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Continued Euro Strength Draws A Long Road Ahead for the ECB

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Markets responded enthusiastically to European Central Bank (ECB) President Mario Draghi's presumably upbeat comments last month, which prompted a surge in the euro that has continued into July. But Matthias Hoppe, senior vice president and portfolio manager, Franklin Templeton Multi-Asset Solutions, has interpreted more recent comments from Draghi as a warning to the market not to get ahead of itself.

Despite the scepticism we expressed in a previous article about the quick appreciation of the euro since European Central Bank (ECB) President Mario Draghi's much-publicised speech in Portugal on 27 June, the currency has continued to appreciate.

In our view, we think the ECB would prefer to avoid any major appreciation of the euro, particularly while inflation is still running below the 2% target. The question therefore is whether the ECB can do anything to avoid the euro's rise.

In his most recent press conference on 20 July Draghi appeared to be decisively dovish, in our view. Although Draghi repeated that eurozone growth was good, he recognised the ECB's inflation target was still a long way from being achieved. "Inflation is not where we want it to be and not where it should be", he said.

For reference, headline eurozone consumer price index inflation was 1.3% in June, while core inflation, which excludes the notoriously volatile impact of energy prices, was 1.1%.[1]

Draghi's comments came after the ECB governing council had maintained its guidance that key interest rates would remain at present levels for an extended period of time, and well beyond the end point of its quantitative easing (QE) programme.

In addition, the ECB had reiterated its pledge to increase the size and duration of its QE programme if the outlook were to become less favourable or if financial conditions were to become inconsistent with further progress towards a sustained adjustment in the path of inflation. "We stand ready to increase our asset purchase programme in terms of size and/or duration", Draghi explicitly said.

In our view, these remarks sound like a warning signal to the bond market. We think the ECB wouldn't want the market to get ahead of itself and threaten to push down inflation even more by pushing up borrowing costs. So the ECB stands ready to act as it has done in the past.

Bond markets seemed to have taken him at his word, as yields fell after the press conference. The currency markets seem to have had another interpretation, however, and the euro moved higher. According to many observers, the ECB missed the opportunity to talk the euro down. It seems that simply suggesting "prudence and patience" may not have been sufficient to hold back the common currency from appreciating.

But central banker’s rhetoric, interest rates and monetary policy alone can’t be the main determinants of the exchange rate. In our view, the strength of the euro is probably driven by the US dollar side of the equation. Since March, US data have been disappointing, while eurozone data have been delivering positive surprises.

In fact, the difference between positive data surprises in the eurozone and negative surprises in the US has done quite a nice job in explaining the recent surge of the euro against the US dollar. On the one hand, progress on achieving the high expectations set by potential fiscal policy and the legislative progress in the United States have been disappointing; on the other hand, the pessimistic expectations created by the eurozone’s debt crisis back in 2012 have been washed away by the waves of improving data.

In such a scenario the euro seems poised to continue to rise against the US dollar. The ECB would want to avoid any major appreciation of the currency as it is already tightening financial conditions, in our view. We think it’s significant that Draghi explicitly acknowledged that tighter financial conditions are “the last thing the Governing Council wants”.

These comments are in sharp contrast to the US Federal Reserve (Fed), which is trying to tighten financial conditions by raising rates and shrinking its balance sheet. While the ECB might further scale back asset purchases as early as this autumn, it won’t mean the end of QE. Moreover, sustained rate hikes are still a few years away, we believe.

Even if the economy in the euro area was close to full employment—which it is still far from—we believe the ECB would still not have much justification to raise rates as both current eurozone inflation and inflation expectations are well contained. In this light, investors may have become too optimistic about the probability of tightening monetary policy. Current interest rates will likely remain in place, in contrast to the US, where the Fed is widely expected to raise at least once more this year, which should be supportive for the dollar.

So how much longer can the rally in the euro last? In the past, major highs in the euro coincided with a peak in growth and inflation. We believe the euro’s appreciation will weigh on growth if it continues in the remainder of 2017 and into early 2018. Since the ECB’s power to control the currency market might be somewhat limited at this stage, it might be forced to hold fire on tapering. Ironically, this market reaction might even push the ECB to act on its threat to increase QE.

Meanwhile, the result is a complicated tug-of-war between a strong euro and a weaker dollar. A strong euro might be a drag on exports and dampen eurozone growth, while a weaker dollar could be actually very positive for the rest of the world, especially the United States and emerging markets.

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1. Eurostat, June 2017.

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