

## ECB: THE WEAKER EURO, A BLESSING OR A HEADACHE?

At first glance, the significant depreciation of the euro looks like a blessing for the ECB. Via its mechanical effect on import prices, it should remove any remaining doubt about the necessity of hiking the deposit rate. However, upon closer inspection, there is concern that the weaker euro, through its effect on inflation and hence households' purchasing power, will weigh on growth. This would warrant a cautious approach in terms of policy tightening. On balance, a deposit rate hike in the second half of the year looks like a certainty, but the real question is about the scale and timing of subsequent rate increases. This will depend on how the inflation outlook develops.

For the ECB, the latest Eurozone data provide a discomfiting combination of record-high inflation and slow first quarter growth<sup>1</sup>. The level and widespread nature of the former are forcing the central bank to act and markets are now pricing in 90 bp of rate hikes this year<sup>2</sup> although the latter provides dovish governing council members with an argument not to rush things.

In a recent Bloomberg interview<sup>3</sup>, Philip Lane, the ECB's chief economist, noted that the first rate hike was not the issue. The question is what happens thereafter in terms of scale and timing of interest rate normalisation. This is a very different world from what we see at the Federal Reserve and its guidance of multiple rate hikes in the coming months, including 50 bp increases, probably as early as the next FOMC meeting on 3 and 4 May.

Unsurprisingly, this difference in monetary aggressiveness has caused a considerable depreciation of the euro versus the dollar on the back of widening interest rate differentials (charts 1 & 2). *A priori*, for the Eurozone, such a move should be considered as growth-supportive – by boosting exports and weighing on imports –, and inflationary, via higher import prices. Philip Lane acknowledged that *“the currency depreciation will be an important factor shaping the June projections”*, one channel being the mechanical effect on import prices.

Seen from this angle, the weaker euro is a blessing for the governing council because it should facilitate reaching agreement on the need for a deposit rate lift-off. However, he continued by saying *“when we think about investments, when we think about consumption, net exports for the euro area, it's a big macro variable and this move is significant”*.

There is some ambiguity on how to interpret the comment on investments and consumption. Inflation is already well-above target, even if we strip out energy and food prices, so a weaker euro, higher import prices and hence more inflation, make matters worse for

households, in terms of purchasing power, and companies, in terms of margin pressure. When suffering from a commodity price shock, the depreciation of the currency is most unwelcome (chart 3) because it implies a bigger headwind for growth.

This would call for a cautious approach in terms of policy tightening. Nevertheless, proceeding swiftly with the first rate hike could help, provided that it would support the euro. Interestingly, whether one considers the weak euro as a blessing – because of its impact on inflation – or a headache – because of its impact on growth – the policy recommendation is to start raising the deposit rate soon.

William De Vijlder

### US VS. EUROZONE: EXCHANGE RATE AND GOVERNMENT BOND YIELD SPREAD

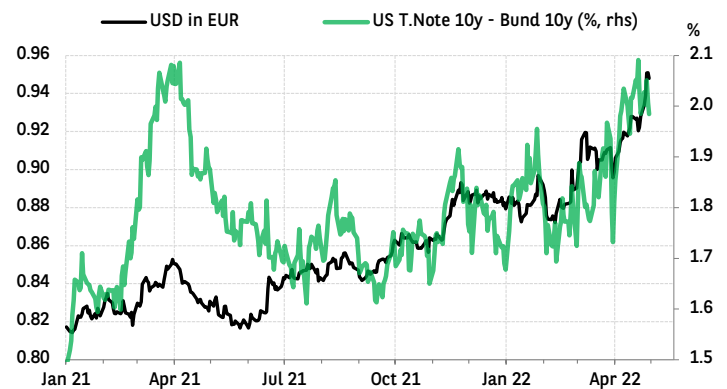


CHART 1

SOURCE: REFINITIV, BNP PARIBAS

1. The preliminary estimate for April shows 7.5% inflation (7.4% in March) and an acceleration of core HICP – i.e. excluding energy, food, alcohol and tobacco – from 2.9% to 3.5%. First quarter real GDP growth was 0.2% (quarter-on-quarter, non-annualised) versus 0.3% in the fourth quarter of 2021. Source: Eurostat.

2. Source: ECB's Lane say first rate hike is no big deal, cautious on further moves, Reuters, 29 April 2022.

3. Interview with Bloomberg Television on 29 April 2022.

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US VS EUROZONE: EXCHANGE RATE AND 1-YEAR RATE SPREAD

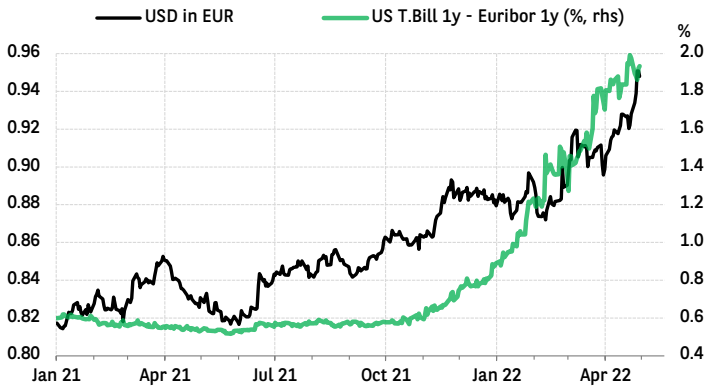


CHART 2

SOURCE: REFINITIV, BNP PARIBAS

BRENT CRUDE OIL PRICE PER BARREL

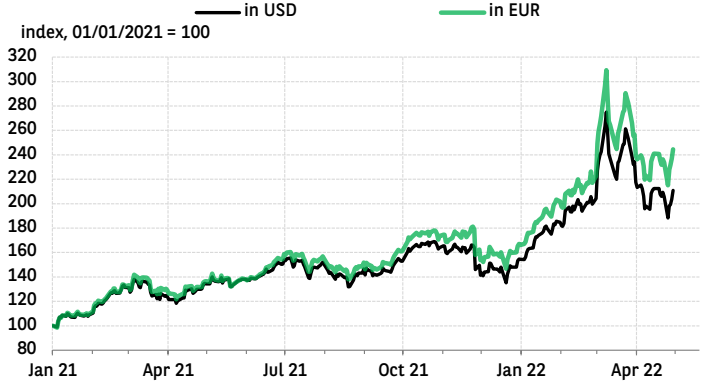


CHART 3

SOURCE: REFINITIV, BNP PARIBAS