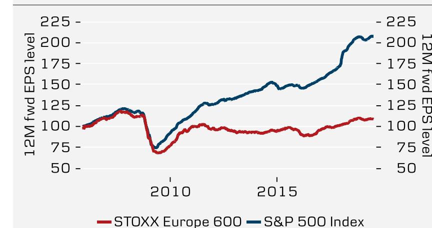
12 July 2019

FX Edge

The EUR and ECB – rate cuts are all that matter

- **With a wide range of easing measures back on the table at the upcoming ECB meetings, we look at which measures would have a greater impact on EUR.**
- **In our view, what matters in the short-term is rate cuts. That would force a greater share of excess liquidity on the market, help turn around inflation expectations and weaken EUR.**
- **A deep rate cut could do the trick (we call for 20bp), but we see a risk that tiering would erode the effect and push EUR higher. We do not expect much market reaction in July, but rather consider the September meeting to be pivotal for EUR.**
- **We forecast EUR/USD at 1.15 in 3M as we look for Fed easing to be more forceful than ECB easing. That in turn would erode carry on short EUR/USD trades and further reverse short EUR/USD positions.**

Chart 2. Weak earnings expectations in euro area

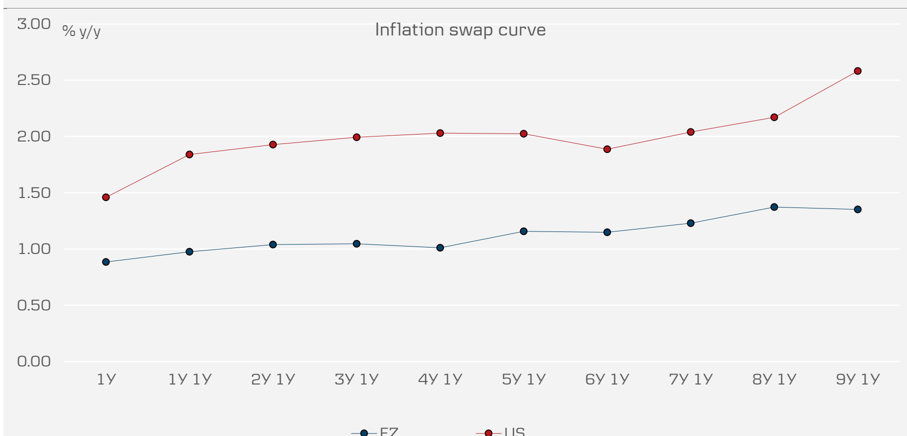


Source: Macrobond Financial and Bloomberg

What to do to create inflation?

For EUR, the outcome of the upcoming ECB meetings has become highly important after ECB President Mario Draghi opened up the possibility of monetary easing in his speech at the Sintra conference a month ago. Our long-held view remains that what matters for EUR is what the ECB can do to create inflation. The market remains sceptical on this part – on a 10Y horizon the market is not convinced the ECB will return inflation to 2%. That is in stark contrast to the US (see chart 1). This nominal divergence is not only evident in the inflation swap market, but also in the stock market where earnings expectations remain sluggish in the euro area (see chart 2). In that respect our predisposition in recent months has been to stay long EUR, as we have been sceptical about the ECB's willingness and/or ability to push hard for a return of inflation back to target. With the potential for monetary easing now back on the table, below we take a stance on what ECB would actually have to do to weaken EUR and turn the negative spiral in inflation expectations.

Chart 1. 2% inflation nowhere in sight in euro area



Source: Danske Bank

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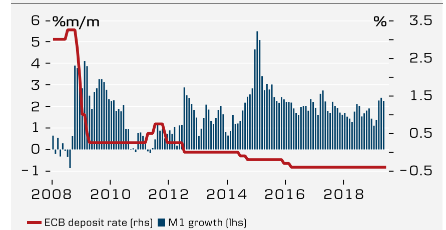
Rate cuts needed to fix the transmission mechanism

We expect the ECB to cut the deposit rate and MRO rate by 20bp to minus 0.60% and minus 0.20%, restart quantitative easing and adopt a tiered deposit rate system at its meeting in September. Before then we look for it to tweak its forward guidance in July in an effort to prepare the market for the above package – see *ECB Research New ECB call – rate cut and restart of QE,* 18 June 2019.

