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ECB preview: The first real 'global euro moment'

We don't expect any changes from the European Central Bank at next week's meeting. However, the recent strengthening of the euro could revive the debate about another rate cut

Last May, ECB President Christine Lagarde delivered a motivational speech aiming to unleash pro-European sentiment and support for deeper integration, calling for a 'global euro moment'. With the recent weakening of the US dollar – and the corresponding strengthening of the euro -next week's ECB meeting could be more interesting than imagined just a few days ago.

ECB still sits comfortably in its 'good place'

When it comes to the basics of monetary policy, given everything currently going on in the world, the ECB has almost become a beacon of continuity – some might even say boredom. The ECB simply calls it a 'good place', i.e., a eurozone economy that looks set to grow at around potential and an inflation rate settling around target. Data releases since the December meeting have only confirmed that view.

What's not to like? Well, maybe the high level of uncertainty in both geopolitics and economic outcomes. Up until now, there has been a clear disconnect between geopolitics and macroeconomics. No one knows whether this disconnect will hold or whether one side of the equation will eventually move. Geopolitical risks could slow down, or the economy could eventually still weaken. However, as long as these geopolitical risks and uncertainties do not translate into substantial changes to the eurozone outlook, the ECB will watch but not act.

Stronger euro could revive debate on possible rate cut

In recent days, however, market developments have started to make the ECB’s 'good place' a little less comfortable. The weakening of the US dollar and hence the strengthening of the euro have led to some unease at the Bank. Austrian central bank governor Martin Kocher said that "if the euro appreciates further and further, at some stage this might create, of course a certain necessity to react in terms of monetary policy. But not because of the exchange rate itself, but because the exchange rate translates into less inflation, and then this is, of course, a monetary policy issue." French central bank governor, Francois Villeroy de Galhau, hinted that the stronger euro was a key factor in guiding monetary policy in the months ahead. And ECB vice-president Luis de Guindos said last summer that an exchange rate of 1.20 versus the dollar was acceptable but levels beyond that could become more complicated. Well, we are at that level now.

From a monetary policy perspective, the recent strengthening of the euro would lower the ECB’s December inflation forecasts by some 0.1 percentage point. Compared with December, the euro has appreciated by some 3.5 percent vis-à-vis the US dollar and by some 1.5 percent vis-à-vis a basket of currencies (nominal effective exchange rate). All else equal, the ECB’s projections would now show headline inflation falling below 2% for the next three years – a development that is likely to revive concerns among those Governing Council members who have long feared an inflation undershoot and view it as a risk to the ECB’s credibility.

Is Europe ready for a 'global euro moment'?

More broadly speaking, these latest reactions show that not everyone at the ECB (or in Europe) is ready for a global euro moment. In fact, the recent strengthening of the euro – and we are talking about strengthening, not yet outright strength – illustrates that Europe should be careful what it wishes for. It is hard to reconcile the ambition of a global euro with an export orientated economy. A global currency normally comes with relative currency strength, deep and liquid financial markets, and often military power. In fact, a global euro should not be a goal in itself but rather the result of a capital markets union, fiscal union and strategic autonomy. If all these foundations are achieved, the euro will be even more attractive and the eurozone economy will be far better placed to absorb a stronger currency.

If the euro strengthens further, the chances of rate cut in March would increase

For now and for next week, the stronger euro is a complicating factor for the cyclical turnaround in industry, which is just materialising, and for the growth outlook in general. The recent appreciation will not be a big enough concern for the ECB to change course next week. For now, the central bank will stay in its good place, and we don’t expect Lagarde to say anything more on the exchange rate, beyond noting that the ECB will monitor it closely.

However, if the latest trend continues and if the ECB wants to send a signal that a slight undershoot of inflation is as much a concern as a slight overshoot, the chances of a rate cut in March would clearly increase.

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