THE MULTIPLE FACTORS UNDERPINNING THE RENEWED STRENGTH OF THE EURO AGAINST THE DOLLAR

After last year's significant depreciation versus the dollar, the euro has found a new strength. Key factors are the reversal in the current account balance, which after moving into negative territory last year is back into surplus, and, since the autumn of 2022, the narrowing of the 1-year interest rate differential with the US. This reflects the view that the Federal Reserve is approaching the end of its tightening cycle whereas the ECB still has more work to do. We expect that this factor will continue to drive the exchange rate in the coming months. Moreover, there is also a higher likelihood that the Federal Reserve will cut rates before the ECB does. International investors have large unhedged dollar positions, so in case of further dollar depreciation, this may force them to reduce their exposure to the dollar by selling dollar assets, which would exert more downward pressure on the dollar. Finally, the euro is still well below its long-term fair value versus the dollar.

What a difference a few months can make. In 2022, the huge depreciation of the euro was making headlines, particularly when in August the common currency dropped below parity versus the dollar. Since early November, the euro has strengthened significantly and recently the 1.10 hurdle has been crossed. Last year's depreciation, which to a large degree was driven by a monetary policy divergence between the US and the Eurozone[1], was a source of policy concern.

The account of the July meeting of the governing council mentioned that "*Members widely noted that the depreciation of the euro constituted an important change in the external environment and implied greater inflationary pressures for the euro area, in particular through higher costs of energy imports invoiced in US dollars.*" Moreover, "*the improvements in competitiveness and support for growth that would normally be associated with a depreciation were being impeded by the prevailing global supply constraints and logistics restrictions.*"[2]

The recent appreciation should, through its impact on import prices, help the ECB in its fight against inflation. A model-based simulation shows that a 10% appreciation of the effective exchange rate of the euro should after a year reduce inflation by 0.7 percentage points.[3]

Several factors are underpinning the newfound strength of the euro. Firstly, the current account balance, which as shown in chart 1, has been closely correlated since 2020 with the euro exchange rate versus the dollar. After moving into negative territory in the spring of last year -mainly driven by a switch from a surplus to a deficit for goods, in large part explained by the jump in the price of energy imports-, the current account has moved back into a surplus.[4]

A current account deficit needs to be financed by net capital inflows and foreign investors are enticed to increase their investments in the Eurozone through a mix of higher interest rates and a weaker currency.

EUROZONE: CURRENT ACCOUNT BALANCE & EXCHANGE RATE

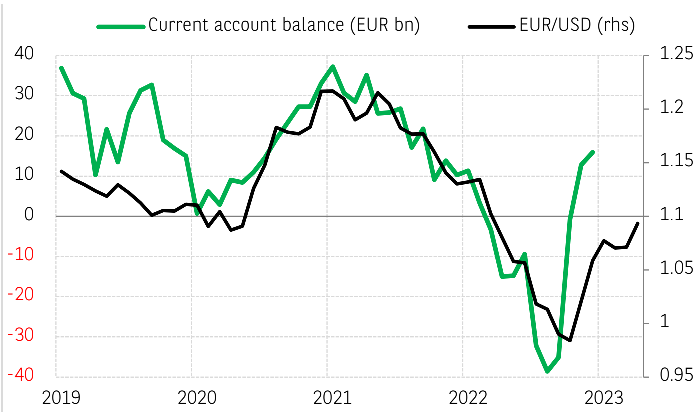

CHART 1 SOURCE: ECB, REFINITIV, BNP PARIBAS

Likewise, a current account surplus should support the currency and/or exert a downward pressure on bond yields.

A second factor is the long-term interest rate differential between the US and the Eurozone. According to a very popular view, when bond yields are rising in country A versus country B, international capital should flow from the latter to the former, causing an appreciation of country A's currency versus that of country B.

1 "*Around half of the 10% depreciation of the euro vis-à-vis the US dollar since the start of the year could be attributed to the divergence in monetary policies.*" Source: Isabel Schnabel, member of the executive board of the ECB, as quoted in the account of the monetary policy meeting of the Governing Council of the European Central Bank held on 20-21 July 2022, ECB, 25 August 2022.
2 Source: Account of the monetary policy meeting of the governing council of the European Central Bank held on 20-21 July 2022, ECB, 25 August 2022.
3 Simulation based on the Oxford Economics Global Economic Model. Since its low point in August 2022, the nominal effective exchange rate of the euro has appreciated 9%.
4 The deterioration was driven by the trade in goods, which moved from a surplus into a deficit, and a decline of the surplus in services. The recent improvement has been driven by goods -again in surplus- and services, where the surplus has increased.

> The recent, renewed strength of the euro versus the US dollar has mainly been driven by the view that there is a higher likelihood that the Federal Reserve will stop hiking before the ECB does and also will be quicker in cutting rates.

