1 Euro = 1.325 U.S. Dollars: The Surprising Stability of the Euro in a Period of Financial Turbulence

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Since the first G-20 meeting in Washington in November 2008, financial turbulence has agitated the world economy and has been the epicenter of the leaders' debates and actions. One surprising aspect of this turbulent period is the stability of the foreign exchange market. As compared with other dramatic evolutions, this proved a welcome source of relief. Mentioning that particular point with any official provokes a sigh: "at least we don't have a currency crisis adding turmoil to the whole set of difficulties for markets, banks and governments!"

But the stability of the euro-dollar exchange rate is like the dog that did not bark. Given all the dire predictions concerning the eurozone, the stability of the euro is a surprising, unlikely, even discordant fact and, as such, it has not attracted sufficient attention. It cannot be convincingly understood if looking only to European affairs; the exchange rate says something about both currencies; in a globalized world, the fate of any currency is the result of global interdependencies. This paper starts from the observation that the euro-dollar exchange rate offers a significant clue about the state of international monetary affairs which has been carelessly neglected and which deserves a more explicit analysis. Could this missing piece become a major determinant of things to come?

Announcing the Death of the Euro Was Premature

For two years now, we have been living with the threat of a collapse of the European currency. How many times have we heard or read definitive judgments like this one: "I was giving 10 years to the euro and I was the most optimistic one in the room." Such comments were supposed to reflect widely spread views in the market. Given such continuously dire predictions, one would have expected to witness a dramatic weakening of the euro.

Looking back, it is easy to remember what a "weak euro" is. Shortly after its introduction in 1999 at a rate of €1 euro for $1.19 U.S. dollar, the European currency entered in a downward trend that lasted two years. In the summer of 2001, its value had been reduced to a record low of 86 U.S. cents. This proved to be a road to hell for a powerless Eurogroup, which month-to-month only received bad news for the euro but had to pathetically reassert its confidence that "a strong euro was in the best interest of the Eurozone".

By comparison, the current sovereign debt crisis in Europe has the appearance of an even more disastrous process. The intractability of many Southern European deficits, the unending conflict between debtors and creditors, and the vicious link between banks and sovereigns were a sure recipe for a slow, messy and inconclusive decision-making process. There were ample reasons to express skepticism, contempt and finally distrust. Following this course of events, a flow of reports and op-eds convincingly detailed the troubles of the sovereigns and the wrongdoings and ineffectiveness of the authorities. Many of these contributions usefully introduced in the debates new ideas, which have been or could possibly be part of the solution. But others, occasionally the most vocal ones, dramatically emphasized quasi-apocalyptic conclusions: "Is this really the end?" asked the cover of *The Economist* in November 2011.

The repeated announcement of a pending collapse of the euro should have had devastating consequences: facing the imminent and chaotic return to the drachma, to the peseta, to the lira, etc, what should have been more rational and more urgent for a global investor than to disengage from a currency without a future? Shouldn't the euro have fallen below its previous low? Remember the size of the forex market at $4 trillion a day; investors have had ample time and opportunity to reorganize their portfolios. However, the market reality proved different. Market reactions have surprisingly been the opposite of the ones observed 10 years ago. This time around, the euro-dollar exchange rate has imperturbably fluctuated between $1.25 and $1.40, with the euro standing in average 12 percent above its purchasing power parity. Those who bet against this stability made losing bets: 2011 proved a bad year for hedge funds working the currencies. "Striking" is thus a weak qualification of the astounding stability of the euro in this context.

A Tale of Two Global Currencies

Why did the euro fluctuate in such a narrow band? This question has one and only one disarmingly simple answer: despite so many pronouncements, the euro remained for most global investors attractive. Despite the European sovereign debt crisis, there was simply no crisis of the euro. The euro remained widely used for trade, it remained widely used as an investment vehicle, it remained widely used as an official forex reserve instrument. These are facts, nothing here is judgmental. And what is striking is that the sovereign debt crisis did not change anything in this matter.

We consequently have two conflicting stories. The seductive comparison with the Titanic until now proves inconsistent with the facts: the attractiveness of the euro has not sunk. We clearly need an alternative narrative and properly understanding the stability of the euro in the forex markets requires a more systemic view of the issues at stake. This is a preamble to any judgment about the future both of the Eurozone and international monetary affairs. Attention has been too narrowly focused on the interaction, as important as it is for endangered debtors and anxious creditors, between the European authorities and the European debt markets. The spotlights illuminating the Eurozone summits or the central bank's procrastinations only let in the dark parts of the scene. The euro is the currency shared by the Germans, the Greeks and a few others, with all the family-style troubles we have witnessed in the open. However, the euro is more than that: it was and it remains a global currency.

