

PART  
I

**MACRO ISSUES**

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# CHAPTER 1

## Euro Versus Dollar

*Many shall be restored that now are fallen, and many shall fall  
that now are in honor.*

—Horace

**L**aunching a new currency for a large economic area is an extraordinary event in the history of monetary economics. The euro area certainly qualifies as large in economic size, as measured by GDP, in population size (hundreds of millions of people), and in political configuration, as it encompasses many nation-states with diverse languages and cultures. History will show the introduction of the euro as a grand and unique experiment in monetary economics.

Euro skeptics existed before the actual launch of the currency. The doubters cited a multitude of reasons why this grand experiment would fail. So far, however, the result has been success, and the world is witnessing the emergence of a strong, reliable, and viable reserve currency. This chapter offers some observations about that evolution and opinions about its continued favorable prospects.

### **Creation of the Euro and Transfer of Currencies**

Getting to a single currency in Europe was a century-long task that first required several catastrophes.<sup>1</sup> One could argue that it started

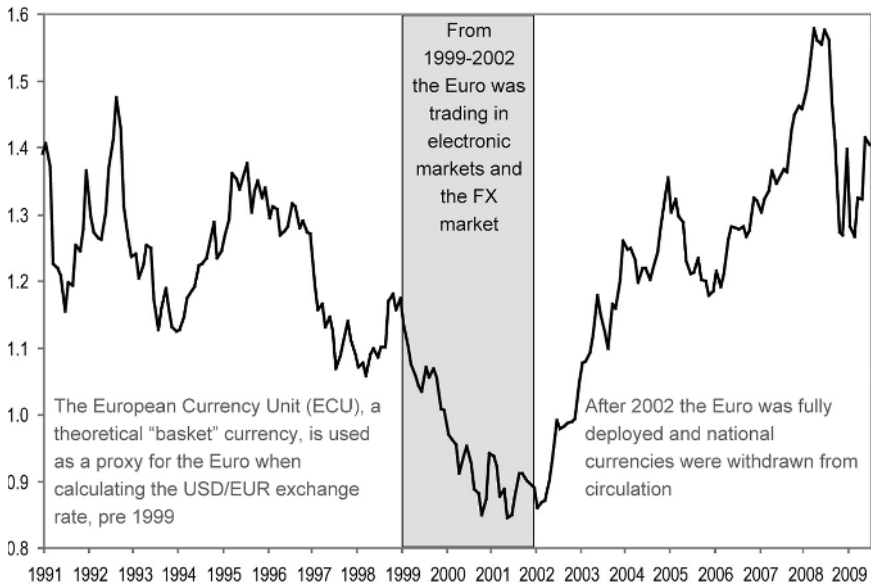
with the collapse of Czarist Russia, coincident with World War I. This led to the division of Eastern and Western Europe. The Weimar Republic's hyperinflation and subsequent demise led to the rise of Nazism. From the final chapters of World War II came the subsequent global dominance by the United States. The largesse of the United States, with the Marshall Plan and the rebuilding of Europe, was followed by four decades of internal European dialogue. 1992 was a special year. The Treaty of Maastricht, signed on February 7, 1992, was coincident with the peaceful emergence of an independent central Europe and the demise of communist USSR domination.

European countries decided to formally set aside war and to coalesce toward a single economic unit. In 1991, they seriously started the contractual attempt to achieve a single currency. After a thousand years of enmity, France and Germany engaged in true *rapprochement*. The 1992 Maastricht Treaty set the Eurozone admission criteria regarding national budget deficits and actual rates of inflation.<sup>2</sup>

The goal of this new "hard" currency was to be dependable and reliable. The condition that the currency could not be manipulated by a single national government led the target list of accomplishments. Devaluation as a single-country option was eliminated. The new euro was to be "inflation-proof."

The Maastricht Treaty required ratification by its members. That process took place in the decade of the 1990s. The final formulas and currency exchange rates among the original eleven members of the Eurozone were not completed until the end of that decade, in 1998. Of the original fifteen countries that determined to form a European economic community, to be named the European Union (EU), only the UK, Denmark, and Sweden decided not to join the currency union.

