

THE DOLLAR AND THE EURO: THE SMOKE AND MIRRORS OF CURRENCY POLITICS

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(Resumen)

La supuesta invulnerabilidad del dólar – que quizás nunca ha sido mas fuerte que ahora – no se debería dar por seguro. Varios factores, tanto cíclicos como contextuales, han sido responsables por la apreciación del dólar durante los últimos años. Pero cada uno de ellos – de naturaleza temporal y cambiante, en el mejor de los casos – podría empezar a influir a la moneda estadounidense en el sentido contrario. No es una sorpresa, entonces, que se ha convertido en una táctica a corto plazo muy atractiva para la élite política y financiera de los EEUU lo de seguir con su política tradicional de ‘negligencia benigna’, cara al tipo de cambio, especialmente cuando el dólar está muy fuerte y, de hecho, significativamente sobrevalorado. La idea de la ‘invulnerabilidad’ del dólar ya es sinónima con la defensa de la expansión económica más larga de la historia de los EEUU, el cuidado de los niveles altísimas de las Bolsa de Nueva York y del Nasdaq, y el mantenimiento del ‘mito del mercado’ de que las economías europeas estén estranguladas por una sobrerregulación desbordante y padecen de una disfuncionalidad patológica. Al fin y al cabo, el dólar fuerte ha llegado a significar la ‘superioridad indiscutible’ del llamado ‘modelo Norteamericano’ – una versión del capitalismo *laissez-faire* sin apenas ninguna auto-restricción – mientras que el euro representa la posibilidad de sostener alguna versión del estado de bienestar, aunque tendrá que reformarse para sobrevivir frente a las nuevas dinámicas competitivas producidas por el fenómeno de la globalización.

1. THE MYTH OF DOLLAR INVULNERABILITY

The dollar has long been considered the world’s ‘safe-haven’ and ‘vehicle’ currency, dominating international trade and finance since World War II, and lending American policymakers and investors enormous leverage – and therefore privilege and power – over the rest of the world. Yet the perceived invulnerability of the dollar – which has perhaps never been stronger than it is now – should not be taken for granted. Twice it has fallen from its seemingly unconquerable high ground: once in the 1970s and again in the late 1980s.

After two decades as the pillar of the Bretton Woods exchange rate regime, the dollar was driven into steep decline by the loose fiscal policies of the Vietnam years, the accommodating monetary policies of the oil shock recessions, and the double-digit inflation rates that appeared at the end of the decade. In fact, the dollar reached a low of \$1.70 against a basket of currencies now constituting the euro. Since then, on only one other occasion has the

dollar been as vulnerable – that is too say, as overvalued – as it is now (with a current \$/€ exchange of \$0.88). That was in the mid-1980s, when dollar peaked against the ‘synthetic’ euro at \$0.69 in February 1985, before beginning its long slide to the early September 1992 tough of \$1.55.¹

The appreciation of the dollar in the first half of the 1980s – the last time the dollar took on an air of invincible strength – was stimulated by a classic combination of tight monetary and loose fiscal policies. The former created the deep recession of 1980-82 while the latter sparked the sharp recovery which is still remembered as the hallmark of the Reagan years. During Reagan’s first term (1980-84), the US economy began to attract foreign investment on the strength of the high interest rates that such a macroeconomic policy combination expectedly produced. The principal attraction for inward investment, however, quickly became the strong momentum of a rising dollar and the closely related stock market boom, as opposed to simply higher interest rates, which naturally subsided as large quantities of capital poured into US markets, pushing the currency still higher into a bubble-type overshoot. Meanwhile the current account deficit, driven by a vigorously widening trade deficit, continued to grow as the strengthening dollar made imports increasingly cheap. This, in turn, helped keep inflation low and Wall Street frothy, making the US economy doubly attractive to foreign investors.

Attempts to coordinate a gradual decline of the dollar were undertaken half-heartedly, as American officials were loathe break the ‘spell’ of the dollar. Nevertheless, more and more US manufacturers clamored for a cheaper dollar, while European and Japanese monetary diplomats found themselves in a parody reversal of the Americans’ ‘benign neglect’ during the late 1960s Bretton Woods drama. Faith in the dollar continued to sweep everything before it, until finally the Plaza Agreement interventions became too much for the markets to bear.² These coordinated interventions, designed to gradually weaken the dollar, eventually made their

1. These figures come from Paul Chertkow, head of global currency research at Bank of Tokyo-Mitsubishi in London, quoted in the *Financial Times*, May 4, 2000, p. 29, and from Datastream Online Services. This longer view of the dollar-euro exchange rate should place into clearer perspective the sensationalist claim that the euro has reached an ‘all-time low’ every time it dips a bit further below \$0.90/€. See, for example, more recently, “Euro hits record low against dollar” in the FT, Friday September 1, 2000, p. 29. Although such a claim wields significant psychological impact over the fickle currency markets and amid the *sturm und drang* debates among financial ‘analysts’, it is baseless superstition. At least one school of thought would argue that this is the very life source of high finance.

