

Fixed Income Research & Macro Strategy (FIRMS) – 9<sup>th</sup> September 2020

## ***Brazen ECB verbal intervention against Euro unwarranted and unlikely***

Markets bereft of key macro data releases and policy events in recent days will be turning their attention tomorrow to the European Central Bank's policy meeting.

The consensus forecast, which we share, is that the ECB will leave its policy rates, including its deposit rate (-0.50%), and the modalities of its PEPP and APP unchanged.

However, unnamed ECB Governing Council members in the past week have alluded to the Euro's appreciation, particularly against the Dollar, and its negative impact on Eurozone exports, economic growth and inflation. This has prompted speculation that the ECB will resort to verbal intervention to weaken the Euro.

Our core scenario is that the ECB will not explicitly try to jawbone the Euro weaker.

We think its policy statement (due out 12.45 London time) will make no reference to the Euro and only likely reiterate the ECB's commitment "*to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry*". At a stretch the ECB may announce a step-up in its monthly APP asset purchases (currently running at €20bn).

President Lagarde may in her introductory press conference statement (13.30) try to short-circuit any temptation for financial markets to push the Euro higher but this would at most constitute verbal intervention "light".

Our main argument is that the Euro Nominal Effective Exchange Rate (NEER) has only appreciated 1.8% since the ECB's last policy meeting on 16<sup>th</sup> July and has thus had a negligible deflationary impact. Moreover, the Euro's rise occurred in the second half of July, following EU leaders' approval of the €750bn Recovery and Resilience Facility. Since then the Euro has treaded water in NEER terms (and against the US Dollar).

Moreover, based on precedent, we think the ECB will privilege low Euro volatility over specific Euro exchange rate levels.

## ECB policy meeting, UK July GDP data and US CPI-inflation figures could make waves

The macro data and events calendar for major economies has been particularly light so far this week, leaving FX and rates markets prone to trading off the back of recently more volatile US equity markets and headlines about the covid-19 pandemic, the run-up to the US presidential elections and stalled UK-EU trade negotiations amongst others. However, a number of key macro data releases and events on Thursday-Friday may refocus markets' attention on underlying economic indicators and their implications for fiscal and monetary policy going forward (all times are London time).

- The European Central Bank (ECB) will hold its policy meeting tomorrow (10<sup>th</sup> September).**  
 While it is unlikely to announce any major policy changes all the talk in recent days has been about whether and how ECB President Lagarde will try to talk down the Euro and how effective such an intervention could be. Our view is that Euro price action in the past month does not warrant any meaningful verbal intervention and that the ECB will instead keep its powder dry for now.
- In the UK, the key release this week will be July GDP data, out on Friday (07:00).** GDP growth accelerated to an all-time high of 8.7% month-on-month in June, thanks in part to very favourable base effects (i.e. the 20.4% contraction in GDP in Q2), and likely slowed in July despite the partial re-opening of part of the critical service sector. How financial markets interpret positive but slowing growth in the context of an economy still slowly emerging from lockdown may have as much to do with the prevailing bearish-Sterling mood than the number itself (see [UK & Sterling Facing Potential Quadruple Whammy](#), 4<sup>th</sup> September 2020).
- CPI-inflation data releases have arguably garnered only fleeting market attention in recent months, with central banks' monetary policies mainly aimed at putting a floor under collapsing economic growth in the context of national lockdowns. However, given the Federal Reserve's recent tweak to its dual inflation and employment targeting regime, **US CPI-inflation data for August due out on Friday (13.30)** may take on greater significance, at least fleetingly (see [US: Much Ado About Nothing](#), 28<sup>th</sup> August 2020).

## ECB policy meeting: Heavy-handed verbal intervention unwarranted and unlikely

The [European Central Bank Governing Council](#), the main decision-making body of the ECB which is made up of six Board members and the central bank governors of the 19 Eurozone member states, holds its monetary policy meeting on Thursday 10<sup>th</sup> September (such meetings are typically held every six weeks).

