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IRISH exporters association

Analysis: Euro Has Limited Upside after Recent Gains; No Threat to Growth

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11:16 | March 25, 2016

▪ ***New Development***: *Euro climbs to near five-month high after mixed messages on policy from ECB*

▪ ***Implications***: *Continued strength in euro may darken the outlook for growth and prices as ECB fights deflation*

▪ ***Outlook***: *Currency likely to remain below historical average vs. dollar despite recent gains*

Strategists and traders are cutting bearish bets on the euro amid mixed messages from the European Central Bank about monetary policy but the currency is likely to remain below its historical average, and won't present a threat to growth this year, according to economists and business group heads.

While the average analyst estimate for the euro's value by the end of 2016 climbed last week to $1.08 from $1.05 at the start of the year, according to a Bloomberg survey, while brokerages including ABN Amro predict the currency will trade at $1.15 "in the foreseeable future."

The upgrades followed comments this month from the ECB President, Mario Draghi, that the bank may well be done cutting rates for now, and after the Federal Reserve on March 16 lowered the extent of expected interest-rate increases this year.

The euro climbed close to a five-month high of $1.13 on March 17, taking its advance in 2016 to 4.2% and confounding traders who had bet against the currency for 2016. The common currency was little changed at $1.12 on Thursday.

While fighting deflation and slow economic growth, and trying to revive tepid lending in the Eurozone, policymakers could find their latest headwind in the form of a higher euro that could stem exports and fuel lower prices. The euro pared gains on March 22**,** dropping 1% to $1.12, following the terrorist attacks in Brussels that killed at least 31.

"The risk with the euro is for a break higher rather than a break lower," Georgette Boele, a foreign-exchange strategist at ABN Amro in Amsterdam, told *Euro Insight*. "The ECB has officially never aimed at a weaker currency, but now they are shifting the focus towards the credit channel and away from a weaker euro. So in a way it is calculated. For now, the exchange rate doesn't constitute a problem" for the growth outlook, she said. Her team, which had a $1.05 forecast for the euro this year, raised it last week to a range of $1.10-$1.20.

NEW STIMULUS

On March 10, Draghi announced a battery of new policies including lower interest rates and expanded quantitative easing. He said key rates will "remain at present or lower levels for an extended period of time," and that the Governing Council does not "anticipate that it will be necessary to reduce rates further." He added that the Bank had refrained from introducing a deposit-tiering system for fees "exactly for the purpose of not signaling that we can go as low as we want'' on rates.

But, in a possible reaction to the euro's rise, ECB policymakers have since appeared to retreat from the March 10 statement, suggesting that rates may still go down.

Draghi said at a press conference on March 17 that interest rates haven't necessarily reached a low, while the ECB's chief economist, Peter Praet, told Italy's La Repubblica newspaper the next day that further cuts in interest rates remain an option.

Still, the euro hasn't retraced its rise and the comments have added to doubts about the outlook for ECB monetary policy.

The euro's upside isn't limited by the Fed, which is likely to be more dovish than the market is betting on, said Boele at ABN Amro. Her team expects the Fed to hold rates unchanged for the remainder of 2016.

Against sterling, the euro has fared even more strongly as investors dumped British assets on concern about a potential British exit from the European Union after the country's June 23 referendum on whether to remain a member of the EU. The euro has risen 11% to 1.27 to the pound since November.

CRITICISM

Any sign of criticism from exporters would add to opposition to Draghi's policies, which have been disparaged by banks seeing an erosion in income and by some economists who say the ECB's loose monetary policy is fueling a credit bubble.

Net negative speculative positions on the euro have halved since the start of the year, according to U.S. weekly data from the Commodity Futures Trading Commission's Commitments of Traders Report, analyzed by Rabobank.

In its March staff macroeconomic projections, a quarterly review of economic performance and forecasts, the ECB cut the outlook for gross domestic product growth in the Eurozone this year to 1.4% from 1.7%, citing "weakening global growth and a strengthening of the effective exchange rate of the euro."

The European currency traded at $1.06 right before the previous staff projections in December. The ECB cuts its exports growth estimate for 2016 to 3% from 4% previously, and predicted the euro will trade at $1.11 this year, climbing to $1.12 in 2017.

In an example of how a stronger euro can affect growth and inflation, the ECB forecast in March that a gradual 5.5% gain in the exchange rate by 2018 would erode as much as 0.3 percentage point from GDP growth every year and reduce inflation by as much as 0.4 percentage point.

"As far as the recent appreciation is concerned, this should not translate into material negative effect on euro area growth," Thibault Mercier, economist at BNP Paribas, told *Euro Insight*. "The main concern regarding growth is weak external demand that weighs on exports, much more than the euro exchange rate, and persistent low inflation.''

BUSINESS OUTLOOK

Trade groups in the region told *Euro Insight* that the euro is still not at a level that could hinder exports.

"Looking at the long-term perspective, euro pricing is not in any way beyond developments that we have not seen before,'' said Rudolf Lichtmanegger, Deputy Head of the Economic Policy Department at the Austrian Federal Economic Chamber. "We're not at worrying levels at this moment."

Eurozone exporters got a boost from last year's depreciation of the euro, which traded at $1.39 in March 2014. The average rate for the common currency between 2009 and the end of February was $1.30.

"The euro exchange rate is currently encouraging export growth in Ireland but if it gets any weaker it will start to affect us,'' said Simon McKeever, Chief Executive at the Irish Exporters Association in Dublin. "Last year the euro, being weak particularly against sterling and the dollar, did a lot to boost Irish exports."