European Central Bank President Mario Draghi, embracing policies dismissed by his predecessor, is forcing euro bears to capitulate.

Since July 26, when Draghi said he would do “whatever it takes” to save the 17-nation euro, the currency has appreciated versus each of its 16 major counterparts tracked by Bloomberg. The cost to protect against a default on government debt in western Europe tumbled to a 15-month low and confidence in the region’s banking system is improving, with bank stocks rallying 33 percent since June 1, exceeding the 18 percent gain in the Stoxx Europe (SXXP) 600 Index.

While former ECB President Jean-Claude Trichet kept the central bank from propping up debt-laden governments by limiting purchases of their securities as the almost three-year crisis deepened, Draghi has done the opposite since he took over in November. His decisions are placing everyone from former International Monetary Fund (MERKX) Chief Economist Kenneth Rogoff to fund manager Axel Merk on the wrong side of the market.

“It has been a game changer, and Draghi has done the heavy lifting,” Merk, president and founder of Merk Investments LLC in Palo Alto, California, said in a Sept. 13 telephone interview. His $526 million Merk Hard Currency Fund has jumped 3.38 percent in the past month, beating 92 percent of its peers, according to data compiled by Bloomberg.

Breakup Odds

Draghi, 65, has shown a greater willingness than Trichet to use the ECB’s balance sheet to aid Spain and Italy, and he relaxed his predecessor’s insistence that senior bondholders at crippled banks shouldn’t suffer losses in bailouts.

Merk, who said he was “very negative” on the euro earlier this year because of what he called the dysfunctional process in resolving Europe’s crisis, has turned into a buyer. “The euro has much higher to go from here, though it’s not out of the woods yet,” he said.

Chances of a breakup of the monetary union by the end of 2013 fell to 50 percent from more than 60 percent in late July, according to Dublin-based Intrade.com data, after Draghi gave details last week of a plan announced in August to buy debt of members including Spain and Italy.

The euro soared to a four-month high of $1.3169 on Sept. 14, before trading at $1.3126 as of 11:11 a.m. in Singapore. It appreciated 3.7 percent over the past month against a basket of nine other developed-market currencies, including the yen, pound and Australia dollar, and is the biggest gainer, according to Bloomberg Correlation-Weighted Indexes.

Highest Forecast

What European policy makers “have shown so far is their willingness to support the currency union and do as much as they can,” said Mary Nicola, a New York-based currency strategist at BNP Paribas SA.

BNP Paribas has the highest year-end estimate for the euro of any of the 50 strategists surveyed by Bloomberg, calling for the currency to strengthen to $1.35. The euro’s lifetime average since it was created in 1999 is about $1.21.

Rising confidence in Europe is helping global markets. The MSCI All-Country World Index (MXWD) of equities has soared 17 percent since its low this year on June 4. The Standard & Poor’s GSCI Index of commodities is up 25 percent from its 2012 bottom on June 21. Corporate bonds have returned 4.8 percent since the end of March, including reinvested interest, according to Bank of America Merrill Lynch index data.

Bank stocks in the Stoxx Europe 600 Index have climbed to their highest level since March 21.
**Sentiment Switch**

Just three months ago bets against Draghi’s ability to hold the monetary union together reached record highs.

The difference in the number of wagers by hedge funds and other large speculators on a decline in the euro compared with those on a gain -- so-called net shorts -- was 214,418, the most ever, on June 5, figures from the Washington-based Commodity Futures Trading Commission show. That amounts to a $33.4 billion bet against the euro.

Protection against losses on the senior debt of 25 banks and insurers with credit-default swaps rose more than 50 percent between March and July. Yields on 10-year Spanish bonds jumped to a euro-era record of 7.75 percent on July 27 as the nation sought a bailout of its banks.

Rogoff, who is now an economics professor at Harvard University in Cambridge, Massachusetts, told Tom Keene on “Bloomberg Surveillance” July 27 that while he expected Greece, which held consecutive elections in May and June amid public opposition to spending cuts after undergoing the largest ever sovereign-debt restructuring, to “ultimately” leave the euro, “the real question is what is going to happen to the broader euro?”

**'Viable Solution'**

Carmen Reinhart, also a professor at Harvard and the co-author with Rogoff of “This Time Is Different: Eight Centuries of Financial Folly” said at the Bloomberg Markets 50 Summit in New York Sept. 13 that euro-area governments must pursue deeper debt if they are to end the region’s three-year fiscal turmoil. “A viable solution is being put off the table,” she said. “Attempts to work on debt restructuring apart from austerity is what’s required within the euro.”

