Social Europe

Strong Euro Is Here To Stay

by Marcello Minenna on 4 September 2017 @MarcelloMinenna

The euro rally on FX markets really begins to look interesting now: 1.2 on the Dollar, a level never experienced since January 2015, just before the ECB's official announcement of its Quantitative Easing program.

This year, the Euro has strengthened by over 14% against the US currency. A paradox lies between the lines: the Federal Reserve has delivered three increases in official interest rates, which according to economic theory should have given wings to the Dollar's flight, encouraging capital flows into the US economy. Conversely, the ECB explicitly intends to wait a lot more after the already controversial expected end of QE that was like the elephant in the room in the last meeting of central bankers at *Jackson Hole* the 25th of August.

To solve the apparent dissonance, one should look to interest rates on the government bonds market. Indeed, the differential between US Treasuries and German Bunds has increased by over 60 bps in seven months, stimulating capital flight towards Eurozone markets. So here the expectations embedded in market bond prices are playing a crucial role in determining the renewed Euro strength. It is true to some extent that the economic recovery of the Euro area is stronger than expected, the falling unemployment numbers and the supposed slowdown of the US economy (a narrative not so supported by the most recent data releases) may be concurring factors in explaining the Euro's rise, but Eurozone headline inflation remains highly subdued and not fully coherent with exchange rate movements.

Markets increasingly believe that the ECB will taper QE, sooner rather than later. And there are sound technical reasons behind this belief. German bunds eligible to ECB purchases are overly scarce, this time seriously. One of the most obvious signs of a probable, drastic reduction of QE is to be found in the abrupt change of purchase patterns taken by the ECB on the secondary market.

Scarce Bunds

Via a consolidated praxis a central bank purchases assets in a predictable way in order to reduce the volatility and the distorting impact that its "artificial" demand of bonds may generate on the market. In particular, the ECB has relied on the capital key rule: the more a national central bank contributes to the ECB's balance sheet, the more government bonds will be purchased. This is why German Bunds are the dominant part of the program (€404 billion), while only €28 billion of Portuguese bonds have found their way onto the ECB balance sheet, despite a huge debt to GDP ratio. This rule has had the advantage of being politically neutral and not linked to the scale of public debts. This benefit has come at the cost of making the bonds of core countries (Germany, Holland, Finland) – already in high demand by market players for their perceived solidity – extremely scarce, by lowering their returns to negative levels. Last year German public debt shrank 4% GDP points thanks to the fact that "lucky" Bund investors have accepted to be repaid by the German government less than they had lent.

Until March 2016, the ECB closely followed the rule of the *capital key*. Then Draghi announced that some temporary mismatch could be allowed for strict technical reasons. What was happening then was that eligible Belgian and Irish bonds were almost exhausted and it would have been necessary to replace them with other countries' bonds whose supply was more abundant (viz. Italy and France). In the following months, that "temporary" deviation became permanent, but nobody has complained too much; less than ever, the Italian government.

Moreover, from April 2017 this "temporary" deviation has no longer been negligible because the ECB has begun to reduce the purchase of German securities – which alone account for 15% of the total – at a sustained pace. What was going on? Another tighter technical constraint was kicking in: a maximum purchase limit equal to 33% of each issue beyond which the ECB cannot go. This is an adamant rule more difficult to circumvent than the capital key – otherwise, according to the rules on new clauses on European public debt (the notorious CACs, *Collective Action Clauses*), Draghi would acquire as a creditor too many veto rights in the event of renegotiation (or redenomination) of the debt. According to recent estimates of Morgan Stanley, at a rate of €18 billion a month, which is the amount the ECB was purchasing before "closing the taps", it would take only 4-5 months before touching this 33% limit.

Hence many traders already forecast a turning-point in ECB monetary policy, maybe between September and October 2017. Draghi's ambiguous statements, associated with the absence of concrete measures from the ECB, simply fuel the building of speculative positions while the expiry date of December 2017 is rapidly approaching. So, it is not by chance, despite an empty ECB meeting full only of reassuring propositions, that since July 20 the Euro has accelerated its upward run. After a brief *hiatus* in the middle of the summer break, the deafening silence shown by Draghi at *Jackson Hole* has rapidly re-ignited a fresh accumulation of speculative trades, as the absence of new information to process has exacerbated betting on the pending QE *tapering*.

Hence, at least over the next few months, regardless of whether Draghi announces *tapering* or not, a stronger Euro is likely to stay, simply sustained by market expectations. This will surely help to mitigate the rising energy costs (oil has consolidated a firm 10% gain from June), but at the same time will probably have a negative impact on Eurozone exports towards the US and the Far East, threatening the recovery in the weaker countries like Italy, where non-EZ exports are over a third of the total and GDP growth is well behind the average rate of +0.6% proudly announced by Draghi at *Jackson Hole*.