- Its policy statement, which at its previous two meetings has detailed decisions regarding its i) Pandemic Emergency Purchase Programme (PEPP), ii) Asset Purchase Programme (APP) and iii) policy rates, is due to be released at 12.45.

2. ECB President Christine Lagarde and ECB Vice-President Luis de Guindos will then hold a press conference at 13.30. President Lagarde will start with a detailed introductory statement, followed by a question-and-answer session with registered journalists.
3. The ECB will publish at 14.30 the staff macroeconomic projections for the Eurozone (these are published four times year).

The consensus forecast, which we share, is that the ECB will leave its policy rates, including its deposit rate (currently -0.50%), and the modalities of its PEPP and APP unchanged. However, a number of unnamed ECB Governing Council members last week reportedly alluded to the Euro's appreciation, particularly against the US Dollar, and its negative impact on the Eurozone's export and economic growth and inflation. This has prompted speculation that the ECB will resort to verbal intervention to weaken the Euro at its meeting tomorrow.

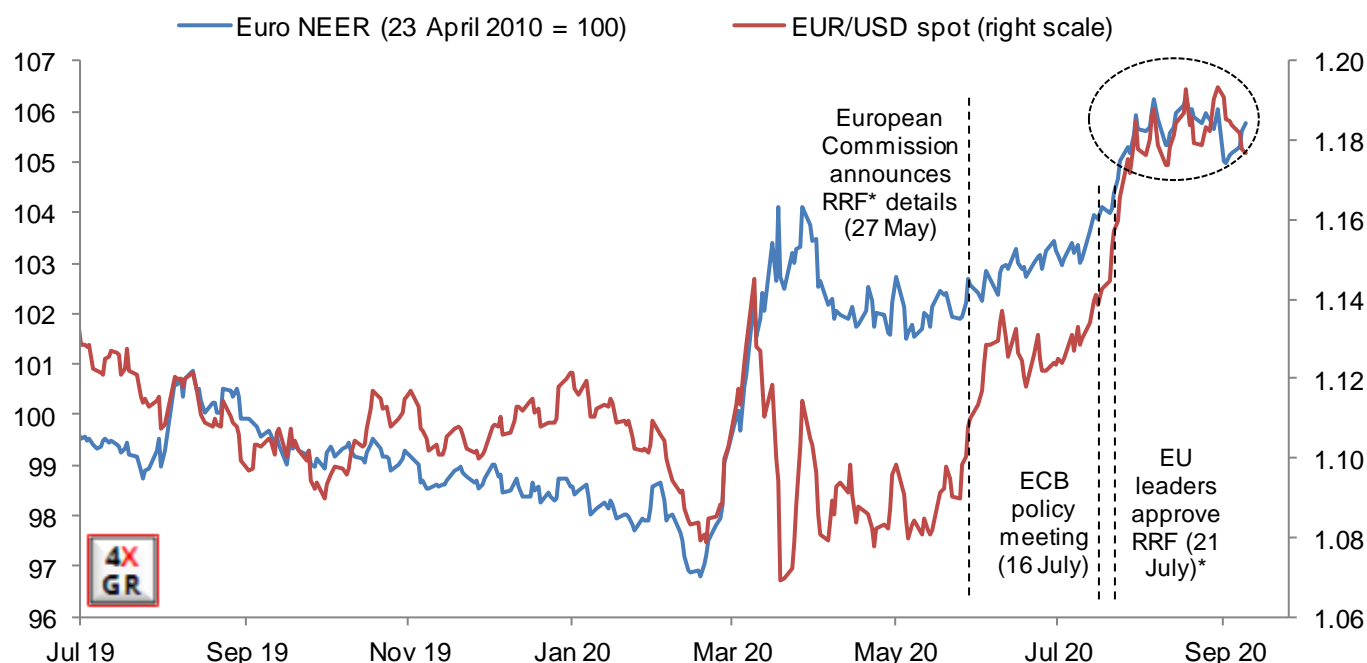
Our view is that the ECB will not explicitly try to jawbone the Euro weaker and instead keep its powder dry for now. We think its policy statement, based on precedent, will make no reference to the Euro and only likely reiterate the ECB's commitment *"to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry"*. At a stretch the ECB may announce a step-up in its monthly asset purchases under the APP which have been running at €20bn. President Lagarde may in her introductory statement try to short-circuit any temptation for financial markets to push the Euro higher by flagging the Euro's (modest) appreciation since the ECB's last policy meeting on 16<sup>th</sup> July and the ECB's ongoing monitoring of currency developments. However, this would at most constitute verbal intervention "light", in our view.