On January 1, 1999, the virtual euro began to trade in eleven countries. It was an immediate success. As agreed, three years later, on January 1, 2002, the paper euro replaced the national currencies of the then twelve countries. The European Central Bank (ECB) was born. It was charged with the responsibility of maintaining price stability, which it defined as an annual inflation rate of under but close to 2 percent in the medium term. It is an independent, separate body, above the political power of any single national government. It has its own governing council. The terms of its construction



**Figure 1.1 Euro Declines Rapidly Against the Dollar, then Rebounds Strongly**

Source: Bloomberg and Cumberland Advisors.

are defined in a treaty to which Eurozone countries subscribed. Only unanimous consent can change those terms.

The early stages of the euro (see Figure 1.1) showed a rapid decline in value against the dollar. From its January 1, 1999, opening price of \$1.17 to its low of \$0.84, the euro seemed to be a candidate for freefall. Euro skeptics had many reasons for claiming the euro would not succeed and that the experiment in monetary union would fail. They were wrong.

Euro skeptics argued that economic, political, and capital market forces were behind the euro's weakness.<sup>3</sup> Their attention was misdirected, and they may have missed the significance of the conversion of cash balances, which were prevalent throughout Europe and in other parts of the world.

Early studies, including a 2001 study by two economists from the University of Munich and published by the National Bureau of Economic Research (NBER), showed large hoards of cash that had been used in the underground economy in Western Europe, Eastern Europe, and other parts of the world.<sup>4</sup> The NBER study focused only

on the Deutsche mark, which was a dominant currency in Europe prior to the introduction of the euro. It was also the currency of the largest single national economy in Europe. Germany provided the lynchpin currency in the composition of the new euro that was replacing the Deutsche mark.

The NBER study argued that the excess balances above and beyond transactional demand exceeded 100 billion D-marks. Many of those balances were located outside of Germany proper. The authors of this book investigated currency balances in several countries during this period. It was clear to us that large underground balances and hoards of cash in lire, D-marks, etc. were targeted for transfer to the new euro. We surmised that the same was true in other countries that we did not visit.

In order to understand this transfer, one has to visualize the circumstances. An underground hoard of cash used for gray-money activity that was originally positioned in German Deutsche marks, Italian lira, Spanish pesetas, or French francs had to be transferred out of those currencies, because they would become the euro. It needed to be done surreptitiously and over a period of time.<sup>5</sup>

The target currencies that were deep enough to absorb such a large transfer were quite limited. They were the Japanese yen, the U.S. dollar, the British pound, and the Swiss franc. Transfers had to be done in relatively small sums and on a continuing basis. Remember, lots of cash was being moved, and it was being done from an illegal or underground gray-money business perspective. Therefore, it had to be done in repeated transactions of smaller amounts. Also remember that each transfer constituted a sale of the new euro and the purchase of U.S. dollars, Swiss francs, or something else.

Among the target currencies, the most difficult one for Europeans was the Swiss franc. This was due to the fact that cash transactions were being followed closely within Europe. There was also national governmental scrutiny, both by the eleven countries that made up the new Eurozone and by the Swiss banking authorities.

The Japanese yen at the time was a suspect currency because of the weakness in the Japanese economic system, which had persisted for years and showed no signs of recovery. That left the British pound, which received some inflows, and last but not most important, the U.S. dollar.

The U.S. dollar was a deeply liquid and large enough world market. It had sufficient transactional capability and probably became the focal point of transfer during the pre-2002 informal

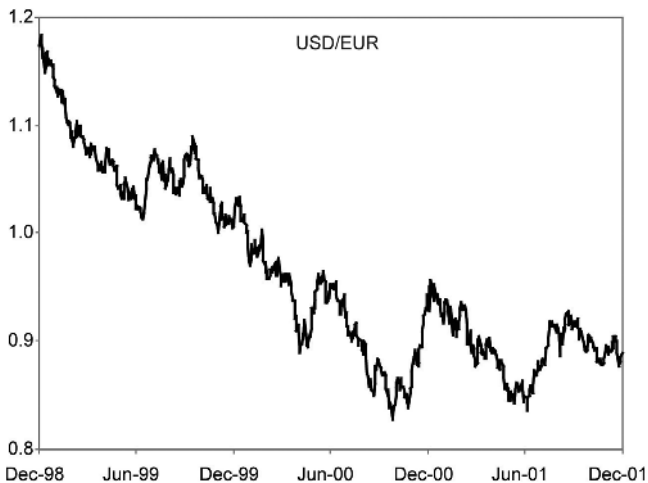
period when gray-money balances were transferring out of the original eleven (twelve, with Greece joining in 2001) national currencies. When the virtual euro was launched, there were only three years left for those transfers.