2. The famous meeting at the Plaza Hotel to coordinate plans for exchange rate intervention to correct for the dollar overshoot took place on September 22, 1985, fifteen years to the day before the most recent coordinated intervention aimed at corrected for excessive dollar strength against the euro on September 22, 2000. During the 17 months subsequent to the Plaza agreements, the dollar depreciated some 60%.

imprint upon market consciousness, but then destabilizing speculation set in, the dollar plummeted, and the stock market crashed in October of 1987.³

Strangely enough, the rise and fall of the dollar during the 1980s is not typically referred to as a potential dress rehearsal for the current evolution of the dollar's exchange rate. One reason for the reticence among analysts to see a parallel with the 1980s is the fact that the macroeconomic policy mix initially responsible for the overshooting dollar in the 1980s was the mirror opposite of that which has accompanied the dollar's rise in the late 1990s. While the dollar had the interest rate support of the 'Volcker-Reagan' recipe (tight monetary and loose fiscal policy) in the early 1980s, the dollar has strengthened in the late 1990s against the backdrop of the 'Greenspan-Clinton' formula (looser monetary and tighter fiscal policy)⁴. Strictly speaking, the standard economic interpretation would expect such a policy mix to have a weakening effect, if any, on the dollar, particularly given the increasingly large current account deficit and the growing amount of external liabilities. Many would argue, however, that the fiscal house-cleaning achieved by the Clinton Administration's budget policies has purged the US economy of its former maladies and dispelled any doubts lingering from the late 1980s, and thereby effectively vaccinated the dollar against major imbalances that could precipitate a serious depreciation.

The current account deficit – having surpassed the 1987 level (3.7% of GDP at the time of the 'twin crashes' of dollar and the stock market) – has now crossed over into the danger zone and stands at some 4.1% of GDP. However, the government budget is now in surplus, in stark contrast to the gaping deficit of the mid-1980s, which was well over 3% of the US GDP and partially responsible for the dollar's slide from its 1985 peak. The so-called Lawson doctrine might be invoked to defend the above argument that while the US external deficit has reached all-time highs, it is still sustainable given the fact that it is not being driven by public sector deficit spending.⁵ A deeper appraisal of the 'fundamentals', then, might find that the dollar is not as vulnerable as it was in 1987. This relatively benign state of affairs –

3. See the discussion on the dollar and exchange rate politics during the 1980s in Joan Spero, *The Politics of International Economic Relations*, Routledge Press, 1997. Of course, this would be the last time that US officials would cooperate with the Europeans on exchange market intervention.

4. While the former would restrict money supply while augmenting demand, and thereby placing pressure on the price of money, the latter would augment money supply and restrict its demand, thereby depressing the price of money and discouraging net inward flows of investment on the capital account.

5. The Lawson Doctrine was actually formulated with reference to the US's "twin deficits" during the 1980's dollar overshoot. While the U.S. might currently meet the Lawson Doctrine's criteria as originally proposed (see *The Economist*, December 16, 1995, p. 91), given that it does not have a public sector deficit, it might have troubled meeting some of the addendums that have been added in the wake of the "tequila" and subsequent emerging market crises of the 1990s. Nevertheless, given the dollar safe haven status, it is difficult to apply the amended doctrine with much certainty to the case of the US.

combined with the emerging market crises (which bolstered the dollar's safe haven status), and the TMT stock market boom (which has underpinned Wall Street's most recent bull market) – has created an even more attractive environment for international capital than the sky-high Volcker interest rates and bulging Reagan budget deficits of the 1980s.

Nevertheless, the dollar's very strength could ultimately prove its crucial weakness. David Bloom, strategist at HSBC in London, claims there are signs that the currency markets are finally beginning to pay more attention to deficits – a bad omen for the still 'almighty' dollar. "Although the US deficit is not too alarming in terms of GDP, at about 4%, it is very large in absolute terms and will at some point pull the dollar lower."⁶

The dollar's current vulnerability becomes clear, however, when we analyze the monetary and financial phenomena that have traditionally underpinned dollar strength, and which have worked to neutralize the weakening impact which traditional exchange rate models would expect from the current Greenspan-Clinton policy mix. These other contextual factors have been particularly influential in the dollar's late 1990s appreciation. Significantly, however, each of these factors – which are temporary at best – could suddenly begin to work on the exchange rate in reverse, generating a self-reinforcing appreciation of the Euro.

1.1. International financial crises

Such crises tend to send money flooding into the US seeking shelter from the storm of currency runs elsewhere. This happened during the Third World debt crisis in the early 1980s and again in 1995 (the Mexican peso crisis) and 1997-99 (the emerging markets crisis). Interestingly enough, the dollar temporarily sagged following the Russian crisis of summer-fall 1998, as international capital temporarily perceived the US economy itself as vulnerable to speculative runs, given the heavy exposure of some important US hedge funds and banks in Russia. At the same time, the incipient Euro zone seemed to offer a liquid safe haven alternative to the dollar. Indeed, during the autumn of 1998, the pre-Euro synthetic equivalent appreciated significantly against the dollar (from \$1.10 to over \$1.20).

The healthy US government budget position was nevertheless a key factor in subsequently allaying the fears of investors, (particularly obsessive about budget deficits) of a dollar collapse. When the Federal Reserve aggressively loosened monetary policy (cutting interest rates three times in rapid succession), tight credit conditions – which were threatening to toughen and choke off the expansion – relaxed, investor confidence returned, and the dollar regained its lost ground against the newly-born Euro, explaining much of the single currency's 'decline' during its first year of life. Another crisis, which catches important US banks or hedge funds overexposed, could easily trigger a new dollar slide, particularly if monetary and fiscal policy are loosened significantly in response.⁷

6. Financial Times, Thursday, August 24, 2000, p. 23.

7. Already the markets are beginning to expect a loosening in US fiscal policy as the new administration (whether under Gore or Bush) would likely attempt to 'use' some of the accumulating budget surplus.

