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Summary: Exchange rates are relative prices. Movements in exchange rates and their impact on the financial markets, the economy, and inflation should be assessed in bilateral, effective, nominal, and real terms. Often popular narratives on the currency markets are as not complete or as correct as the analysts' level of conviction suggests. In this note, we focus on one particular aspect of the currency movements this year that has not drawn as much attention as it should have, that the effective exchange rate (NEER) of the EUR has appreciated significantly and will have meaningfully negative effects on Europe's economic growth and inflation outlook.

1. The NEER of the EUR has risen by 8% between February and August, and is running at 9% above the five-year moving average.

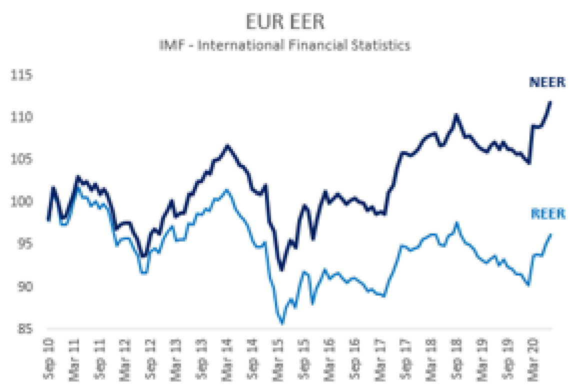
2. Europe's monetary conditions (MCI) have evolved over the years, with the ratio of relative impact of interest rate and exchange rate changes on Euro Area's economy and inflation having declined from around 4:1 to 2:1 more recently, i.e., a one-percent change in interest rates used to have four times as big an impact on the EA economy, but has since declined to less than twice as impactful. With this ratio of 2:1 (or lower), and consistent with the findings of research done by the ECB, the recent EUR appreciation should reduce inflation by between 0.2% and 0.5% over the coming four quarters.

3. No wonder there have been, since early-September, more than a dozen comments made by the ECB to highlight this link between the stronger EUR and what it means for the ECB's policy stance. The ECB's wording, we note, is broadly in line in logic but less assertive with that of Mr Draghi back in 2014. Similar to 2014, market commentators have dismissed and downplayed these warnings, which we believe should be heeded. The EA is not like China: the former's economic growth outlook is weaker than the latter, and it does not have the capital account needs for hard currency that China does. The EZ cannot afford to have a strong EUR to undermine its Herculean efforts.

4. In sum, we maintain our out-of-consensus call that the dollar is not nearly as flawed or in a terminal decline as the consensus seems to believe, and that the rest of the world is not at all in better shape as many analysts argue. In fact, we think the EZ and parts of EM are much more vulnerable now than in the previous episodes of global economic recovery from a recession, and that the cyclical decline in the dollar, as the safe haven effects fade, will be resisted by other economies, as it is starting to happen in Europe. EURUSD, as a result, is experiencing either an important inflection point if not a turning point. EURUSD, in our view, cannot go much higher, and we see conditions under which EURUSD could trade back down to 1.13 by year end.

Recent movements in the currency markets: some facts

The prevailing perception in currency markets is that 2020 has been a year of dollar weakness. YTD, however, Fed's Broad Dollar Index is actually up 1.5%, even though swings this year have been as large as 10%. Against the EUR, however, the dollar is indeed down 5.4% YTD. Thus, the dollar sell-off since April has been concentrated against the G10 currencies, in contrast to past patterns and popular perception. Because of this particular feature of the dollar sell-off, our measure of the NEER of the EUR has appreciated 6.8% this year. Different measures of NEER put the EUR at, or very near, its all-time high. On the ECB's measure, it has been the sharpest appreciation over a six-month period on record.



Source: Refinitiv Datastream and Eurizon SLJ Capital Limited

The chart above shows that the NEER of the EUR is now 9% above its five-year moving average, and some 20% higher than its low in April 2015.

In sum, it has not been as much a 'dollar story' this year as some analysts seem to believe. On these effective exchange rate measures, it has been as much a 'euro story' so far this year, given the euro's out-performance against a basket of currencies.

