Dollar strengthens while euro weakness prevails

Federal Reserve moves point to a stronger dollar later this year. But the ECB needs to change tactics if the euro is to benefit, says Neil MacKinnon of Merrill Lynch.

The first half of this year in the financial markets has been dominated by the aggressive (and unprecedented) interest rate cuts by the Federal Reserve. US interest rates have fallen 250bp (basis points) to 4.00% in response to a sharp slowdown in the US. In the run-up to the recession during the 1990-91 period, the Federal Reserve was far more cautious in cutting rates and, while the actual recession was relatively mild and brief, the five-year period either side of the recession was characterised by comparatively sluggish growth. This time it seems Alan Greenspan did not want to be criticised for undue caution.

Greenspan to the rescue

Is Greenspan targeting the US stockmarket? Possibly. The Fed raised interest rates last year partly on the basis that rising share prices inflated financial wealth and threatened economic overheating and the risk of an upturn in inflation. The spectacular collapse in dotcom stocks early last year put this chain of logic into reverse.

Now the collapse of share prices generated negative wealth effects which did contribute to a sharp fall in consumer confidence and a sharp retrenchment in the US corporate sector.

However, Greenspan came to the rescue as soon as a stockmarket collapse threatened to produce a 'hard landing' for the US economy.

On top of all this, oil prices have remained high and the outlook for the rest of the year looks like ensuring at least an average oil price of $25. The US consistently proves able to absorb a variety of economic and financial shocks, especially as the Fed has proved itself skilful in judging its interest rate policy to match the demands of the US business cycle.

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The Fed can cut interest rates again, but the low point in the US interest rate cycle looks as though it will be established in the summer. Remember that tax cuts will soon be kicking in ($40bn in Q3 alone).

This combination of a looser monetary and fiscal policy should ensure that the US economy starts to recover later this year for a return back to trend rates of growth at about 3.5%. Perhaps the Fed might start thinking about raising interest rates next year if the stockmarket breaks previous highs. Not surprisingly, global investors retain their enthusiasm for holding US financial assets, and the resultant capital inflows are likely to underpin the resilience of the dollar on the foreign exchanges.

Neil MacKinnon

The same cannot be said of the euro. Sure, the ECB is different from the Fed in that its mandate is exclusively price stability. But in the real world, no central bank can afford to ignore what is going on in the real economy. This is why euroland is experiencing capital outflows and why the euro has proved such a disappointment. As yet, it is too early to say that the euro has made a low against the dollar for the year.

UK dilemma

Further out, it is difficult to believe that the euro can sustain much upside above 0.90-95 against the dollar. As far as the UK is concerned, an early announcement of a EMU referendum would undoubtedly generate 'knee-jerk' selling of sterling, as well as creating expectations of interest rate convergence between the UK and euroland. However, it is debateable whether the UK government actually favours a weak pound or that it would want to be participating in monetary union with a perceived weak currency.

Likewise, the UK's EU partners would not want to see it 'locking' a super-competitive pound into the EMU system. Invariably, some sort of compromise will be reached, but it would be ironic if the eventual agreed rate was little different from the DEM2.95 rate which ultimately ended in the UK's departure from the ERM. ■

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