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EUROPEAN MARKET COMMENT: THE EURO APPRECIATES

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The Euro Appreciates
Be Careful What You Wish For

The European press and many market pundits have heralded the recent jump in the euro, apparently in the belief that its strength represents a panacea for all their economic ills. After steadily and painfully depreciating 26.7% against the greenback since its launch in 1999 until January 2002, the currency has appreciated 14.7% against the US$ over the last five months (see Exhibit A). While the appreciating euro may go a long way to restoring pride and confidence in the European Monetary Union, it will probably end up generating more frustration than hurrahs.

The Positive Side of a Stronger Euro

The rising euro will certainly bring several significant economic benefits to the region. A higher euro will lower the price of imports, which in turn should boost consumer spending and keep inflationary pressures in check. With inflation slightly above the European Central Bank's 2% inflation ceiling target, lower import prices should bring down pricing pressures enough to allow it to hold interest rates steady. Higher consumer spending would provide a significant fillip to Europe's economy, which suffers from sluggish household demand. The Continent's capital markets would also benefit to a certain extent should European investors redirect a portion of their funds away from the United States and toward their domestic markets.

Optimists hope that a stronger euro will propel consumer demand to a higher and stable plateau, which will reduce the degree to which the Continent's economic health depends on exports. The Continent has typically recovered from economic slumps via higher imports rather than through rising domestic demand, underscoring Europe's dependence on the strength of the global economy, particularly the U.S. economy. Other pundits, however, are more skeptical that a stronger euro will shift the plates that power Europe's economic growth. They note that European companies were not able to expand their market share, either in global or local markets, by exploiting their currency's weakness over the last few years. Therefore, they argue, a stronger euro will certainly not help the Continent decouple from the U.S. economy. This concern also suggests that going forward, the appreciating euro could be a more significant drag on the Continent's economy than is widely expected.

The Dark Side of a Stronger Euro

If a stronger euro persists, it would likely set in motion two forces that would brake the region's economic growth. First, a higher exchange rate would increase Europe's export prices, which would dampen exporters' sales. Exports and corporate earnings growth have already dropped dramatically from January 2001, which can largely be attributed to the sharp slowdown in the U.S. economy (see Exhibit B).

Second, a stronger euro will cut into the profit margins of European multinationals that have significant exposure to the U.S. market as profits get translated to euros on the balance sheets of their parent companies. Sales of U.S.-based European affiliates contribute more to the Continent's economy than do exports. In 1999, the last year of available data, sales from U.S.-based European affiliates exceeded by more than fourfold the total amount of exports to the United States from the European Union. If the U.S. economy encounters additional setbacks, European multinationals would be further affected by falling U.S. demand.

What If the US$ Crashes?

The above analysis assumes the euro rises gradually relative to the US$. However, if the US$ crashes,[1] the economic prospects become starker. In Europe, a dollar crash would be particularly detrimental to countries where domestic demand is weak and economic growth depends heavily on external demand, such as Germany and Italy. According to Morgan Stanley, this worst-case scenario, if it comes to bear, would probably slash one percentage point from Europe's GDP growth over the proceeding 12 months. Most analysts, however, contend that the probability of this scenario is remote. First, they have thus far interpreted the slide in the US$ as a natural correction from extremely overvalued levels, and they are not terribly concerned that its fall may provide indications of more serious cracks in the greenback's underlying fundamentals. Second, they believe that major central banks would probably intervene to support, or at least slow the fall, of the currency should a crash ensue.