The pace accelerated through 2001 until January 2002 when, with the successful launch of the paper euro, the national currencies of twelve countries were withdrawn and replaced. At the same time, the process of withdrawing gray-money hoards from dollars, pounds, etc. and replacing them with the euro commenced vigorously.

It took only a few months to reverse the trend of dollar strength and euro weakness. The euro skeptics, who had argued against the euro in economic terms, were discredited.

Following the 2002 launch of the full euro, including paper currency and coins, the large cash balances and hoards were rebuilt in euros. This caused the selling of dollars and buying of euros. After the start in 2002 the process accelerated. The more the euro persisted and was accepted, the stronger it got. We can see that the extreme weakness against the U.S. dollar coincided with the launching of the paper euro (Figure 1.2).

By 2003, the euro was a full-fledged currency, standing on its own. The European Central Bank's policies and the implementation of same were going to determine its value, just as the ongoing



**Figure 1.2 Euro Weak During Virtual Period January 1999 to January 2002**

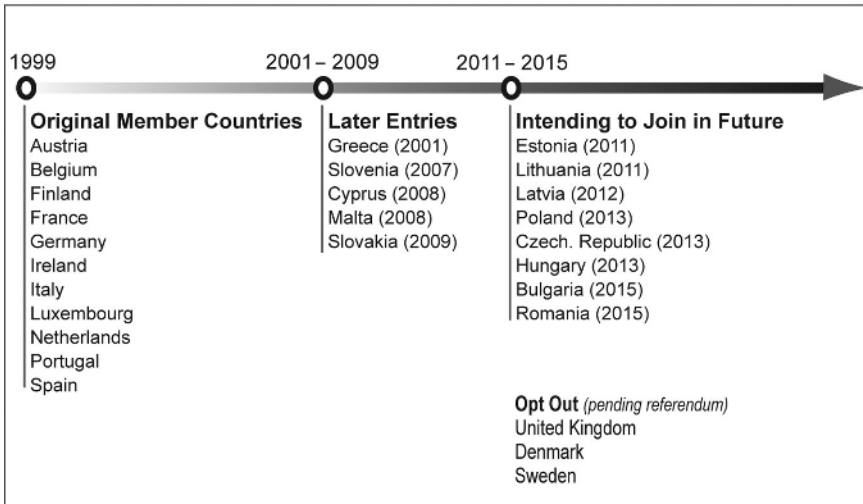
Source: Bloomberg and Cumberland Advisors.

policies and implementation of the Federal Reserve would determine the value of the U.S. dollar.

Starting in 2003, the world was about to witness a strategic monetary race between the euro and the dollar, between the ECB and the Federal Reserve. Never before had such a large enterprise as a supranational currency in a major economic body been launched. Eleven national governments agreed to give up their sovereignty over their currencies and cede it to a central bank. National decision making was limited. The euro was and is a grand experiment in the history of monetary economics.<sup>6</sup>

### Success of the Euro, 10 Years Later

We can fast-forward to the present and see that the euro is a resounding success. After ten years, the eleven countries have now expanded to sixteen (Figure 1.3). Additional EU countries are in the Exchange Rate Mechanism (ERM) as they prepare to adopt the euro.



