MARKET COMMENTARY

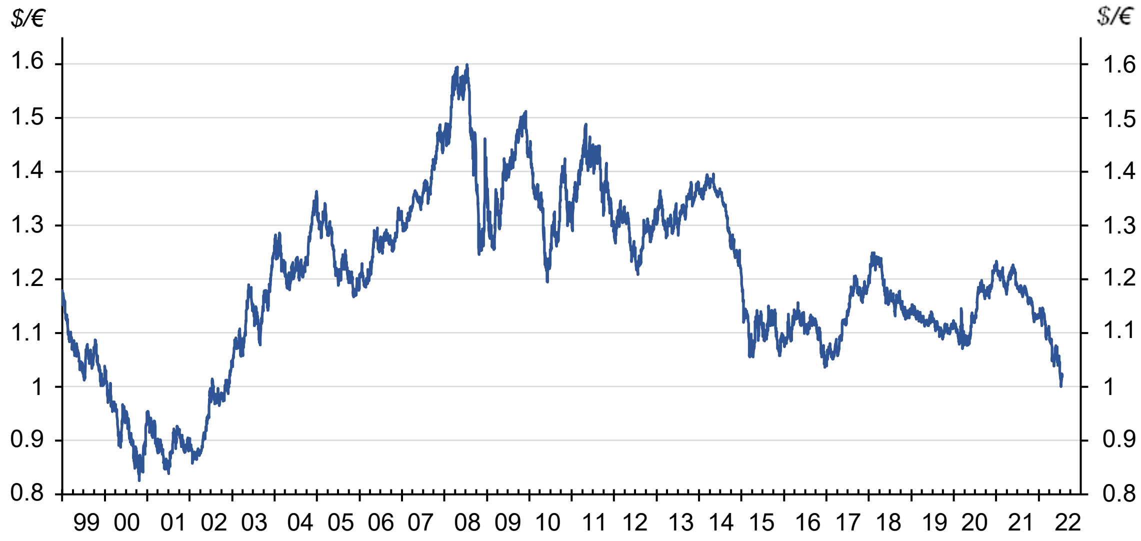
26 July 2022

The Euro – a soft currency

Dieter Wermuth, Economist and Partner at Wermuth Asset Management

Ten years ago, annual euro area nominal GDP per capita was €29,230 while that of the US, translated at the average 2012 exchange rate, was €40,190. Today, the euro area is at €37,160, the US at €71,840. This means that Europe's per capita nominal GDP has increased by 27%, compared to America's 79%. In relative terms, the US has thus pulled ahead by a large margin. Put differently, the currency of Europeans buys a lot less of American goods than ten years ago, people are significantly less well-off. For many highly qualifies and motivated Europeans there is now a strong incentive to emigrate to the US (or Switzerland), causing a so-called brain drain which impairs the international competitiveness of our continent. Imports have become much more expensive than exports. The main reason for both effects is the weak euro exchange rate.

dollar/euro exchange rate



source: ECB, design & research: Uwe Richter ©UR

How did it happen? In the past, a currency would appreciate in reaction to a surplus in a country's balance on current account – it meant that the demand for the currency from that source exceeded its supply on foreign exchange markets. This argument is still valid but it has lost its power: the euro area had a current account surplus for many years while the US had been in the red for a near-eternity. It does not matter anymore for the exchange rate.

The same holds for government finances. The original reasoning was: the larger the budget deficit and the larger public sector debt, the less solid, or trustworthy are fiscal policies supposed to be. If a country is not concerned about its deficits and debt, FX market participants used to conclude that in the end it will try to monetize, ie, devalue its debt, at the expense of financial investors who hold these assets in their portfolios. This leads to selling pressure and a devaluation of the currency. Also not necessarily true any longer! During the Corona years 2020 to 2022, the European aggregated budget deficit was 5,2% of GDP, compared to 10.6% in America. As to the situation of public sector debt: the IMF estimates that the euro area is presently at 95% of GDP, the US at 125%. Even so, FX markets refuse to be impressed by these differences in favor of the euro. Reckless public finances are regarded as a problem for the euro area, not for the US.

