

CURRENCIES: EURO

ECB'S HAWKISH PIVOT IMPROVES EURO'S OUTLOOK

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SUMMARY

- The hawkish shift in ECB rhetoric at its February monetary policy meeting suggests that short-term rate differentials may turn less negative for the euro.
- More importantly, net portfolio investment flows into euro area debt securities could significantly improve, reversing the outflows that stemmed from the ECB's introduction of negative rates and asset purchases programme in 2014 and 2015.
- Consequently, we have decided to revise upward our EUR/USD projections to take into account more limited downside risks in the short term and scope for some upward surprises in the medium term. Our projections for the euro are now USD1.13 in three months (vs. USD1.10 previously), USD1.15 in six months (vs. USD1.10 previously) and USD1.19 in 12 months (vs. USD1.15 previously)

The ECB pivots to a hawkish stance

We have long argued that short-term interest rate differentials are a key medium-term driver in the EUR/USD exchange rate. Since the Fed's hawkish pivot in June last year, this driver has been a constant drag on the single currency versus the greenback, especially in the last two months of 2021. But the more hawkish tone adopted by the European Central Bank (ECB) at its Governing Council meeting in February suggests this differential has bottomed and may even rise in the course of the year, thus helping the euro (*see chart 1*).

CHART 1: EUR/USD VS. MARKET EXPECTATIONS FOR THE DIFFERENTIAL BETWEEN FED & ECB POLICY RATES

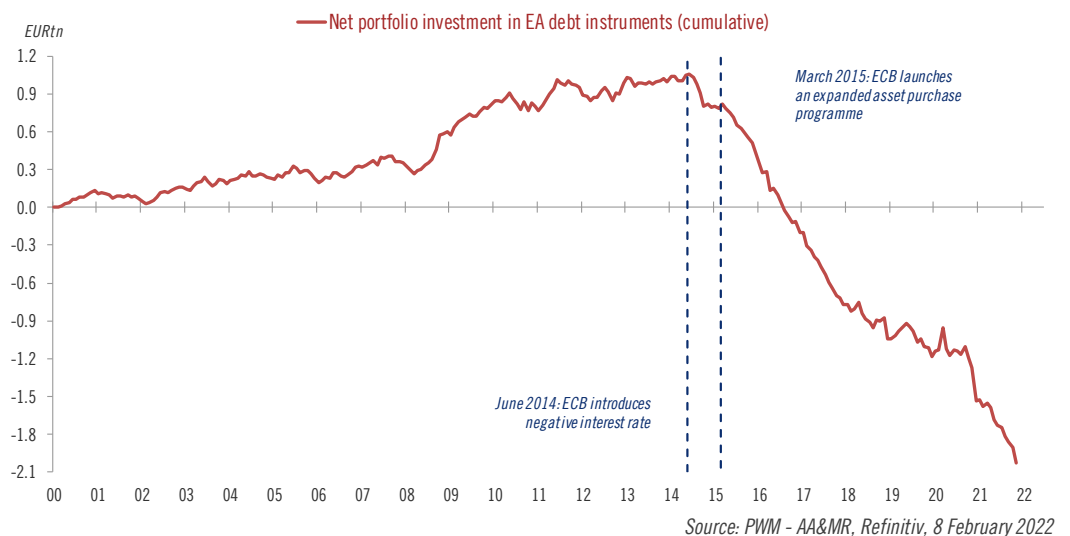


Scope for an improvement in portfolio inflows to the euro area

An end to negative interest rates could prove particularly positive for portfolio investment inflows into the euro area. Before the ECB introduced negative deposit rates in June 2014 and expanded its asset purchases programme a few months later, portfolio investments into euro area debt instruments were net positive. The combination of

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negative rates and the ECB's large-scale purchases of European government bonds since March 2015 have crowded out bond investors and led to massive investment outflows out of debt securities (*see chart 2*). The prospect of a faster tapering of the ECB's bond purchase programmes and a move out of negative territory for the policy rate in the not-so-distant future could considerably brighten the outlook for net investment flows again.

CHART 2: NET PORTFOLIO INVESTMENT FLOWS INTO EURO AREA DEBT INSTRUMENTS**Other factors supporting the euro**

In the meantime, we think a second key medium-term driver, the economic growth differential, should also support the euro versus the US dollar in 2022. Improvements in both the growth and the interest rate differential—both medium-term factors that have been helping the USD—point to a brighter outlook for the euro. Long-term factors, such as deviation from long-term equilibrium value and the US imbalances (current account and fiscal deficits), also favour the euro relative to the US dollar.

Forecasts on EUR/USD revised upwards

Short-term rate and economic growth differentials have a major influence on our projections for the EUR/USD rate. We have been cautious on the euro's prospects for the first part of the year given the combination of a hawkish Fed and a patient ECB, which has widened rate differentials in the USD's favour. But the ECB's hawkish shift last week may mean the rate differential has peaked. That said, we may see only limited closure of the rate gap in the near term, as we think market pricing of two ECB rate hikes this year is rather optimistic.

Our new projections for the EUR/USD rate are USD1.13 in three months (compared to USD1.10 previously), USD1.15 in six months (USD1.09 previously) and USD1.19 in 12 months (USD1.15 previously).

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