**Figure 1.3 Expansion of the Eurozone**

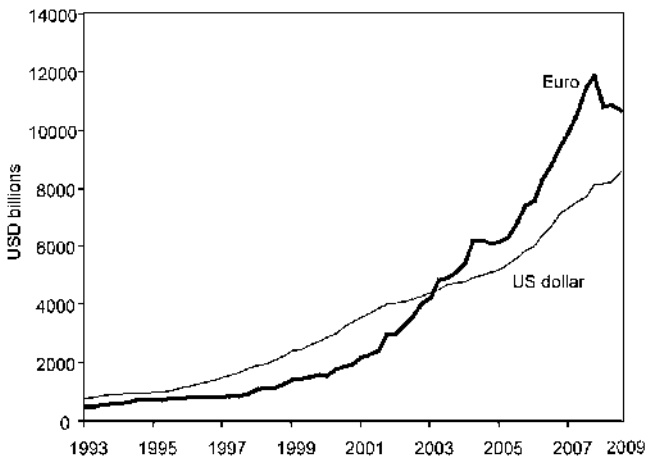
Source: “The Euro Area,” European Central Bank, [www.ecb.int/euro/intro/html/map.en.html](http://www.ecb.int/euro/intro/html/map.en.html); “Where Eastern Europeans Stand on Euro Adoption,” Thomson Financial, [www.forbes.com/feeds/afx/2009/01/22/afx5951139.html](http://www.forbes.com/feeds/afx/2009/01/22/afx5951139.html); January 2009 Reuters poll of analysts on euro adoption dates.



Latest estimates indicate the euro constitutes approximately 25 percent of the world's reserves.<sup>7</sup> That's not too bad for an upstart currency only 10 years old. The U.S. dollar share of the world's reserves is down to about 65 percent.<sup>8</sup> The other 10 percent consists of currencies from the rest of the world.

On the subject of financial markets, one has to look at both the components of the stock market, which this book does in detail, and at the world's bond markets when considering how the array of currencies now interact in the world. One can see that indebtedness issued in the euro is roughly equal in size to indebtedness issued in the U.S. dollar. These two have become the dominant debt currencies of the globe. The British pound and the Japanese yen have secondary roles, and other OECD countries have much smaller shares. Of the approximately 85 trillion U.S. dollar equivalent of global indebtedness, about \$24 trillion is issued in euros and \$33 trillion in U.S. dollars. Taking only international bonds, about \$10.5 trillion is issued in euros and \$8.5 trillion in U.S. dollars (Figure 1.4).<sup>9</sup>

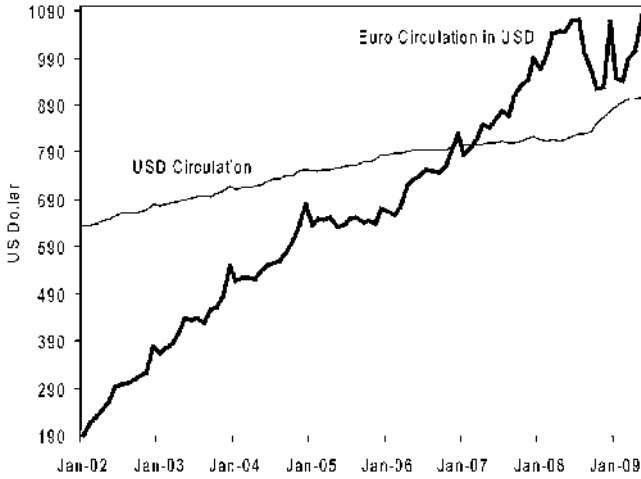
During its first decade the euro has continued to strengthen against the dollar as both a virtual and paper currency. Outstanding



**Figure 1.4 International Debt Issued in Euros and U.S. Dollars Is Roughly Equal**

Note: Amounts outstanding of international bonds and notes by type, sector, and currency in billions of U.S. dollars.

Source: Bank for International Settlements *BIS Quarterly Review*, June 2009.



**Figure 1.5 Global Cash Outstanding in Euros Is Greater than in U.S. Dollars**

Source: Federal Reserve Bank of St. Louis, European Central Bank, and Cumberland Advisors.

cash in the world denominated in euros is now a larger amount than that denominated in U.S. dollars (see Figure 1.5). Such cash is utilized in legitimate transactions in the global economic arena, as one would expect. Cash is also used in underground activity. Gray-money balances are now denominated more in euros than in U.S. dollars.

The euro has achieved credibility, respectability, and power in circulation far beyond anyone's expectations. When it comes to currencies of choice around the globe, the U.S. dollar is morphing into second place behind the euro. When it comes to trade, the euro is also holding its own: The euro area share of trade (imports + exports) has gained relative to the U.S. share. In 2000 it stood at 14.9 percent versus the U.S. share at 15.9 percent. Through mid-year 2009, the euro area share of global trade held steady at 14.8 percent, while that of the U.S. share fell to 11.7 percent.<sup>10</sup> When it comes to outstanding bond indebtedness, it is fair to say that the U.S. dollar and the euro are in a tie. As this book argues in other chapters, stock market trends are likely to follow this pattern.

