

EUR: The big disappointment from Germany

The German Constitutional court's ruling reinstated a risk premium into the EUR. While negative for the euro, for now, we don't see the same risk premium built into EUR/USD as was observed after the March ECB meeting - the ECB is still in the market and has three months to respond. We think, EUR/USD to stay above 1.07, but downsides risks are building



Source: Shutterstock

PSPP constitutes an economic policy

The German Constitutional court ruling reinstated a risk premium into the euro today.

While the court dismissed the idea that the European central bank purchases constitute monetary financing, it ruled that PSPP purchases constitute an economic policy and are therefore out of the ECB remit. The court also gave the ECB and Bundesbank three months to fix the issue.

[Read more about eurozone's big bang from Karlsruhe](#)

Disappointment for markets as ECB measures had been containing EUR risk premium

The euro reacted negatively given that:

- (a) such a ruling was not expected, hence the disappointment effect;
- (b) in the current times of stress, the ECB easing measures (including the PSPP programme) have had a risk premium reducing the impact on the euro (decreasing the odds of the renewed eurozone fiscal crisis and keeping BTP-Bund spreads contained).

The second point is crucial for the euro and its outlook as the risk premium containment measures have been the key prerequisite for a more meaningful EUR/USD upside going into the summer months.

But the impact shouldn't be as bad as it was in March, at least for now

Following the ruling, we estimate EUR/USD to trade with around 1% risk premium (Figure 1). This is still below the around 2% risk premium observed after the March ECB meetings and President Christine Lagarde's miscommunication during the press conference.

However, in our view, the near-term outlook for the euro was more negative back in March than it is today, given that back then it was the ECB that appeared unwilling to contain the market stress. Hence, the euro risk premium may not reach the 2% level or more in coming days and EUR/USD stays above 1.07 as (1) the lender of last resort is willing to do 'whatever it takes' to deliver the financial stability (though maybe eventually constrained by the court ruling); (2) there are still three months to find a solution / to challenge the German court ruling.

Both options should reduce the imminence of the worst-case outcome when compared to March and hence shouldn't be as detrimental for the euro.

Figure 1: EUR risk premium today less than it was in March

EUR/USD risk premium estimate (derived from ING Short-term Financial Fair Value model). Negative number means negative euro risk premium



Source: ING

Contained EUR/USD until we have more clarity on the response

Rather than a profound decline in EUR/USD (where a degree of risk premia is already priced in), today's ruling should contain its upside and make it more difficult for the EUR/USD to profoundly and persistently break above the 1.10 level – until there is more clarity on the future of the ECB purchases.

Equally, a more meaningful EUR/USD downside (below 1.07) cannot be ruled out, but in our view, first, we need to see the ECB response and its implications for asset purchases.