FOREX FOCUS: Watch The Euro's Defences Crumble

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-- Political will and ECB's hawkish stance won't support euro for long

-- Merkel's weakening coalition will make support for peripherals harder

-- Fed's more hawkish talk, lower yield differentials helping the euro

-- Fears of debt default will rise if funding costs increase any more

LONDON (Dow Jones)--The euro's defences are under attack again, and they could well crumble this time.

For the last few weeks, the single currency has been supported for two key reasons--market confidence in the political will to keep the euro-project alive and the staunchly hawkish stance of the European Central Bank.

However, the political will is becoming more difficult to preserve and the hawkish stance may not be so helpful after all.

The importance of political will has been illustrated by the euro's resilience despite the recent flurry of bad news including the resignation of Portugal's prime minister, the downgrade in Spanish and Portuguese banks, the likely failure of major Irish banks to pass stress tests, and the lack of progress on the extension of the European Financial Stability Facility at last week's summit of European Union leaders.

The assumption is that despite their inability to negotiate a quick and obvious solution to the sovereign debt crisis, there is still enough political will among EU leaders to ensure that a serious default is prevented.

This assumption has been strong enough to bring a fresh wave of central bank interest in the single currency as the banks diversify more of their foreign exchange reserves out of the U.S. dollar.

Election results from Germany over the weekend could well change this.

Sure, Chancellor Angela Merkel's CDU party lost in Baden-Wuerttemberg for the first time in 58 years because of the anti-nuclear vote. But that doesn't detract from the fact that her ruling coalition is that much weaker and her ability to vote through support for peripheral debtor countries will be that much more difficult.

This will be particularly important in weeks to come, especially if the threat of a Spanish bailout increases and the need for a considerably larger EFSF becomes more urgent.

Meanwhile, expectations that the ECB will raise interest rates by 25 basis points at its policy meeting next month could also prove to be less of a plus for the euro.

Certainly, market emphasis on yield differentials has helped the single currency to rally back as far as $1.4250 in the last week or so.

But, those differentials could well start falling again now that the U.S. Federal Reserve has started to take a more hawkish stance, suggesting that U.S. rates will start rising once the country's second quantitative easing program, known as QE2, runs out in June.

Friday's news that fourth-quarter GDP had been revised up to 3.1% from 2.8% has contributed to the feeling that the U.S. recovery is proving stronger than expected, despite inconsistencies in recent U.S. employment data.

There is another reason why ECB rate rise expectations will stop helping the euro.

The lack of an agreement on the EFSF extension means that the risk of a sovereign debt default persists and will only grow if the ECB raises rates, making the cost of funding peripheral debt even more expensive.

A shift in sentiment towards the euro could be particularly violent against the dollar, given that recent data show that speculative short positions in the U.S. currency have risen sharply.

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