### **Focus on EUR/USD provides inaccurate picture of Euro's underlying performance**

For starters, we think that price action in the Euro since the ECB's last policy meeting on 16<sup>th</sup> July does not warrant heavy-handed verbal intervention, let alone new monetary policy easing measures.

Markets and a number of ECB Governing Council members have seemingly honed in on the Euro's 3.4% appreciation versus a broadly weaker US Dollar since mid-July to around 1.18 at time of writing – a non-negligible move for a cross which between mid-September 2019 and early July had rarely traded above 1.13 (see Figure 1). The ECB's chief economist, Philip Lane, went as far as saying last week that *"the euro-dollar rate does matter" [...]. If there are forces moving the euro-dollar rate around, that feeds into our global and European forecasts and that in turn does feed into our monetary policy setting"*.

Figure 1: Euro has treaded water against the US Dollar and more importantly in NEER terms since late-July



Source: 4X Global Research, European Central Bank, investing.com

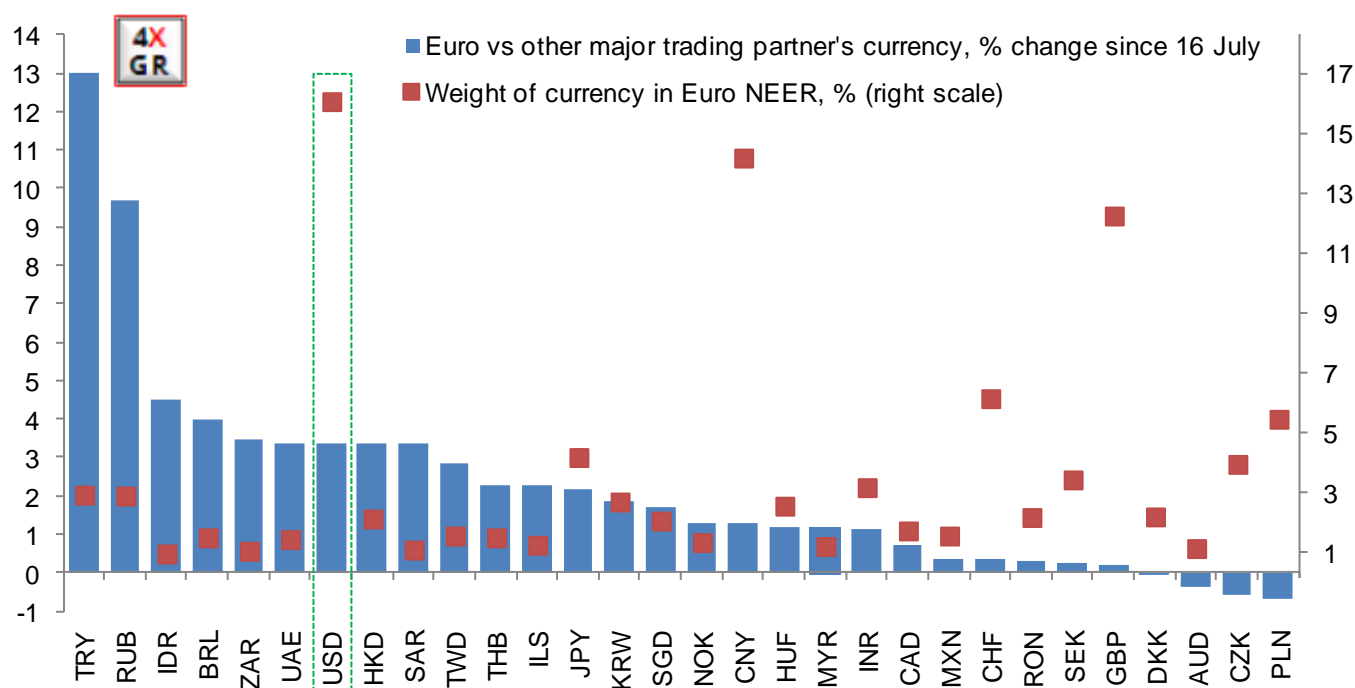
Note: RRF is €750bn Recovery and Resilience Facility.

