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Two Structural Factors for the Appreciating Euro

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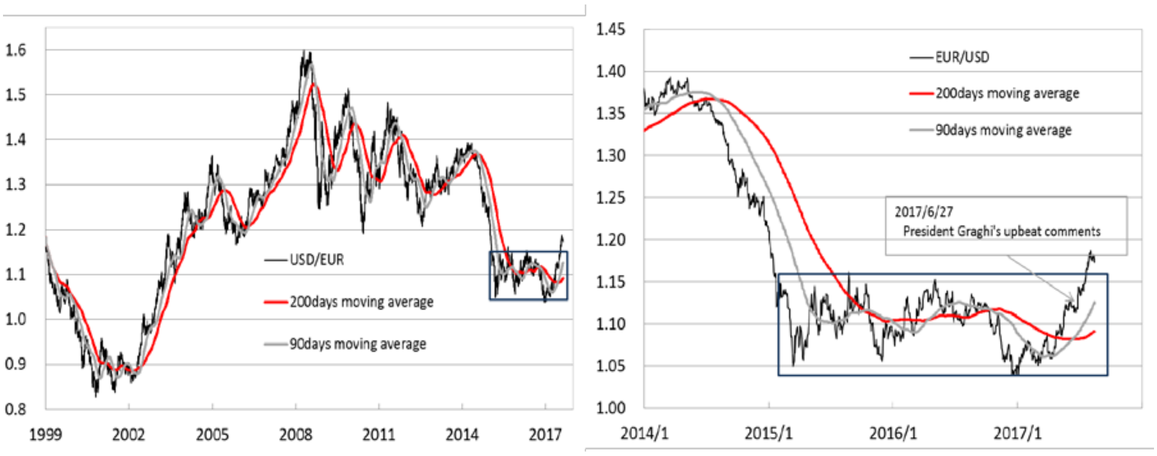
1. Introduction

The exchange rate of the euro against the dollar (EUR/USD) has shown a big rebound. As is shown in Chart 1, the EUR/USD rate had been in an extraordinary stalled condition for about 2 and half years since January 2015, fluctuating within a narrow band of 1.05-1.11(left figure). However, it started to show a clear rising trend, temporarily recording in early August the highest level since January 2015. It has clearly jumped above the former fluctuation range (right figure).

Chart 1 Euro/Dollar Exchange Rate Development
(Development since 1999 on the left figure and since 2014 on the right figure)



(Source) Thomson Reuters

The factors that triggered the upward move to stronger euro and weaker dollar after two and half years of range bound were the triple incentives from economic, policy and political fronts that were incidentally put on the table, as noted below. However, more important factors seem to underlie in the backdrop of the recent change of fundamental trend, that is, the structural factors that have become clearer in the U.S. and Europe respectively. They are the two important structural changes: the dramatic change in the current account balance of the euro zone (to a large surplus=appreciation pressure on the euro) and prolonged low economic growth in the U.S. (stagnant natural rates of interest=smaller room for the U.S. interest rate hike). Coupled with other factors, these changes are likely to have triggered the biggest turn of the trend in the past two and half years. In this report, the author tries to overview the background factors of recent rapid appreciation of the euro against the dollar.

