

All at sea with the euro?

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In a kind of déjà vu, the European Central Bank (ECB) is once again showing how ill at ease it is with exchange rate volatility. It did so last September when the euro appreciated to 1.20 against the dollar, and this was a factor in the downward revision of its inflation forecast and the subsequent announcement of the extension of its asset purchase programme for another nine months.

So it is appropriate to ask what is behind the euro's appreciation - and what the ECN will do.

Some considerations regarding the strength of the euro. Firstly, if we have learnt anything at all about non-conventional monetary measures, it is that, whether in the adoption or the withdrawal phase, they can have significant effects on the financial variables, particularly the exchange rate. Between mid-2014 and the beginning of 2015, in a weaker and more uncertain economic and political environment, the euro depreciated against the dollar from 1.36 to 1.05, as a result of, among other things, the adoption of negative interest rates and the QE programme (just when the US Federal Reserve was signalling the withdrawal of stimulus measures). The view that the ECB is ever closer to moving ahead on monetary normalisation is undoubtedly one of the factors behind the recent movement of the euro. It comes on top of the upside surprises in growth, the continuing positive external balance and a reduction in perceived political risk in the euro zone, contrasting with the uncertainty aroused by protectionist rhetoric and the growing fiscal deficit in the United States. Thus there are fundamental factors that support and will continue to support the single currency, moving it towards its equilibrium level. And it is hard to see how this would worry the ECB.

Secondly, the increased optimism about Europe is arousing keen investor appetite for its assets, such that the repositioning of portfolios is feeding back into the strength of the euro. This factor, which is rather of a financial nature, is more unpredictable by its very nature, and could lead to exchange rate volatility - with relative valuations and even speculative decisions entering into the equation. This is something to keep an eye on, but it forms part of the normal functioning of the markets.

And thirdly, what really bothers the ECB are "other" elements, as Mr Draghi made clear last week, referring to certain communication policies on exchange rates that do not reflect terms of reference agreed in international forums. In this regard, the recent messages from the US administration in Davos, mixing contradictory declarations about the dollar with protectionist rhetoric and insistence on reducing the trade deficit, are cause for concern. Not only because of their impact on currencies, but because if they escalate they may jeopardise the current status of international relations. A scenario with no winners, only losers, and which is not seen as the most likely.

So what will the ECB do? The European economy again beat expectations in the last quarter and will end 2017 with growth of 2.4%. Inflation has moderated recently but is expected to recover slightly once the downward effect of energy prices dissipates (1.5% at the end of this year). The deflationary pressure from a stronger euro could be more than offset by higher oil prices as well as by the pull of domestic demand. Also pointing in the same direction is news on wage negotiations in Germany, where there is hardly any slack in the market. In fact, the mechanism is in place and ready to signal the end of qualitative easing (QE), and the

strength of the euro should not hold it up. Otherwise the European Central Bank risks falling behind. So the key question is not what it will do, but how it will do it. And here it is appropriate to conform to the mantra of gradualism, to stick to the sequence and to ensure smooth meshing of gears. In other words, careful and coordinated communication by ECB members, whatever their individual positions might be. In Europe, in contrast with the United States, leaving negative interest rates behind adds an element of complexity to the normalisation process.

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