1.2. Business cycle divergences

The US economy is traditionally at a later stage in the business cycle than the European economy. This tends to create rather volatile growth and interest rate differentials. When the US economy heads into a downturn, as it did in late 1979 and again in 1989, the dollar displays a conspicuous lack of strength against European currencies (1979-80 and 1989-90), as European economies are still relatively strong. At such times, the US-EU growth rate differential declines because the economies of Europe tend to follow the US in the cycle and move into recession later. When the US recovery comes, however, as it did in 1982-83 and 1993-94, European economies are either still in recession, or are only sluggishly pulling themselves up. The relatively fast growth rates of the US, vis-à-vis Europe make the US economy appear particularly strong, widening the trans-Atlantic growth rate and interest rate differentials attracting investment to the US, and pulling up the dollar. The implication is that the next US economic slowdown and the long-forecast slide in the dollar/euro exchange rate (not to mention the long-feared stock market correction) will be inextricably bound together.⁸

European growth rates have recently begun to catch up with those in the US. Germany's GDP growth rate in 2Q00, for example was an annualised 4.7%, not far behind the US's 5.3% (recently revised upwards to 5.6%), and actually higher if one takes into account slower population growth in Germany and its more conservative techniques for measuring investment in information technology.⁹ Nevertheless, the Euro's recent weakness against the dollar, it has been repeatedly noted, has stubbornly resisted steady improvements in the Euro zone's growth prospects. This has been principally attributed to even better continued growth prospects in the US, in turn reflecting a faster growth rate in productivity as a result of a more profound Internet transformation in the US. However, given Europe's potential to use UMTS mobile technology and leverage upon its higher mobile penetration rates, it could rapidly catch up with the US in terms of Internet's impact on the economy. During this 'catch up' process, Europe is likely to turn recent growth differentials on their heads.

Combined with further evidence of a slowdown in the US (expected to be confirmed with the first release of 3Q00 GDP figures in late October), continued European growth over the next year or two would be enough to push the dollar down and pull the Euro up.

8. While stock markets are particularly jittery during the month of October for superstitious historical reasons, this October – just before the US presidential elections on 7 November – the consensus of informed opinion expects the first release of the 3Q00 GDP growth figure for the US to be substantially below the peak performance in 2Q00 of 5.3%. This would be yet a further sign that the long awaited slowdown in the US economy had finally arrived. Meanwhile, it is still not clear that Europe's economy will close the growth differential gap; much will depend on the current oil price scare and its effect on consumer confidence over the next few months in Europe where the economy is more vulnerable to an oil supply shock than the US.

9. See "Old world, new economy" in *The Economist*, September 1, 2000.

1.3. Structural transformations and general policy shifts

A number of changes have transformed the world's financial markets and given the dollar an advantage – if only temporary – against European currencies. Such changes include: (1) the shift from a 'current account' financial world to a 'capital account' financial world; (2) the displacement of bond markets by stock markets as a central influence on currency movements; (3) the displacement of the DJI by the Nasdaq as the principal 'dollar mover'; and (4) the increased level of private – as opposed to public – indebtedness in the US.

In 1973, when the dollar cut itself free from the gold-based trunk of the Bretton Woods 'variable peg' exchange rate regime, and began to float freely on world currency markets, the world's international transactions still took place predominantly on the current account, and currencies movements, by and large, were still largely linked to trade balances. The freeing of capital movements and the explosion of the bond markets in the 1980s, particularly in the US, gave the capital account increasing relative influence on the balance of payments and, therefore, upon the evolution of a currency's external value.

But the transformation of international finance from a current account-dominated world to a capital-account dominated world is only part of the story. In the 1990s, equity markets began to displace the bond markets as the principal influence on currency values within the increasingly influential capital markets. Likewise, the shift from loose fiscal and tight monetary policies to tight fiscal and loose monetary policies has meant that the bond markets have become relatively dry as the supply of government debt has been curtailed, and money as a result has flooded into equities. With the increasingly open and globalized nature of the capital markets – as more and more countries have liberalized their capital accounts in the 1990s, and as emerging market stock exchanges established themselves as a favored alternative destination for more adventurous money – the dollar became increasingly linked to the relative performance of the Dow Jones.¹⁰

Nevertheless, with the emergence of the Internet, the DJI has parted ways with the TMT-driven Nasdaq, and the latter has now overtaken the former as the markets' central reference. The dollar/euro exchange rate, in turn, has increasingly become a derivative of the relative performance of the Nasdaq against European bourses (which are much heavier in TMT weightings than the DJI). As Michael Lewis, senior economist at Deutsche Bank in London has claimed, "The correlation between the dollar and the Nasdaq has not always been particularly strong; but...the Nasdaq is seen by many as a proxy for risk aversion and demand for the dollar..."¹¹ The TMT boom that has propelled the US equity markets in 1999 and 2000 has preceded and, to a certain extent, led the corresponding tech booms in Europe. As a result, the

10. See the Economist reference ("Test-driving a new model", *The Economist*, March 18, 2000, p. 81) to the study of Cameron Crise, an analyst at Warburg Dillon Read, linking currency exchange rates to equity risk premiums.

11. *Financial Times*, June 1, 2000, p.27.

dollar has strengthened as perceptions still favor the US stock markets over European bourses.¹² Recently, however, European stock markets have begun to outperform, suggesting that the Euro will be stronger over the medium term. % at the underlying level (having risen only two-tenths of a percentage point since the 1.1% level)

None of this should really come as a surprise. Indeed, the current strength of the dollar, while more intense and enduring than most analysts and observers had expected, could easily be transformed into *relative weakness* the moment any of a number of short-term cyclical factors change their tendencies. This would likely come as soon as the trans-Atlantic growth rate differential narrows – as they are soon likely to do – or when a series of US economic data releases surprise the consensus negatively (increasingly likely at this stage of the US longest expansion in history).