Soon after its creation, the euro quickly became an international currency. The extent and the logic of this statute have been well documented and properly assessed. The euro never was a competitor to the dollar and this was neither its purpose nor the result of its short successful debut. But it eventually became a junior alternative to the dollar in the international monetary realm. The important point here is that such a recent statute could and arguably should have been severely damaged by the sovereign debt crisis. The above mentioned negative scenario describing the euro as an artificial and unsustainable regional currency implies that, after 2010, the euro experience had failed and that there was nothing in the world economy reasonably qualifying as a "junior alternative" to the dollar. This is precisely what the reality of the markets disproves. "Monopoly No More" is the title of a chapter in Barry Eichengreen's book on *The Exorbitant Privilege*, a title that was accurate and proves premonitory: the sovereign debt crisis in the Eurozone created the conditions for a return to monopoly; that didn't happen.

The Dollar under Scrutiny

The stability of the euro as a testament to the unimpaired attractiveness of the European currency is nonetheless hard to believe. Due to the many weaknesses of the Eurozone, both in terms of its economic dynamism and political governance, this cannot be convincingly attributed only to its present substantial strengths. But the point is that "attractiveness" is by comparison only. The euro sinking in the previous decade to 86 U.S. cents

did not express a decidedly negative perception of the European currency (a perception which by the way reversed as early as 2001) but rather the tail of a period of irrational exuberance greatly overestimating the promises of the "new economy" in America. An exchange rate is always the result of a dual judgment; it ponders both sides of the equation. Note that nothing in this analysis is related to the level of the exchange rate. It happens that, at an exchange rate of 1.325 dollars to the euro, the European currency is slightly overvalued. But what we described as a clue in the introduction is that the changing perception of the respective attractiveness of the two currencies has followed the same pattern since the summer of 2007.

That the stability of the exchange rate between the euro and the dollar reflects a balanced judgment on the attractiveness of both currencies could be discounted as trivial. But, given what we know about the euro, this finding speaks volumes about the dollar. With all the benefits of its reserve currency statute, the dollar has the dubious distinction of having done as well or more crudely as badly as the euro. Limiting our investigation to the impact of recent financial turbulences, this means that "global investors" in aggregate proved as anxious about the unsustainable evolution of U.S. debt as they were about the unmanageable debts in Europe. Since the crisis of the Eurozone has correctly been described as a political as well as a financial crisis, it can be concluded that a stable exchange rate finally reveals as severe a judgment about the Washington decision-making process as it does about the Brussels decision-making process.

Turning to Washington to understand the fate of the euro, it is interesting to briefly focus on the downgrading of U.S. debt by Standard and Poor's in the summer of 2011. The decision was not followed by any change in the financing conditions of the U.S. Treasury, interest rates even modestly declined in the following weeks. The loss of the AAA credit rating consequently turned out to be a non-event and the U.S. dollar continued to be as attractive as it always has been. Another interpretation, more in line with the present analysis, is that the downgrading was already priced. This was noticeably the case for a Chinese rating agency, Dagong, which had attributed an "A+ with negative watch" to the U.S. debt as early as November 2010. It is tempting to dismiss this reference since this rating agency is a young player, equipped with a weak methodology and was possibly influenced by political considerations. The problem is that these data, with all their limitations, are part of the information system of the world's biggest investor in dollar-denominated assets. Experts can qualify such a quotation as arbitrary, but it nevertheless seems to be in line with what we anecdotally know about the Chinese sentiments regarding the financial situation of the U.S. government.

For years now, the Chinese authorities have expressed their preoccupation with the lax design of American monetary and tax policies. They have been reported as having expressed their dissatisfaction in a series of public and private comments. The one, which attracted the most attention, happened in March 2009 when the governor of the Chinese central bank called for a revitalization of the Special Drawing Rights, which is considered as an international reserve currency safer than the dollar. The proposal never got traction but the dissatisfaction with the U.S. dollar only increased. The year 2011 eventually amplified the fears about the way Washington was addressing its financial troubles. In the spring, the inconclusiveness of the debate on the national budget pushed the Obama administration to prepare for an interruption of its business. This "countdown to shutdown" was considered as traditional theater by most pundits familiar with American politics. But Beijing's reaction to the budget battles in Washington was that it didn't make sense for the U.S., the most powerful on country in the world, to be marching endogenously toward "shutdown". A few months later, the debt ceiling debate started another war on Capitol Hill. Tensions mounted at a point where part of the American government acted as if it were ready to push the country, and possibly the world, into a financial abyss. In China, this is not political theater, but 2.5 $trillion of "hard won money" at stake. Where do we go from there?