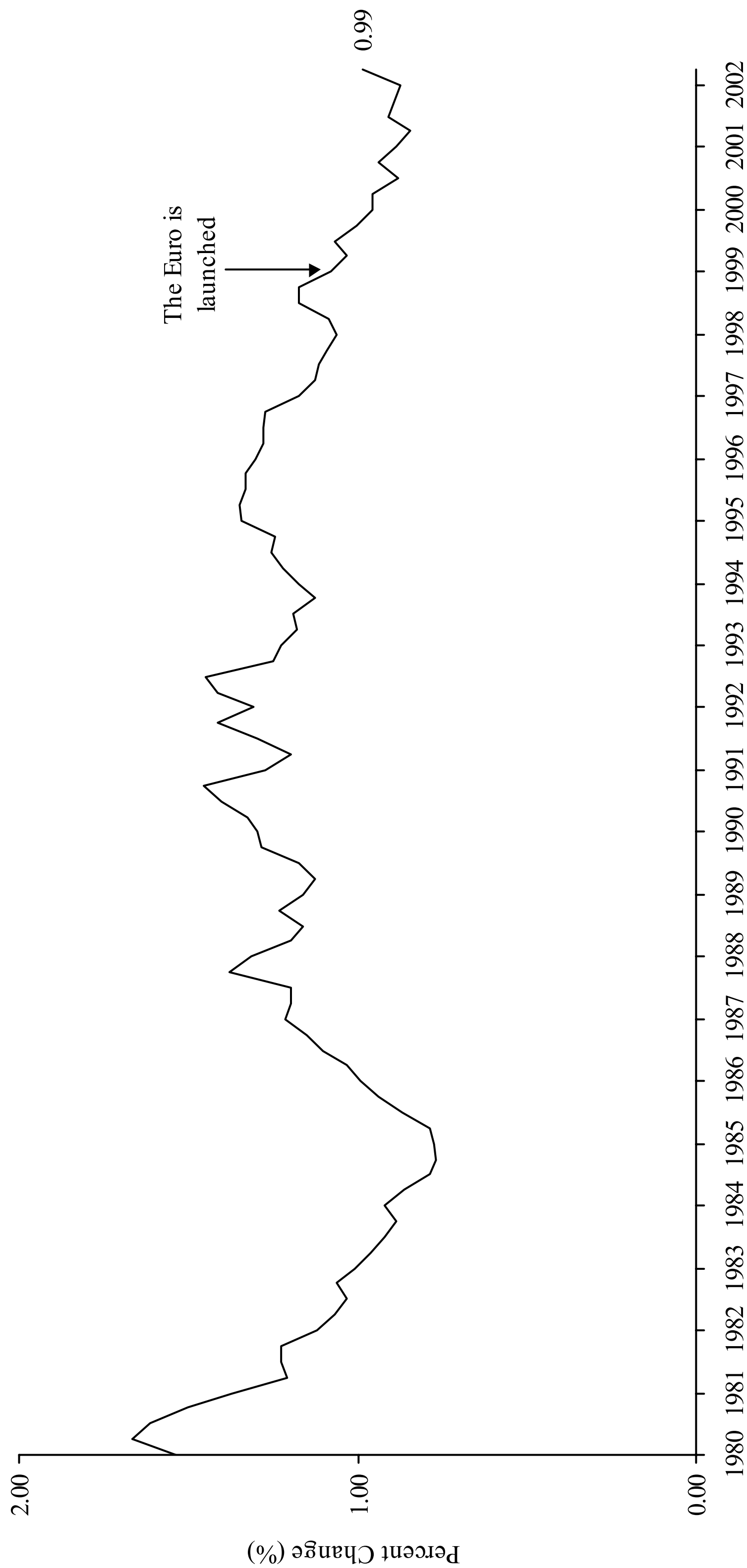
Eurozone policymakers have long-maintained that the euro has been undervalued against the US$. The currency's rise holds symbolic significance for the Continent and will likely help stave off a monetary policy tightening for the time being. However, until domestic demand in the region improves, the strengthening euro could undermine the Continent's economic growth, corporate profits, and, hence, equity prices.

[1] Pundits often use the term, "hard landing for the US$," without defining it. Stephen Jen, currency strategist at Morgan Stanley, provides a useful definition of a 3% or more fall in the value of the greenback per month, or a 20% fall against the euro and yen by the end of 2002.

