The ECB can do little to stop the euro's rise

A EUR/USD break of 1.20 may cause a few headaches for the ECB, but there's little they can do about it.

Will the ECB be worried by a move above 1.20?

When the ECB last met to discuss monetary policy on July 20th, concerns were expressed about the risks of the EUR 'overshooting'. Since then EUR/USD has rallied a further 5% and the ECB's trade-weighted EUR is up close to 3%. The ECB was right to worry. Certainly, the speed of the move has surprised the market as well. The EUR/USD consensus, as published on August 7th by Consensus Economics, was rooted at 1.15 until end 2018. Rising traded volatility in the FX option markets also suggests the scale of the move was unexpected.

The ECB will worry this euro strength is coming too early for the Eurozone recovery and in particular too early in the ECB's battle to return inflation back to target of close to, but just below 2%. The stronger euro should leave its marks on the next round of ECB staff projections, which are also due at next week's meeting. The appreciation of the euro since the June forecasts could easily shave off 0.4 percentage points from the ECB's growth forecasts and around 0.2 pps off the inflation forecast. However, the ECB will take some solace from lower bond yields, which should partly offset the impact from the stronger currency on growth and inflation.

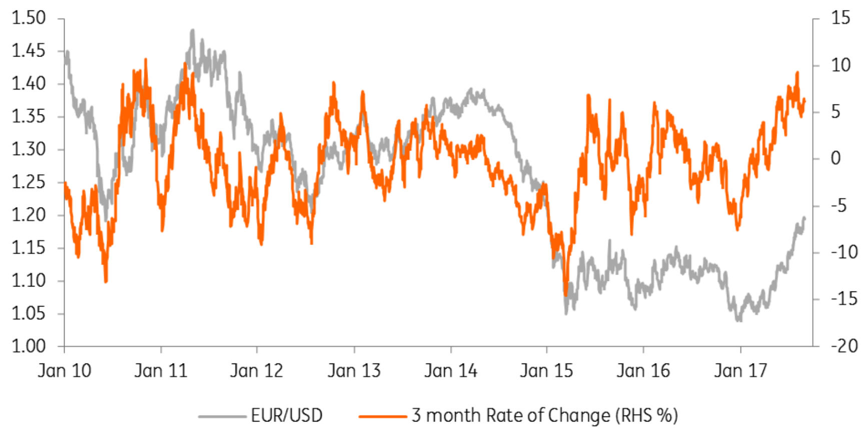
The stronger domestic economy should shield the Eurozone against too negative an impact from a stronger euro

More generally, the strong domestic economy should shield the Eurozone against too negative an impact from a stronger euro. Still, even if there is no reason for the ECB to panic, worries will grow.

Even if the absolute level of the euro is still around its historical average, the change over the last few months would clearly qualify what the ECB in the past referred to as "brutal movements'. Anecdotal reports suggest eurozone central bankers have seen 8-10% appreciations in EUR/USD, over short periods (two to three months), as far too abrupt for European corporates.

The problem with a stronger euro is also that it will hurt the Eurozone economies asymmetrically. Normally, a stronger euro would first hurt countries which could potentially also suffer from tapering. Italy, for example, is one of the countries which has benefitted significantly from the weak euro in recent years.

EUR/USD and its 3 months Rate of Change (%)



Source: Bloomberg, ING

So what can the ECB do about a strong Euro?

Given that a central bank cannot target inflation and the exchange rate at the same time, the ECB's primary route to slowing the EUR rally will be through its impact on inflation. As Peter Vanden Houte highlighted in August's Monthly Economic Update, research by the ECB pointed to a 1% depreciation in the trade weighted exchange rate increasing HICP by 0.1% after one year. Whether a negative pass-through of a similar magnitude applies to EUR appreciation remains to be seen. But our point is here that the ECB's most credible path to curtailing EUR strength is through its impact on inflation and hence monetary policy. As above, we expect the ECB staff forecasts for 2018 and 2019 inflation to be revised lower from 1.3% and 1.6% respectively on September 7th.

In terms of monetary policy, a downward revision of the ECB's own inflation forecasts would make the case for tapering even more complicated. As described in our recent note "Taper Tiptoeing –

The ECB after Jackson Hole", we expect the ECB to change its narrative, away from a pure inflation-focus towards the strong economic performance of the eurozone and the bond scarcity issue.