The debt turmoil has slowed economic growth. The Kiel-based Institute for the World Economy said Sept. 13 in an e-mailed statement that growth in Germany, Europe’s biggest economy, will slow to 0.8 percent in 2012 from 3 percent last year. The euro zone may shrink 0.5 percent this year, according to the median of 50 forecasts in a Bloomberg survey.

**Market Divergence**

Foreign-exchange strategists cut their forecasts for the euro throughout the summer. They expect the common currency to fall to $1.23 by the end of the year, compared with the median estimate of $1.28 in a May survey. That’s the second-largest decline among major currency pairs behind franc-dollar forecasts, which have dropped 2 percent.

That has led to the biggest divergence between 2012 fourth-quarter forecasts and current trading levels in 14 months.

Rising borrowing costs and diminished confidence in the euro prompted Draghi to signal in a July 26 speech to the Global Investment Conference in London that the ECB was ready to buy bonds to curb rising yields and boost confidence.

“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro,” he said. “Believe me, it will be enough.”

What’s different from Trichet’s policy is that the plan proposed by Draghi is open ended and doesn’t require the ECB to be treated with more seniority than other bondholders. The ECB’s balance sheet swelled by about 442 billion euros ($580 billion) to 2.33 trillion euros during Trichet’s last year as ECB president. The central bank’s holdings have increased by 745 billion euros since Draghi took over in November.

**A 'Genius’**

ECB Governing Council member Panicos Demetriades said the bank might not have to spend a cent on government bonds. The threat of unlimited buying under the ECB’s new bond-purchase program may mean that “in the end, action is not needed,” Demetriades, who heads the Central Bank of Cyprus, said Sept. 12 in an interview in Nicosia.

Germany’s top constitutional court on Sept. 12 rejected efforts to block a permanent 500 billion-euro euro-area rescue fund, which is meant to work in tandem with the unlimited bond-purchase program aimed at containing interest rates in countries such as Spain and Italy. The ECB may buy bonds with maturities as long as three years on the secondary markets of countries that ask Europe’s bailout fund to purchase their debt on the primary exchanges.

“The way he proceeded, I’ve called him a genius,” Merk said of Draghi. “He has managed to do what the politicians haven’t
been able to do without becoming too political. He’s moving the responsibility to political bodies.”

**Dollar Depreciation**

The currency is also getting a boost from a weakening dollar, as the Federal Reserve embarks on a third round of bond purchases, or quantitative easing, buying $40 billion a month in mortgage bonds to inject cash into the economy and attempt to bring down unemployment.

Intercontinental Exchange Inc.’s Dollar Index slumped as much as 19 percent to 72.696 from 89.624 as the Fed printed currency to buy $2.3 trillion of mortgage and Treasury debt in two rounds of QE from December 2008 to June 2011. It’s down more than 6 percent from its intraday high this year of 84.1 on July 24 to 78.781.

The Markit iTraxx SovX Western Europe Index of credit swaps on 15 governments fell to 188 basis points last week, the lowest level since the series started trading in March. A previous version of the index that included Greece was last this low in May 2011.

**Options Bets**

A basis point on a credit-default swap protecting 10 million euros of debt from default for five years is equivalent to 1,000 euros a year. Swaps pay the buyer face value in exchange for the underlying securities or the cash equivalent should a borrower fail to adhere to its debt agreements.

Options traders have eased bets the euro is going to fall against the dollar by year-end since Draghi hinted the ECB would purchase debt at the Aug. 2 central bank meeting.

The three-month so-called 25-delta risk reversal rate was minus 0.79 percent today, signaling greater demand for euro puts that give the right to sell the shared currency, versus calls. The rate was minus 2.05 percent on Aug. 2 and minus 4.39 percent on Nov. 17, the most since at least 2003 based on data compiled by Bloomberg.

Futures traders decreased their bets that the euro will decline against the U.S. dollar last week, figures from the Washington-based Commodity Futures Trading Commission show. The difference in the number of wagers by hedge funds and other large speculators on a decline in the euro compared with those on a gain, so-called net shorts, was 93,658 on Sept. 11, compared with net shorts of 102,306 a week earlier.

**Mighty ECB**

“We are expecting some more upside on euro-dollar to develop,” said Ian Stannard, head of European foreign-exchange strategy in London at Morgan Stanley, which capitulated last week on its call for a lower euro.

Morgan Stanley said in a report dated Sept. 13 that it now expects the currency will rise to $1.34 by Dec. 31, rather than fall to $1.19.

“Over the years, global investors have learned that it does not pay to fight the Fed,” Holger Schmieding, chief economist at Berenberg Bank in London, said this month in an interview. “Those betting on the demise of the euro may now have to realize that the ECB is as mighty as the Fed.”

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