PICTET 1805

Flash Note

Euro area: monetary policy

The ECB and the EUR, from Amsterdam to Sintra

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The trade-weighted EUR has appreciated by 4.8% since the ECB's June meeting. ECB models and Mario Draghi's rule of thumb suggest that a stronger currency could lower euro area inflation by about 30-40bp in 2018-2019, all else being equal.

But all else is not equal, and the euro area economy is in a very different shape than three years ago, when Draghi hinted at implicit FX targeting in Amsterdam. His speech in Sintra this year marked a decisive shift in the ECB's assessment of economic conditions, with more emphasis on confidence, patience, prudence and persistence.

We continue to expect the ECB to reduce the intensity of its monetary stimulus with great caution and flexibility, extending its QE programme, but at a slower pace in H1 2018 (EUR40bn per month instead of EUR60bn). A detailed announcement is more likely to be made at its 26 October meeting.

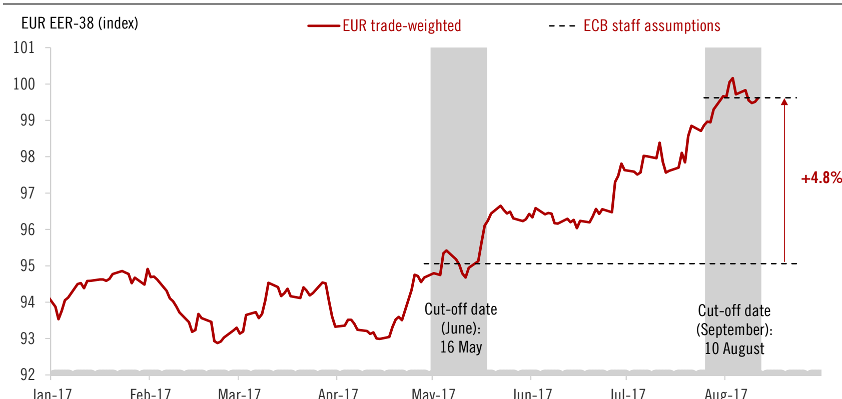
It was never meant to be an easy ride for the ECB. Just as the recovery is getting stronger, EUR appreciation is threatening to push inflation lower, delaying a return to the 2% target that has been postponed for too long already. We estimate that the 4.8% rise in the trade-weighted currency since the June meeting will force the ECB staff to cut its 2018 inflation forecast by about 20bp, from 1.3% to 1.1%. All else is not equal, however, and stronger growth should lead to a smaller revision to 2019 inflation, from 1.6% to 1.5%.

Officially, the EUR is not a policy target. The ECB only considers the currency insofar as changes in its value affect price stability over the medium term, although in the crisis years, concerns over an "unwarranted tightening" of financial conditions led to implicit FX targeting, culminating in Mario Draghi's 'three contingencies' speech in Amsterdam in April 2014.

This time is different. Draghi's assessment in Sintra that "deflationary forces have been replaced by reflationary ones" is increasingly backed by the data. **Although a stronger EUR may complicate the ECB's exit, it should not derail it**, all the more since the currency is appreciating "for good reasons".

The key question ahead of the September meeting is to which extent stronger GDP growth will help offset the stronger EUR. The ECB's response, starting with Draghi's speech in Jackson Hole later this month, should involve **more of the 'Three Ps' – patience, prudence, persistence** – for inflation to return to its 2% target by 2020 at the latest. We continue to expect the ECB to extend QE at a slower monthly pace of EUR40bn in H1 2018, with a detailed announcement more likely to be made in October.

Chart 1: the trade-weighted EUR is up by 4.8% since the June meeting



Source: Pictet WM – AA&MR, ECB, Bloomberg

AUTHOR

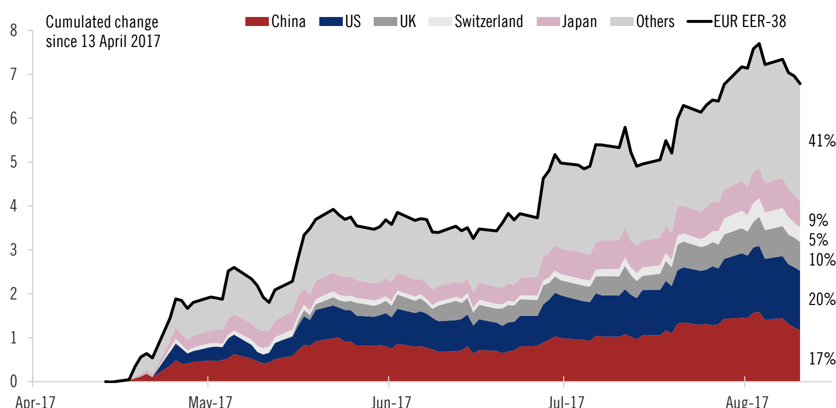
Frederik DUCROZET
fducrozet@pictet.com
+41 58 323 4582

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

A net drag on inflation of around 0.20 percentage points

The ECB staff will set out the technical assumptions underlying the updated macro projections it presents in September, including for oil prices and exchange rates, using the average values over a two-week period ending on the cut-off date (which we expect to be 10 August). As shown in Charts 1 and 2, this would result in a 4.8% appreciation in the trade-weighted EUR since the June meeting, driven by broad-based weakness in both DM and EM currencies.