Chartered Seas

Let us start with the major lesson of Reinhardt and Rogoff's historical inquiry. These authors have described how severe financial crises cast a long shadow on the economy. They produce a deep recession, the recovery is weak, and public debt reaches pharaonic levels. This is where we are today on both sides of the Atlantic and we can unfortunately expect new developments of the financial crisis in the second part of 2012. Interestingly enough, we are not entering unchartered seas; European fragilities, most recently exposed by the tensions surrounding Spanish finance, are perfectly known as are American ones, which are expected to dramatically rise in the weeks following the November elections. The way the global economy will cruise among these dangerous reefs depends on an increasingly tense mix of unsustainable debt and fractious politics. At the intersection, when politics is facing the prospect of unsustainable debt, the question is "who owes what to whom"? This is what we must focus on now.

The decisive intervention of the European Central Bank in December produced a welcome relief in the financing conditions of Southern European countries in the winter of 2012, but it proved short-lived. As of April, tensions are back, particularly for Spain, which after Greece, Ireland and Portugal is the elephant in room for the Eurozone. Increasing concerns regarding austerity and recession have renewed a vision of the Eurozone pursuing its two-year long "debacle". Is this finally the end, already announced months ago? Or is it another episode of the distorted narrative we have criticized in the previous paragraphs?

In 2012, according to the World Economic Outlook, the International Monetary Fund expects contrasting transatlantic evolutions with growth rates at 2.1 percent in the U.S. and at -0.3 percent in the Eurozone; the government deficit is expected to amount to -8.1 percent in the U.S. and –3.2 percent in the Eurozone. Given better GDP figures than in previous years, the U.S. is frequently said to have embarked on a more promising, even if fragile, recovery thanks to a more aggressive use of fiscal policy. This is true, but at what price? The initial financial crisis in the U.S. was so severe that an oversized Keynesian stimulus was required to avoid the repetition of the Great Depression. The cumulative public deficit in the U.S. between 2007 and 2011 amounts to a huge -42.6 percent of GDP. But the results, after closer examination, are less than impressive. In the Eurozone, deficits have been limited to 19.5 percent and the resulting growth rates are nonetheless very similar (+0.9 and +0.6 percent respectively during the period of 2008-2011). The most disappointing fact in the American recovery is that the private sector has not geared up. The level of the private gross fixed capital formation in the U.S. in 2011 remains at 14 percent below its pre-crisis level whereas the corresponding gap has been closed in the Eurozone.

Different policies, followed for years, now place public debts on widely diverging trends (see the IMF Fiscal Monitor). The U.S. debt increased from 67 percent of GDP in 2007 to 107 percent in 2012 and is expected to reach 113 percent in 2017; the similar figures for the Eurozone are 66 percent, 90 percent and 87 percent. In addition, given the public guarantee offered by the U.S. government to Fannie Mae and Freddie Mac, one should consider the outstanding debt of government related enterprises which in 2011 amounts to more than 50 percent of GDP in the U.S. (as compared to 20 percent in Germany and 10 percent in France); even if only a small fraction of these amounts could end in fiscal outlays, Fannie and Freddie have been massively financed by Asian investors, China in particular, and the government sponsored enterprises will have huge refinancing needs. These data, as well as others major indicators like the cyclically adjusted primary balance or the gross financing needs taking into account the maturing debt, are well known but frequently discounted for two reasons. The intractability of U.S. debt is reduced to a fact of life, with which the rest of the world has to adapt since Congress is definitely not willing to curb these trends; and the comparison with the Eurozone is disqualified since the Eurozone is not a country. With the insight of the previous analysis, these arguments should be considered more attentively.

The last well known difference between the U.S. and the Eurozone is that the former has had and is expected to have in the coming future net external financing needs amounting to 3 percent of GDP while the latter has had and is expected to have a limited external financial surplus. The statute of the dollar as a reserve currency as well as the euro's weaknesses in recent years have protected the dollar against the dramatic consequences which American profligacy would already have had for any other country; but the stability of the dollar-euro exchange rate demonstrates that this protection is suspended to the supervision of global investors whose confidence has to be constantly renewed. The statute of the euro as a regional currency has had the unenviable consequence to highlight the conflicts inside the monetary union. But the stability of the euro-dollar exchange rate demonstrates that these financial tensions, as long as they remain politically manageable within the union, fundamentally remain a domestic political issue and have limited financial international consequences. Thus, China's Premier Wen Jiabao has expressed that both America and the Eurozone must "put their houses in order" and the ways this recommendation will be followed will determine the state of the world economy at the end of 2012.