However, the Euro Nominal Effective Exchange Rate (NEER) – a trade-weighted basket of the Euro's exchange rates against the Eurozone's main trading partners – matters far more for the Eurozone's overall competitiveness, economic growth and inflation than the Euro's exchange rate against specific currencies, including the US Dollar. Unsurprisingly the ECB has historically focussed on NEER developments in the context of policy setting rather than on individual Euro crosses. After all the US Dollar accounts for only 16% of the Euro NEER according to [ECB trade weights](#) (see Figure 2).

The Euro has appreciated far less rapidly versus the Chinese Renminbi, Japanese Yen, Swiss Franc, Swedish Krone and Korean Won, been broadly flat against Sterling and weakened slightly versus the Polish Zloty and Czech Crown – the currencies of the Eurozone's other main trading partners – since the ECB's 16<sup>th</sup> July policy meeting (see Figure 2). As a result the Euro NEER is up only 1.8% from eight weeks ago, according to our estimates (see Figure 1).

Moreover, this appreciation materialised in the second half of July, spurred in part by EU leaders' decision on 21<sup>st</sup> July to approve the €750bn Recovery and Resilience Facility (RRF). Put differently there were fundamental and justifiable reasons for the Euro to make some ground beyond ECB President Lagarde making no reference to the Euro in her [press conference statement on 16<sup>th</sup> July](#). Since end-July the Euro NEER has treaded water and is currently in the middle of a narrow 1.2% range, according to our estimates (see Figure 1).

Figure 2: Euro has appreciated modestly or depreciated against most of its main trading partners' currencies



Source: 4X Global Research, European Central Bank, investing.com

Note: Figures in brackets are currency's weight in Euro NEER basket according to [ECB](#). They do not add to 100% as currencies with a trade weight below 0.6% are omitted.