Table A

U.S. DOLLAR TO EURO EXCHANGE RATE

January 1, 1980 - June 30, 2002



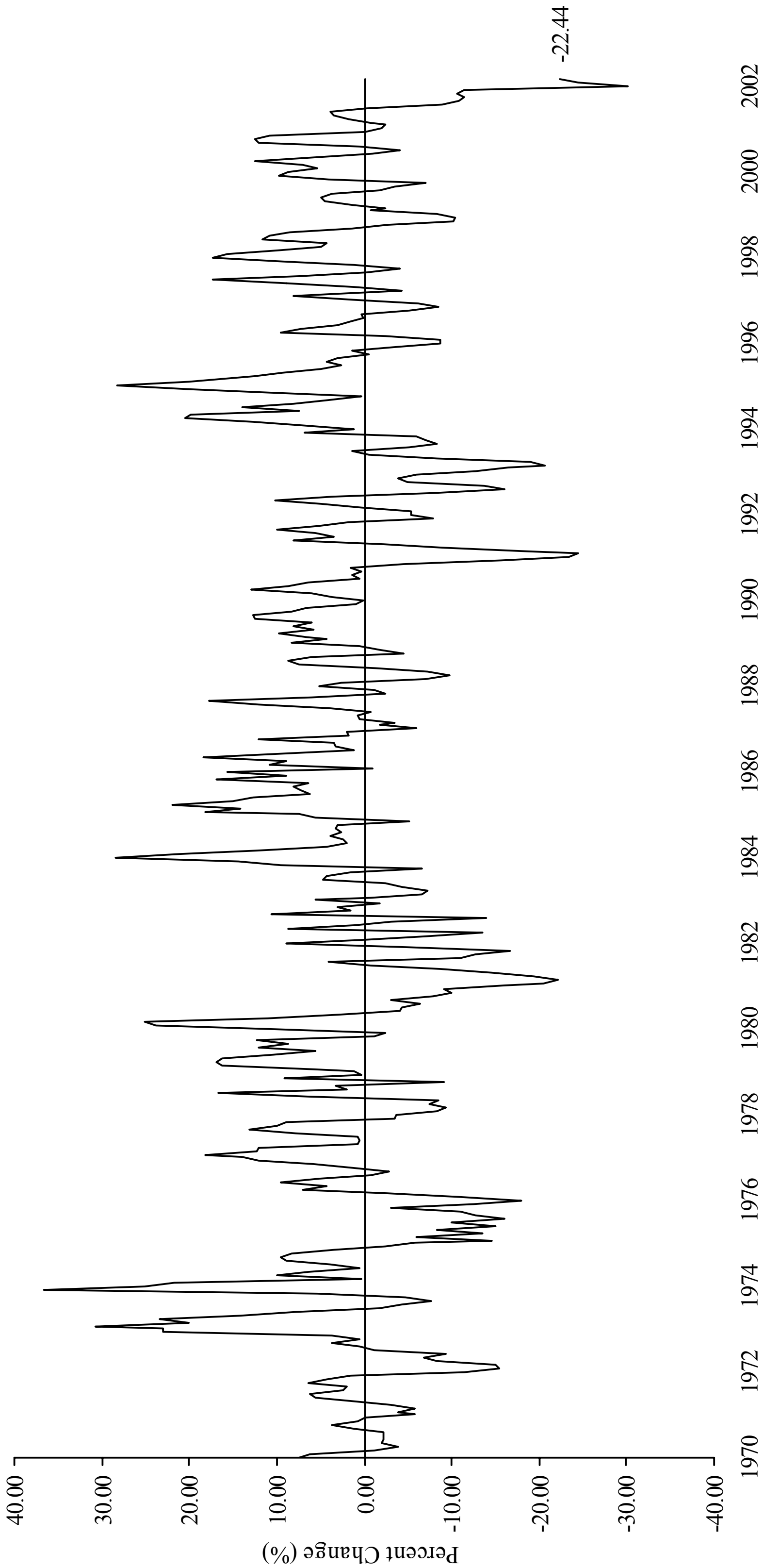
Sources: Eurostat and Thomson Financial Datastream.

Note: Data prior to 1998 use a synthetic exchange rate calculated by Thomson Financial Datastream, based on information supplied by FTSE International.

Table B

EUROPEAN CORPORATE EARNINGS GROWTH

January 1, 1970 - June 30, 2002



Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: Data represent the MSCI Europe ex U.K. Index. Data represent the quarter-over-quarter growth rate.