Over the medium term, when the cumbersome weight of the U.S. current account deficit should begin to make itself felt, and when the euro various advantages and strengths begin to emerge (eg, when the new euro notes and coins begin circulating, bringing the advantages home to the average EU citizen who travels to her neighboring country, reinforcing a sense of European identity and infusing renewed confidence and enthusiasm in the European project), the last lingering suspicions that the EU's currency experiment might not be permanent will vanish, and with them the alibis of the most radical of the 'Euro bears'. And as the EU continues to introduce further structural reforms in the product and labor markets – which even the Bundesbank has recently acknowledge having been occurring in Europe at a faster rate in recent years), the dollar is bound to weaken against the euro. The very fact that European markets are currently still have room for further reform may provide Europe's economies with more ample scope to grow relatively faster over the medium term than the US economy, simply by catching up – even if reforms do not ultimately make Europe as *laissez*

12: The penultimate slide of the euro's exchange rate (during the week of April 24, 2000) was ironically provoked by negative sentiment arising from many of the die-hard euro bulls as the currency failed to rebound in the wake of the Nasdaq correction in the US. It should obvious, however, that if European bourses are heavily weighted with TMT stocks, they will merely follow the Nasdaq when TMTs experience a correction. It will only be when the US economy (or stock market) as a whole goes through a correction in investor perceptions vis-à-vis their perceptions of European prospects, that the euro will respond by appreciating against the dollar. This naturally will not happen until US economic figures stop surprising the investment community positively and begin to undershoot consensus forecasts (ie, surprise negatively) Most analysts do not expect this until the final quarter of this year. Indeed, a growing consensus of opinion now sees the first significant slowdown signs coming with the end of October release of 3Q00 GDP growth data in the US. The only uncertainty remaining surrounds the future of European growth rates which may have actually peaked in 2Q00. That, of course, remains to be seen.

faire as the US. The process of technological catch-up, in which Europe begins to build its 'new economy', should only contribute to the process of exchange rate realignment.¹³

It is – as with so many other phenomenon forecast on the basis of fundamental analysis – only a matter of time. Once a sea change has occurred in the relative external values of the West's two principal currencies, the chances that more public and private economic protagonists around the world will pay more serious attention to the euro will undoubtedly increase. The oft-mentioned portfolio shift among private investors will have a much greater chance of being unleashed once the euro has confirmed its upward rebound.¹⁴ Many of the world's central banks may also be just waiting for the unexpected euro decline to reverse itself before beginning their 'euro-strengthening' reserve shift out of dollars and into euros.¹⁵ The euro's coming rise is likely quite nigh. There is far more uncertainty with respect to its timing than to its likelihood.

No wonder it has become an appealing policy agenda for the US to continue its long tradition of 'benign neglect' toward the dollar's exchange rate. Stretching out the current period of dollar 'invulnerability' has become synonymous with shepherding the country's longest economic expansion on to even further record lengths, and nursing Wall Street's increasingly

13. The serious prospect of exchange rate intervention by the world's major central banks to strengthen the euro could also end the dollar's current overvaluation. More on this in the following section.

14. See Fred Bergsten, "The Dollar and the Euro," *Foreign Affairs*, New York: July/August 1997, pp.83-95 and "The Coming Rise of the Euro", Speech before the World Economic Forum, January 28, 2000 (<http://www.iie.com/TESTIMONY/davo2000.htm>).

15. See Stephen Roach, economist for Morgan Stanley Dean Witter, "Alan Greenspan, Where Are You?" *Global Economic Forum*, October 14, 1999. (<http://www.msdc.com/gef/>) "Foreign investors have had it with the safe haven play on dollar-denominated assets. I have been overseas in four of the past five weeks – first two weeks in Europe and now two weeks in Asia. What a contrast between the view from afar and that at home. The eyes of US-based investors glaze over when you speak of the dollar and America's record-setting current account deficit. By contrast, foreign investors are all ears. Particularly noteworthy are the responses I have received from those charged with managing foreign exchange reserves. I have had many officials warn me of the coming asset allocation shift out of dollars and into euros. It hasn't happened yet, but they are certainly thinking about it. This was the shift that was supposed to have happened at the time of EMU launch. But the cyclical shortfall in Euroland activity and the related slippage of the euro, put it on hold. With Europe back on the mend and the ECB apparently about to spring into action by initiating its first monetary tightening cycle, that play now appears once again to be under active consideration out here in Asia. With Asian authorities collectively managing close to \$650 billion in currency reserves – Japan, China, Hong Kong, Taiwan, and Singapore combined -- the implications of this asset allocation shift out of dollar-denominated assets should not be taken lightly. These guys are still overweight dollars, and believe me, virtually all are thinking about reducing their exposure to the world's largest international debtor."

vulnerable bull run, and maintaining the myth of pathologically dysfunctional and overregulated European economies. Hence, the 'euro-bashing' fashion – one trader was recently quoted referring to the euro as a 'trash currency' – in the US press.

The dynamic – and therefore US national economic interests – may be changing, however. It appears that the Federal Reserve was finally provoked into cooperating with the ECB and the Bank of Japan in last week's coordination exchange market intervention by the growing list of large US firms announcing warnings of lower than expected earnings as a result of pressures on their margins from a strong dollar squeezing foreign sales. Evidently, the Fed has decided that during the historically jittery month of October (which this year is also the final run-up to the US elections) – with equity markets already skidding sideways at best – there is more risk of a stock market correction being provoked by a slide in corporate earnings than by a depreciation of the dollar (whether managed by coordinated central bank intervention, or sparked by a speculative correction unprovoked by active intervention).

2. THE CONFUSION OVER EURO WEAKNESS

Although the ECB has spent much time and effort attempting to claim that it does not target the exchange rate, it is ironic that it actually began raising interest rates in response to a sliding euro. The irony becomes more perverse when one realizes that the past five rate increases undertaken by the ECB (November, February, March, April and August) have all been followed by further slides in the currency's exchange rate. On the other hand, five of the six "rebounds" the currency has made since July 1999 (July, September/October, January, February/March, May and September) have followed closely upon aggressive comments from EU monetary doyens like Win Duisenberg, Otmar Issing, Christopher Noyer or Ernst Welteke in their varied attempts to talk the currency up. It is as if the markets sometimes listen to the central bankers talking tough, but lose respect for them – and their currency – when they are forced to act on interest rates to defend the exchange rate¹⁶.

