WHY IS THE DAMNED EURO SO DAMN STRONG?

By Paul Horne, Independent International Market Economist

Why IS the euro so strong against the dollar when bond markets have it on its death bed?

Since the onset of the crisis in Greece in late 2009, foreign exchange-traders have been forecasting that the euro will sink to dollar parity before becoming extinct. This expectation is considered "common sense" among most Americans, including those watching the euro's fluctuations with a view to their costs for vacations or alimony or investments from dollar accounts.

Despite all these expectations, the fact is that the euro has maintained an average value of $1.36. What is sustaining the euro at this level against the dollar?

The answer is simple and slightly paradoxical. A collapse of the Euro system would be so dramatic for the world's already shaky financial system that market-movers believe -- perhaps with a large dose of wishful thinking -- that Euro zone leaders are being forced to make the decisions necessary to save the single currency.

In other words, the dire outlook for the euro has the psychological effect of sustaining its value in currency exchange markets.

So far, this view is holding up. Of course, there is a race against the market clock. The dynamic of belief will collapse the day time runs out on European procrastination.

In recent days, there are signs of significant progress in finding a solution to the euro crisis. The combined movements by the world's major central banks to increase liquidity were a signal of concerted action that impresses markets but has often been lacking. The most recent comments by ECB head Mario Draghi suggest the European Central Bank is seeking to become more pro-active. Blueprints of closer fiscal integration are emerging ahead of a crucial summit meeting of EU leaders on Dec. 8.

The fact remains that, so far, German Chancellor Angela Merkel and French President Nicolas Sarkozy (the odd couple nicknamed "Merkozy") have been unable to make the dramatic changes in eurozone governance which markets believe necessary.

As a result, euro-skeptical bond traders have ratcheted up borrowing rates, first for the weakest (Greece surprised nobody in the know) but then others, now including France (whose once sacrosanct AAA bond rating is in question) and finally even Germany (which had the embarrassment last week of seeing investors shun its bonds).

Of course, Merkozy and other Eurozone leaders have responded to rising market pressures. Alongside the bail-outs, which presented political problems to electorates, there was the initial 750 billion euro package in May 2010 that centered on a new institute, the European Financial Stability Facility (EFSF), which began functioning in record time for a European institution. The EFSF was designed to cooperate closely with the IMF, adding to its credibility and ability to impose austerity on Greece and Portugal -- and by extension to other countries with potential debt exposure. The IMF itself has seen its resources dramatically expanded in response to the consensus of the G-20 meeting of the world's largest economies. The ECB has taken a page from the Federal Reserve's crisis book and started buying Greek and Italian government bonds on secondary markets. The amounts remain small in the view of many analysts and there has not yet been any public change in the ECB's policy stance against becoming the "lender of last resort," but these recent steps nonetheless broke the taboo (ingrained in Germany and the Netherlands) against this form of disguised "bail-out" by the ECB. The eurozone's new package of measures – for the EFSF, for banks' capital reserves and for EU-IMF advancing monitoring of national budgets in Greece and Italy – still remains to be translated into action, perhaps in early December. In many quarters, the IMF is seen as a rescue vehicle that can bring water from China and other emerging markets to put out the fire in Europe that threatens to bring down the global economy around the ears of everyone.

Nevertheless, interest rates continued to rise -- for EU sovereign borrowers -- to levels which reinforce that threat of economic recession and even the termination of the euro experiment. By early November it was evident that only the ECB had enough fire power to ensure that euro governments could borrow at economically viable rates. The ECB's charter expressly forbids it to directly finance eurozone governments – as set under the terms of the Maastricht treaty (in which West Germany gave up the deutschmark for the single currency in conjunction with German reunification). Chancellor Merkel faces sharp resistance in inflation-phobic Germany to "printing money," and it remains to be seen whether Berlin and Frankfurt (headquarters of Draghi's ECB) will relent on their old dogma and use their powers to protect the euro.

The impasse over ECB intervention drove interest rates for EU government bonds to rise still higher and by late November “Merkozy” was forced to go for more fundamental changes. These include an agreement in principle on much tighter fiscal and budgetary requirements for euro zone governments, enforced through treaties among the 17 member countries only. (This would avoid the lengthy and politically-fraught process of amending the Lisbon Treaty which governs all 27 EU countries.) In addition, Merkel and the ECB indicated this week that they may consider special arrangements with the IMF to leverage EFSF borrowing power in markets to help troubled eurozone governments.

