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THE FEDERAL RESERVE BANK of ST. LOUIS

International Interest Rate Linkages

A change in the federal funds rate target often prompts observers to comment that other central banks are likely to follow suit by changing their own targeted interest rates. The accompanying chart shows that central banks of different countries often change interest rates in the same direction, at about the same time. This is especially true for central banks of countries with close economic ties.

There are at least three reasons why central banks might tend to change their interest rate targets in a similar fashion.

1. Countries react similarly to "common shocks." In making monetary policy, central banks consider the state of the economy, including international commodity prices, like oil. Changes in such prices tend to affect countries in the same way, leading to similar changes in monetary policy.

2. Countries may desire to maintain stable exchange rates. By raising and lowering interest rates in tandem, central banks might minimize swings in the external value of their currencies.

3. Economic conditions in one country affect those in other countries through trade and capital flows. A U.S. recession that leads to lower U.S. interest rates might also slow our trading partners' growth, prompting their central banks to lower rates as well.

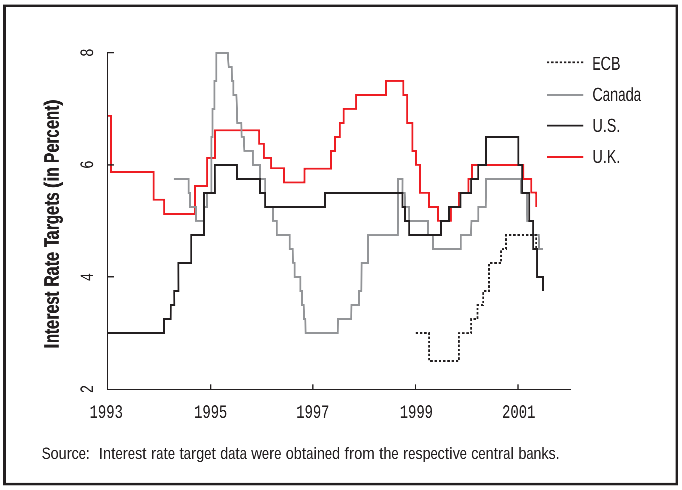
The latter two reasons might explain why the interest rate changes of larger countries generally precede those of their smaller trading partners. Conditions in large countries, like the United States, affect conditions in smaller trading partners more than the reverse; therefore, smaller countries are more likely to take external factors into account when making monetary policy.

Because the Federal Reserve has conducted monetary policy for the largest economy in the world, it has been less concerned with external factors than most central banks. As a result, it has frequently been a "leader" in international interest rate movements. For example, the chart shows that the Fed led the way for other central banks by starting the most recent series of interest rate reductions in January 2001.

With the formation of the European Monetary Union, monetary policy in Europe may be more concerned with European trends and less concerned with external factors—like Federal Reserve policies—than were the central banks of the constituent states. The president of the European Central Bank (ECB), Wim Duisenberg, underscored this change in explaining the decision to decline to match the most recent Federal Reserve interest rate cuts: "The impact of events outside the euro area is not so significant. The euro area is a much more closed economy than its constituent parts were previously." (*Irish Times*, February 2, 2001)

Monetary policy is not, of course, a game of "follow the leader." Central banks make interest rate decisions for their own domestic reasons, not to simply keep in step with other central banks. They do, however, consider the effect of external factors—including foreign interest rates—when making monetary policy for their own countries.

—Christopher J. Neely



Source: Interest rate target data were obtained from the respective central banks.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.

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