Some might take the ECB officials at their word. Interest rate increases, according to ECB spokesmen, have not been specifically aimed at lifting the external value of the currency (which, after all, should matter little to a monetary authority that has expressly chosen a flexible exchange rate regime) but rather at combating the potential inflationary effects of a declining euro. Assuming we are content with the level and intensity of the ECB's concern with inflation (relative to any ex-official concern it might have for growth and unemployment) then such an explanation should suffice.

16. Of course, the most recent September recovery in the Euro's exchange rate is due to more than tough words; the point is that rate hikes have consistently been taken as a sign that the European growth cycle would continue to lag behind that of the US, leaving the closing of the growth differential hostage to the US growth rate. For the first 18 months of the euro's 'life' hawkish words from the European monetary authorities had an effect; from now on words will need to be backed up by ECB intervention that does not put European growth rates at risk.

Strangely enough, however, the ironies continue. During the debate on the infamous Maastricht 'convergence criteria', one of the principal arguments in favor of a 'wide' euro (incorporating many European countries and transforming Europe into a relatively 'large, closed' economy) was that it would both allow for a floating exchange rate and insulate Europe from external influences.¹⁷ The euro zone would be shielded from both external economic shocks (a typical problem of fixed exchange rates) and the destabilizing risks to investors implied by oscillations in the currency's external value (particularly acute under a flexible exchange rate regime when the economy in question is relatively small and open). In this way the single currency might shelter Europe from volatility and uncertainty, making the monetary authority's job in overseeing growth with stable prices, much easier, just as the large, freely-floating dollar has done for the US economy since the early 1970s.

A mere 15% of the Euro zone's GDP is exposed to imports from the dollar zone, and much of this is accounted for by oil imports which as inputs would filter out much of the depreciation effect and prevent it from reaching end prices.¹⁸ As a result, the nearly 15% depreciation of the euro during its first year of life – and the 15% depreciation during 2000 – should mean a surprisingly small contribution to European inflation rates. Indeed, 1999 inflation should have included the effects of the euro's first year depreciation (as will as increasing oil prices), yet it remains at a mere 1.3 in August 1999). Euro depreciation would necessarily have to turn into a true free fall for its inflationary effects to become a serious concern – not the mere rhetorical 'free fall' referred to apocalyptically by financial journalists whenever the euro's slide brings the new currency to yet another technically real, if artificial, 'all-time low'. Indeed, looked at historically, according to Paul Chertkow, head of global currency research at Bank of Tokyo-Mitsubishi in London, the euro has not yet reached its long-term low (exposing the shallowness of all the "all-time historic low" headline analysis which unduly distorts market perceptions toward the euro). The long-term trading range of the synthetic euro is between \$1.70 (breached in December 1979) and \$0.69 (reached February 1985). As recently as September 1992 the euro currencies collectively stood at \$1.55 and it was trading at \$1.40 as recently August 1995, confirming what many would call the inherent volatility of flexible exchange rates.¹⁹

17. This is also why Danish, Swedish and UK entry into the EMU are such important concerns for the ECB and the EU at large. The 'wider' the euro, the less exposed to the external sector will be European growth and price levels. The wider the euro, the less vulnerable – relative to the US economy – will be Europe to external influences and fluctuations in its exchange rate.

18. The average of exports and imports – the standard measure of 'openness' – for the EU-11 as a percent of GDP is some 16%. This means the economy of the Euzo zone is much more invulnerable to external shocks than were its constituent member economies, but it remains somewhat more open – and more vulnerable – than the US (12%) and Japan (11%) See "The International Role of the Euro," speech by Wim Duisenberg, president of the ECB, at the 2000 Spruce Meadows Round Table, Calgary, September 8, 2000.

19. *Financial Times*, May 4, 2000, p. 29. All other exchange rate data is from Datastream Online Services.

Nevertheless, despite rising headline figures, inflationary pressures in Europe remain subdued. The most recent inflationary pressures have come from oil price rises which have once again begun to subside. Although the headline inflation rate in the Euro zone recently topped the 2% threshold – guarded over the medium run by the ECB like a bridge troll – the core rate (excluding energy prices) has held steady throughout the summer at 1.3%. While the core rate – much more important to the ECB as a signal of underlying price pressures – is expected to rise a bit further by the end of the year (perhaps to 1.5%) as higher energy prices feed further into the economy. But assuming oil prices do not continue rising from current levels (US\$30.00/bbl), there is everything reason to believe the statistical ‘base effect’ will bring headline rates of inflation down to below the middle run threshold of 2% next year (and perhaps to a level even below the core rate).²⁰ In any event, it is very difficult to argue that the declining euro, by itself, has generated much inflation at all. Had not the latest oil price increase of the last year coincided with the euro’s depreciation, the issue would not exist.

During its first year of existence the ECB has had the admittedly tricky task of stimulating the sluggish core Euro zone economies – to avoid alienating the European public whose objections could easily push national governments into public rows over Euro policy, thus ‘spooking the markets’ – while maintaining public respect for its currency. This has meant relatively loose monetary conditions (real interest rates under 2% for much of the time, even if they are slightly higher now) while simultaneously attempting build ECB credentials – to satisfy the ubiquitous and all-powerful ‘markets’ – as a credible and reliable monetary authority capable of keeping inflation low and stable. This is not and will not be easy. The markets have known all along about the ECB’s razor’s edge dilemma and, when convenient, have often exploited it with bearish sentiment on the euro.