2. Economic, Policy, and Political Factors for the Appreciation of the Euro

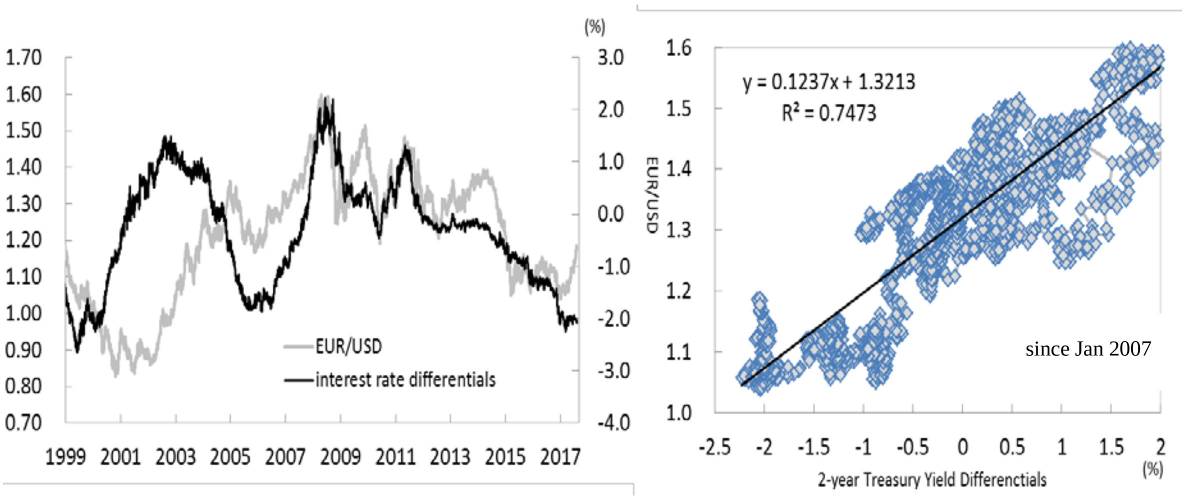
The factors behind the recent appreciation of the euro on the Euro zone side are the lineup of three favorable factors on the economic, policy and political scenes. Specifically, (i) on the economic scene, economic recovery in the euro area has gained a solid and broadening momentum, (ii) on the policy environment, the communication of the European Central Bank (ECB) has shifted to the one that is more aware of normalization of its monetary policy, and (iii) on the political scene, a rise of populist forces with anti-EU sentiment has been halted for the moment in the region. Especially an emergence of an observation for a normalization shift of monetary policy under the factor (ii) had a strong impact, along with the statement President Draghi made on June 27 saying that “deflationary forces have been replaced by reflationary ones in the euro area”[1]. It spurred the rise in interest rates in the euro area and pushed the euro exchange rates higher. (Chart 1, right figure)

As Chart 2 shows, there has been a certain level of correlation between the EUR/USD and the US-Germany interest rate differentials. Two-year government bond yields were adopted here since they are regarded to reflect fairly well the monetary policies among the yields for individual maturities. Looking back the development since 1999 (left figure), the two rates have not always moved in tandem with each other, but a relatively strong correlativity can be recognized especially since 2007 (right hand figure). In the U.S., the Federal Reserve have already implemented four rate hikes in the current normalization process. As I will discuss later, the hikes have led to a gradual peak out in the outlook for higher interest rates. On the other hand in the Euro area, where the ECB has just started the ground leveling of normalization process, it is expected there is a substantial room for future interest rate hikes, which prompted a

[1] Introductory speech by Mario Draghi, President of the ECB, at the ECB Forum on Central Banking, Sintra, 27 June 2017. https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170627.en.html

sudden fever of euro buying against USD.

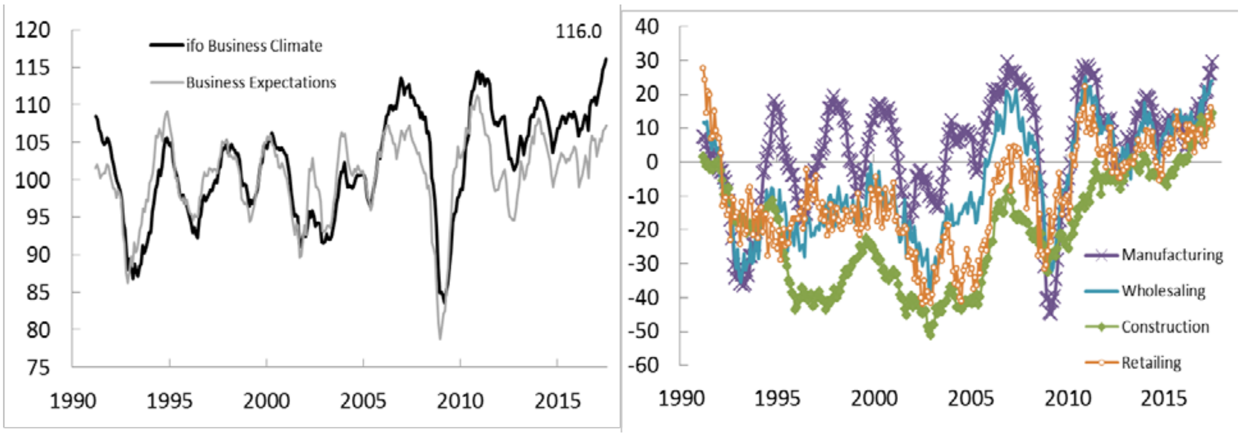
Chart 2　EUR/USD and Interest Rate Differentials (2yr Treasury Bonds)



