

FOREX FOCUS: Sacrificial PIGS May Still Burn The Euro

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- High cost of boosting ECB's credibility
- Last thing peripherals need is higher rates, higher euro
- Core inflation in euro zone and U.S. both at 1.1%
- Peripherals now need longer-term bailout accord

LONDON (Dow Jones)--Jean-Claude Trichet may have boosted the credibility of the European Central Bank, but only at a high cost to the euro.

The ECB president's decision to signal a rate rise as early as next month certainly gave the single currency a strong boost, but Portugal, Ireland, Greece and Spain must have the distinct feeling they are being sacrificed for the good of the central bank.

As these 'peripheral' countries of the euro zone struggle to avoid defaulting on their debts, and funding their banks becomes increasingly difficult, higher rates are the last thing they need.

Sure, Trichet has attempted to mollify the markets with the promise that a little rise next month doesn't mean the start of a series of interest rate increases.

But, as the euro's 10-cent rally since the start of the year shows, just talk of higher rates is enough to push the currency sharply higher.

See the euro's recent rise against the dollar:
<http://www.dowjoneswebservices.com/chart/view/5437>

So peripheral debtors--who are already teetering on the edge of default--are now faced not only with higher rates, but also with a stronger euro that will undermine export growth just at the time they need it.

On top of all this, there is the rally in commodity prices, particularly the rise in crude oil prices to their highest levels in two and a half years.

Trichet's rate rise hint may well have been a direct response to the higher cost of energy, but this will prove an additional burden to the economies of the peripherals, especially if Middle East tensions intensify and higher crude oil prices become more of a permanent feature for financial markets.

Although Trichet has justified his hawkish position along the lines that the central bank needs to preempt inflationary pressures and preserve its prime purpose of price stability, the highly-anticipated rate rise could well prove premature.

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Core inflation in the euro zone of 1.1% is the same as in the U.S., yet the U.S. Federal Reserve only this week reassured financial markets that, while it is poised to move if needed, the central bank has little intention of abandoning its ultra-easy policy just yet.

At the moment, the currency markets may be voting in favor of the ECB, pushing the euro higher at the expense of the dollar as yield differentials move more in favor of the euro zone.

However, if the ECB proves to be premature and the peripherals start to suffer, the euro could well come under selling pressure again.

Chances are that higher rates in the euro zone will not only push Portugal closer to a bailout and Spanish banks closer to a shake down, but will also ensure that Ireland has even more problems negotiating a restructuring of its debts. Unless, of course, euro-zone leaders pull a rabbit out of the hat at their summit at the end of this month and provide a longer-term solution that reduces the risk of debt default.

Then the euro zone might be strong enough to withstand a hawkish ECB and the recent rally in the euro itself might be more justified.

Bloomberg TNI FRX POV
Reuters USD/DJ
Thomson P/1066 or P/1074

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