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Economic Research:

Could The Strong Euro Delay QE Tapering?

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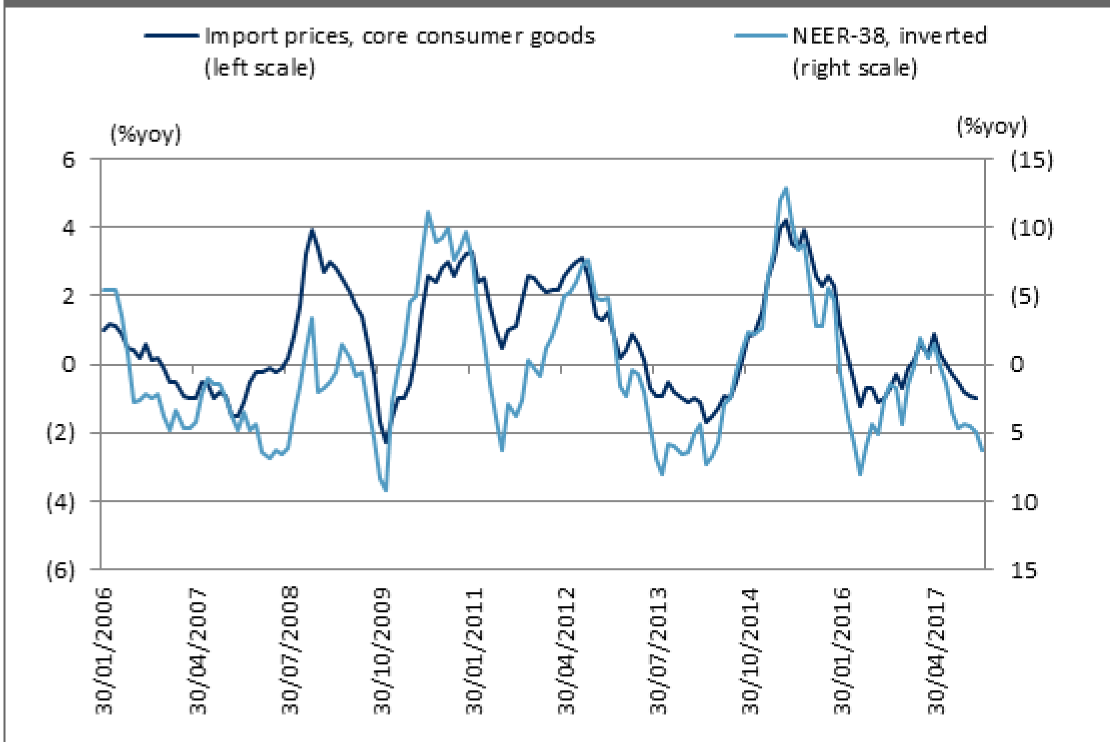
The strong euro and its drag on inflation have increasingly been the subject of comments by the European Central Bank's Governing Council members. At $1.24 at the time of writing, the euro-U.S. dollar exchange rate is back to levels not seen since end-2014, before the announcement of quantitative easing in early 2015, and is 18% above its low point a year ago.

With a strengthening exchange rate, the ECB's current task of lifting inflation close to but below 2% becomes harder. Cheaper imported goods are weighing on price dynamics in the eurozone (see chart 1). ECB estimates of exchange rate pass-through to inflation suggest that eurozone headline inflation would be a cumulative 0.7 percentage points higher today (the latest eurozone inflation read was 1.4% in December), in other words much closer to the central bank's target, had the euro had stayed at early 2015 levels instead of appreciating since the second half of last year.

Chart 1

Exchange Rate Pass-Through To Import Prices Is Strong



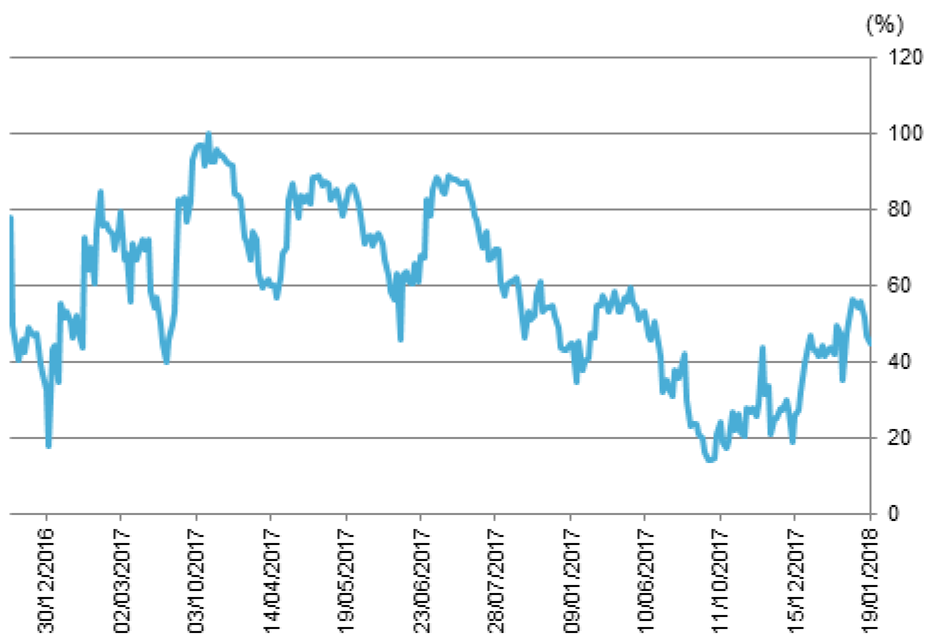
Sources: Eurostat, Bloomberg.