The concept of the MCI (monetary conditions index)

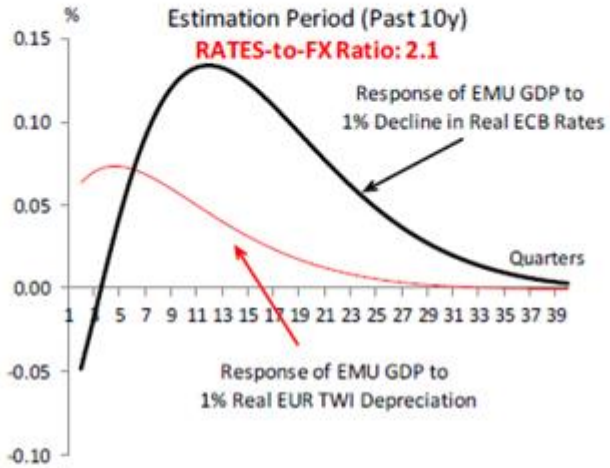
Currency movements affect the financial markets, the real economy, and inflation. In simple terms, the financial markets are mostly driven by the expected future movements in the bilateral exchange rate of EURUSD; the economy is affected by the real effective exchange rate (REER); and inflation is driven more by the nominal effective exchange rate (NEER).

This is why discussions on currencies are often blurred and misleading, because of the multiple measures of exchange rate movements and the different ways exchange rates affect different aspects of what investors care about.

On the economy and inflation, one important and useful economic concept is the MCI, which is a composite measure of the overall monetary conditions dictated by the levels of interest rates and exchange rates. The relationship between interest rates and the exchange rate is not mechanical, because there are different forces at play. For example, most believe that the higher the interest rate, the higher is the value of the currency. However, covered interest parity predicts precisely the opposite, that the interest carry on a currency cross should be offset by currency movements so as to achieve investment return parity. For what it is worth, a simplistic way we think about this conflict is that there should be a positive relationship between interest rates and the exchange rate in the long run, because economic forces ought to determine the long-term valuation of currencies. But in the shorter run, financial flows could be so powerful that covered interest parity could disturb this presumed relationship between interest rates and exchange rates.

In any case, the MCI framework takes the levels of the interest rates and the exchange rates and computes the historical relationships between the composite of these two measures on either the real economy or inflation. One statistic economists focus on is the MCI ratio – the ratio of the relative impact of changes in the interest rates and the exchange rates on either the real economy or inflation; the MCI ratio is essentially the ratio of the two elasticities.

In a note we published in 2014 ('*The EMU Needs a Weaker EUR*' September 2014), we reported the results of our calculations, which we replicate below.



Source: Refinitiv Datastream and Eurizon SLJ Capital Limited

The chart above shows the simulated effect, based on the elasticities we recovered from our calculations for the decade that ended in 2014, of 1% impulse shocks in the real interest rates and the real effective exchange rate on Euroland's GDP. Thus, historically, a 1% real interest rate shock in Europe normally led to more than 0.15% boost to GDP six or so quarters later. Similarly, a 1% real effective exchange rate shock (a weaker EUR) normally should lead to 0.08% boost to Euroland's GDP four quarters later. Neither of these simulated shocks have permanent effects on GDP because they are temporary shocks

What these elasticities mean is that the MCI ratio was around 2:1, i.e., a 1% shock to the real interest rate should have roughly double the effect of a 1% shock to the REER on the EZ's real GDP.

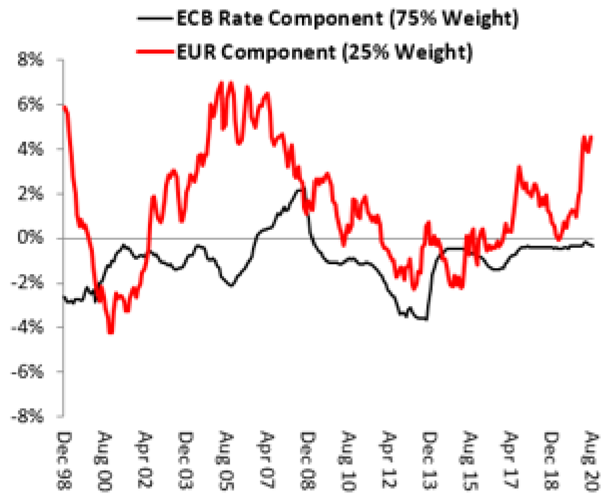
Euroland's MCI ratio has been declining over time

This MCI ratio of 2:1 marks a decline from close to 4:1 a decade earlier. This was due largely to the decline in the impact of interest rates on GDP, with the elasticity from the REER having remained relatively stable over time.