(Source) Thomson Reuters

Certainly the political and economic environment in the euro area is something to allow a “breathing room”. Although there has been no big change in the situation where the economic recovery has been driven by Germany which has been at its best, the robustness of German economy has been further reinforced (Chart 3 left figure), with all the major sectors of the economy sharply recovering in synchronization, which has not been seen in the past two decades or so (Chart 3 right figure). Further, an acceleration or continuance of the economic recovery has been confirmed also in Spain and France, showing an economic pickup spreading in a wider region with decisively strengthened stability than before. The GDP growth in the euro area recorded 2% (at an annual rate) in the first quarter and 2.3% in the second quarter. The statement of ECB President Draghi may have resulted from his confidence straightforwardly strengthened by the apparent economic recovery of the euro area. In France, the second largest economy (with a share of about 20%) in the euro area after Germany (with a share about 30%), the political risks caused by rising anti-EU forces have been largely abated and the advent of Macron administration which has a pro-EU stance and promotes reforms provided a big sense of relief. In some corners there has emerged an optimistic mood which leads to a declaration of “the revival of Europe”. It is understandable that the buy-back of the euro has been prompted in such a psychological atmosphere.

Chart 3 Germany -ifo Business Climate Index



(Source) Thomson Reuters

If we change the viewpoint a bit, however, the euro area has no more than reached the stage that, after managing somehow to avoid the worst case scenario of anti-EU forces becoming mainstream politically, it finally got on a firm recovery track economically, although lagged behind other countries and regions. In addition, since the statement of president Draghi of the ECB triggered somewhat excessive response in June, the communication of the ECB seems to have become slightly more cautious. After all, the message of the ECB may only mean that given the spreading economic recovery, minor policy adjustment may be taken to maintain a comparable degree of monetary easing stance as in the past. At the regular board meeting on July 20, the Governing Council decided to maintain, as expected, the basic stance that aims to achieve the price target and the forward guidance of monetary policy "geared towards appropriate accommodation", which will be flexibly managed if the outlook becomes less favorable. The present consensus forecast of market is that it will be in 2018 at the earliest that the ECB actually moves to take tapering measures (narrowing of the quantitative easing measures) and further it will be after 2019 that the negative interest will be normalized. So there will be a limitation to the purchase of the euro simply based on the current positive surprises of economy, policy and politics.

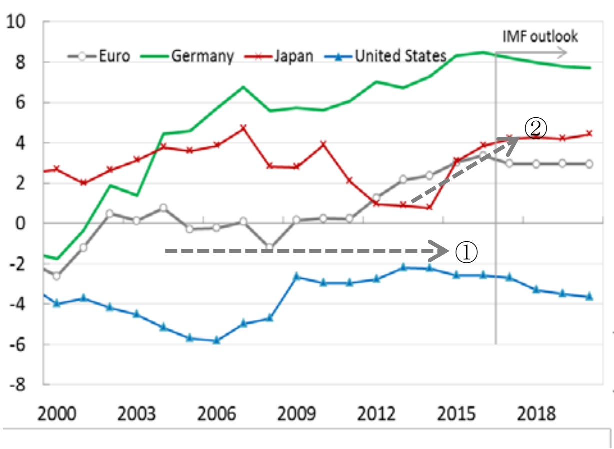
3. Expanding Current Account Surplus of the Euro Area