## Central Banks: The ECB Versus the Fed

Let's address the construction of the central banks. Eurozone monetary policy is directed by the governing council of the European Central Bank. Inflation is the primary enemy of the ECB. The currency's buying power is mandated to be kept as stable as possible. Inflation is targeted (below but close to 2 percent) and monetary policies are directed first and foremost at the maintenance of a strong and reliable currency. The ECB's monetary-policy strategy includes a quantitative definition of price stability and a two-pillar approach to the analysis of the risks to price stability (an economic and monetary analysis).<sup>11</sup> Europeans have a long history. Clearly, they do not trust the political construction of their governments. Over the course of a thousand years they have watched the value of currency erode through inflation. They have watched governments confiscate wealth. They are suspicious of government, and they have good reasons.

The formulation of the European Central Bank was directed at providing Europeans a safe and reliable currency in which they could transact their monetary affairs. The purpose was to define the characteristics of a medium of exchange in which they could hold their currency and not worry about rapid inflation, which would erode its value.<sup>12</sup> Monetary policy was aimed at meeting the classic economic definition of money, that it be a way to "store value." The euro was quickly accepted after 2002, thereby meeting the third requirement of a currency, which is to be a unit of account. These are the three things necessary for a currency to succeed:

1. Be a medium of exchange
2. Store value
3. Be a unit of account

The euro now meets all three tests.

The political construction of the European Central Bank is resolved, accepted, and clearly determined in a way in which that central bank's independence is maintained. The ECB has become increasingly credible during the decade of its activities.

When we look to the dollar, we find a different construction underway. For years the dollar was paramount in the world. It was the preeminent currency and was viewed as qualified by all three

standards. After the suspension of the Bretton Woods fixed-currency regime and the closure of the gold window under President Nixon, the U.S. dollar started to lose its luster.

As this is written, there are serious questions about the persistent and continuing value of the U.S. dollar vis-à-vis most other currencies in the world. Over time, the dollar has developed a reputation for bouts of weakness. Very few forecasts of a long-term nature view the dollar as the dominant, preeminent global currency for the next several decades. Many more forecasts focus on the euro and the construction of the ECB, which is keeping that currency strong.

In the United States, the Federal Reserve in the last few years has developed a reputation of being held hostage to U.S. politics, with regard to the makeup of its Board of Governors, its loss of policy independence, and problems with policy strategy. This has accelerated and intensified the suspicion about weakness in the U.S. dollar.

With regard to the current Board of Governors, at the time this book is written, the confirmation of two governors has been held up by the U.S. Senate Committee on Banking, led by Chairman Christopher Dodd (D-Connecticut), throughout the financial crisis of the last several years.<sup>13</sup> This has meant the Fed had to operate under a unanimity rule when it needed to deploy emergency decision making during the financial crisis.

Very few observers understand the difference between a unanimity rule and a supermajority rule. During the creation of the Federal Reserve rules as a response to the Great Depression in the 1930s, it was determined that the Board of Governors would make normal decisions with four of seven affirmative votes, but to invoke “emergent and exigent powers” would require five of seven votes. Never was it contemplated that there would only be five governors seated. When you have a supermajority rule, you allow room for dissent, debate, discussion, a record, and a narrative that can be examined and studied with respect to policy-making decisions.

Under a unanimity rule any governor has a veto. In fact, the records of the financial crisis indicate that the only emergency actions we know about coming from the Fed Board of Governors are those with five affirmative votes. We have no way of knowing about votes with four in favor and one dissenter. They were not recorded; no formal record exists. We have no way to know whether Chairman Bernanke, under pressure during those critical decision-making periods, was unable to obtain five votes. During crisis periods,

failure to have agreement at the Fed may have exacerbated the disasters, including the Fed's primary-dealer difficulties involving Bear Stearns, Lehman Brothers, Merrill Lynch, and Countrywide.

With regard to the erosion of policy independence at the Fed, we look at the redefinition of the Federal Reserve's role under the Obama administration proposals. Under certain circumstances, the Treasury Secretary of the United States will have the power to veto a Federal Reserve action. If there is an action, the Fed will not be able to implement it until it receives written permission from the Secretary of the Treasury.

