The euro is worth $1.20 for the first time in its history. That may hurt Europe. Will it help America?

TIME to hail the almighty euro? During trading on Friday November 28th the currency was worth $1.20 for the first time in its history. By the following Wednesday it had topped $1.21. Europe's exporters will bewail this development, but for everyone else involved in the European project, the currency's strength will bring some satisfaction. After being introduced at a rate of $1.17 in 1999, the euro slumped to become worth less than 83 cents the following year. But the euro’s weakness in those humiliating days was not evidence of a congenital defect in the new-born currency. Rather, it reflected the unusual strength of its older rival, the dollar. Likewise, the euro’s rise since February 2002 should not be taken as a great vote of confidence in the economies of the euro area. It is, instead, the flipside of the dollar’s fall.

What is pulling the dollar down? In short, foreign demand for America's output lags far behind American demand for foreign production, leaving the United States with a current-account deficit of over $500 billion in the past year. To finance this unprecedented deficit, America needs to attract about $2 billion of foreign capital every business day. Much of that capital comes from Europe. Every month from January to August of this year, Europeans poured an average of $28 billion (net) into American stocks, bonds and notes. But in September they reversed course, selling off $403m. Since September, of course, America has posted breathtaking third-quarter growth rates and healthy corporate profits. But the prospect of enticing returns may not be enough to tempt Europeans back into American assets so long as the Damoclean dollar hangs over their heads.

The dollar also dangles over the heads of Europe's exporters. This matters, because they are currently the leading players in the euro area's nascent recovery. An export surge of around 9% (at an annualised rate) in the third quarter helped the euro area grow at an annual pace of 1.5%, despite falling investment and flat consumption. But will these exporters be able to live with a strong currency? They have done so in the past: the basket of currencies the euro represents was worth more than $1.36 as recently as July 1995, and more than $1.20 as recently as January 1997. In its present fragile state, the euro area can probably tolerate a euro worth up to $1.25, reckons Stephen Jen of Morgan Stanley.

But if the rising euro will inflict pain on Europe's exporters, it need not do lasting damage to the euro-using economies as a whole. The rising single currency improves Europe's terms of trade and boosts its real income, as any European tourist in America is finding out. It will ward off inflation in the euro area, which, despite Europe's sluggish growth, remains slightly above the European Central Bank's ceiling of 2%. This will give the ECB an opportunity to cut interest rates and stimulate domestic demand, helping
the euro area to wean itself off its dependence on foreigners and pull its weight in the world economy.

Will the ECB take this opportunity? The danger is that the guardians of the euro will sit back and smile with complacent pride as their baby grows in strength. Indeed, most expect the ECB to keep its hands off interest rates until it is ready to raise them. But a 5% rise in the trade-weighted value of the euro is itself equivalent to a one percentage point increase in interest rates. So, even as interest rates remain on hold, monetary conditions in the euro area are tightening considerably. The first sign that the ECB recognises this danger came on December 2nd, when a source close to the bank told the Reuters news agency that the ECB might consider an interest-rate cut should the euro appreciate “too much or too fast”.

Complacency is not a charge that can be levelled against the central banks in America's other major trading partners. The Bank of Japan has spent well over ¥13 trillion ($120 billion) so far this year resisting the dollar's fall against the yen and China’s authorities have kept the yuan controversially pegged to the dollar. Asia’s central banks do not buy dollars as a rational investment; they are not looking for the best mix of risk and return. They are buying dollar assets to keep their own currencies competitive. If they think the dollar is going to fall, they may well buy more of them, rather than less.

Some, such as Peter Garber of Deutsche Bank, see Asia's official purchases of dollars as part of a grand bargain: Asia ploughs its savings into America, and America, in return, remains open to the products of Asia’s export industries. But protectionist pressures rising in Congress raise worries that America may fail to keep its side of the bargain. If so, the central banks of Asia, the dollar’s most loyal customers, may threaten to switch, or at least spread their allegiance to euros. That would put intolerable pressure on the dollar. It would also drive up American interest rates, as Asian capital flowed elsewhere.

Though they will welcome the dollar’s steady decline, America’s authorities must tread carefully. Washington may complain about Asian currency manipulators, but without them the dollar could easily go into free fall. As Mr Jen points out, Washington’s best hope for a soft landing is for East Asia to try but fail to resist the dollar’s fall. America wants enough Asian money flowing into American assets to keep yields (and therefore interest rates) down, but not so much as to keep the dollar up. In so far as a “dollar policy” exists, it is being set in Tokyo and Beijing, not in Washington.

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