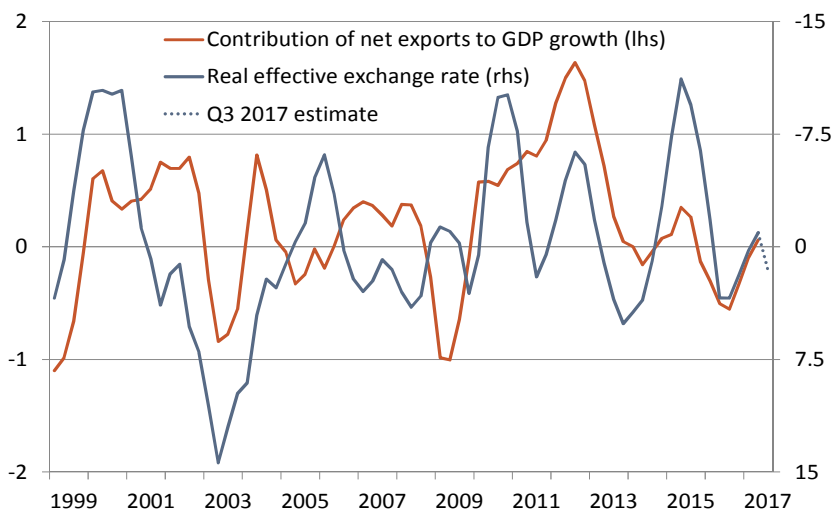


4 August 2017

## Who's afraid of super euro?

The euro exchange rate drives Eurozone growth – sometimes



Real effective euro exchange rate versus 38 major trading partners, yoy change in %, right-hand scale; contribution of net exports to yoy change in real Eurozone GDP, in ppt, left-hand scale. Source: ECB, Eurostat, Berenberg calculations

- **Eurozone on a roll:** Since the start of the year, we have upgraded our forecasts for Eurozone growth from 1.5% to 2.0% for this year and from 1.5% to 1.9% for next year. At the same time, the US has disappointed. While we still expect Congress to pass a corporate tax reform coupled with a fiscal stimulus eventually, probably next spring, we had to scale back our expectations for the scope of such reforms and the size of the stimulus. We now project 2.0% instead of 2.4% US growth for 2017 and 2.4% instead of 2.9% for 2018.
- **How strong is the euro?** Reflecting the balance of surprises, the real effective exchange rate of the euro has risen by 6.9% so far this year. The move gathered pace after financial markets misinterpreted Mario Draghi's Sintra speech on 27 June 2017 as hawkish. On 3 August, the real trade-weighted value of the euro exceeded its Q2 2017 average by 4.5%.
- **Only one of many factors:** The exchange rate matters. Our chart shows that significant moves in the real effective exchange rate often go along with changes in the contribution of net exports to growth. A stronger exchange rate can weigh on export growth and stimulate imports. But the fit is far from perfect. Many other factors such as the state of trading-partner demand relative to domestic demand as well as the impact of major shifts in oil prices affect net exports.
- **How much does it matter?** Upon presenting its June 2017 staff projections, the European Central Bank (ECB) suggested that a gradual decline of the nominal effective exchange rate by 1.8% until 2019 relative to its baseline scenario would raise growth and inflation by 0.1ppt in 2018 and 0.2ppt in 2019. Taking these estimates at face value and assuming a symmetric response of growth and inflation to an appreciation instead of a depreciation, the 4.2% rise of the euro since the 16 May 2017 cut-off date for these ECB projections could reduce growth and inflation by 0.2ppt in 2018 and 0.4ppt in 2019. That would be a significant impact. It could imply a slower pace of tapering next year.
- **Do not worry too much:** In our own last major forecasting round, we had assumed that the euro would trade at 1.12 to the US dollar at the end of 2017, rising to 1.18 at the end of 2018 and 1.22 at the end of 2019. We now project 1.17, 1.19 and 1.23 for the end of 2017, 2018 and 2019 respectively. As the market may now be a bit too pessimistic about potential US fiscal reform, we still look for the dollar to recover slightly later this year before returning to a long-run mean reversion back to purchasing power parity of around 1.25 to the euro. If we assume the usual relationship between the US dollar and the effective exchange rate of the euro, our new currency calls would warrant a downward revision of 0.1-0.2ppt for our Eurozone growth and inflation forecasts for 2018 and 2019.
- **Balance of risks:** After a 2.2% average annualised pace of Eurozone growth in the last three quarters, we project a gradual decline to 1.9% next year and 1.7% in 2019. Recent survey data such as the 10-year record in the European Commission's economic sentiment index for the Eurozone suggest an upside risk to our forecasts. The rise in the euro exchange rate probably neutralises this upside risk. But so far, we do not see it as a reason to lower our calls for growth.

# Economics

## Chart of the week



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