The Secretary of the Treasury in the United States is a cabinet official appointed by the President, reporting to the President, and meeting with the President on a weekly basis. Clearly, the U.S. central bank's independence is being undermined. Political forces in the United States continue to threaten other aspects of the Fed's activities and independence. And in the early months of the Obama administration, the Federal Reserve Board of Governors has continued to operate with two vacancies.

The authors of this book believe the long-term trend does not favor central-bank independence in the United States. Instead, it favors federal government intervention in monetary affairs. History is replete with examples of central-bank policy failure when the national government directs that policy.

This outcome doesn't always have to be extreme, as in the cases of the Weimar Republic or Zimbabwe. It can be a relative weakness. One currency can be more preferred than another currency. Part of that preference can be due to the political influences and directives that the national government imposes on its central bank. Sadly for the United States, the outlook for the Federal Reserve as an independent central bank of the United States is not sanguine. In sum, U.S. politics are set to permanently weaken the U.S. dollar.

Turning to the Fed's policy strategy, we believe that the central bank's two mandates are also a negative for the dollar. The Fed is supposed to control and restrain the rate of inflation. The Fed is also to maintain full employment and achieve maximum economic growth. These standards are conflicting, even though members of the Federal Reserve sometimes argue that they are consistent. They argue that inflation itself destroys growth and, therefore, by fighting inflation they will attempt to achieve the best level of economic growth. Recall, it was former Fed Chairman

Greenspan who introduced “risk management” as a policy strategy aimed at resolving the inconsistency of the two mandates.<sup>14</sup>

However you want to phrase the debate, the Federal Reserve faces a dual mandate. It has to fight inflation, and it has to stimulate growth. The process by which it determines priorities is a function of the U.S. political system. Contrast this with the European Central Bank and the euro, where the ECB’s primary purpose is to keep inflation low and keep the currency dependable and reliable. Furthermore, the ECB does so with a stated mathematical target, so that all can measure its success. The Fed has no formal target, therefore no policy anchor.

Studies by central banks, including the Federal Reserve, indicate that inflation-targeting regimes are able to reduce the inflation risk premium in their financial markets when they are successful.<sup>15</sup> The reason is simple. Market players are able to access what the inflation target is, understand how it is measured, and, subsequently, determine whether the central bank is doing a good or bad job in achieving the results. Where there is no inflation target, there is a band of uncertainty that creeps into the pricing of financial assets. We call this the inflation risk premium. In the case of the United States, one can guess at the degree of inflation risk premium by measuring the spread between inflation-indexed Treasury securities (TIPS) and conventional Treasury securities in order to determine a market-based forecast of inflation and, hence, an inflation risk premium. Survey data is another way of estimating the inflation risk premium.

What does all this mean for stock market investors when they have to choose between two currencies? The same question can be asked in virtually any asset class. The answer is always the same.

If an investor is seeking to conserve the value of his or her investments, obtain growth, and endure minimal distortions in the accounting methodology used to report earnings and balance sheets of the various companies in which he or she invests, that investor seeks the more reliable currency. Inflation and a weaker currency have the tendency to distort the real economic value of a corporate entity. A company that is making money because of the change in the currency in which it reports its activities is not demonstrating unit growth, productivity, or reliable and dependable earnings that are understandable. That company’s results are distorted through financial accounting; it is reporting profits because of changes in price levels due to inflation. Therefore, corporate inventory results

are misstated. Debt payments or other accounting reports from the company have to reveal the impact of price changes. Companies manage their finances in currencies based upon whether the currencies that they choose can store value and are reliable. Otherwise, they have to engage in costly hedging operations because of changes in currency exchange ratios.<sup>16</sup>

## **Global Capital Reallocation Toward the Euro**

Over a long period of time, currencies that hold their value become a more attractive investment domicile than weaker and more distrusted currencies. In the case of the euro, developments in its markets have led to more reliability of the euro and focused a global reallocation to it.

