You have to speculate to accumulate

Roger Bootle predicts better times for the ailing euro and says the markets should put their short-sighted and fickle ways behind them.

Why is the euro so weak? There are almost as many possible explanations as there are economists – may be more. Essentially, they all fall into one of two camps – those who attempt to explain why the currency is rationally valued at the current level, and those who adduce some powerful structural factor that explains why the euro is irrationally under-valued by the market.

In the first camp comes the argument that the market has no faith in the ECB's ability to control inflation in the medium-term and, whereas the euro was originally sold to the European people as a pseudo-deutschmark, the markets have rumbled its true identity – it is a pseudo-lira. Umpteen variants of this argument exist, including the belief that the monetary union will break up or that disagreements at the ECB will render it feeble, or that it will increasingly come under political influence. The trouble with this argument, however, is that it is openly contradicted by the valuations in the bond market, where investors are happy to lend to euro-land governments, including the Italian one, at rates close to 5.5%.

Structural explanation

Then there's the argument that euro-land is a slow growth area that offers poor returns on capital. But the problem here is that, although growth has been weak, it has picked up substantially, and it is not too fanciful to imagine euro-land overtaking US growth performance before too long. And, from where we are now, surely it is Europe, not the US, that offers the greatest potential for re-structuring and dynamic growth over the medium-term. In any case, the performance of European equity markets does not support the idea that profit prospects in euro-land are so poor. Okay, so there has been a substantial net outflow of direct investment, but that may be not so much a reflection of European growth prospects as portfolio considerations.

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The best structural explanation runs as follows. Before the advent of the euro, businesses, investors and ordinary individuals felt they had to keep pools of liquidity in the different currencies, which were subsequently absorbed into the euro. Once the deed was done, liquidity in these various currencies was now serving the same purpose. The result is that the formation of the euro has caused a once and for all reduction in the demand for money balances in euros which, stretched out over time, provides a flood of euro sales onto the market that will only cease when businesses and individuals have adjusted their holdings to the lower levels that are now appropriate. At the very least, this explanation is consistent with the behaviour of all the big markets – that is to say, a weak currency but strong bond and equity markets.

Roger Bootle

Silver lining

But this, similar to all the other possible structural explanations, still has to contend with the fact that, as a short-run phenomenon, such sales of euros should have been met by speculators willing to purchase euros in the confident expectation that the currency would rise. That this did not happen may tell us more about the exchange markets than it does about the euro – that they are short-sighted and fickle, and their behaviour is dominated by bandwagon effects, as summed up in the crass market expression, 'the trend is your friend'.

But there is a silver lining. If that is a fair description of the currency markets then I predict that the euro could recover as sharply as it fell. Before long, there may be articles in this publication bewailing the strength of the euro, seeking explanations and asking what can be done to bring it lower. Just look at the history of the dollar, yen and pound over the years. Exchange rates readily make fools of us all. ■

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