However, the reality is more complex. Due to investor preferences and differences in risk characteristics, a bond yield differential may not cause changes in the exchange rate.[5] Chart 2 shows that, occasionally, the correlation between the exchange rate of the euro versus the dollar and the difference between 10-year Bunds yields and 10-year US Treasury yields has been positive, meaning that, when US yields increased versus German yields, the dollar was appreciating.

However, for the entire period covered in the chart, the correlation is very low.[6] Between the spring of 2021 and the end of 2022, the bond yield differential fluctuated in a narrow range whereas the euro depreciated very significantly versus the dollar, so other factors have played a role. As explained before, there was the worsening of the current account balance, but also the divergence in terms of monetary policy outlook. This can be assessed by looking at the 1-year interest rate, which, to a large degree, reflects expectations of future decisions by the central bank. Chart 3 shows a high correlation since the end of 2021 between the 1-year interest rate differential and the euro versus the dollar.

Early on, the prospect of a more aggressive stance by the Federal Reserve -reflected in an increase of the 1-year US Treasury yield versus its German equivalent- was accompanied by a significant appreciation of the dollar. Since the autumn of last year, the interest rate differential has narrowed, reflecting a view that the Federal Reserve is approaching the end of its tightening cycle whereas the ECB still has more work to do. This has underpinned the euro. We expect that this factor will continue to drive the exchange rate in coming months given the higher likelihood that the Federal Reserve will stop hiking before the ECB does. Moreover, considering that the former has two objectives -price stability and full employment-, there is also a higher likelihood that the Federal Reserve will cut rates before the ECB does.[7] Both factors imply that the 1-year rate differential might narrow further, which should underpin the euro.

Two additional factors should push in the same direction. International investors have large unhedged dollar positions, so in case of further dollar depreciation, this may force them to reduce their exposure to the dollar by selling dollar assets, which would exert more downward pressure on the dollar. In addition, the euro is still well below its long-term fair value versus the dollar -which we consider to be higher than 1.30-, so this could also act as a magnet, particularly when the cyclical conditions -the monetary policy outlook- push in the same direction. Our year-end target is 1.14 and we expect further appreciation in 2024 to 1.18.

William De Vijlder

EUR/USD 10-YEAR INTEREST RATE DIFFERENTIAL

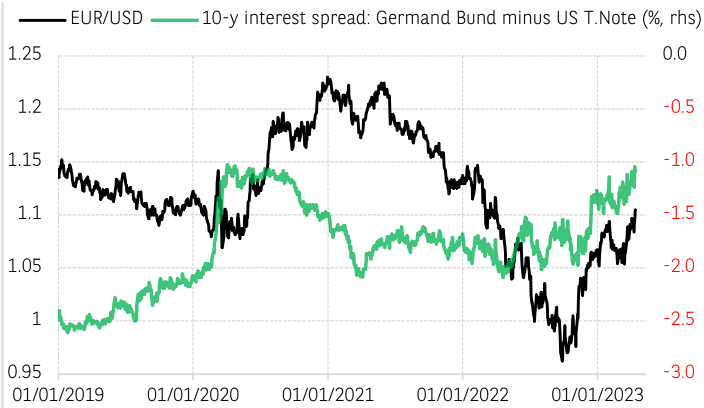

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

EUR/USD 1-YEAR INTEREST RATE DIFFERENTIAL

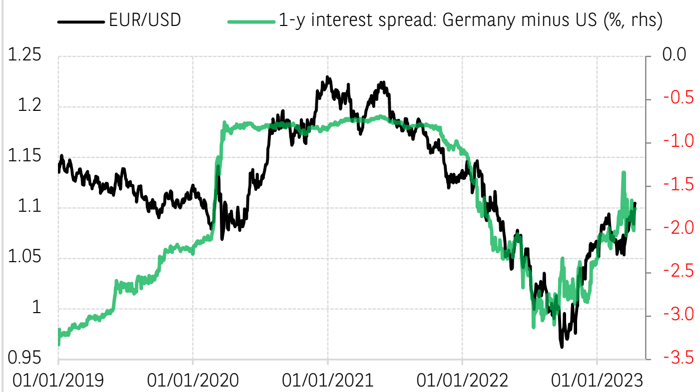

CHART 3 SOURCE: REFINITIV, BNP PARIBAS

5 When the risk profile of country is deteriorating, higher bond yields are necessary to slow down capital outflows. In that case, a rising bond yield differential is associated with a weakening currency.
6 Since the start of 2019, using daily data, there is a positive correlation of 5% between the level of the euro against the US dollar and the 10-year interest rate differential. Using the 1-year (2-year) differential instead gives a 66% (62%) correlation.
7 The consensus established by Bloomberg expects a peak in the policy rate in the US and the Eurozone in the third quarter of this year and a rate cut in the US in the second part with more cuts to follow next year. In the Eurozone, a rate cut is only expected in the second quarter of 2024.