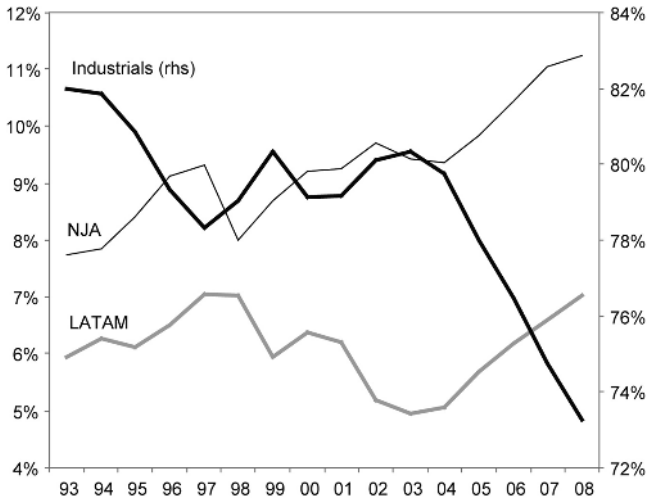
A good example of this can be seen in the aftermath of the global financial crisis. Here we have an opportunity to examine the banking sector and stock-market capitalization by currency and valuation that banks experienced in stock markets around the world.

In 1999, at the time the euro was launched, 24 U.S. banks were listed among the top 50 banks when ranked by total market capitalization.<sup>17</sup> Eleven continental European banks were on the list. So were seven British banks. The rest of the banks that made the top-50 list in market cap included six from Japan, one from Australia, and one from Hong Kong.

Compare those statistics with the spring of 2009. Of the top 50 banks in market cap, only 11 U.S. banks made the list.<sup>18</sup> This is a pronounced and dramatic decline from the period in which the euro was launched, ten years earlier. There were still eleven continental European banks in the top-50 list. Only three British banks made the cut.

Of the remaining, Japan could list four banks. There were many new faces, including six Chinese, five Canadian, four Australian, three Brazilian, one Russian, one Indian, and one bank from Hong Kong. The three largest banks in the world as measured by market cap were Chinese. Their combined market cap exceeded the total market value of the five largest U.S. banks.

The depth of the impact of the financial crisis in the United States was certainly a major force causing U.S. banking decline. Less recognized is the strength of the euro. It is probably largely responsible for the shift.



**Figure 1.6 Shares of World Consumption**

Source: IMF and OECD.

Economist David Hale has noted how the recent financial crisis has produced major changes in the global balance of financial power,<sup>19</sup> such as in the changes in bank market cap and the changing composition of global consumption (see Figure 1.6, which depicts the share of consumption by industrial countries relative to global consumption as ebbing, while that of emerging markets is rising, a trend that will likely intensify in years ahead).

The shift in the balance of financial power can be teased out from Western Europe’s annual personal consumption, which in 2008 exceeded that of the United States for the first time in history. Both the Western Europe economic region and the United States have personal consumption by their respective citizens in excess of 10 trillion USD.<sup>20</sup> The difference between them is that Europe has grown and in fact has nearly doubled since the start of the millennium on January 1, 2000, while the United States has increased by only a third. There are a variety of reasons why consumption has risen faster in Europe. Among them is the success of the euro, due to the reduction of internal frictions and costs as national currencies gave way to a unified regional currency.

People are better off in the Eurozone than they were a decade ago because of the strength and dependability of their currency. The



long march of the euro to successful equilibrium with the U.S. dollar is complete. Perhaps euro dominance as the world's reserve currency is underway.

There was one event in the 10-year lifespan of the euro that interrupted this process. In late 2004, the U.S. Congress passed and the Bush administration accepted a change in federal tax law.<sup>21</sup> By that change, international companies headquartered in the United States were allowed a one-time repatriation of foreign accumulated profits at a particularly low tax rate. For one year only, the federal corporate income tax rate was about 5 percent instead of 35 percent. Companies seized the opportunity to bring foreign earnings back to the United States, and did so in an amount measured in the hundreds of billions of dollars.

