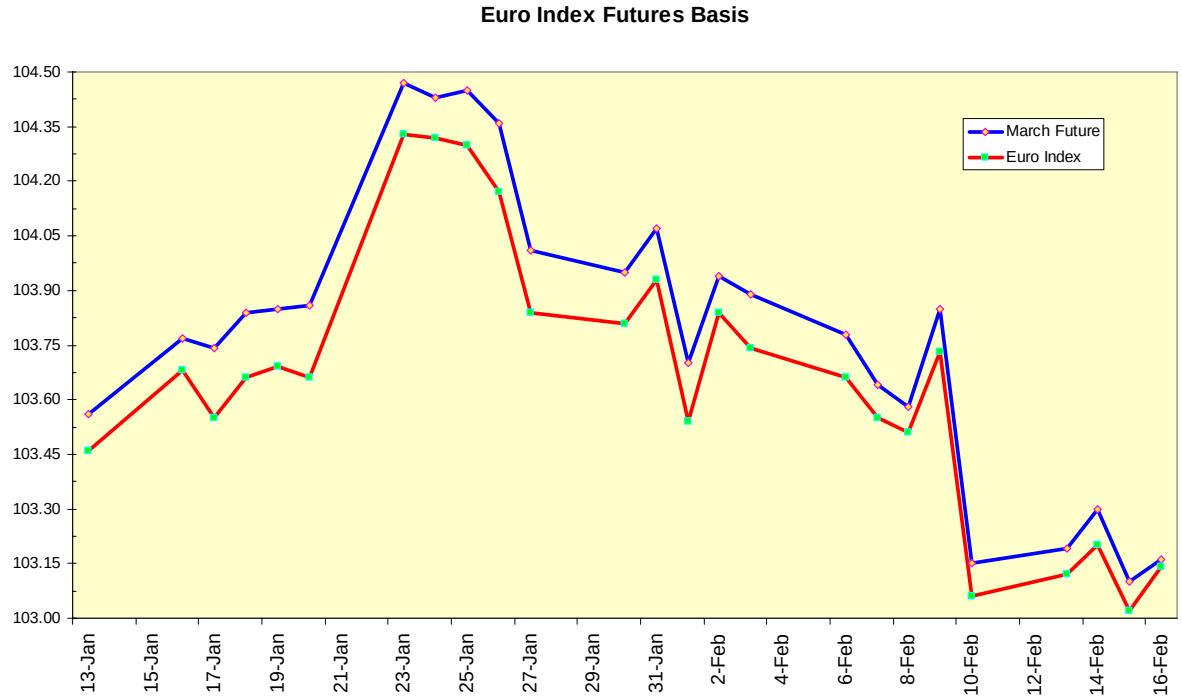
The New York Board of Trade's FINEX division got around this problem in the time-honored tradition of equity basket traders: It constructed a representative sample out of five different currencies, the U.S. dollar, Japanese yen, British pound, Swiss franc and Swedish krona. This new Euro Index (ECX), a geometric weighted average of these five, is designed to match the original 12-currency index. This it did between its January 2001 start and mid-July 2005, at which point the 23-currency index weakened on a relative basis. Both of these largely trade-weighted indices had more moderate histories against the euro-dollar exchange rate, both during the euro's 2001-2002 weakness and later during its 2004 strength. This may be the cleanest example of the advantage a trade-weighted index has relative to a single-currency rate: It is less volatile.



Trading The Index

What's the point of being an exchange-created index if tradable instruments are not created to access the index? Futures and options now trade on the familiar quarterly expiration cycle at the FINEX, although only the March 2006 contract has been active to-date.

The pricing of these futures contracts reflects the net interest rate differential between the cash index and the interest-bearing short-term deposits in each currency. If the average yield on the ECX is less than that of the euro itself – and money rates for the Japanese yen, Swiss franc and Swedish krona are less than the euro rates – we should expect the future to trade over the index. Why? Because a long futures position here is equivalent to borrowing at the higher euro rate and lending at the lower ECX rate. You "pay" this net interest rate differential by buying the future for more than the index and then suffering basis deterioration along the way. We can see this over the contract's brief history.



While dollar-domiciled investors are likely to focus on the bilateral euro-dollar exchange rate, expect to see a gravitation toward the ECX as an analytic and eventually as a liquid trading tool for global investors with euro-denominated assets or for euro-domiciled investors looking to hedge their own currency as so many Americans were looking to hedge the dollar in 2004.