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Chief Economist's Comment

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Don't be afraid of Euro weakness

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Since December of 2009, when it was trading at 1.51 US Dollars, the Euro has fallen most recently to between 1.30 and 1.35. This is the lowest it has been in ten months. As the reason, observers have pointed in the last months to the supposedly imminent state bankruptcy of Greece, and recently to the downgrade of Portugal by the ratings agency Fitch. Are these countries driving the Euro over the cliff?

Greek risk premium appropriate

Without a doubt, Greece's national debt has reached a level that is difficult to maintain over the long term. With a debt level of more than 120 % of GDP, Greece is at the top of the debtor list not only in Europe (along with Italy). However, the refinancing is not in danger, at least not for the time being, as indicated by the strong demand for the most recent emission of Greek bonds. Moreover, a risk premium of around 300 basis points compared to German government bonds should not be seen as a burden impossible to bear. Rather, it makes sense that the capital markets price different risks in different ways.

Safe haven Germany?

The premium on Portuguese bonds is currently 1.2 %. In view of the fact that the debt level in Portugal will amount to about 90 % that seems appropriate. However, one should bear in mind that German government bonds, which are currently traded as a safe haven, have a debt level of more than 80 % behind them, that is more than Spain, which many observes keep saying should be given a critical rating. In Spain, the debt level is "only" right around 70 %. Thus, the debt problem is not an issue only at the periphery of the Euro zone, but encompasses all member states. At this time, not a single country is able to meet the Maastricht debt criteria. That applies both to current debt, which, according to the Maastricht Treaty, is not supposed to exceed the 3 % level, and to the overall debt level of 60 %. Thus, attributing the recent depreciation of the Euro solely to the debt situation of the countries at the periphery would seem to be too simplistic.

British Pound also weak

Moreover, it is not sufficient to look only at one side of the equation. Rather, one must also analyze a variety of currency-pairs. For example, the Euro has not lost value against the British Pound over the last few weeks, in fact it has shown its strong side here. If we look at the current British debt, that comes as no surprise.

USA economically strong

And if one compares the situation in the US with that in the Euro zone, one gets a more differentiated pictured: with current debt of more than 9 % and a debt level of more than 90 %, the US is not exactly a model student. The market seems to completely blocking this out at the moment. From a purely economic point of view, however, that is more than understandable. After all, the economic recovery in the US is apparently more robust than most expected: the investment cycle is kicking in and consumers are showing themselves willing to spend, even though the labour market is only close to making a turn for the better. Thus, one should expect that the US central bank will lead its monetary policy out the extremely loose mode in the second half of the year, while the structural problems in the Euro zone – continuously highlighted also by the capital markets – are making it much more difficult for the European Central Bank to turn the interest rate screw.

Fundamental fair value of the Euro closer to $1.20

As long as the markets direct their focus at the structural problems in the Euro zone while blocking them out in the US, one should expect a continuation of the appreciation of the Dollar and accordingly a further depreciation of the Euro. Of course, one should not rate this development as Euro weakness, but rather an adjustment to the long-term fundamental value, which we see in the area of 1.20 US Dollars to the Euro. It seems to have been forgotten that this value was already reached nearly a year ago, and that neither the fear of Greek nor the Portuguese Fado could be held responsible for it. Flexible exchange rates are precisely characterized by the fact adjustments necessitated by fundamental reasons are also possible by way of the exchange rate. One should therefore not demonize such fluctuations, but simply accept them and not strike up a swansong for whatever currency is depreciating.

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