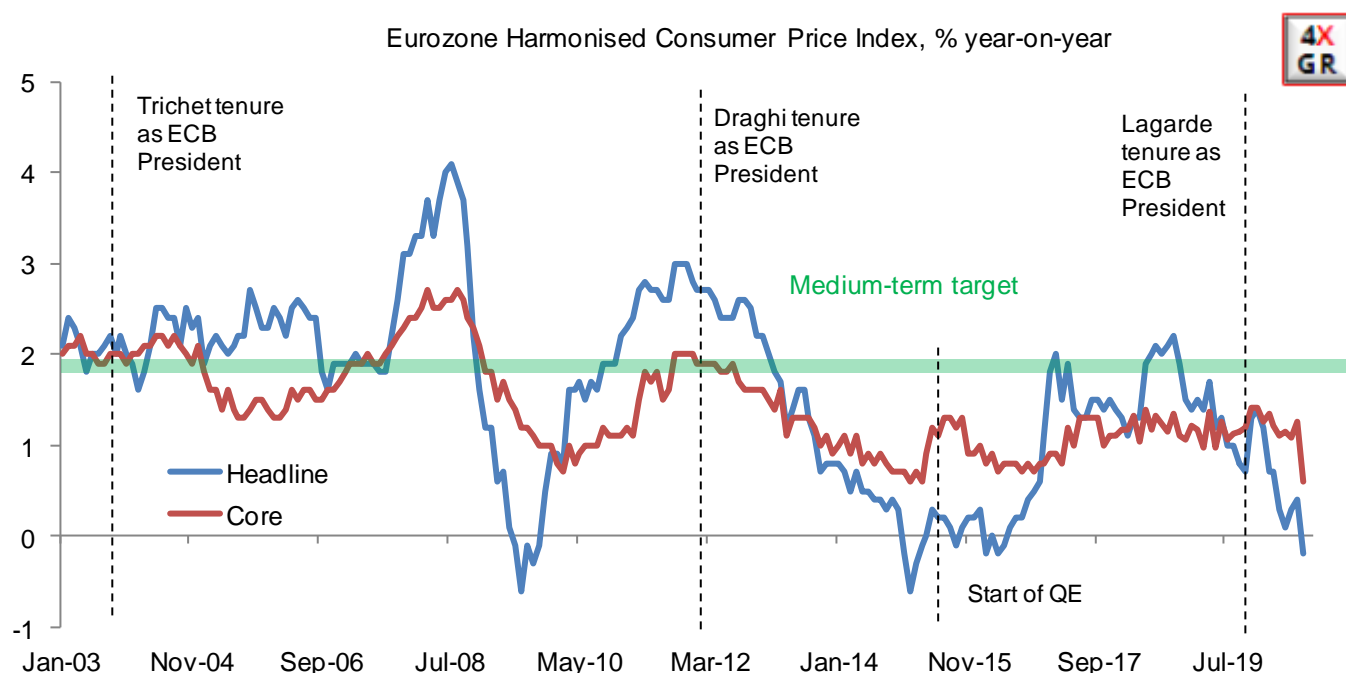
## Modest Euro appreciation unlikely to have material deflationary impact

At least one ECB Governing Council member has reportedly taken the view that in the context of the covid-19 pandemic and weak demand any headwinds to Eurozone growth and inflation need to be tackled head on, potentially with more monetary policy stimulus. Headline and core CPI-inflation indeed collapsed in August to -0.2% yoy (a 67-month-low) and 0.6% yoy (a multi-decade-low), respectively, well below the ECB's inflation target of "below, but close to, 2% over the medium term" (see Figure 3).

However, the Euro NEER's 5.5% appreciation in the year to August arguably had only an incremental deflationary impact given the limited pass-through from the Euro exchange rate to headline and in particular core CPI-inflation (which excludes more volatile energy and food prices). First, Eurozone imports of goods and services from the rest of the world amount to only 15% of Eurozone GDP, as a result of extensive trade within the Eurozone. Second, the exchange rate is only one determinant of the price of imported goods and services, which itself is only one determinant (along with the price of domestic goods and services, the cost of labour and tax rates) of the final price of goods and services. Finally, producers and retailers may not always pass on the full extent of a price decrease caused by a stronger currency to end-consumers.

Therefore, while the ECB may opt to revise down its [current 2020-2022 inflation forecasts](#) on Thursday, such revisions are likely to be modest, in our view.

