

## **Might be time to short the euro against dollar**

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(This is the third article in a three-part series.)

In parts one and two of this series, I explored looming deflation in Europe and why central banks fret over it. The European Central Bank is gearing up to depress the euro, which it blames for much of the deflation threat in the euro area, or at least the portion it can influence.

The ECB reduced its overnight reference interest rate from 0.5 percent to 0.25 percent in November. If it cut the rate again, the ECB would join the Federal Reserve and the Bank of Japan with rates of essentially zero. With all the central-bank-created liquidity sloshing around the world, these rates are largely symbolic. Yet another ECB reduction could make foreign investment in the euro area less attractive, to the detriment of the euro.

Currently, ECB member banks are paid nothing on their deposits. A negative rate – charging banks to leave their money at the central bank – would encourage them to lend and invest elsewhere. That would push down returns in the euro area and discourage foreign investors, also to the detriment of the euro.

Austrian central banker Ewald Nowotny backs this approach. Bundesbank President Jens Weidmann and Bank of Finland Governor Erkki Liikanen, like Nowotny members of the ECB's governing council, have expressed interest. Denmark introduced negative rates on deposits in 2012, but no major central bank has followed so far.

The Fed, the Bank of England and the Bank of Japan have bought government securities extensively, but such quantitative easing would be difficult in the euro area. One reason is that corporate and other types of financing are concentrated in the banks and not in the bond markets, as in the US, where QE works its way into the economy rapidly. QE would also be harder because there are 18 euro-area countries and, therefore, 18 bond markets for the ECB to consider.

Still, the ECB could purchase securities backed by mortgages, auto and small-business loans, corporate debt, and packages of bank loans, as well as government debt. ECB President Mario Draghi and governing council members Liikanen, Weidmann, Jozef Makuch of Slovakia and Benoit Coeure of France have all expressed interest.

Purchases of long-term securities would tend to depress their yields and make them less attractive to foreign buyers, again achieving the ECB's objective of depressing the euro. A weakening euro would chase away foreign investors, leading to further declines. Lower long-term interest rates would also encourage borrowing and economic activity in the euro area. The ECB has yet to try QE overtly, yet it has done so in the past, indirectly. In late 2010 and early 2011, it lent 1 trillion euros to its 800 member banks with repayment terms up to an unprecedented three years. Those banks in turn largely used the money to buy their own sovereign issues. Spanish banks bought Spanish government bonds, Italian banks purchased Italian government bonds, and so on. During those dark days, there were few other buyers.

Draghi gets a lot of credit for his July 2012 "whatever it takes" statement, but it was foreshadowed by the earlier lending program. In the last year-and-a-half, most of those ECB loans have been repaid. The ECB could probably reactivate this form of QE by "encouraging" its member banks to renew their borrowing. In any event, it will take much more than words to reduce the euro's value significantly and head off deflation.

Looming deflation is pushing the ECB rapidly toward measures aimed at depressing the euro as well as stimulating euro-area economies. The time to be short the euro against the dollar may finally have arrived.

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