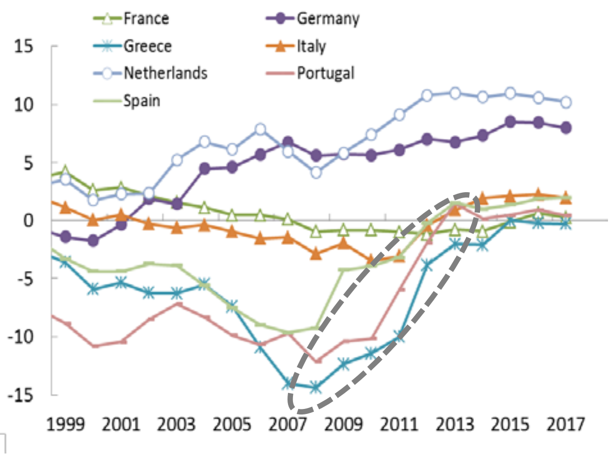
Well then, will there be no possibility that the EUR/USD exchange rate has gotten on a rising trend path? The author considers that not only with the cyclical supportive factor noted above, there are structural factors that exert an upward pressure on the euro, one of which is the large entrenched surplus on the current account balance of the euro area. (Chart 4 left figure) The current account balance greatly improved in the Southern European countries like Italy, Spain, Portugal, which were forced to correct the imbalance under the harsh situation in the European sovereign crisis. (Chart 4 right figure) What is more important is the enormous current account surplus of Germany centering on its trade surpluses. Not only with a criticism from the U.S., the surplus has already become an international issue. The IMF also pointed out in its Article 4 Consultation Report on Germany that “Germany should embrace a set of coordinated fiscal and structural policies to safeguard its strengths and address remaining challenges, including reducing external imbalances.”

The theoretical implication of a large current account surplus on its currency value is that there will be eventually an accelerated appreciation of a currency in the midst of an increased pressure for the correction of external imbalances. On this point there may be an objection that the development of the current account balance had not worked thus far consistently with the formation of an appreciation or depreciation trend of the euro. It is true that the influence of the current account balance on the currency value has been quite marginal as the aggregated current account balance of the euro area has been for long at an “equilibrium position”, hovering around ±1% of GDP. (Chart 4 left figure ①). Since the European sovereign crisis, however, an expanding trend of the surplus noticeably intensified, (Chart 4 left figure ②), with the surplus accounting for a bit less than 4% of GDP for the euro area as a whole, and over 8% for Germany individually. These are the largest level of surplus since the launch of the euro. As an accumulated effect of these current account developments, it will be necessary to bear in mind the possibility that the euro has been growing into “a currency less susceptible to depreciation”. On an empirical rule, it is often at the time of a big change in the sustained trend of current account balance to a fall to deficit or a rise to surplus that the current account balance has a big influence on the foreign exchange rates.

In the U.S., the large surplus of Germany has been loudly criticized or invited concerns since the days of the Obama administration. Therefore, if the low level of exchange rate of the euro that had lasted for long should be corrected, it may give some political benefit to the authorities of the euro area.

＜Chart 4＞　Current Account Balance of the Euro Area and Major Countries (% of GDP)