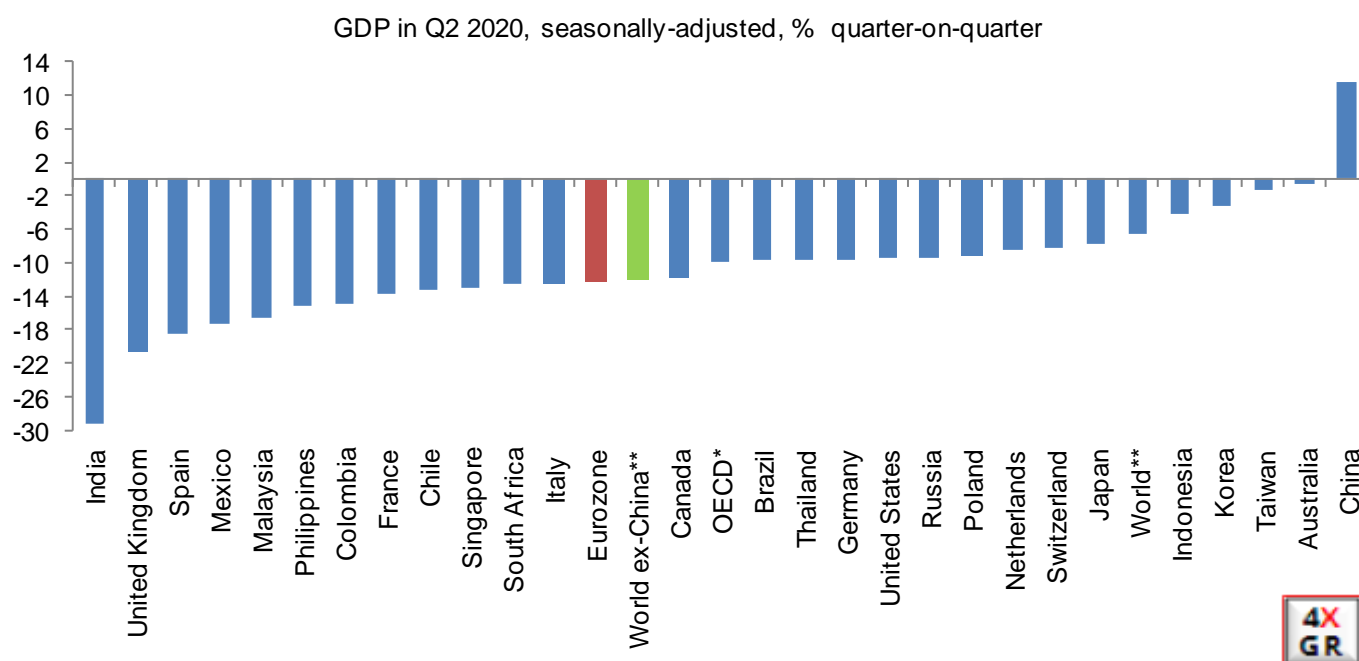
Figure 3: Eurozone CPI-inflation collapsed in August but Euro appreciation played only bit part



Source: 4X Global Research, European Central Bank, Eurostat

Moreover, the Euro NEER's 2.5% appreciation since end-June will have translated into only a very modest loss of export competitiveness and is unlikely to have been a major drag on the Eurozone's economic recovery since Q2 when the Eurozone's GDP contracted "only" 12.1% qoq (see Figure 4). So while in an ideal world the ECB would have likely preferred for the Euro NEER to continue trading at the depressed levels which prevailed pre-March, even if the ECB could slightly weaken the Euro from current levels this would do little to address the far more pressing challenges which European economic actors face today. ECB Executive Board member Isabel Schnabel, in an interview with Reuters last week, went further and argued that a boost to global trade from a weaker dollar could offset a drag on eurozone exports from the stronger Euro, adding: *"At the moment I am not worrying too much about exchange rate developments."*

Figure 4: Euro developments unlikely to be critical factor behind Eurozone's GDP path