The problem is: the US is a single country with common fiscal policies and a mighty military whereas the euro area is not. Member states have kept their autonomy in these key policy areas. It is actually by no means certain that the currency union will survive in a severe crisis. In Italy, but also in France important segments of the electorate are susceptible to right or left wing arguments about giving up membership in the EU and the currency union. If things get tough, Europeans will most likely look to the US for help, and under a possible new Trump administration such help may not be forthcoming. Financial investors have their doubts that Western Europe on its own can defend the three Baltic states in the event of a Russian invasion. For them, it is therefore safer to hold dollars than euros – even though wage developments suggest that American inflation will stay above European inflation for several years to come, causing the dollar to depreciate. But inflation is clearly a second-order concern.

Moreover, the Fed is fighting inflation a lot more energetically than the ECB. Policy rates have been raised earlier and in large steps. This may lead to a recession, but so be it, as long as the US labor market remains in good shape. The Fed funds rate will probably climb to nearly 3% by year-end and will thus continue to exceed the ECB's main refinancing rate by at least 200 basis points. These interest rate differentials create extra demand for dollars. The entire US yield curve stays well above the European one.

Add to this that the reputation of the ECB is not particularly good. Rather than trying to be market neutral the central bank gets engaged in structural policies which under normal circumstances should be in the domaine of other political institutions, by preferring "green" assets over others under its quantitative easing program, or targeting yield spreads between, say, Italian or Portuguese and German Bunds, or subsidize banks which agree to exceed certain quantitative benchmarks in their lending policies to the private sector. For several months, the ECB had indicated that it would raise policy rates by 25 basis points this July, but then raised them by 50 bp. It has understandably discontinued its so-called forward guidance, previously an important part of its toolkit.

Must we be worried about the ongoing weakness of the euro? For several reasons, a strong currency is better than a weak one, just as high wages are better than low wages (as long as they don't cost you the job). It is good for a country's purchasing power and changes the structure of the economy in the direction of goods and services which can successfully be sold in spite of their high costs and prices – which in turn is a guarantee of high incomes. In the long run it does not make sense to be a cheap Jack. It's ok for a while after a deep recession or a costly war. But for countries with a large capital stock and a well-qualified labor force it does not make sense to sell cheap wares, especially in a situation of strong employment growth. A strong exchange rate means that the standard of the goods and services on offer must be improved all the time, and in this way creates its own demand and thus anticipates future demand trends rather than following them.

As the reader will have noticed, this has been a plea for more rapidly rising ECB policy rates and a stronger euro. It's a significantly undervalued currency.

###

For more information please contact:

Instinctif Partners // Lars Hofer
E lars.hofer@instinctif.com
T +49 162 562 8917

Visit us: https://wermutham.com/
Follow us on Twitter and LinkedIn

About Wermuth Asset Management

Wermuth Asset Management (WAM) is a Family Office which also acts as a BAFIN-regulated investment consultant.

The company specializes in climate impact investments across all asset classes, with a focus on EU "exponential organizations" as defined by Singularity University, i.e., companies which solve a major problem of humanity profitably and can grow exponentially. Through private equity, listed assets, infrastructure and real assets, the company invests through its own funds and third-party funds. WAM adheres to the UN Principles of Responsible Investing (UNPRI) and UN Compact and is a member of the Institutional Investor Group on Climate Change (IIGCC), the Global Impact Investing Network (GIIN) and the Divest-Invest Movement.

Jochen Wermuth founded WAM in 1999. He is a German climate impact investor who served on the steering committee of "Europeans for Divest Invest". As of June 2017, he is also a member of the investment strategy committee for the EUR 24 billion German Sovereign Wealth Fund (KENFO).