

12 March 2010

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Currency Confusion

The foreign exchange market is being accused of confusing the euro for the Greek drachma. Whereas many might be tempted to ignore the accusation, the fact that it was issued by the highly respected Martin Feldstein who is a Harvard professor, an official in the Reagan government and a member (and former chairman) of the NBER committee that is the official arbiter of US recessions, requires taking the claim seriously.

Feldstein's argument is straight forward. It can be recapitulated quickly. He says the euro's decline this year is unjustified. He told a Bloomberg TV audience that "There is in my judgment, no real reason for the euro to have sold off overall. After all, Germany is not at risk. France is not at risk". Feldstein would have us believe that the euro is really more the German uber-mark than the Greek drachma.

Greek's debt woes have weighed on the euro. For example, in the three month period to the euro's peak on November 25th, 2009, the correlation (daily, on a percent change basis) between the 10-year German-Greek yield spread and the euro/dollar exchange rate was -13.7%. From the euro's peak through March 1st, 2010, the correlation nearly doubled to -26.2%.

Yet it is only -26.2%. While it is noteworthy that the relationship has in fact tightened, it is still not that robust. Indeed since about March 1, the anxiety over Greece has calmed. The spread has generally trended down over the last couple of weeks, but the euro has hardly benefited.

The euro has remained, with a couple minor exceptions, in the trading range that was established on February 17 and February 19—between \$1.3788 and \$1.3444. The combination of only modest correlation with the German-Greek bond spread and the range-bound euro for the better part of the past four weeks suggests something else is driving the euro and not simply the Greek tragedy.

Welcome to My World

Of the forces that should drive the relative prices in the foreign exchange market many economists traditionally believe that trade gets a privileged place. Feldstein seemed genuinely surprised at the euro's decline because the region enjoys a trade surplus.

That is so yesterday.

In the modern era, capital flows exceed trade flows by a huge magnitude. World trade is roughly \$16 trillion. Turn over in the foreign exchange market exceeds this in a little more than a week, even assuming some slowing in the pace since the last Bank for International Settlements triennial survey in 2007.



Moreover, the US trade deficit has been roughly halved over the past four years. It is near levels that economists regarded as sustainable a few years ago. (see chart of US current account as a percent of US GDP.)

The other important trade issue that many traditional economists still fail to get their heads around is growth of intra-firm trade, which is a function of the globalization of production and distribution. Roughly half the US trade deficit can be traced to intra-firm trade. Lastly, few economists take into account demographic factors when comparing external positions.

The real surprise is that when many free-market economists are pressed they sound a great deal like the old French physiocrats (where laissez faire really comes from) that Adam Smith, the patron saint of capitalism argued so vehemently against. The origins of the wealth of nations, he taught, do not lie in running trade surpluses and accumulating reserves. He argued that wealth was to be found in an extensive division of labor that boosted productivity.

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Driving Miss Daisy

Capital flows rather than trade flows can help explain why the euro has declined against the dollar. That capital is flowing into the US in excess of what is needed to fund the reduced trade deficit seems evident by the combination of a rising dollar and rising asset prices.

There is no doubt that speculators have played a role. The Commitment of Traders at the IMM shows that the net non-commercial (speculative) euro position reached a record in late February. At its peak the value was around \$11 bln; substantial, but still a relatively minor part of the spot foreign exchange market most of the time for most of the currencies, and especially the most liquid currency pair in the world. Nevertheless, anecdotal reports suggest some larger pools of capital, including hedge funds, have also been selling the euro.

To be sure, it is not like these participants wake up in a bad mood, or flip a coin to decide to sell the euro. That decision is usually the result of some kind of analysis. This includes economic analysis.

Essentially, the speculators are motivated by the same factors as investors and businesses. The difference often is one of time frame and vehicles. Speculative capital, portfolio capital and direct investment are being drawn to the U.S.

The Race

While the cynics tell us that the foreign exchange market is an ugly contest, with the best currency being the least ugly. None are beautiful. That seemed to be a fair description during the crisis, but it is less apt now. Instead, it seems that the race in the foreign exchange market is who can close the output gap fastest.

The economic contraction created a large gap between actual output and potential GDP. As the gap is closed, real interest rates will likely rise and may help boost earnings. Those countries that grow relatively faster should have relatively stronger currencies.

It is true that the U.S. economy is not experiencing the strength of the recovery that it has experienced during past recoveries. Still, the average quarterly (annualized) growth rate of 4% in H2 09 is nothing to sneeze at. Of course this pace is unlikely to be duplicated here in 2010, but even allowing for consensus or IMF forecasts, the US is likely to be the fastest growing in the G7 economy this year and next, with the possible exception of Canada.

Those very growth differentials which will help the US close the output gap ahead of the other major industrialized countries could translate into a wider current account deficit. This may worry some, but in this part of the economic cycle, the growth and its implications will offset it.

Business and other investors will likely be increasingly attracted to the US as the recovery broadens. Not only is stronger growth associated with increased profit opportunities, but the U.S. is highly competitive. In the past three years, US unit labor costs have fallen about 9% and the dollar's trade weighted index (against major countries) has fallen about 6% in the same time.

Couple the decline in unit labor costs with a decline in the dollar, which remains well below levels of valuation economists use (like purchasing power parity or fundamental equilibrium exchange rates), and the persistent threat of protectionism offer a powerful inducement to business to locate plant and production in the US.

In conclusion, the idea that the euro should be treated like the Deutschmark seems surprisingly unrealistic. It sounds as disconnected from reality as the Greek Prime Minister saying that Greece does not want assistance; it just asks to pay the same rate of interest as others. The euro is no Deutschmark. It may not be a drachma either, nor is it really being treated that way.

The downside momentum of the euro has waned and the short-term speculative market is sitting with an apparently large short position. The market has taken on board the general scenario sketched out above. This would seem to enhance the risk of a near-term bounce in the euro. However, rather than traders coming to their senses under Feldstein's rubric, a euro bounce into the \$1.3850-\$1.4000 is better understood as the bus backing up, giving medium and long term investors an opportunity to get aboard.

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