The Reefs Ahead

The risks for Europe remain high. But the vision adopted in this paper is that the transformations of Eurozone governance since 2010 are underestimated and the role of Germany improperly analyzed. Germany, for sure, was never ready to "offer its credit card" to its fellow Europeans and this is more than understandable. But, if Germany demonstrated steadiness in the defense of its domestic interests, it also proved cooperative in the pursuit of common interests. The rescue mechanisms, in which Germany is by far the most exposed country, have been implemented with wide support of the Bundestag; successive "urgency" measures, which run so contrary to the German monetary doctrine, have been adopted by the ECB and tolerated by the German government. These are undoubted political achievements without which the worst predictions concerning the Eurozone would have been realized.

There is broad agreement in the Eurozone about what went wrong and the red line in the political debate has been sequencing. Germany could not accept going further (the creation of Eurobonds for example) without sufficient protection against reckless behaviors in the union. This is why the design of a sustainable framework—the so-called "fiscal compact"—was an absolute preamble before any other issue was put on the table. Now, the European crisis is entering a new phase, both in economic and political terms. On one side, austerity measures are, as expected, pushing the European economies into recession, debilitating German export markets and making the rehabilitation of public finances more difficult; on the other side, the power balance established under the leadership of German Chancelor Angela Merkel and former French President Nicolas Sarkozy is changing, with the election of François Hollande as France's new president. After Italy and Spain, France and the Netherlands are now desperate to push growth to the top of the agenda. It will be time to enlarge the Eurozone political economic debate and to more closely associate the timely enforcement of fiscal discipline with broader issues, which could include some sort of mutualization of past debts and a pan-European initiative for growth. Is this credible? If past is a prologue, the most likely forecast is that the search for compromise will continue to be the rule because, as they visibly demonstrated, all the member countries, whether debtor or creditor and whatever the color of their government, have huge common economic and political interests at stake.

What about the United States? In its debt-ceiling showdown last August, Congress came close to a spectacular act of self-inflicted damage. Voluntary default was only narrowly avoided. Financial gridlock has become the natural outcome of a dysfunctional political system described by Francis Fukuyama as a "vetocraty". The two parties are ardently nurturing a radical disagreement about what went wrong. The possibility of compromise simply

seems to have vanished. Action is not blocked by a divergence about sequencing but by a frontal opposition about principles. The frightening thing is that no one in Washington sees this ending soon. Later this year, the American government will face even more difficult challenges: Congress will be simultaneously asked to raise the debt-ceiling again, to determine the fate of the Bush tax-cuts and of the Obama payroll tax holidays and social benefits and finally, would it fail to find a solution, to face the cataclysmic consequences of the $1.2 trillion 10-year automatic spending cuts which were part of the August 2011 compromise. All these deadlines will happen during the so-called "lame duck session" which will follow what is expected to be the most bitter elections in decades. Many hope that Congress will be able to complete this program successfully in time. Should this be considered as another illustration of hope triumphing over experience?

Conclusion

The present essay doesn't share the widespread pessimism about the Eurozone. Much more has been achieved than frequently recognized and the willingness to stay the course and find compromises have been regularly confirmed. Designing a new governance for the monetary union has been a messy political process but it has a direction and moves forward. This vision is arguably backed by the striking stability of the euro on the foreign exchange market since 2007. We demonstrated that this is the result of a balanced view of global investors regarding the respective financial situations and political processes in the Eurozone and in the U.S. Given what has been extensively written on the former, this finding says a lot about the less publicized global skepticism surrounding the latter. Following a traumatic year in 2011 and a brief period of relief in the first quarter of 2012, the second half of this year now promises to be a defining moment on both sides of the Atlantic.

Risks remain high in Europe, as the threat of recession, renewed tensions in Spanish finance, and the potential for contagion to Italy or France are all very real. European governments will need to audaciously extend their cooperation which has until today been based on commitments to fiscal discipline. The "fiscal compact" is the basis of a better functioning monetary union but governments now have to design a broader agenda, which probably includes some mutualization of past debts and new initiatives to restore growth.

Risks remain high in the U.S. as well. The recovery proves fragile and the rise of public debt seems out of control. Returning public finance to sustainable levels will unavoidably require tax increases as well as spending cuts. But the political willingness to compromise has disappeared. The government is paralyzed by a camp that sees any tax increase as a threat to American exceptionalism. There is a threat that, whatever the result of the November election, this camp will have a veto power precisely when the time arrives to make hard financial decisions. Inaction in December would be a surefire recipe for pushing the U.S. into a severe recession and into a dramatic default.

These are challenging times for policymakers. In the months following the Lehman Brothers' failure, they demonstrated their willingness and ability to shape circumstances; these qualities will be tested again shortly.

Note: On April 30, 2012, 1 euro = 1.324 U.S. dollars. The exchange rate was 1 to 1.326 prior to that.

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