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CHAPTER 12 Money and Financial Institutions

The Euro: Back From the Depths

Now the question on everyone's lips is: ''How high?''

by David Fairlamb in Frankfurt

The chilly December markets were merciful to at least one person—Wim Duisenberg. As late as October, the European Central Bank chief's days seemed numbered as the euro fell against the U.S. dollar. Then, in late November, the currency began climbing. On Christmas Day, it hit 93 cents in thin Tokyo trading. The level stuck. As of Dec. 28, it was holding around 93.10 cents. That's 13% above its low of 82.25 cents reached on Oct. 26. Merry Christmas, Mr. Duisenberg!

As forex traders drift back to their stations from their holiday revels, the talk is of what happens next. While the speculation all autumn centered on how low the euro would go, now the punters are trying to guess whether the currency really is a comeback kid. So far, the euro looks good. ''There will be ups and downs,'' says Ashraf Laidi, chief currency analyst at MG Financial Group, an online foreign exchange trading service in New York. ''But the euro is now on track for a long-term upswing.''

That doesn't mean a roaring return to the price the euro commanded at its launch two years ago: It will be a long time before traders bid $1.17 for euros. After all, the euro is still the currency for a region that has a lot of economic problems and adjusts far less easily to the vagaries of the business cycle than the U.S. But a series of short- and medium-term factors are converging to give the euro the boost it needs, not just against the greenback but sterling and yen as well.

The heavy pressure on the euro let up on several fronts simultaneously. First, the go-go U.S. economy slowed, making U.S. securities less attractive to Europeans. Data suggest the tide turned in late summer. Net European purchases of U.S. equities were only $3 billion in September, according to the most recent U.S. Treasury data, well below the $10 billion to $12 billion range seen in the first three months of 2000. With European interest rates holding and U.S. rates expected to fall, European bonds look sweeter. Net foreign purchases of euro-zone bonds topped $12 billion in September, while last February, sales exceeded purchases by nearly $3 billion. On the corporate front, European companies have slowed their acquisition binge, so they don't have to swap billions of euros into dollars. Finally, high oil prices—which cut half a point off European growth this summer—are falling. Deutsche Bank figures that each $1-a-barrel drop saves Europe $4 billion.

All this has prompted traders to put their chips on the euro for now. The euro zone grew by an annualized 3.4% between July and September, as U.S. growth slowed to 2.2%. That's the first time the euro zone grew faster than the U.S. since 1991. One of the euro's banner days was Dec. 22, the day after the U.S. cut third-quarter growth estimates from 2.4%.

ALL IN FAVOR? Also, the gloomy economic news out of Japan makes buying the euro and selling the strong yen an attractive strategy that also boosts the euro against the dollar. This play—which weakens the yen, and thus may help Japan export its way out of its woes—may even have quiet support in Washington. ''The market sense is that the Europeans want the euro to rise, the Japanese want the yen to weaken, and the [incoming] Bush Administration isn't opposed,'' says Paul Podolsky, chief currency strategist for Fleet Global Markets.

Don't get the idea, though, that forex traders think Europe is the next wonder economy. ''Europeans have been celebrating vindication that the euro is a great currency, but I think that this is a bet on the market's part about the intentions of Frankfurt, Tokyo, and Washington,'' says Podolsky. A hard landing in the U.S. could hurt Europe as well, he says. Though exports to the U.S. account for 3% of euro-zone GDP, European companies have invested hundreds of billions in the U.S.: German companies alone have 800,000 employees there.

That roundly exposes Europe Inc. to a weakening U.S. economy. According to Morgan Stanley Dean Witter & Co., income from U.S. units of European companies dropped 20% in the third quarter from the second. That could hurt the companies' ability to invest in Europe itself, slowing European growth and dragging down the euro. The euro-zone economy has already had some rough sailing. Growth peaked six months ago at a year-on-year rate of 3.7%. Industrial production in the 11-nation bloc fell 0.1% in October.

Traders are betting, though, that these problems will take a while to catch up with the euro. Other favorable factors may come into play. The price of North Sea Brent crude oil, the European benchmark grade, is now under $23, down from $36 at its Oct. 12 peak. That should boost growth in the second half of 2001, according to Deutsche Bank economists. There's also the stimulus from a total of $50 billion in tax cuts passed in nine euro-zone countries for 2001—the equivalent of 0.6% to 0.8% of GDP.

Euro-zone corporate execs are also doing their bit. They plan to increase spending on facilities and equipment by 7% in 2001, just marginally less than the 8% in 2000. ''Europe is at the beginning of an economic recovery,'' says Deutsche Bundesbank chief Ernst Welteke, ''whereas America is at the end of its cycle.''

European portfolio investors could also give the euro a boost by repatriating some of the $70 billion they poured into U.S. equities in the first nine months of 2000. On the bond side, euro-zone governments intend to issue up to $120 billion in extra paper in 2001. Faced with a 2.9% inflation rate, central bank watchers say the ECB may raise its benchmark rate from the current 4.75% level to 5.25% over the next six months. That would raise the yields on euro-denominated debt, appealing to U.S. and European investors looking for a conservative haven in the wake of the Nasdaq's plunge.

Welteke claims the euro was undervalued by as much as 30% at its nadir and says the currency should strengthen. He feels obliged to say that, of course. But for the first time in two years, others are putting money on it. Currency futures prices suggest the euro will reach parity with the dollar by mid-2001. Sweden's National Debt Office plans to pre-pay euro-denominated debt before the euro gets much stronger.

Currency trading is traditionally thin during the end-of-year holidays. So it's dangerous to overplay what has happened over the past few weeks. The euro also faces a tough test after initial figures for fourth-quarter U.S. economic growth come out on Jan. 31. If—as many economists expect—they're better than the third-quarter figures, the euro may be in for another round of selling. But the bet is that the fundamental euro story will remain the same for the next few months. It may be a balmy winter for Mr. Duisenberg.

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