Nevertheless, even if the stronger euro is no reason to panic, it could affect the ECB's taper game plan in the coming months, particularity once it would start to harm the current recovery.

> *The stronger euro makes the case for dovish tapering even stronger*

Therefore, the stronger euro makes the case for a dovish tapering even stronger. The ECB will take some solace from the fact that a stronger euro has not been accompanied by higher interest rates. Talking down the euro would be counteractive to any tapering plans. This is why we expect the ECB to package any tapering plans in the most dovish way possible.

For example, they could do this by keeping the easing bias for QE in the official communication but also by stressing the (still) benign impact of a strong euro on the economy and strong domestic activity in the Eurozone. It could also mean that any tapering announcement in the next three months will be combined with an extension of the eligible assets for QE purchases, in order to avoid what the ECB often refers to as "unwarranted tightening of financial conditions". However, all of these measures would probably not be enough to turn around market sentiment; it could only help capping a further appreciation of the euro.

If and when the ECB would really want to reverse current euro sentiment, only a clear announcement of a postponement of tapering would in our view help. However, bond scarcity makes it extremely hard not to start tapering at all.

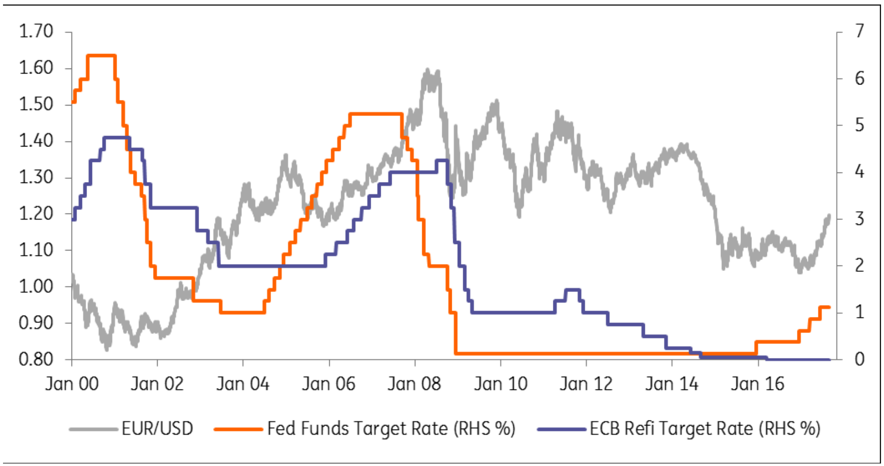
Can verbal intervention be effective?

Beyond cutting its inflation forecasts, the ECB could also start considering its verbal intervention options. References have been made to the adjectives, 'brutal', 'sharp' and 'abrupt' that former ECB President Trichet used through 2004 and then again in 2007 in an effort to slow the EUR/USD advance. Yet those remarks from Trichet barely put a dent in the 2002-2008 EUR/USD bull trend – with the largest correction actually seen in 2005, when George Bush's Homeland Invest Act finally encouraged the repatriation of US$300bn+ into the US tax system.

We think comparisons with 2004 are quite apt at this point. Back in September 2003, the US Treasury had hijacked the G7 Communique and in an effort to force China (and Japan) to allow their currencies to strengthen had crafted a phrase: '*more flexibility in FX rates is desirable for major countries'.* This was targeted at China, but the market took the dollar lower across the board.

Fast forward to 2017 – there has been no Communique, but there is a suspicion that a surge in hawkishness in June from the ECB, the Bank of England and the Bank of Canada might have been coordinated to stop the dollar appreciating after the June Fed hike. It is probably no surprise that Washington would like a weaker dollar now and the problem for the ECB will again be trying to slow a EUR/USD advance which is increasingly being driven by the dollar.

EUR/USD versus Fed and ECB policy rates



Source: Bloomberg, ING

Pain thresholds

We imagine the ECB would scream were EUR/USD to near 1.25 over the next couple of months – primarily to defend Eurozone corporate business-plans. But unless the ECB is prepared to substantially delay its tapering plans, a move that looks unlikely at this stage, we expect verbal intervention will merely slow and not reverse the EUR/USD rally.

The ECB would scream were EUR/USD to hit 1.25 over the next couple of months

Our best guess is that EUR/USD now trades a range around 1.20 before breaking even higher after Italian elections next year. And the risks to our preferred profile remain on the upside. After all, before the Eurozone crisis, there were many talking of a systemically important range for EUR/USD between 1.20 and 1.40.

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