



Economy

ECB: how not to find itself (already) with its hands tied

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Mario Draghi cannot do less at the upcoming ECB meeting, on Thursday next, than at the previous meeting of 3 September. On the economic situation, the tone will remain highly cautious, primarily flagging up the downward risks. Inflation has slid back below zero (even if this is mainly an oil-effect) giving him every latitude to show that the ECB can do more QE. It would nonetheless be politically astute to remain relatively vague. First, to avoid giving the impression that the ECB deems its current policy ineffectual. Second, not to give rise to excessive expectations which would tie its hands in the coming months.

The ECB (officially) has no exchange-rate target

The ECB's latest meeting was held on 3 September after a somewhat choppy summer for the markets. The ECB's staff had at that time revised slightly down its macro forecasts relative to June, and Mario Draghi added that the risks were downward for both growth and inflation. Without going into greater detail, he affirmed that the ECB had the "willingness and ability to act, if warranted ". Since then, ECB officials have repeated this message on numerous occasions without really giving more details on the measures which could be taken or on when they would be announced. Recent trends in the euro's exchange rate have been mentioned on several occasions. For a central bank for which one of the articles of faith since its creation has consistently been "we have no exchange-rate target", this is a highly significant point.

Concerning the euro's exchange-rate, two points must be borne in mind: the spatial dimension and the timeline. From the geographic standpoint, we can analyse the euro/dollar FX rate or the euro's exchange rate against a basket of currencies. Historically, elasticity between these two measures is close to 50% (the euro-dollar parity, in general, varies twice as much as the "euro basket"). Moreover, we need to be able to establish what current levels should be compared with. Should we be looking at the variation of the last month, last quarter or the last year? The following table summarises euro exchange-rate variations.

	Euro exchange rate variations (in %) vs...									
	Basket (38 currencies)	Emerging markets	China	US	UK	Swit.	Japan	Russia	Turkey	Brazil
Weight in basket =>	100.0	54.6	17.7	12.7	10.3	5.5	5.3	3.5	3.3	1.4
current vs...										
... 1 month ago	-0.3	-0.7	0.4	0.5	0.9	-1.3	-0.4	-6.2	-3.1	0.9
... 2 months ago	1.5	1.6	2.1	2.4	3.4	-0.3	-1.5	-4.1	3.3	13.9
... 3 months ago	5.1	6.5	6.8	4.3	5.5	3.9	0.3	12.0	13.6	27.8
... 6 months ago	7.4	9.8	9.0	5.4	2.0	5.2	6.2	29.5	13.8	34.7
... 12 months ago	-3.1	-0.4	-7.6	-11.4	-7.7	-10.4	0.0	32.5	13.2	38.5
... average 2014	-4.9	-2.2	-11.7	-14.6	-8.8	-10.9	-3.4	36.0	13.0	40.0
avg 2015 vs avg 2014	-7.5	-5.9	-14.8	-16.0	-9.6	-12.4	-4.0	30.8	2.9	14.5

As we can see, the euro's appreciation has been general over the past three or six months, but it is particularly marked with respect to the currencies of Brazil, Russia and Turkey. Although these three countries have a relatively modest weight in the euro's nominal effective exchange rate, the depreciation of their currencies is so marked as to significantly contribute to the euro's appreciation. **All told, over the last six months, the euro has appreciated by c. 7.5% vs a broad basket of 38 currencies.** But if we take a longer reference period, this observation is completely inverted. **Relative to its 2014 level, the euro reflects a depreciation against a basket of currencies (around 5%), and an even more marked weakening against the dollar (around 15%).**

In any case, the euro's recent firming trend is awkward for the ECB on two counts. First, it heightens downward pressure on growth and inflation. According to the ECB's

sensitivity analyses, the euro's rise over the past six months would reduce growth by 0.4 points and inflation by 0.5 points compared with the scenario of stable exchange rate trends (all other things being equal)¹. Bear in mind that the ECB forecasts average inflation of 0.1% in 2015, 1.1% in 2016 and 1.7% in 2017. Nevertheless, it is accepted that an exchange rate shock does not have an immediate impact on activity or prices. The euro remains at a level which is more favourable to economic growth and reflation than was the case last year. The ECB does not question this, but it is worried about this source of support diminishing.