(Source) IMF WEO Database

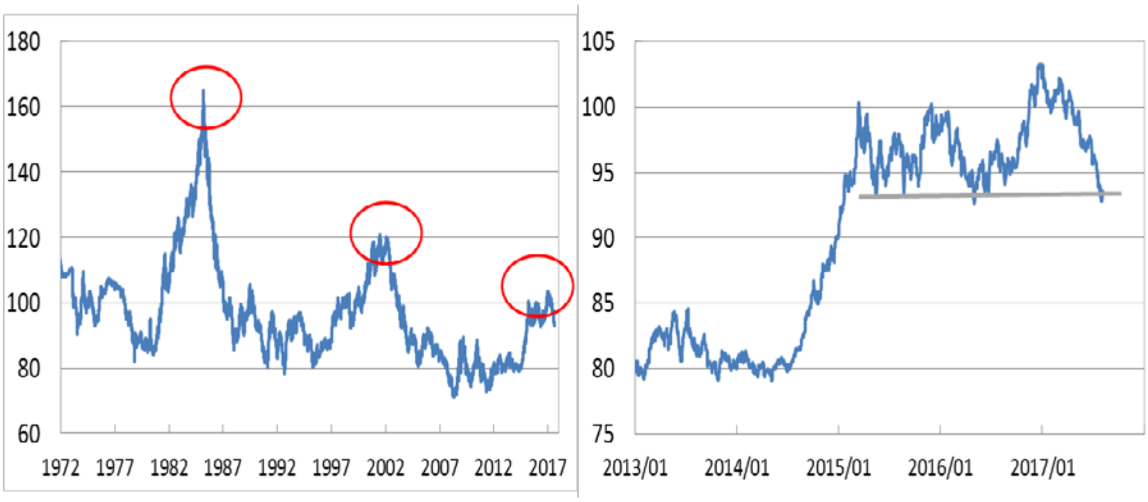
4. Peak Out on the Longstanding Trend of the Dollar Appreciation

The points seen above are the factors for the euro appreciation viewed from the Euro Area side. On the other hand, the current appreciation of the EUR/USD has been also much influenced by the factors on the dollar side, i.e., factors for cheaper dollar. Looking at the comprehensive value of the dollar by DXY[2], as Chart 5 shows, the dollar has depreciated more than 10% since the start of the year, especially depreciating by 2.9% in a single month of July. As the left hand figure shows, a rising cycle of 6-7 years can be observed, and it suggests a possibility that the long-term rising trend may be hitting a peak. Further the right hand figure shows the Effective Exchange Rate of the dollar has been falling below the recent floor level since 2015. This may be taken as technically (on a chart analysis) signaling that the dollar has started to move lower.

[2] A leading effective exchange rate of the dollar computed at a real time by the New York Board of Trade (NYBOT). It is composed of euro, yen, British pound, Canadian dollar, Swedish crone, and Swiss franc.

＜Chart 5＞　USD Effective Exchange Rates

(DXY, since 1972 on the left and since 2013 on the right)



(Source) Thomson Reuters

There are numerous factors for a depreciating dollar, including the turmoil about the management of the Trump administration for which many posts are still to be appointed, debt ceiling problem with the U.S. Treasury Department, and the possibility that President Trump himself is seeking for a lower dollar. As stated earlier, the EUR/USD originally have strong co-relation with the interest differentials between the U.S. and Germany. On the one hand in the euro area there has emerged an expectation that the negative interest rates are finally going to hit the bottom, even though it may be still to come. On the other hand, the U.S. has raised its interest rates for the fourth time with the expectations on the rise of interest rates already making a circuit. Therefore, in the future the exchange rate will be more likely to be influenced by the time difference between the U.S. and Europe.in promoting the exit strategy for each.

More essentially, the development of "interest rates hard to rise or a sense of reaching a ceiling on the dollar exchange rates" may have been fostered by the market uncertainty over the pace and scale of the future interest rate hikes to be made by the FRB. Vice Chairman Stanley Fischer disclosed at a lecture on July 31 an estimate that the natural rate of interest in the U.S is currently 0.50%[3]. The FRB indicates that the pace of interest rate hike will be in tandem with the rise of natural rate of interest. If so, no increase in the natural rate of interest is synonymous with no increase in the long-term outlook of the FF rates and as long as we stand on the premise of the analysis presented by Mr. Fischer, it would be a natural consequence that the present