The logic behind this secular decline in the impact of lower interest rates on economic activities could include the hostile demographic trend in Europe that has undermined overall demand for credit, the persistently high loan-to-deposit ratio (LDR) of European banks that has prevented them from lending aggressively, the negative interest rate policy and the flat yield curve that have eroded the profitability of European banks, and other factors. We will go into the high LDR issue below.

We have not had an opportunity to update our calculations from 2014. However, considering the limited movements in interest rates in the past six years, we would guess that the MCI would be even more sensitive to FX now. That is, the elasticity of interest rates may have gone down further. Our guess is that the MCI ratio could be as low as 1.3-1.4:1 now.

The chart below shows, visually, why we suspect the MCI ratio has continued to decline in recent years.



Source: Refinitiv Datastream and Eurizon SLJ Capital Limited

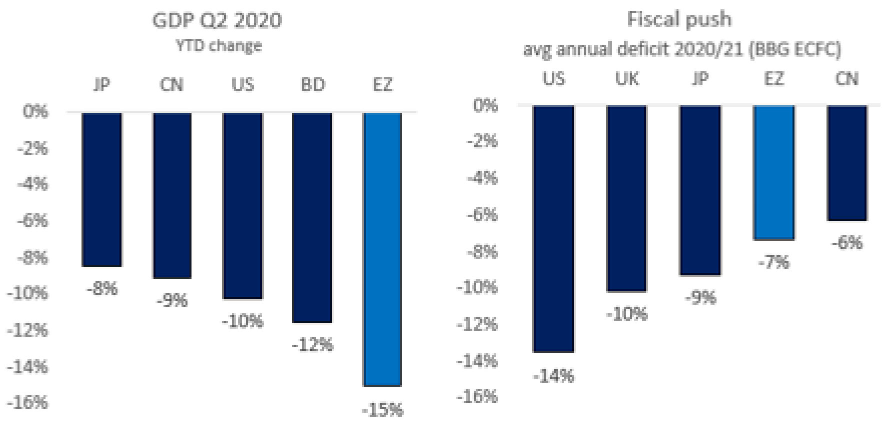
Eye-balling the chart, one could clearly see that the currency component (in red) has been much more volatile than interest rate changes (in black). Quite often, in fact, the interest rate component deviated from the overall MCI and the exchange rate component is more correlated with the overall MCI. The intuition here is analogous to GDP accounting and the role of investment in determining the business cycle: while consumption is by far the biggest component of GDP, it is investment – usually only one-quarter the size of consumption – that determines the swings in the business cycle.

The hit to Eurozone's economy and inflation from the stronger EUR

Using the elasticities we have calculated, the appreciation in the EUR since March would translate into around a -0.60% shock to GDP over the next four quarters, theoretically offsetting much of the monetary easing that has been imparted by the ECB in the past year.

In contrast to market commentaries, Europe has not obviously outperformed global peers in the recovery thus far, at least not other large economies. Europe suffered the deepest contraction among its peers, and it has had the most modest fiscal stimulus.

The chart on the left below shows the size of the GDP contractions in each of the large economies in the world. Japan, China and the US contracted -8%, -9% and -10%, respectively YTD in Q2, less than Germany (-12%) and the EMU (-15%). The chart on the right below shows the magnitude of the fiscal efforts in the selected countries, with logical implications for the likely vigour of economic recovery in the quarters ahead. Both charts contradict the popular narrative of relative strength of the EZ's recovery.



Source: Refinitiv Datastream and Eurizon SLJ Capital Limited

Furthermore, Europe is now experiencing a second wave of infections, with new daily cases now exceeding those in the US. With rising risks of localised shutdowns in Europe, a tightening in the MCI in the EZ would be unhelpful.

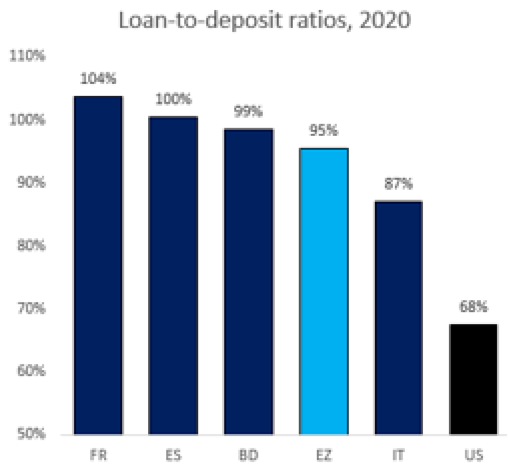
Further thoughts. We have a few other thoughts to add to this discussion.