Source: 4X Global Research, Eurostat, IMF, national statistics offices, OECD

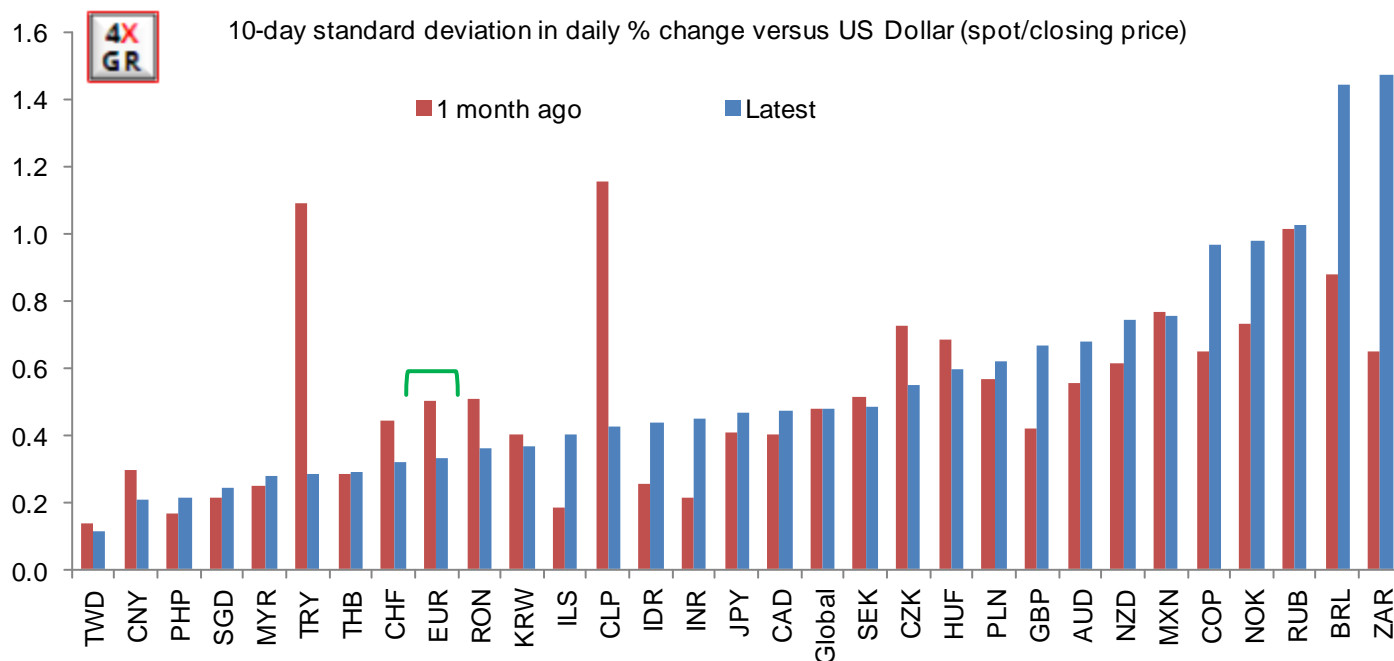
Note: \* Organisation of Economic Cooperation and Development; \*\*4X Global Research measures of global GDP growth using IMF Purchasing Power Parity country weights

## ECB likely as concerned about Euro's volatility as it is about specific levels

We see another reason why the ECB and President Lagarde will on Thursday stick to a benign script, saying enough to keep the Euro broadly steady without taking the risk of inviting markets to rock the boat – namely its implicit goal of minimising Euro volatility. It is by design, not by chance, in our view that the Euro has in the past decade consistently been one of the least volatile major currencies against the US Dollar (along with heavily managed Asian currencies) and this remains the case today (see Figure 5).

Finally, we think that explicit verbal intervention against the Euro without accompanying policy measures would lack credibility and prove counter-productive. While the Euro may weaken temporarily markets could be tempted to test the ECB's policy resolve, ultimately resulting in a stronger not weaker Euro, particularly if other major central banks follow up with verbal intervention against their own currencies.

Figure 5: It is no coincidence that Euro remains one of the least volatile currencies outside of Asia



Source: 4X Global Research, BIS, investing.com

Note: Global is realised volatility in a turnover-weighted basket of 32 major currency pairs against the US Dollar. Currency pairs are AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD, SEK, ARS, BRL, CLP, COP, MXN, CZK, HUF, PLN, RON, RUB, ZAR, TRY, ILS, CNY, IDR, INR, KRW, MYR, PHP, SGD, TWD and THB.





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