European Central Bank intervention does little to boost euro

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7 November 2000

The European Central Bank carried out a surprise intervention into foreign currency markets last Friday in order to try to boost the value of the euro. But the move, which involved the expenditure of around $1 billion, has done little to convince markets that the fortunes of the currency have turned around. In fact, it may well be that the only result of the intervention will be to further expose the inability of the ECB to lift the currency.

In the words of last Friday's *Financial Times* editorial, the ECB intervention had the “unfortunate impression of a doctor administering tonic to an invalid. The patient showed brief signs of recovery but soon relapsed to his formerly poorly state.”

In a statement on the intervention, the ECB said it was “concerned about the national and worldwide effects of the euro's exchange rate, including its consequences for price stability.” The weakness of the euro has aggravated inflation by increasing the price of imports into the 11-member currency zone.

Running at 2.8 percent, inflation is already above the ECB's upper limit target of 2 percent, with most of the pressure coming from oil prices which have increased three-fold in the past two years. In Germany, the biggest European economy, import prices have risen by 13 percent in the past year and financial authorities have been pressing for action to try to lift the euro's value.

The ECB intervention was the second in the space of six weeks. On September 22 central banks from the Group of Seven nations took action to boost the euro, lifting it to almost 90 cents against the US dollar. But since then the currency has been undergoing a steady decline, reaching its all-time low of just over 82.3 cents on October 26, representing a 30 percent decline since its launch at the beginning of 1999.

While there has been an upward movement of 4 percent in the value of the euro since then, no one is predicting that the rise will be permanent.

One of the reasons last Friday's intervention had relatively little impact was because the central banks of Britain, Japan, the US and Canada did not take part this time. The US had only been a reluctant participant in the first intervention with the US Treasury Secretary Lawrence Summers making it clear the administration favours a “strong dollar”. US financial authorities are loath to intervene too strongly as they are haunted by the fear that at some point investors are going to take fright over the widening US balance of payments deficit and shift their funds elsewhere, possibly triggering a recession.

In the words of Guillaume Sciard, a fund manager with Barclays Asset Management in Paris, cited in the *Washington Post*, the United States “is being forced to play a very risky game. They have to do everything possible to keep the dollar strong because that is absolutely vital for them in order to keep money coming in that is used to finance the balance of payments deficit.”

In a statement on Friday's ECB intervention, Summers reaffirmed the commitment to a strong dollar but indicated the US was concerned about the impact of a weak euro on the world economy.

“We share the concern expressed by the European Central Bank in the context of its action ... in the exchange markets about the implication of a broad movements in the euro for the world economy,” he said.

One of the reasons for the slight upward movement of the euro since its all-time low 10 days ago appears to have been the release of figures showing that US growth had slowed to an annual rate of 2.7 percent.

According to some interpretations, the European growth rate is now faster than in the US.

This at least appears to be the view of Germany's finance minister, Hans Eichel. “Now that the European economy is growing faster than that of the US,” he said, “ the markets should recognise that the euro/dollar rate is no longer justified.”

Most commentators and analysts have dismissed this view, pointing out that increasingly exchange rates are not being determined by relative growth rates or even trade balances but by capital movements. Accordingly, the chief factor in depressing the value of the euro has been the capital outflow from Europe into the US seeking higher rates of return.

Figures compiled by Lehman Brothers, cited in the *Financial Times* last Friday, tend to sustain this view. They show that while the US accounts for about 30 percent of total world output, its receives around two-thirds of all the investment funds leaving capital exporting countries.

According to figures issued by the ECB in the first eight months of this year, the combined net outflows of direct and portfolio investment from the euro-zone was E56.8 billion. The outflow of foreign investment from Europe has risen from E44 billion in 1997 to E120 billion last year.

In its editorial the *Financial Times* pointed out that the underlying reason for the weakness of the euro might lie not so much in the lack of investment inflows into Europe but rather a surge in outflows and that “ironically, this has come about as a direct result of the introduction of the single currency.”

The merging of 11 individual currencies into one has transformed the euro-zone's capital markets. With the elimination of currency risk, investment no longer needs to be organised within national boundaries, leading to increased efficiency and a reduction in the cost of capital.

The issuance of corporate bonds, it pointed out, has risen to about 10 times the level before the single currency, helping to fuel a wave of mergers and acquisitions. At first mergers were undertaken by companies within national borders to strengthen their position but they were now reaching out on a global scale, resulting in huge outflow to the US, which remains the most favoured investment destination.

Spokesmen for the international financial markets, such as former US Treasury Secretary Robert Rubin, now a top executive at Citigroup, have insisted that the outflow will only be reversed when the European economy is “restructured” to sweep away government regulations, reduce corporate taxes and lower the cost of sackings and “downsizing”.