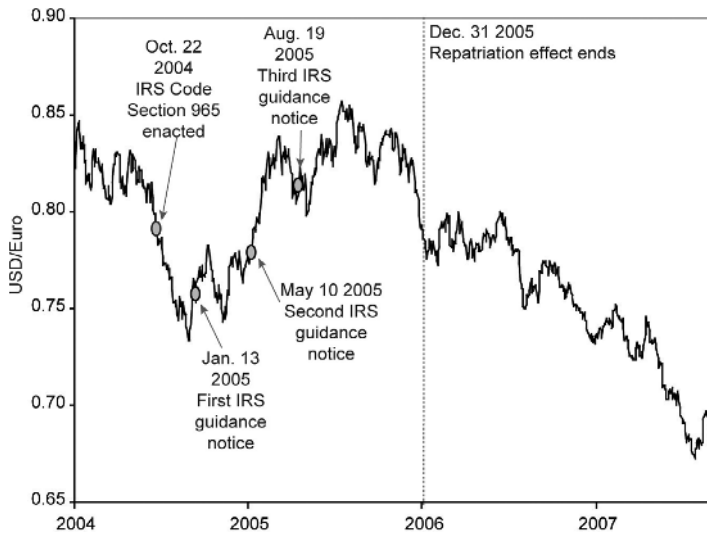
The law required that the repatriation be done in U.S. dollars. That had two consequences. Companies abroad that did not hold dollars but had accumulated earnings over the years in their foreign subsidiaries needed to raise the dollars by either:

- Borrowing in euros or other currencies and converting to dollars.
- Accumulating the dollars by selling euros or other currencies. The repatriation itself had to be done in dollars.

Second, the statute required those companies to have a trail of the use of the dollars for a certain period of time. They could not use the dollars, for example, to pay dividends or executive compensation. The purposes for which dollars could be used were defined. Companies would face tax penalties if they violated the rules. Therefore, many businesses segregated the dollar payments into a dollar hoard so they could track it and demonstrate compliance with the law.

The 2004–2005 one-time event increased the demand for U.S. dollar balances. While all dollars were fungible in normal transactions, the risk of a tax penalty encouraged U.S. multinational companies to follow this hoarding technique as a precaution.

These tax code changes caused world businesses to buy dollars and sell foreign currencies, particularly the euro. We saw the dollar strengthen against the euro (see Figure 1.7). Once the repatriation period was over, the U.S. dollar resumed its weakness against the euro and has continued that trend through today.



**Figure 1.7 Effects of 2004–2005 Repatriation Tax Change, Data through July 2009**

Source: Federal Reserve Bank and Cumberland Advisors.

## Outlook for the Euro

The authors of this book expect the euro to strengthen over the next decade. As mentioned above, the political construct of the ECB has become increasingly credible during this past decade, while the Fed’s credibility is seen as being undermined by the Obama administration’s proposals. This comes on top of a fundamental problem in the United States, namely, the economy’s lack of savings and reliance on foreign capital to finance investment, a long-term negative for the dollar.

Notwithstanding all of the political elements in Europe, which are complex and volatile, it is important to note that the Eurozone continues to enlarge. The financial crisis has taught non-Eurozone members and the European Union that it is better to be a part of the Eurozone than to go it alone.

If one looks at inflation rates, currency-exchange rates, and interest rates in the Eurozone countries versus non-Eurozone countries, one is continually reminded that the euro is the better option. Today, we see most of the remaining countries in the European

Union attempting to qualify and enter the Eurozone through the Exchange Rate Mechanism (ERM).

As this book is written, Baltic countries are attempting to accelerate their qualifications so that they can be admitted to the Eurozone. In other countries that are not qualified and in peripheral European countries that are not EU members, the euro is the dominant outside currency. No longer does the U.S. dollar play the number-one role. There is a de facto acceptance of the euro as a reserve currency and as a store of value. This is true even when there is no de jure compliance with the terms of the ERM.

Travel to Ukraine, which is not a member of the European Union, and you find the euro is widely accepted. The same is true in Turkey. Furthermore, in continents outside the European area, the euro has a stature that is now equal to or perhaps even ahead of the dollar's. The authors have seen that in both Africa and Asia.

To sum up, in only 10 years the Eurozone economy has grown larger than the U.S. economy. Euro-denominated cash in the world exceeds U.S. dollar cash. Euro-denominated international debt equals U.S. dollar-denominated international debt.

Last, and of special interest to readers of this book, euro-based stock-market shares of global market caps have been growing relative to dollar-based shares. If the trends in currency, economic size, and debt aggregates continue, stock-market weight must eventually follow.

