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Europe—a Source of so Much Pain and Distortion

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Europe is spreading pain around the world in so many different ways that the catalogue has reached ungainly proportions. The panic from the risk of default and the possible dismantling of the euro has gained the headlines and depressed most asset prices across the globe. The austerity measures, seemingly demanded by the situation and certainly by the European Union (EU) and the European Central Bank (ECB), have clearly set Europe on a recessionary path that threatens the pace of global growth. Europe's problems have also distorted currency values across the world, creating problems in yet another way. These will linger even though the ECB seems to have overcome its former objections and has begun to provide the liquidity needed to quell market fears.

The currency distortions have emerged as investors and money managers, unnerved by European risks, have shifted funds away from Europe's periphery and from the eurozone altogether. The US dollar has been the major destination. This flight has pushed up its value some 13 percent against the euro since the crisis reemerged last spring. The euro surely would have declined more against the dollar if not for the great liquidity in both the European and American markets, which has blunted the effect of even large fund flows. Nor did all the flight from the periphery leave the eurozone. Much has moved toward German and Dutch deposits and assets, for instance. Even if the euro were to dissolve, investors are likely to reason that they would be in a stronger position in these more-resilient economies when the conversion to national currencies occurs.

If flows out of the euro have had only a moderate dollar effect; they have had a much more profound impact on less-liquid currencies such as the Swiss franc and Japanese yen. In these currencies, values have risen dramatically at times. The yen has jumped from 85 to the dollar last April, to 76 recently, a record level and an appreciation of about 10 percent in a remarkably compressed time. The Swiss franc's dollar value rose more than 25 percent from last spring to that currency's highs last summer. And since the dollar has itself risen against the euro during these times, the yen's appreciation against Europe's common currency has verged on 25 percent, while the Swiss franc's appreciation has approached 40 percent.

Where the currency appreciations have occurred they have tended to hurt exports, as every notch in the ladder of appreciation has eroded that economy's global pricing advantage. For the United States, the experience has been a lot easier than for the others. Not only has the dollar appreciated less against the euro than have the yen or the Swiss franc, but also the dollar appreciation comes after a long period of dollar depreciation, amounting, in fact, to more than 70 percent against the euro during the past 10-plus years. For America, then, the recent currency moves merely take the edge off a strong competitive pricing advantage. The United States is also much less export dependent than either Switzerland or Japan.

But in these smaller economies the currency moves have hit hard. Japanese sales overseas have slowed so significantly since Europe's crisis started to push up the yen that the country now faces an atypical foreign-trade deficit. Switzerland through the second quarter this year (the most recent period for which data are available) had seen nearly a 2 -percent drop in its exports of goods and services, a shock after 2010's gain of more than 7 percent. Matters by last summer had reached such a difficult pass that both these countries felt obliged to fight the rise in their currencies by intervening in currency markets for the first time in years. Japan's efforts managed to push the yen down 2-3 percent from its highs against the dollar, but have left it pricy nonetheless. Switzerland has been more aggressive and managed to return its franc back to its former, more competitive value. Data are inadequate to determine if these desperate policy moves have improved the export positions of these economies, but in any case the need for ongoing efforts to keep the currencies down will continue to distort markets.

To some extent, the pain of Japan and Switzerland should redound to the Eurozone's benefit. The loss of competitive pricing in these countries, as the euro has depreciated, should give Germany, France, and even the continent's beleaguered periphery an improved relative-pricing edge on global markets and so improved export prospects. But such benefits definitely have limits. The euro's drop against the dollar is too small to make much difference in either Europe or America, especially given past euro gains. Meanwhile, Japan is less a direct competitor to Europe than is China, for instance, especially in consumer goods, and there the currency shifts have been less powerfully favorable to Europe, only slightly better than with the dollar, in fact. Meanwhile, Switzerland, significant as it is culturally and historically, is simply too small of an economy to make that much difference for the European Union, which, by common measures, is more than 31 times its size. Whatever effects do emerge will help less in the eurozone than they will harm the affected, smaller economies. Meanwhile, the currency pressures and accompanying distortions will persist until the ECB makes a more concerted effort to relieve the immediate fears in Europe and stop the flight of funds.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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