1. **ECB's verbal interventions have commenced.** In the Appendix, we tabulate a dozen or so quotes from the ECB on how they are now watching the EUR. The stream of explicit references to the EUR began on September 1, 2020, when EURUSD tested 1.20. A similar period of EUR appreciation was 2014, when the EUR had appreciated 15% against the dollar over a period of less than two years, following Mario Draghi's London speech, in July 2012. Around Spring that year, it started to become clear that, for the ECB, a weaker euro was a desired outcome – a critical lever to provide easier monetary conditions to the euro area economy. At the ECB's May 8, 2014, press conference, Mario Draghi said that

   '*the exchange rate is not a policy target but it's a serious concern for our objective of price stability and therefore this concern will have to be addressed*' and '*it's actually the exchange rate that keeps the inflation rate low and depressed*.'

In various studies conducted over previous years and updated in 2020, the ECB has calculated that a 1% trade-weighted euro appreciation could translate into import price declines ranging between 0.3% and 0.9% after a year. Correspondingly, the level of CPI could decline by between 0.03% and 0.08% after a year. While the recent comments from the ECB are not as strong as these words from Mr Draghi in 2014, we believe there are well-founded concerns about a strong EUR jeopardizing the EZ's recovery and its fight to maintain price stability. Finally, on May 8, 2014, when Mr Draghi made his first complaint about the strong currency undermining EZ's economy, EURUSD traded close to 1.40. By the following Spring, EURUSD was below 1.10.

2. Bank lending in Europe remains constrained. In assessing the EZ's economy, it is important to pay attention to bank lending. In contrast to the US, which is about 80% financed by the capital markets and 20% financed by banks, the EZ is about 20% financed by the capital markets and 80% financed by banks. Bank lending, thus, dictates the general vigour of the EZ's economic growth. The impact of the systemic shock of the GFC of 2008 is still being felt in the European banking sector. From an average growth rate of 9% in the five years leading to 2008, bank credit growth collapsed to an average of only 0% between 2009 and 2014, only to recover modestly to 2% since 2016. One of the reasons behind the unwillingness of European banks to lend is their relatively high loan-to-deposit ratio (LDR). The chart below shows that European banks still have substantially higher LDR, compared to the US. With such a levered collective balance sheet, rate cuts or strong credit demand might not necessarily mean more bank lending, if these banks are unwilling to raise their leverage. What this means is that interest rate reductions would have diminishing effects on bank lending, and in turn general economic activities.



Source: Refinitiv Datastream, the ECB and Eurizon SLJ Capital Limited

2. **The ZLB (zero lower bound) applies only to interest rates.** The ZLB is a concept that applies only to the interest rates. Because nominal interest rates cannot normally go significantly below zero without leading to negative side-effects (though central banks are experimenting with slightly negative interest rates), economists refer to this limitation as the ZLB. However, there is no ZLB for the exchange rate. Thus, as interest rates have fallen around the world after the GFC in 2008, interest rate changes have been smaller and less effective. The role of the exchange rate, in relative terms, as a factor influencing the MCI, therefore, is greater the closer we are to the ZLB. A further thought on this is that the magnitude of the potential shock arising from exchange rate changes is much bigger than interest rate changes.

4. A weak currency is more important to the EZ than to the US or China. Eurozone companies derive a higher share of their income and profits from exports than American companies do. Indeed, European equity indices have gone sideways since June, just as the EUR began to appreciate. At the same time, China needs a stable to strong RMB to help it achieve its ambitious goals in reforming and internationalising its capital account and the financial sector. We have long contested the popular presumption that China still has a mercantilist mindset on the RMB; exactly the opposite is the case, we believe. In sum, neither the US nor China needs weak currencies, but the EZ still does. Whatever the cause of the rise in the EUR, from the perspective of the state of the EZ's economy and the scope for more policy actions in Europe, it seems that allowing the EUR to rise uncontested would be a policy mistake for Europe.

