

Why some ECB officials are suddenly concerned about the weak euro

Several European Central Bank officials have become more vocal, showing their concern about the weakening euro. As much as we think that these concerns are overdone, a strengthening euro could be the single most efficient way to temper inflation quickly



In recent days, ECB officials have become more vocal with their concerns about the weak euro. French central bank governor, Villeroy de Galhau, pointed out that a weaker euro would undermine the ECB's goal of price stability. ECB executive board member, Isabel Schnabel, was quoted saying that the ECB was closely monitoring the impact of the weaker euro on inflation. This is in stark contrast with the minutes of the ECB meeting in April when the exchange rate was only mentioned four times. There was also market speculation that major central banks could go for a kind of Plaza Agreement, using coordinated action and even FX intervention to stop the US dollar from strengthening further and the euro from weakening further.

How much of a concern should the recent weakening of the euro really be for the ECB? Since the last ECB staff projections in March, the euro has lost some 5% against the US dollar. The trade-weighted euro exchange rate lost almost 2%. However, compared with one year ago, the euro has depreciated by more than 13% vis-à-vis the US dollar and around 6% in trade-weighted terms. In

normal times, this weakening of the currency would have been a welcome relief for eurozone exports but at the current juncture, it is an additional inflation concern. According to standard estimates, the euro depreciation since March could add another 10bp on inflation this year and 20bp next year. However, at a time in which the main inflationary drivers are energy and commodity prices, which are invoiced in US dollars, the impact of the weaker euro on inflation might be even stronger.

With headline inflation rates above 7%, it is hard to see why some ECB officials are concerned about a few additional basis points. The weak euro might not be the reason for high inflation but it is at least reinforcing it. The main reason why ECB officials have become more vocal on the exchange rate could be the fact that even if higher policy rates will not bring down energy prices or fill containers in Asia, higher policy rates could strengthen the euro. The so-called exchange rate channel could currently be the most, and probably only, efficient way to ease inflationary pressures relatively quickly. This is why the hawks at the ECB might be inclined to use the currency as an argument to support a 50bp rate hike in July and strong forward guidance that more rate hikes are to come. Expect more than the four references to the exchange rate at the April meeting in the coming weeks ahead of the ECB's 9 June meeting.

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