The euro, which previously made headlines when it declined against the dollar, has recently made headlines again, this time because the G-7 nations intervened on its behalf and the Danes decided not to adopt it.

On September 22, the central banks of the U.S., Canada, Britain, Japan, and Europe bought several billion dollars’ worth of euros, at least temporarily arresting the slide. On September 28, the Danes voted to continue using their currency (the krone) rather than adopt the euro. The net result of these actions was an appreciation of the euro (relative to the dollar), from 85 cents to 88 cents.

The intervention’s ultimate effect remains unclear, partly because the reasons behind the euro’s slide are murky. One standard theory, purchasing power parity, holds that the exchange rate between two countries’ currencies reflects the countries’ relative price levels because the real price of traded goods should be the same in both. This suggests that the euro would fall if the inflation rate were higher in Europe than in the U.S., but a comparison of consumer price indexes belies this. One might suppose that expectations of future inflation are higher in Europe, except that so far this year the European Central Bank has raised interest rates more than the FOMC has. Likewise, the spread between longer-term Treasury bonds and 3-month interbank deposits, which should be sensitive to inflation fears, in fact has flattened noticeably in 2000.

Just as exchange rates relate different countries’ currencies, yield spreads relate their interest rates.
Among the most closely watched is the Treasury-to-eurodollar (TED) spread, which compares the yield on 3-month T-bills with that on 3-month eurodollar deposit rates. (The TED spread comes in several flavors, depending on whether spot or futures prices are used.) Historically, T-bill and eurodollar rates generally move together, but that does not keep the spread from widening, particularly when rates are high. Both assets have the same maturity, and both pay off in dollars, so their yields differ because T-bills are guaranteed by the U.S. government and eurodollars are the liability of foreign banks. This makes risk the TED’s primary influence, which is why the spread is sometimes termed a “global anxiety index.”

In keeping with this designation, the TED spread has reliably picked out such international crises as the collapse of the stock market in October 1987 and Operation Desert Storm in 1990, as well as the Russian default and the Long Term Capital Management debacle in late 1998. But it has also responded strongly to more narrow financial concerns, such as the fall of Continental Illinois Bank in 1984 and the Herstatt crisis of 1974. Certainly the 1990s appear more quiescent than either the 1970s or the 1980s, and the current TED spread is low, even by recent standards.