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The strength of the euro is no accident

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Earlier this year, the euro was sold as a proxy for a variety of ailments in the eurozone. However, as we argued then and now, the euro will not only prevail, but triumph over the US dollar in the medium to long-term.

Let's first debunk the myth that economic growth is necessary to have a strong currency – just look at Japan.

To understand why the euro may continue to strengthen, consider the yen: how has Japan, with its dismal economic growth had such a strong currency? Unlike the US, which requires foreigners to finance its current account deficit, Japan has a trade surplus while financing its budget deficit domestically. Indeed, the yen has experienced great strength since 2007, a period where Japan went through eight finance ministers, a reflection of weak governments unable to spend money or exert pressure on the Bank of Japan to print money. The US dollar, in contrast, is highly sensitive to perception changes about economic growth, as foreigners are more inclined to invest in the US when growth is anticipated. The eurozone's current account is roughly in balance; as a result, lacklustre growth and a strong euro are quite compatible.

In our assessment, European Central Bank monetary policy is more robust than that of the Federal Reserve. The ECB's model of providing unlimited liquidity to the banking sector can be phased out within a year for the longest such facility. In contrast, the Fed has been buying mortgage-backed securities and bonds to stimulate the economy. Huge challenges are inherent to such a strategy, one being that the Fed has lost control of its balance sheet: the low interest rates encourage consumers to refinance their mortgages, in the process paying back the loans underlying the MBS held by the Fed, thus increasing the levels of pre-payment risk and volatility of the Fed's underlying assets. Moreover, the Fed's balance sheet is much less flexible than the ECB's. With so much of the Fed's assets tied up in longer-term MBS, which has little to no functioning market, the Fed's ability to implement effective monetary policy may be severely compromised.

It's often been lamented that the eurozone has no central finance minister to co-ordinate a fiscal response in a crisis. It's true that the eurozone sorely needs improvements to existing communication channels, although great strides have been made with Olli Rehn, EU commissioner for monetary affairs, who has given his office the profile it deserves and requires. Rarely observed, however, is the major advantage of not having a central Treasury secretary: it is far more difficult to spend money. In the US, it's comparatively easy to stuff a trillion dollars into the banking system; in the eurozone, the money has to come from regional, often local, governments which is a far more painful process.

Importantly, the sense of urgency in the eurozone has prevailed, encouraging policymakers to engage in real reform. Weaker eurozone members have not only announced, but implemented substantial austerity measures. In the US, the government came to the rescue too quickly, producing a financial reform that won't make the system as a whole more stable. Fiscally, neither Democrats nor Republicans have laid out credible visions for sustainable budgets.

In an effort to impose structural reform, the ECB has held the eurozone on a comparatively short leash ever since the introduction of the euro. As a result, most European consumers, particularly German ones, are far less leveraged than their US counterparts. Tightening in the eurozone won't, therefore, automatically derail a eurozone recovery.

In contrast, US consumers remain on life support; most of the support by way of extraordinary monetary policies is aimed at reducing the number of homeowners "under water" in their mortgages. Given that it is politically unacceptable to encourage consumers to downsize, the most realistic alternative is to push up the price level to bail out these homeowners. As free market forces would favour further de-leveraging and lower home prices, such a policy is going to require an extraordinary monetary and fiscal effort; this may not lead to sustainable growth, but will show up in assets with the greatest level of monetary sensitivity, i.e. through a weaker dollar, and higher precious metals and commodities prices.

This story is beginning to unfold before our eyes: the Fed is likely to engage in more quantitative easing, amplified by Bernanke's unequivocal comments that the Fed will resist market pricing of inflation expectations that it deems too low. Those regions that resist this path, such as the eurozone, may experience weak economic growth on the backdrop of relatively strong currencies.

There are many potential pitfalls to the Fed's strategy; we can, however, be reasonably certain, that the strategy poses grave risks to the US dollar. A strong euro is no accident; a temporarily strong dollar was.

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