Chart 2: main contributions to trade-weighted EUR appreciation



Source: Pictet WM – AA&MR, ECB, Bloomberg

Changes in oil prices and interest rates will be much more modest, adding only a marginal boost to growth and inflation in the projections.

Table 1: financial inputs used in the ECB staff projections

	September 2017 (cut-off date 10 August)			June 2017 (cut-off date 16 May)			Change (positive = higher inflation)
	2017	2018	2019	2017	2018	2019	
3-month Euribor	-0.3	-0.3	0.0	-0.3	-0.2	0.0	unch
10-year EA government bond yields	1.2	1.4	1.7	1.2	1.5	1.8	+
Oil price (in USD/barrel)	51.9	52.9	53.5	51.6	51.4	51.5	+
change since previous meeting	*0.6%*	*2.9%*	*3.9%*				
EUR/USD	1.13	1.18	1.18	1.08	1.09	1.09	-
change since previous meeting	*4.5%*	*8.1%*	*8.1%*				
EUR NEER (EER-38; annual % change)	2.0	2.6	0.0	-0.4	0.3	0.0	-

Source: Pictet WM – AA&MR, ECB, Bloomberg

The ECB has made references to various estimates of the FX pass-through in the past, in terms of growth and inflation elasticity to changes in the trade-weighted currency. As usual with such time-varying estimates fraught with considerable uncertainty, what matters is the ECB's own assessment. Mario Draghi provided his own rule of thumb during the March 2014 policy meeting, saying that "each 10% permanent effective exchange rate appreciation lowers inflation by around 40 to 50 basis points" (without being more specific as regards the time lag).

Using this simple rule, the recent 4.8% appreciation of the euro would lower inflation by 20-30 basis points in 2018-2019, all else being equal.

The ECB staff provided similar estimates in the past under an "alternative exchange rate path", e.g. in March 2016 and in March 2017 in the case of currency depreciation. Assuming symmetrical effects, the staff assumptions implied that a 10% EUR appreciation would lower inflation by around 0.2pp, 0.6pp and 0.8pp in years one, two and three, respectively. Note that the small differences between staff estimates in various years are likely due to rounding errors as well as hypotheses for non-core HICP components. Again, using this simple rule, the recent EUR appreciations would lower inflation by 30-40 basis points over two to three years.

Other estimates of the FX pass-through tend to be larger than the ones mentioned by Draghi or his staff. In a recent article, the ECB described some of those models (see Table 2). Crucially, the article notes that "***the size of exchange rate pass-through is documented to have declined in the euro area***", an important point that the ECB is likely to make in the current situation – more on this below.

Table 2: effect of a 5% appreciation in the trade-weighted EUR on euro area inflation

Models	1Y	2Y	3Y
OECD (2001)	-0.4	-0.4	-0.5
OECD (2010)	-0.2	-0.4	-0.5
Draghi's rule (Mar-14)	-0.1	-0.2	-0.3
ECB staff (Mar-16; Mar-17)	-0.1	-0.3	-0.4
Average (sample 1)	***-0.2***	***-0.3***	***-0.4***
Hahn (2003)	-0.5	-0.8	-1.2
Comunale and Kunovac (forthcoming)	-0.6	-0.6	-0.6
New area-wide model (NAWM)	-0.1	-0.6	-1.0
New multi-country model (NMCM)	-0.5	-0.9	-1.3
Average (sample 2)	***-0.4***	***-0.7***	***-1.0***

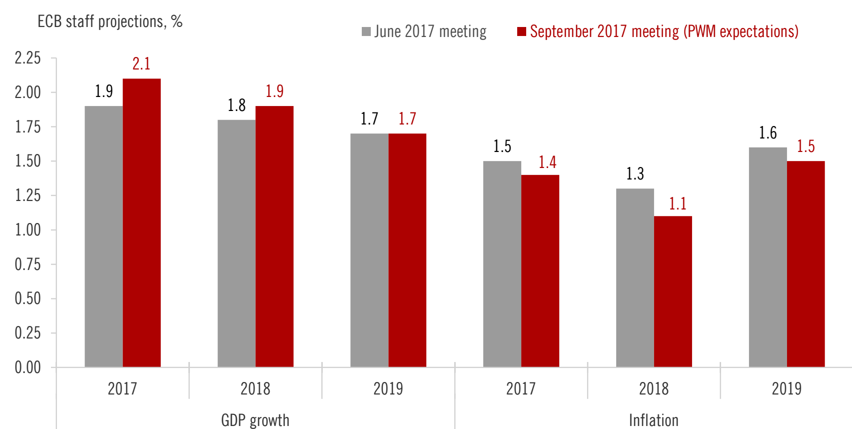
Source: Pictet WM – AA&MR, ECB, OECD

In the end, we favour ECB staff models and Draghi's rule, suggesting an impact on 2018-2019 HICP inflation of about 30-40 basis points. However, we suspect that the revisions to the ECB staff projections in September will be somewhat smaller.