But the Euro bulls’ bad luck did stop there. Born in the year in which the American economy became literally possessed by the Internet fever, the euro would inevitably suffer from the effect of Europe’s newly respectable growth rates being overshadowed by the even brighter light of the US’s ‘new economy’, Wall Street’s TMT boom, and the long string of ‘positive surprises’ (by their very nature temporary, if surprisingly enduring, phenomena) coming from monthly releases of US economic data. Indeed, the most conventional analysis would not be surprised at all by the euro’s depreciation, and nor would it be overly concerned – at least not until speculative trading would seem to push the euro to within reach of its true ‘all-time low’ of US\$0.69 (February 1985).²¹

The dominant – if suspect – opinion in the markets is that the Euro’s current weakness has been driven not by speculation by rather by long-term capital flows. European firms have

20. Because oil prices began rising most steeply beginning last summer, a mere levelling off a prices would produce smaller and smaller year-on-year percentage increases over time, as the broad range of consumer prices continue to rise from a larger ‘base’.

21. This is indeed where the euro seemed to be heading – reaching a low of US\$0.8440 on Wednesday, September 20 – until the ECB intervened in the exchange markets in a coordinated action along with the Bank of Japan, the US Federal Reserve and a number of other central banks on Friday, September 22, 2000.

gone a buying spree in the US where they perceive returns to be higher over the medium and long term. According to Ben Funnell of Morgan Stanley Dean Witter, in 1999 alone Euro zone companies were net buyers of \$54bn worth of US companies in cash. The buoyancy and optimism of the US economy has only made this trend even stronger, as more \$125bn in long-term capital (FDI) flowed into the US from Europe in net terms from the euro's birth through to April 2000. Nevertheless, the most recent figures show the net FDI inflows into the Euro zone in the first seven months of 2000 were €117.3bn. The markets, however, still seem entrenched in their view that the Euro zone is suffering from a chronic outflow of long-term capital, particularly to the US. The decline the 'basic balance' so often referred to recently by analysts arguing that the middle-term prospects for the Euro are less than rosy stems from the temporary and volatile oil price factor which has squeeze the Euro zone's current surplus and depressed the basic balance despite the notable improvement in long-term capital flows for Europe. But in the end, as is typical, it has been short-term liquid asset purchases, convenient for speculative purposes – despite many recent claims to the contrary – that have been powering the dollar/euro through its current overshoot. According to economists at Bear Stearns in London, in the first two months of this year, the net portfolio outflow from Euroland has zoomed up to €156.2bn, against only €17.5bn in the first two months of 1999. The net portfolio outflow by September had reached well over €200bn. At the margin, as always, the short-term outflows (ie, "hot money" or its liquid asset equivalent in this age of footloose and free capital markets), not long-term oriented FDI, have made the difference in the currency markets.²²

Up until the big March/April TMT correction, many analysts believed that a strong drop in the Nasdaq, relative to European bourses, would push up the Euro. The problem with such a line of analysis, however – and, of course, the Spring 2000 performance of the euro bears this out – is that:

- (1) European stock markets have roughly followed the Nasdaq, both on the way up, and on the way down; and
- (2) If the Nasdaq has done *relatively* worse, the expected relative effect on the euro was nullified by the fact that the euro was already being pushed down by a speculative overshoot when the Nasdaq correction occurred.

Investors pulling money out of the Nasdaq were not going to escape into European equities when they could see that European indices (much more tech heavy than their Dow Jones counterpart, if less than the Nasdaq) were also falling in response. Even if the pan-European indexes were dropping relatively less spectacularly than the Nasdaq, investors still would not

22. Adding to the string of ironies, over 65% of the net issuance of euro-denominated debt in 1999 (a total €105.4bn) was undertaken by non-Euro zone residents (attracted to euro issuances by the rising network economies) who converting these euros back into their home currencies, creating heavy selling pressures on the European currency early on, while the actors purchasing these bonds tended to be Euro zone residents who did not need to buy the currency. This would, of course, however perversely, only add to Euro weakness.

put money there, *particularly* if the euro was depreciating rapidly at the time – as it was. Money temporarily fleeing out of the Nasdaq more likely went, if not into the old economy Dow stocks, then certainly into US paper. As we might expect long bond yields in the US have fallen faster than in Europe, as bond prices have been pushed up. Many euro bulls, having remained overweight in the euro and maintaining the faith that the inevitable Nasdaq correction would provide the spark for their currency, then unwound their positions as they lost the faith and contributed to the speculative overshoot.

Such a convergence of events, colliding with a brand new ECB trying to get on its feet and learn to walk the credibility tightrope, have laid the perfect seedbed for an extended Euro overshoot far below its fundamental values. Indeed, the consensus of opinion at the mid-April meetings of the G-7 and the IMF in Washington was that the euro was undervalued by approximately 20%-30% against the dollar. This diagnosis was reiterated at the latest G-7 meeting on Saturday, September 23, the day following the ECB first coordinated intervention.

That the euro's decline no longer has much to do with fundamentals has become something of a mantra for European policymakers. While traders in the exchange markets have tended to interpret this as a cover for weakness, Europe's policy-makers are nevertheless correct about this. The euro's extended drop below parity with the dollar has been a classic speculative overshoot. We should pay little attention to the self-interested tales from the 'herds' of financial journalists and analysts who try to tell us that euro weakness is due to a lack of 'structural reform' in Europe. Even the Bundesbank, one of the most hawkish European institutions on issues of economic reform – has recently argued that structural reforms have been taking place in Europe at the most intense pace in recent memory. The euro has continued to depreciate simply because investors have seen the euro depreciation – the real factors actually become secondary issues to those who most directly influence the short run exchange rate – and now seem inclined to bet that that slide will continue. On the other hand, the plethora of voices speaking out on the euro's exchange rate, often in a way which could easily be perceived as contradictory or vacillating, has certainly helped fuel the euro's decline.