On the other hand, the euro's recent rebound suggests that the monetary easing measures adopted between June 2014 and January 2015 and then rolled out in recent months are seen as being less effective. In the meantime, the ECB - like the rest of the planet - had to revisit the monetary scenario in the US. Last year, as the Fed's expected first rate hike in 2015 drew closer, it was obvious that the euro would depreciate against the dollar, especially since the ECB kept easing its policy at the same time (zero interest rate, negative rate, TLTRO and QE). In recent weeks, the Fed's resolve to exit the ZIRP has weakened. The market thinks that the Fed is unlikely to hike its rates before next spring, and is not completely ruling out the possibility of a longer delay (see our *Eco Note* published on 24 September: "What would happen if the Fed never raised its rates again?").

By postponing the normalisation process, the Fed is putting the ECB in a difficult position because it has removed one of the reasons accounting for the euro's slide last year. Must the ECB react? And if so, how? These are the two questions being asked right now.

This first question was answered in a key speech given by Mario Draghi one and a half years ago². The answer is yes. At the time, the ECB's president had identified three risks that would encourage further easing measures: 1) an unwarranted tightening of monetary conditions after an appreciation of the euro, for instance; 2) poor credit conditions following a defective transmission of monetary policy; and 3) a deterioration in inflation expectations in the medium term. The third still applies, but it is nevertheless less intense than a few months ago. Core inflation is low, in the region of 1%, but it did not collapse in 2015, signalling that low energy prices did not have a negative second round effect on other prices. The second risk has now largely been eliminated. The credit cycle has started again. That leaves the first risk, and in particular the continued appreciation of the euro. **All told, the ECB's analysis can be easily summarised. The economic cycle in the Eurozone is lagging considerably, probably by several years, vs the cycle in the US. As such, everything should be done to ensure that the ECB's cycle is largely delayed relative to the Fed's. If the Fed does not raise its interest rates fairly soon (which would push downward pressure on the dollar) the ECB would have no other choice but to demonstrate that it can also further ease its monetary policy.**

The question of means is more difficult to settle. There are three possible measures of monetary easing. The first would be to intensify the forward guidance on the zero-rate policy by announcing that the end to sovereign QE has been pushed back from September 2016 to a later date. The second would be to increase the monthly amount of asset purchases, currently set at € 60bn per month, probably by broadening the list of eligible assets. The third measure would be to push the deposit rate (currently -0.20%) even further into negative territory, with the idea that in weighing on short-term interest rate spreads vis-a-vis the US would exert pressure on the euro. There are merits and risks associated with each of these measures.

We think it is too early for the ECB to make an announcement this week in any event. In six weeks, the ECB has received no information affirming that downward risk has materialised. The recent stabilisation in the oil price even points in the other direction, as does the good resilience shown by the business climate indicators in September. Neither has uncertainty on the Fed's policy been settled in one direction (maintaining a scenario of interest rate hikes) or in another (delay extended), unless the bilateral meetings at the recent summit in Lima provided Mario Draghi with information to which the market is not privy. All told, it would be preferable for the ECB not to make any promises in order to avoid creating too much expectation regarding an extension to QE. The ECB's reflation strategy, operated last year, helped to eliminate the theme of a Japanese-style situation in Europe. If the ECB extends its QE policy immediately, it runs the risk of being associated with the Bank of Japan, for which we cannot claim that the quantitative policy has been a roaring success.

¹ We have taken the elasticity provided in the "ECB staff macroeconomic projections for the euro area" published every quarter.

² Draghi (2014), "Monetary policy in turbulent times", 24 April.

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