That situation triggered the well-timed global initiative in which the Federal Reserve, the ECB, the People’s Bank of China and other key central banks announced measures to assure massive low-cost dollar liquidity to euro zone banks through early 2013. The palliative was similar to U.S. policy moves after the Lehman brothers’ collapse. Markets welcomed the breathing space and the signal of governments’ cooperation.

Of course, this relief did not provide any solution to the euro crisis. But the pressures seem, at least to some observers, to be concentrating the minds of European leaders and getting them to grips with the scale of the urgent crisis and with the underlying problems of a monetary union created without fiscal union. Getting there, however, must involve some immediate actions to cope with the bond vigilantes who are threatening to bring down one or more eurozone countries. This week and next are crucial, according to European Commission officials. They seem to realize that there has been too much talk about grand reforms on future governance in a situation when such long-term plans sound like doctors talking about a diet to a patient in intensive care.

Meanwhile the euro has actually clawed back a few pennies in value against the dollar. In the euro’s performance, there are many technical factors. One is the high cost of shorting the euro. There is a tempting but misleading comparison with events in the 1980s when hedge-fund managers such as George Soros managed to borrow enough funds to bet against a national currency (famously the pound sterling) and force a devaluation within days. That operation is not really feasible against the euro for two reasons. One, the combined potential resistance of the 17 euro nations dwarfs the numbers in play in those earlier national situations (euros represent 35 to 37 percent of all foreign currency reserves of the world’s central banks). And secondly, the cost of borrowing short-term money is too high to make this gamble realistic.

Another element of support for the euro’s value in currency markets is the pressure of EU governments on their countries’ most solvent banks to buy bonds – something that these banks can do by borrowing dollars (from the U.S. Federal Reserve) and then buying bonds denominated in euros. China, too, is buying euro assets on a growing scale as Beijing pursues its plans to diversify its holdings away from the dollar, find investment opportunities in Europe that seem relatively cheap and stable and politically useful, and to protect the survival of the euro as an alternative to the U.S. dollar as a world-class reserve currency.

And there is the 800-pound gorilla in the sovereign debt arena – the U.S. and its problems with a giant deficit, with debt on steroids and a dysfunctional government incapable of legislating. The U.S. dollar has not benefited as much as might have been expected in the euro crisis because it is a sinking vehicle to many traders who expect to see it continue depreciating in real terms. (It is already down nearly 40 percent in real terms against the basket of other major currencies since 1985.) That course could be reversed, but probably only if Congress agrees on a long-term budget deficit reduction that stabilizes the debt-to-GDP ratio and only, too, if the savings rate rises durably.

The main psychological factor in the currency market remains the trend for participants to hold euros based on their view that it is impossible to see how European leaders could proceed with the dissolution of the euro. The resulting mess would overwhelm national currencies and central banks. The door would be thrown open to competing monetary policies, competitive devaluations, protectionism and an end to the EU's free trade and capital zone. How would ex-eurozone countries service their debt, all of it euro-denominated? If they defaulted, either by depreciating their new national currencies or inflation, they would cut themselves off from new credit from the international financial system, as happened to Argentina.

A much-discussed “two-speed eurozone” seems technically problematic. How could markets price two different currencies for two economically integrated regions? Would there be two ECBs with two different interest rate structures?

The hope and presumption has to be based on the view that EU leaders have shown that they will move to structural reform under market pressures and that they will continue. In practice, this means that EU leaders, galvanized by “Merkozy,” will ultimately approve effective use of the combined firepower of the ECB and EFSF (with IMF reinforcements) to calm the markets' short-term worries. A key to this development involves finding a formula to minimize the resulting risk of moral hazard, i.e. the fear, well articulated in Germany, that weak eurozone politicians will see salvation now as a pass to future fiscal fecklessness without reckoning. Then there will be a basis for

installing new eurozone governance of the sort that has now been widely aired -- and received implicit democratic backing by the outcome of elections in a half-dozen eurozone countries where the incoming governments have embraced EU-dictated austerity.

Meanwhile the euro is trading at $1.35 in the first days of December. It has been kept there basically by the no-other-outcome-possible thinking which continues to prevail.

A final paradox is that the success of this determination to keep the sky from falling actually carries the day and brings about the changes that European leaders embrace in theory, expectations about the dollar and the euro might be reversed – this time in the euro's favor. Instead of the euro at parity with the dollar in three months, it might be approaching new peaks. A euro again above $1.50? What about a euro at $2?

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