Such speculative dynamics can be undermined and reversed by one of two factors:

- (1) A change in ECB policy – or a change in the market's perception of ECB policy. A broad floor could be placed under the euro by ECB interventions, stimulating speculation to change its direction to become a 'stabilizing' influence. Much of the aggressive central bank and finance ministry rhetoric in May and June was meant to create the perception that such intervention might easily take place.²³

23. Such 'dirty float' interventions are standard practices in the event of extreme currency movements, whatever the rhetoric of finance ministries or newspapers might have to say about them. The US has used such techniques at least twice in the 1990s to moderate extreme dollar fluctuations against the Japanese yen (once in 1995 and again in 1998). The most recent coordinated intervention of September 2000 is of the same nature. It should be noted that there is often a time lag before the effects on the exchange rate become clearly evident.

- (2) A narrowing in the transatlantic growth rate and interest rate differentials and a corresponding string of 'negatively surprises' from US growth rate figures.²⁴

Until recently, the ECB seemed loathe to let the markets perceive any standard attempt to defend the euro, even if this has become the most accurate way to describe the central bank's actual behavior. After all, four of the last five rate increases in Europe have closely followed significant slides in the euro's exchange rate.²⁵ For supposedly being unconcerned about the external value of the euro, the ECB certainly seems to be overly concerned about just that. Nevertheless, ECB rate increases, far from stemming the euro's slides, have actually exacerbated them, as the markets have tossed aside the traditional interest rate differential as the primary guide to their exchange rate movements and instead concentrated on the momentum of markets and asset prices, thus placing much more emphasis on perceived growth rate differentials and expected exchange rate movements. Only recently, as concerns have arisen as to the sustainability of the European growth cycle, has the ECB, in its opaque way, communicated a change in its strategy, away from interest rate defense of the currency to direct market intervention.

3. CURRENCY POLITICS AND EXCHANGE RATES

But why should it matter that the euro has slumped against the dollar? The weaker Euro has helped stimulate European growth and has not yet proven inflationary, all the press frenzy on euro weakness and the overly conservative rhetoric of central banks, notwithstanding.

The Bundesbank recently weighed into this confusing debate. Their spokesman have attempted to refute the contention – brandished by continental EU politicians like Schröder in public defense of the single currency project – that the weakening euro helps stimulate Euroland exports and job creation, particularly in the 'core economies' like Germany and Italy, more dependent on exports beyond the euro zone. In this Bundesbank version of the argument,

24. This is indeed what appears to be finally happening. The recent OECD report warning of overheating and a resulting hard landing in the US sparked fears that the Fed would necessarily continue to raise rates to avoid such a prospect. (Financial Times, June 5, 2000, p.1). That report however was quickly followed by new 'softer' economic data out of the US which seemed to convince the markets that the Fed's recent rate increases have successfully cooled the economy enough to avoid the need to continue hiking interest rates as aggressively as previously anticipated (FT June 7, 2000, p.35). The market consensus is also now expecting a significantly softer 3Q00 GDP figure from the US on October 27: this would be the most significant sign of the slowdown in the US economy.

25. And the ECB's fifth rate increase – +50bp from 3.75% to 4.25% on June 8, 2000 – was twice as high as the expectations of the market consensus and is widely believed to have been partially aimed at consolidated the euro's late May-early June rally to above \$0.95/€.

Euro zone exports are too small in relation to GDP for a depreciating currency to make a relevant impact on aggregate demand. According to the Schröder version of the argument, however, a weakening euro provides a loosening supplement to conventional monetary policy. Not surprisingly, such insinuations have made the Bundesbank uneasy, pushing it to argue that a weaker euro is indeed an inflationary danger (and by extension essentially agreeing with Schröder but shifting the nature of the controversy to one of relative priorities between growth and stable prices). But the Bundesbank – and everybody else trying to stand on this conceptual fence – cannot have their cake and eat it too. Either the Euroland's exposure to international trade is large enough to significantly effect output and prices, or it is not.

One of the primary arguments in favor of a 'wide' continental currency, it should be recalled, was that it would make a floating exchange rate regime more viable for European economies, as it would reduce the percentage exposure of the domestic price level to exchange rate movements via international trade and investment links. After all, West German mark 'weakness' was even more pronounced in the 1980s when its external exposure was much higher. Germany is thus presumably better off now with the euro and – given sluggish German growth rates and high unemployment in the mid-1990s – particularly if it is weak vis-à-vis the dollar and the yen. Nevertheless, even if euro weakness is considered potentially inflationary, euro depreciation should be welcomed for its stimulating effects until it clearly threatens to become inflationary.

But why not let the euro drop as the markets would have it, overshoot or no? Such a development would continue to stimulate the existing real economy in Europe, improving still further the environment in which 'structural reforms' – about which the financial press will not stop harping, and which certain politicians and corporate leaders (and not necessarily European) silently anticipate with relish – could proceed. Why not accept euro weakness now as the necessary pre-requisite for euro strength in the future? The longer the euro contributes to faster growth in the relatively sluggish Euroland core, the more time politicians have to push through tough-to-swallow structural reforms during relatively good times. When the euro finally rebounds, and perhaps overshoots on the upside, the exchange rate will, if anything, be contributing to tighter monetary conditions on the continent, injecting contractionary pressures into the European economy, and souring the atmosphere for further reform.

Until the September slump below US\$0.90, which threatened to gather speculative momentum and breach the US\$0.80 threshold, euro depreciation presented a problem only in terms of misguided perceptions and misplaced pride, while the real economy in Europe gathered momentum. In the final analysis, the only thing we had to fear from euro weakness was fear itself – meaning a speculative and then panic run on the euro which might provoke arbitrary and unanticipated policy responses. In such a rarified environment of a speculative run, comments like those made by Alfred Broaddus of the Richmond Branch of the US Federal Reserve – to the effect that the current Euro weakness was bringing into question the entire future viability of the single currency – have the power to generate powerful one-way speculative moves, particularly against the backdrop of a market nearly convinced of American benign neglect and of 'No' vote at the Danish Euro referendum.