Draghi to be dovish because markets expect tapering too soon

The recent rise in the euro owes not only to a globally weakening dollar, but also to market expectations of ECB rate hikes in early 2019 and, more recently, even by the end of this year (see chart 2). This is earlier than ECB hawks have signaled. With this and the inflation target in mind, ECB President Mario Draghi is likely to strike a dovish tone at this week's ECB conference. While most of the attention will focus on changes in forward guidance, Mr. Draghi is more likely to tame market expectations of early rate hikes. That said, we think that beyond communication, a strong euro alone may not be reason enough to divert the ECB away from tapering. We think a lower exchange rate pass-through to inflation as demand accelerates, along with higher commodity prices, are likely to offset some of the euro-driven negative short-term effects on the inflation rate.

Chart 2

ECB Rate Hike Probability: December 2018 Meeting



Source: Bloomberg.

Firms' higher pricing power to mitigate the exchange rate pass-through

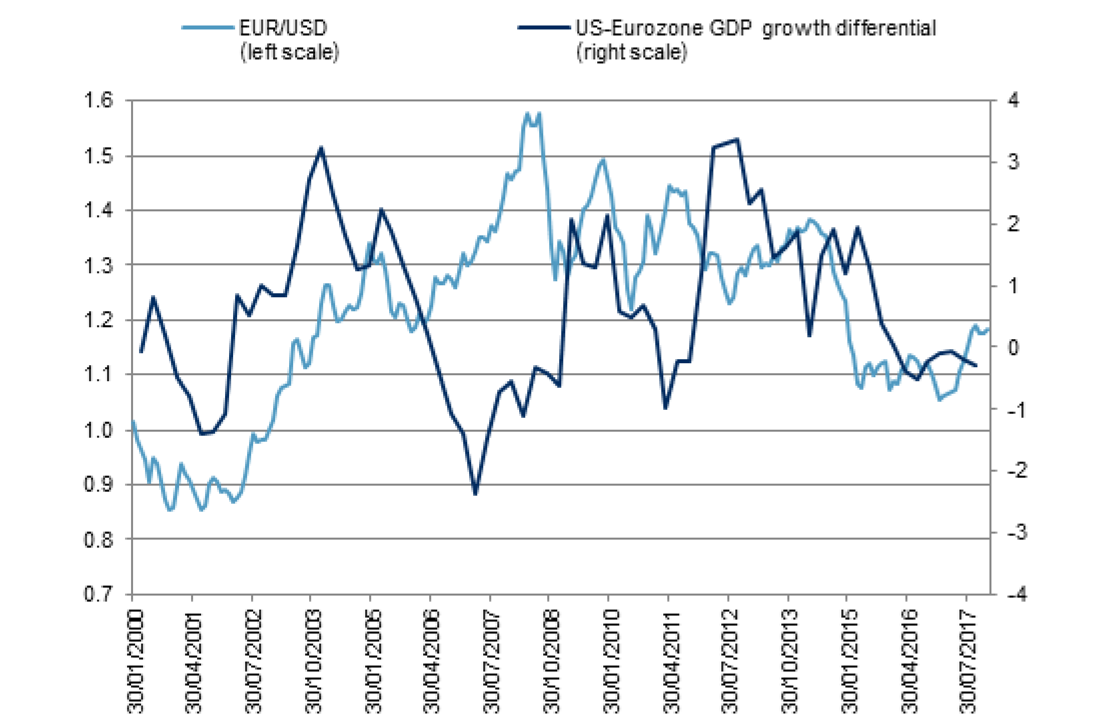
To assess the impact of the strengthening euro on eurozone inflation dynamics, we need to look beyond the strong correlation of the euro exchange rate with import prices. Eurozone headline inflation, which the ECB targets, varies much less with the exchange rate. The exchange rate pass-through has even declined since the 1990s, as globalization, a low global inflationary environment, a changing composition of imports, and increased euro invoicing have all reduced price fluctuations linked to the exchange rate in the eurozone, according to the ECB.

