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Is the Euro the Victim of Its Own Success in the Capital Markets?

by

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The fall of the euro from $1.19 at its inception on January 1, 1999 to a recent low of $.85 has surprised everybody. It has been a pleasant surprise for European exporters, such as Airbus, that compete head-to-head with their American counterparts such as Boeing. But it has been a most unpleasant surprise for European consumers of dollar-invoiced primary products. Because of the new currency's depreciation, the euro prices of oil, and refined products, have risen more than their dollar prices in America. This inflation worry prompted Thursday's intervention by the European Central Bank (ECB) to prop up the euro.

Most surprised of all are exchange rate forecasters who thought that the advent of the euro would, at least partially, undermine the dollar's monopoly as the world's premier reserve currency. They foresaw a significant sell-off of dollar assets in favor of euro assets in the foreign exchange reserves of central banks and official agencies around the world—as well as in private portfolios. This diversification out of dollars assets would then have strengthened the euro and weakened the dollar. However, with the benefit of hindsight, the forecasters should have also considered the liability (borrowing) side of international balance sheets.

The euro has unified and expanded capital markets *within* continental Europe at an astonishingly rapid rate. Before the euro's advent, the Deutsche mark was the central safe-haven currency within Europe; only Germany could support substantial long-term bond and mortgage (pfandbriefe) markets. Countries on the German periphery had weaker currencies with high risk premia in their interest rates so that domestic finance was short-term and largely bank-based. However, with the replacement of the lira, peseta, escudo, franc, and so on, corporations—Italian, Spanish, Portuguese, French, and others—could finance themselves by issuing long-term bonds denominated in euros at the same low interest rates paid by German corporations. Risk premia were largely eliminated. From 1999 until today, new euro-denominated bond issues by private corporations have been more than four times those issued before 1999 in the old currencies.

Obviously, the demand for euro-denominated bonds must have expanded to accommodate this increased supply. Before 1999, finance was narrowly national. By law or prudence, Italian insurance companies, pension funds, banks and other financial institutions with liabilities denominated in lira, would buy assets mainly denominated in

lira—Spanish financial institutions would buy mainly peseta assets, German buy mainly D-mark assets, and so on throughout Europe.

With the elimination of multiple currencies, each country's financial institutions could diversify by purchasing euro-denominated claims on other countries. Italian insurance companies could buy claims on German assets, German on Italian, and so on. This sweeping portfolio diversification created a huge new euro-denominated bond market with lower interest rates and a marked lengthening of the term structure of corporate finance within Europe. Worldwide, new issues of euro-denominated bonds are now on a par with new issues of dollar-denominated bonds—if only because Europe has a large current-account surplus and, collectively, is a huge creditor to the rest of the world. (In contrast, America's status as the world's champion debtor, with ever-rising current account deficits, remains unchallenged.)

But governments and corporations outside Euroland have also taken advantage of the improved state of the European capital markets. Foreigner borrowers, including developing countries and the United States itself, have found a ready market for euro-denominated bonds at a percentage point or less than for their traditional dollar-based financing. And the main buyers have been financial institutions within Europe. (In contrast, buyers of dollar-denominated debt are often outside of the United States.) It is this unanticipated surge in capital outflows from Europe after January 1999 that has led to the euro's "surprising" weakness.

So we have the paradox: a great financial improvement in Europe results in a weak currency. From this angle, there is no need to despair over the euro's future. The completion of the intra-European bond market has led to a massive, but one-time, reshuffling of international bond portfolios that took the foreign exchange market and the ECB by surprise.

However, to restore market confidence and undermine "momentum" speculators in the foreign exchanges, the ECB and the U.S. Federal Reserve should intervene jointly to nudge the euro back up to a level that better balances European industrial competitiveness with that of the United States and reduces inflationary pressure in Europe. Since the Plaza Hotel Agreement of 1985 to reduce an overly strong dollar in the foreign exchanges, joint intervention by the major central banks to correct an obviously misvalued exchange rate has been remarkably effective—whereas unilateral intervention by one central bank often washes out. Joint intervention signals to the market that the principal governments are prepared to make future policy changes *if necessary* to sustain the new direction for the exchange rate. But such policy changes have seldom proved necessary in practice.