Bottom line. The core strength of the EZ economy is not as robust as some analysts claim, in our view. In late-2019, before the pandemic, Germany was on the verge of falling into a recession and the EZ was decelerating. Extrapolating the recent bounce in data from an exceptionally sharp pandemic-induced economic contraction is likely to lead to mistaken conclusions. We believe Europe needs a weaker EUR, because the ECB cannot cut interest rates any further or provide additional fiscal stimulus on a sustained basis. It will need to rely on a weaker EUR to achieve easier overall monetary conditions, as the EUR offers the cheapest and only meaningful degree of freedom at present. The wave of verbal interventions from the ECB have thus far, rather strangely, been downplayed by the market, even though they are similar in logic to what Mr Draghi said on May 8, 2014. We recall that, within a year after Mr Draghi's verbal intervention, EURUSD fell to more than 30 big figures lower. While we do not believe the exact same pattern in EURUSD will be repeated, we see the recent verbal interventions marking at least an inflection point if not a turning point in EURUSD. 1.13 or lower by year-end is entirely possible, given a certain outcome of the US election.

Appendix: Comments from the ECB on the EUR

Recent ECB comments on the exchange rate

When	Who	What was said...
Sep 21	Christine Lagarde	Euro appreciation puts downward pressure on prices; ECB hasn't run out of ammunition
Sep 17	Olli Rehn	The exchange rate is "not a policy target for the ECB, but it's one important element" in euro-area inflation outlook
Sep 17	Luis de Guindos	We watch very closely the evolution of the exchange rate and it's impact on inflation and our target for price stability
Sep 16	Isabel Schnabel	We continue monitoring incoming information carefully, including developments in the exchange rate, and we stand ready to act if the incoming data is not consistent with the objective of our emergency measures to close the inflation gap that has emerged as a result of the pandemic
Sep 16	Luis de Guindos	The exchange is a fundamental economic variable which affects imports, exports, imported inflation or deflation A relatively brisk and intense fluctuation in the exchange rate affects inflation expectations and the conditions that determine inflation."
Sep 16	Pablo Hernández de Cos	ECB will continue to monitor euro exchange rate Significant appreciation can have negative impact on exports
Sep 13	Christine Lagarde	Near-term price pressures will also remain subdued due to the recent appreciation of the euro exchange rate The Governing Council will carefully assess incoming information, including developments in the exchange rate, with regard to its implications for the medium-term inflation outlook
Sep 14	Philip Lane	Euro appreciation has had "a countervailing pressure" in terms of its impact on output and inflation dynamic and has marked back projected inflation "a bit," "Exchange rate does matter for inflation forecast," he says "We're driven by what happens to our inflation forecast"
Sep 11	Philip Lane	...the scale of the upward revision in core inflation has been significantly muted by the appreciation of the euro exchange rate
Sep 11	Villeroy de Galhau	We don't target exchange rates. But obviously the exchange rate does matter for inflation and monetary policy. ... and accordingly we will carefully monitor developments in the exchange rate, with regard to its implications for the medium-term inflation outlook
Sep 10	Christine Lagarde	Our mandate is price stability and clearly to the extent that the appreciation of the euro exercises a negative pressure on prices, we have to monitor carefully such a matter. ...As a good observer of our introductory statements, exchange rate and the appreciation of our currency was not mentioned in previous documents. So that is clearly an indication of the fact that we do not target, but we monitor and we monitor carefully because obviously the appreciation of our currency has an impact on our inflation. As I said, it's not a policy target for us. I am not going to comment on the level of our currency, but it is clear that the external value of the euro is an important determinant of price setting in the euro area. So we will continue to monitor the development and be very attentive to that. ...we are observing negative pressure on the price level. That is partly attributable – largely attributable actually – to the appreciation of the euro. While we don't target at any level, and I have not, do not and will not comment on any level, we are also monitoring carefully the appreciation of our currency in relation to its impact on our inflation medium-term level. (...) if and when necessary, and warranted by circumstances, and in accordance with our mandate, the Governing Council is determined to use all the policy tools that it has available, and to deploy them and calibrate them as necessary and as appropriate in order to deliver on our mandate.
Sep 10	ECB Intro. Statement	...the Governing Council will carefully assess incoming information, including developments in the exchange rate, with regard to its implications for the medium-term inflation outlook Moreover, in the near term price pressures will remain subdued owing to weak demand, lower wage pressures and the appreciation of the euro exchange rate, despite some upward price pressures related to supply constraints
Sep1	Philip Lane	The euro-dollar rate does matter **It will be important to recognize that the euro-dollar rate is also endogenous to monetary policy** 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
Aug 31	Isabel Schnabel	I am not worrying too much about exchange rate developments" as "if there is a depreciation of the U.S. dollar, this tends to boost global trade and global growth"

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