FOREX FOCUS: The Euro Needs More Than Just a Rabbit

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LONDON (Dow Jones)--Investors are still giving the euro the benefit of the doubt. But serious cracks are starting to appear.

Unless European Union leaders pull a very convincing rabbit out of the hat at their Brussels summit this week, the single currency's future will once again be in doubt.

For most of this month, the euro has found itself well supported, attracting enough buyers to keep it trading above $1.30, despite continuing tensions in the indebted 'peripheral' euro-zone nations.

The euro derived some of its strength from dollar weakness after the U.S. extended its quantitative easing program last month. But it also benefited from speculation that euro-zone leaders will come up with a longer-term rescue plan to prevent a sovereign default.

However, the closer this week's summit comes, the less this more permanent plan seems likely.

Proposals launched a few weeks ago for issuing euro-zone-wide bonds have essentially been shelved, with even European Central Bank President Jean-Claude Trichet admitting this week that he doesn't like the idea.

Certainly, German Chancellor Angela Merkel isn't keen on them, given that the bonds would mean Germany has to provide even more subsidies, through higher bond yields, for its poorer neighbors.

In a speech Wednesday, Merkel failed to raise market expectations for any magic at the summit, sticking largely to calls for deeper economic integration.

So there is still considerable doubt about whether the EU leaders will compromise on other plans for increasing the rescue funds that the EU is setting aside for further bailouts or for raising the capital of the ECB itself so that it can continue stabilizing the peripheral bond markets.

In the meantime, though, market pressure for EU action is growing.

Moody's may have insisted Wednesday that its warning of a downgrade of Spanish debt doesn't mean the country is going to default. But the timing of the credit-rating agency's warning and the focus it puts on Spanish debts won't help the euro.

Nor will fears about fiscal reform in Belgium and Italy. The former had its credit-rating outlook cut to negative from stable by Standard & Poor's as the country's inability to put together a government since July hardly bodes well for fiscal discipline.

Likewise, Prime Minister Silvio Berlusconi's paper-thin parliamentary majority after Tuesday's no-confidence vote means he will have even less chance of accelerating the fiscal reforms needed to achieve the country's financial restructuring.

As tensions rise ahead of the summit, the euro may be holding up well against the dollar.

Data on speculative futures positions on the Chicago Mercantile Exchange up until the Tuesday before last show that, despite all the sovereign-debt concerns, investors still weren't shorting the euro.

However, there have been signs over the last day or two that investors are starting to lose their nerve.

At least one major hedge fund is believed to have sold the single currency heavily against its Swiss counterpart this week. Also, Citigroup reported a rising bank demand for the dollar through euro/dollar swaps, encouraged both by year-end preparations but also by concerns that the tensions among the euro zone's peripheral debtors will persist well after the EU leaders have left Brussels late on Friday.

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

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