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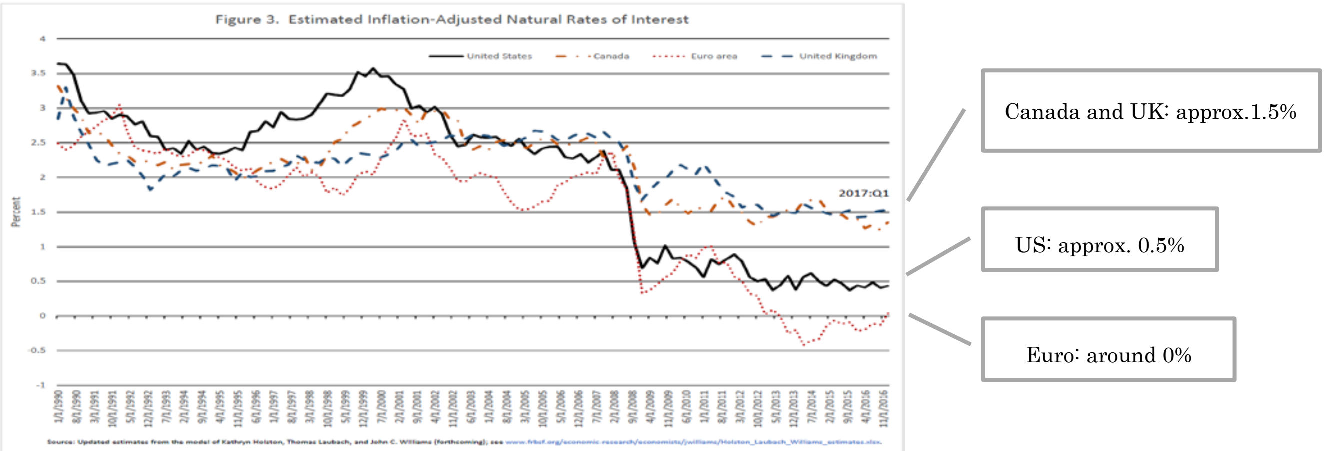
3 From his lecture given on July 31 in Rio de Janeiro, Brazil "The Low Level of Global Real Interest Rates" (https://www.federalreserve.gov/newsevents/speech/fischer20170731a.htm). The estimated natural rates of interest are quoted from the Working Paper of the Federal Reserve Bank of San Francisco (http://www.frbsf.org/economic-research/files/wp2015-16.pdf) and others.

3.0% forecast for the long-term FF rate looks too high. Although it is not limited to the U.S., in the background of the natural rate of interest that remains low there lies a low economic growth symbolized by sluggish capital investment. The progress of a higher euro and depreciating dollar may reflect a possible dimension of a “secular stagnation” of the U.S. economy which should have in the normal situation the strongest fundamental strength and also the difficulty for the market to expect an upward revision in the U.S. economic outlook, i.e., a rise in the interest rates thereof. It is highly likely that, as such a perspective becomes widespread, a perception that the dollar, which has led the exit strategy, might have hit the ceiling will be strengthened.

＜Chart 6＞ Estimated Natural Rates of Interest in Major Countries (Based on the San Francisco Fed Model)



(Source https://www.federalreserve.gov/newsevents/speech/fischer20170731a.htm)

5. Conclusion

In the euro area, for the first time since the European sovereign debt crisis, an economic recovery has been felt with a certain level of strength and breadth. So it was only natural that, reflecting such a situation, the ECB has started to float the first balloon to indicate its intention to initiate the normalization process of its extraordinarily easy monetary policy ahead of the market speculation, and that along the way the EUR/USD has started to show a clear rising trend after a prolonged stalled period. Further, two fundamental factors seem to have contributed to the turn to a rising trend of the euro against the dollar. That is, an accumulation of current account surplus observed in the euro area centering on Germany, and the low natural rate of interest in the U.S., which shows a narrow room for an interest rate hike.

It is true that there has already emerged in some quarters a view that the rapid appreciation of the euro against the dollar, appreciating about 15% since January this year, will hold down the exports of the euro area, at the same time retard the pace of economic recovery and price increase, which in turn will postpone the implementation of exit strategy of the ECB. Of course the ECB is still cautious in the assessment of price development, and according to the latest staff estimate published in June the inflation outlook was revised downward from 1.7% to 1.5% for 2017, and from 1.6% to 1.3% for 2018. Given the current development of prices, there may be a situation where the pace of the appreciation of the euro and depreciation of the dollar will see a temporary adjustment process, hovering around the present level. Yet, given the background of the above-said two important structural factors, the mildly rising path of the euro/dollar exchange rate is most likely to be maintained.

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