An overvalued euro, on the other hand, would generate real opposition in Europe as the tough exchange rate begins to throw down the breaks on Europe's long awaited economic

take-off. Whether the real danger presented by euro weakness is inflation or just fear and the unpredictable over-reactions it might provoke, not many in Europe would complain about a euro rebound now, even if ECB intervention were required to unleash it.

Still, there is no clear consensus on whether or not exchange rate intervention would be effective at stemming the tide of a Euro slide, particularly given the market myth that the Euro's most recent slides still reflect the outflow of long-term investment to the economic nirvana of the United States. Nevertheless, coordinated intervention proved to be at least an essential catalyst to exchange rate realignment in the 1980s, the last period of extended upside dollar overshoot. Even the threat of central bank intervention can effect perceptions and turn speculative sentiment in the opposite direction once a currency has remained for an appreciable period time with a significant overshoot. The only real question is whether US Fed and Treasury cooperation would prove essential. This question then quickly boils down into another: Why would the Americans resist?

Until the coordinated intervention in the exchange markets on Friday, September 22, the consensus of opinion did not believe that American monetary authorities would support an intervention in defense of the euro. The argument was that deliberately weakening the dollar would inject extra inflationary pressure into the American economy precisely at the moment that underlying inflation is beginning to rise, placing even yet more pressure on the Fed to continue raising rates. Deliberately undermining dollar strength – now something of a totem of resurgent American national pride – during the home stretch of the presidential election campaign, and pushing the Fed toward an even more aggressive contractionary stance would alienate voters and risk a severe stock market correction, a 'hard landing' and a significant dollar slide before the November elections.²⁶

Such a scenario would obviously not be welcomed by the Democrats (the White House incumbents), but neither would it be celebrated by the Republicans, whose advocacy of free and unfettered capital markets would be somewhat discredited by a crash on Wall Street and a new recession. While the Republicans might be the beneficiaries of such a scenario in the race for the White House, they would likely suffer a setback in the House of Representatives as a result, and perhaps even in the Senate, as the bust would renew pre-election calls for the kind of regulation and oversight that Democrats are always more comfortable in advocating. Treasury Secretary Larry Summers repeated statements during September that the US 'strong dollar policy' remained unchanged helped to convince the markets that the US would not collaborate

26. Some observers view this correction as nearly inevitable. See for example William Greider, "Greenspan and Gravity", *The Nation*. January 24, 2000, and "Shopping Till We Drop", *The Nation*. April 10, 2000. Greider points out in the first article that at the end of 1999 the US financial system was put on Standard & Poor's 'watch list' of twenty countries that are "vulnerable to a credit bust", while in the second piece he states that the country's net debtor position has grown in less than 15 years from being nil to over 20% of the current GDP. "If the music stops and the foreign money rushes home," Greider writes, pointing out the obvious, "Icarus will land with a thud."

with the ECB in an intervention to prop up the Euro and perhaps return the trans-Atlantic exchange to levels closer to its mid-term equilibrium.

Even if a strong dollar does help the Fed inject a bit of short-term contractionary pressures into the American economy (although the strong dollar clearly has not been able to effectively substitute for this year's Fed tightening), the real danger to the stability of US output and prices is not the Euro, but rather the dollar's relationship with the yen. The dollar's fall against the yen has mirrored its appreciation against the euro and has already injected far more inflationary pressures to the US economy than would come from a dollar/euro realignment. Hence, there is no valid economic reason for resisting exchange rate collaboration with the Europeans, particularly if it is combined with coordinated intervention with the Japanese on the yen in the opposite direction, (ie, strengthening the dollar against the yen).

Given the approaching election, and the attitude of American officials toward the strong dollar, the September 22 coordinated intervention took everybody by surprise. Two schools of thought developed to explain the surprise US participation.²⁷ The first explanation focuses on the recent string of profit warnings by large US firms who claim to be suffering from the overly strong dollar. Perhaps the Administration feared the possibility of stock market collapse in the traditionally jittery month of October provoked by a squeeze on corporate profits from the effects of a strong dollar more than it feared a stock market crash provoked by a market-driven correction of the dollar against the Euro. The other school of thought, while not at odds with the first, would claim further that the intentions of the US Treasury department were just that – to set minds to rest by capping the dollar's rise, but not to engineer a depreciation of the dollar. Summers' post-intervention comments claiming that the strong dollar policy remained intact despite the intervention strengthened this point of view. At best the US will cooperate with the Europeans to stem the slide in the Euro, but not to reverse the exchange rate trend. This would only happen after the elections, and the possibilities for such a change in dollar policy would be enhanced by a Gore victory but not necessarily ensured by it.

Still, the November elections provide us with the most obvious short-term explanation for what appear to be a continued policy 'benign neglect' toward the dollar's overshoot. The most likely middle term explanation for American intransigence on currency policy is that the dollar/euro exchange rate, together with all the accompanying commentaries and press debates, has become the convenient battleground for American and European egos and ideologies (however unconscious or infantile). In the end, for the world's media consumers, the strong dollar has come to represent the superiority of the so-called 'American model' – a more unrestrained, footloose version of *laissez faire* capitalism – while the euro represents the possibility of sustaining some kind of welfare state, however much it must be streamlined to successfully withstand the forces of globalization. In other words, the short-run evolution of the dollar/euro exchange rate now functions as the sublimated expression of the survival struggle of a modified version of the 'European model' – which the rest of the world might be interested in

27. The combined Euro purchases by the Fed and the Treasury are now believed to have reached \$1.34billion, over 30% more than analysts had originally estimated.

considering – in the face of the outright hostility of the American financial elite and, one might add, its allies in Europe and around the world.