

Euro resumes its downward slide

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Less than a month after intervention by the central banks of the Group of Seven (G-7) nations, the value of the euro has again fallen to near-record lows against the US dollar. The immediate impetus for the plunge, which sent the euro to below 85 cents after rising to 89 cents following the G-7 intervention, was provided by remarks made by European Central Bank head Wim Duisenberg in an interview with the *Times* on Monday.

In a series of unprecedented public comments on the conduct of central bank policy, Duisenberg appeared to rule out further intervention.

Asked if it would make sense for intervention to prop up the euro in the event of a war in the Middle East, he replied: "I wouldn't think so." Further pressure to sell was provided by his comment that the September intervention had been influenced by the US presidential elections.

"We of course took into account that the preparedness to come to such dramatic action for the Americans might be more difficult the closer it was to the elections," he said. Duisenberg also revealed that he had failed to persuade US Treasury Secretary Lawrence Summers to be more supportive of the euro, confirming widely-held suspicions that the US had only half-heartedly agreed to last month's move.

In the aftermath of the latest euro plunge, Duisenberg might well be pondering the World War II saying "loose lips cost lives", for his comments appear to have all but nullified the impact of central bank attempts to prop up the European currency.

While few public comments have been issued, there are signs that behind closed doors European bankers are fuming over the ECB president's remarks. In a thinly-veiled criticism of Duisenberg, the president of the German Bundesbank Ernst Welteke said: "Interventions ... are only effective when one doesn't talk about them."

Others have not been as restrained. Jim O'Neill, the

head of currency research at Goldman Sachs, told the *Financial Times* that speculative traders who had bought the euro after the intervention had now "thrown in the towel". "Mr. Duisenberg has broken the cardinal rule of foreign exchange intervention: never discuss your strategy in public. His remarks are stunningly incompetent."

London-based Bank of America economist Jeremy Hawkins said Duisenberg's comments "raises once again the question of whether the ECB knows how to handle the financial markets."

However, setting aside the Duisenberg gaffe, it was clear that the G-7 intervention was only going to have a limited impact—the main reason being that the fall in the European currency was not primarily the result of currency speculation but was caused by the massive outflows of capital, running at up to \$3 billion per week from Europe to the US.

While the further weakness of the euro is in line with the stated US preference for a "strong dollar", the latest round of currency turmoil is creating problems not only for European policy makers but their counterparts on the other side of the Atlantic as well.

For Europe, the falling currency will generate further inflationary pressures. Last month the annual rate of inflation in the 11 countries which have adopted the euro rose to a six-year high of 2.8 percent, compared to 2.3 percent for August, well above the ECB target of 2 percent.

The conventional response both to rising inflation and the falling currency would be to again lift interest rates. But this may have perverse effects. Inasmuch as increasing interest rates will bring a slowdown in the European economies, capital will tend to flow out to the US seeking better profit opportunities, thereby depressing the value of the euro still further.

But the US also faces acute policy dilemmas. The US dollar has been rising in currency markets despite the

fact that the current account balance of payments deficit has been running at a record level of more than \$400 billion annually and is expected to hit \$500 billion by the end of the year.

The US has been able to cover this payments gap through the inflow of foreign capital attracted by the higher rates of return both for investment and on the stock market. This inflow has had the effect of pushing up the dollar even further.

But the higher dollar is having an impact on company profits. On the one hand it subjects US firms to greater price competition in the domestic market, while on the other it decreases the dollar value of profits made by US firms manufacturing and selling in foreign markets.

Some of the biggest US corporations make a considerable portion, if not the majority of their sales, in foreign markets, above all in Europe. For companies such as Colgate-Palmolive, Coca-Cola, Dow Chemical, Gillette, IBM and Motorola, foreign sales form well over 50 percent of their total revenue.

The impact of the falling euro on sales returns is illustrated by the latest results for IBM. While the company reported a third-quarter income of \$2 billion, compared with \$1.70 billion a year ago, the sales figure of \$21.8 billion represented an increase of only 3 percent. However, without the effect of the falling euro sales would have increased by 6 percent.

The increasing number of companies reporting lower sales and profit expectations has increased the downward pressure on share values on Wall Street. The Dow Jones Index is down by more than 12 percent since the start of the year and may soon fall below the 10,000 mark. The Nasdaq index, which provides a measure of technology-based stocks, has fallen by 25 percent since the beginning of September and is down 39 percent from its peak in early March.

The fear in banking and financial circles, though rarely commented upon publicly, is that a rapid fall on Wall Street could precipitate a recession and a fall in the value of the dollar as capital moves out of the US. This would present financial authorities with something of a “nightmare scenario”.

On the one hand, in order to halt capital outflow and maintain the dollar's value they would need to lift interest rates. But such a response could bring a slowdown or even a recession in the US economy, leading to a further capital outflow and adding to the

downward pressure on the dollar.

At the same time there are signs of further global financial problems. Asian stock markets have been falling consistently over the past few months with Tokyo down by 26 percent and Taiwan by 42 percent since their peaks earlier this year. In Japan, the world's second biggest economy, bankruptcies are running at near-record levels amid concerns that the economy could slide back into recession. And while the euro continues to slide, both the Australian and New Zealand dollars are hitting new lows against the US currency on an almost daily basis.

While the official predictions are still that the US economy will make a so-called “soft landing”—a slowdown in the growth rate without a recession—there are concerns that the decline could be steeper than anticipated.

Morgan Stanley chief economist Stephen Roach commented recently that before the latest increase in oil prices he put the chances of a global recession at about one in ten. But today those odds have shortened to about one in three.



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