Indeed, all the above estimates imply that all other variables remain constant. **But all else is not equal.** Recent data suggest that the euro area recovery is strengthening and becoming more broad-based and robust, even though the pace of activity expansion is likely to slow down a little in H2 2017. The reliance on domestic demand rather than on exports should make the euro area economy more resilient to external shocks, including from currency appreciation, provided that a certain pain threshold is not breached on the currency front. This is especially true for more vulnerable countries like Italy, which are believed to be more sensitive to the exchange rate. The same models from the ECB staff point to **a drag on GDP growth from recent EUR appreciation of 0.1pp, 0.2pp and 0.3pp in years one, two and three, respectively**, which we expect to be broadly offset by upward revisions of recent GDP numbers as well as stronger external demand.

In turn, as long as activity holds up, the ECB should remain confident that wage growth and core inflation will gradually rise. Factoring in slightly stronger GDP growth, the ECB staff is likely to continue to forecast the output gap to close over the time horizon (by 2019). **Our best guess is that euro area core HICP inflation is lowered by the staff by 20bp in 2018 and by 10bp 2019**. This would imply a similar downward revision to headline inflation, to 1.4% in 2017, 1.1% in 2018, and 1.5% in 2019 (see Chart 3). If the last figure is instead left unchanged at 1.6%, it would imply an even higher degree of confidence that price stability will be achieved eventually. Either way, we would expect the ECB to emphasise that **by 2020 at the latest, inflation is expected to return close to the 2% target**.

Chart 3: likely revisions to ECB staff projections at the 7 September meeting



Source: Pictet WM – AA&MR, ECB, Eurostat

This time is different – the 'three Ps' should prevail

The history of the ECB's attitude to the EUR's value is fraught with considerable ambiguity. After the sovereign debt crisis, the ECB's focus on the currency increased in a challenging international environment where several major central banks were using currency devaluation as a key tool in their arsenal. The ECB's reaction function moved according to circumstances, often in response to external shocks.

In his speech in Amsterdam in April 2014, Draghi highlighted currency appreciation as one of those contingencies leading to an "unwarranted tightening" in financial conditions to which the ECB would respond using (negative) policy rates. Then, in Jackson Hole in summer 2014, the main justification for fresh action was the threat of the dis-anchoring of inflation expectations. But ultimately the ECB's asset purchase programme led to significant currency devaluation in anticipation, and then as the result of, massive outflows (from fixed-income investors in particular). Discussing "The international dimension of the ECB's asset purchase programme", Benoît Coeuré, member of the ECB's executive board, recently argued that capital outflows may not be the only driver of depreciation, but rather that QE might weigh on the EUR in the same way as conventional monetary policy, through interest rates expectations.

Either way, the 14% decline in the trade-weighted EUR from peak (March 2014) to trough (April 2015) was more than helpful at the time.

This time is very different indeed, and so is the main question the ECB will have to answer ahead of the September meeting: to what extent will stronger growth offset a stronger EUR and make the region more resilient to small shocks? Or, in more technical terms, will the output gap close fast enough to offset downside risks from second-round effects on wages and hysteresis due to headline inflation being lower for even longer?

What does all this mean for the ECB's communication and exit strategy? We believe the ECB will continue to sound confident *and* patient in terms of the medium-term outlook for inflation, for the following reasons:

- A **stronger, domestic-led recovery** will prove more resilient to external shocks, including currency appreciation;
- There is some evidence of **a declining FX pass-through** on growth and inflation over recent years;
- There is also a great deal of evidence that **the EUR is appreciating for good (endogenous) reasons** as capital outflows turn into inflows since the euro area is becoming more attractive to foreign investors. This means that EUR appreciation may accompany *looser*, not tighter conditions in equity and fixed income markets, which is again a very different situation from 2014. In other words, if a stronger EUR is the price to pay for political stability after the euro bears were proven wrong, then so be it.

We expect no specific action in response to EUR appreciation at this stage, but Draghi will likely reiterate his Sintra message, **sounding confident while calling for more of the 'three Ps' – patience, prudence, persistence.** One option would be to mention the 2020 horizon for the first time, although the staff is expected to extend their projections to 2020 in December only.

We continue to expect the ECB to reduce the intensity of its monetary stimulus with great caution and flexibility, extending QE at EUR40bn per month in H1 2018 instead of EUR60bn. We still believe that a detailed announcement of the scaling down of asset purchases is more likely to be made at the ECB's 26 October meeting.

The risk is that financial conditions tighten further and that there is little the ECB can do to talk down the EUR only adding to the risks of further delays in the ECB's exit, or at least of a more gradual tapering. We continue to expect asset purchases to be fully wound down by the end of 2018. **In an extreme case of sustained EUR appreciation above 1.20-1.25, one cannot rule that QE will be extended into 2018 at its current pace of EUR60bn per month.**

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