Whether short-term exchange rate dynamics are reflected in domestic prices mostly depends on firms' pricing behavior. As a large share of imported goods goes into intermediate consumption, the transmission of lower input costs to producer and consumer prices depends on the state of the economy and the type of exchange rate shock firms are facing.

Exchange rate shocks driven by relative strength in demand (that is, accelerating growth in the eurozone respective to the U.S.) tend to accelerate inflation, while monetary and exogenous shocks, which point to tighter financial conditions, typically slow it. According to ECB Executive Board Member Benoit Coeure, the current euro appreciation seems mostly driven by accelerating growth in the eurozone (see chart 3), and a bit less by the relative tightening of monetary policy respective to the U.S.

Chart 3

The Recent Appreciation Of The EUR/USD Partly Reflects Growth Differentials

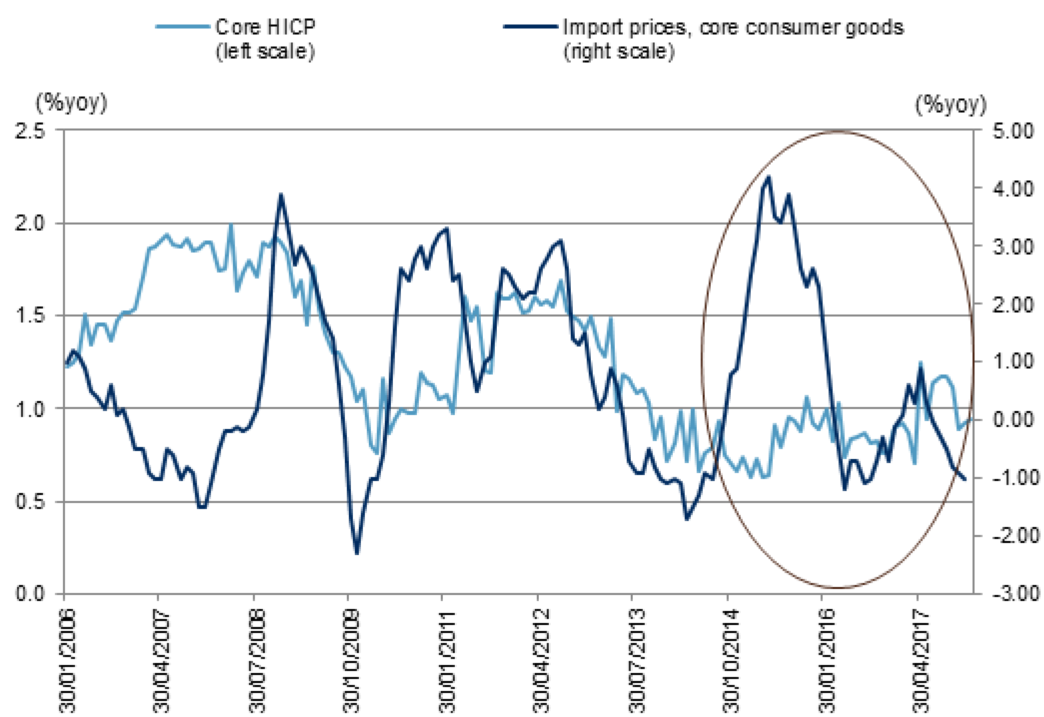


Sources: Bloomberg, Eurostat, Bureau of Economic Analysis.

Focusing on the positive demand shock, the buoyant economic outlook suggests firms' pricing power is higher now than at the start of QE in March 2015. They are thus unlikely to pass on lower input costs entirely to consumer prices, thereby mitigating the effect of a stronger euro. The relatively muted response of core inflation to higher import prices in 2015 (see chart 4) also suggests that firms internalized higher input costs in order not to lose market shares back then. This time, corporates are likely to use lower input costs to make up for their compressed margins since the downturn, especially as nonfinancial firms' profit margins remain below their precrisis average. Therefore, the overall negative effect of a strengthening exchange rate might be relatively mild in the longer term. However, there is still a risk that the euro continues to rise against the dollar, reaching levels closer to the $1.30 mark, in which case the ECB would have to become even more vocal.

Chart 4

Domestic Inflation Is Less Correlated With Import Prices



Source: Eurostat.

Higher commodity prices to offset some euro-driven inflationary weakness

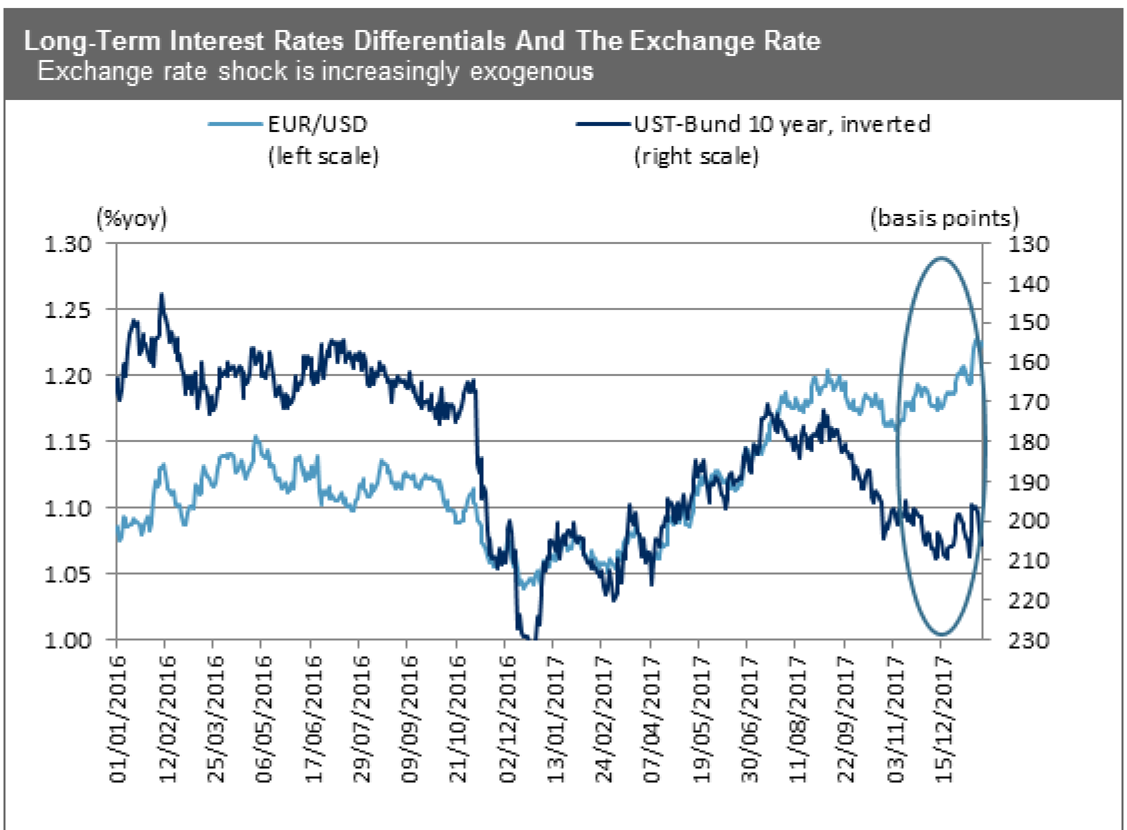
Higher commodity prices are another factor that will offset some of the euro-driven inflationary weakness this year. Traditionally, commodity prices are very sensitive to changes in the euro exchange rate. Yet so far, the recent rise in oil prices has more than offset the negative impact of the weakening dollar (see chart 5). The Brent price in euros is around 4% higher in January than last year and 20% in dollars. Even assuming that oil prices average $60 a barrel this year and the euro-U.S. dollar exchange rate stays at 1.22, the Brent price in euros would still be 2.8% higher on average this year. This compares with current ECB's projections of only 0.8%, somewhat suggesting that the disinflationary impact of a strengthening euro is not yet likely to move the ECB's inflation projections.

What's more, apart from a recent fall, likely driven by one-off effects, the eurozone core inflation measure remains on an upward trend, consistent with the closing output gap trajectory of the eurozone economy this year. Domestic inflationary pressures are also increasingly visible in the labor market, with wage pressures building across all sectors. Even in Germany, where wage growth had been persistently low, trade unions have started wage negotiations by asking for a 6% pay rise this year.

Dovish ECB members retain the upper hand for now

Nonetheless, in the short term, a strong euro suggests that dovish members of the ECB Governing Council are still likely to set the tone. Given that the ECB's inflation forecasts are still below target (1.5% for 2019), the ECB will keep monitoring exchange rate dynamics that do not reflect fundamentals (that is, the exogenous component) and could slow inflation by triggering tighter financial conditions. The latest disconnect between the exchange rate and the long-term interest rate differential (see chart 5) in the U.S. and the eurozone point to such an exogenous shock, which explains why an increasing number of comments from the ECB have tended to focused on the strong euro lately.

Chart 5



Source: Bloomberg.