For the FX market, it is the rate cut part of the package which really matters. There is currently a lot of dead money ending up back in the ECB because a deposit rate of minus 0.40% is quite attractive when big parts of the government bond market trade at lower levels. A cut in the deposit rate would heat up the cold potato and force a bigger share of the EUR1.5tn excess liquidity out onto the market. Hence, a sizeable rate cut (and 20bp is a bare minimum in our view) would work and weaken EUR. An easy way to illustrate this transmission is by looking at what happens to M1 money supply growth when the ECB cuts interest rates. Growth accelerates, albeit temporarily – see chart 3.

Chart 3. Rate cuts speed up money supply growth



Source: Macrobond Financial

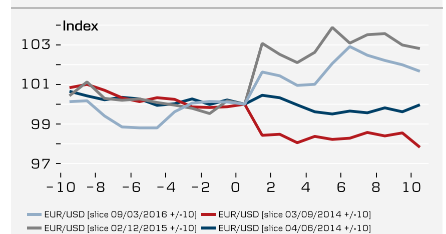
For the same reason, QE would not have a significant currency impact at the current stage in our view. QE without a sizeable rate cut would be futile as the liquidity it creates would just end up back in the ECB. QE has helped satiate banks' demand for high quality liquid assets to satisfy the liquidity coverage ratio (LCR) requirement though. Furthermore, there it can also be argued that ECB QE is not particularly effective, since the ECB plans for it to be temporary – QE is much more potent when it is deemed to be permanent.

A tiered deposit system would mitigate the stimulating effect of a rate cut and all other things equal support EUR. The question is rather how much it would mitigate. That depends on how it is structured, i.e. how much banks can deposit at a higher rate. The most straight forward way of assessing the currency impact of the introduction of tiering (in combination with rate cuts) is to look at how much it changes the average deposit rate banks face at the ECB, as it would determine whether banks will have an incentive to trade more of their total excess liquidity away.

ECB has disappointed in recent years

If history repeats itself, the market is more likely to be disappointed with the ECB's monetary policy actions, triggering a rally in the EUR. In chart 4, we have looked at the reaction in EUR/USD to the past four ECB cut rates. In December 2015 and March 2016 it was not able to live up to market expectations, triggering a sharp rally in EUR/USD, and in June 2014, EUR/USD was more or less unchanged. The exception was the September 2014 rate cut, where EUR/USD fell afterwards as the ECB surprised the market.

Chart 4. Reaction in EUR/USD to previous ECB cuts



Source: Macrobond Financial

The market is currently priced for EONIA to fall to 10bp in September and 20bp by April next year. On the surface, that is less aggressive than our call for a 20bp rate cut in September, but we see a risk that mitigating measures, e.g. a tiered deposit system, would erode the pass through to market rates. Hence, we actually see a risk that the market is too aggressively priced for rate cuts and EUR/USD could rally even though the ECB might deliver rate cuts. The sticking point is the net impact of rate cuts *and* tiering. The showdown is more likely to take place in September than in July though.

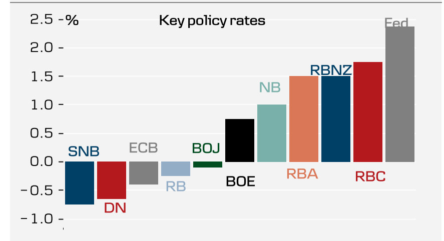
A surprise for all of the above would be if the ECB pulls a rabbit out the hat and introduces some sort of 'Evans rule', tying its forward guidance more effectively to a numeric target or range for inflation, i.e. something along the lines of committing to maintain QE and the current level of interest rates until headline inflation has averaged above 2% for a 12M period. That would be an extension of the recent discussion in the Governing Council about

adopting a more symmetrical inflation target, where it would tolerate inflation above target to compensate for persistent undershooting in recent years. That could help convince the market that ECB is in it for the long run, which could send the EUR lower.

ECB has less ammunition than other central banks

In about two months' time, when all is said a done, we see a potential for a higher EUR. In particular vs USD, as the Fed has a lot more room to ease monetary policy than the ECB. In the broad G10 FX space we like to pair EUR with the likes of CHF and JPY; hence, currencies where central banks have limited room to manoeuvre – see chart 5 and our analysis in *FX Strategy Risk off: winners and losers*. We still forecast EUR/USD to rise to 1.15 in 3M on relative monetary policy (Fed easing more aggressively than ECB), erosion of the carry lure on short EUR/USD trades and a further reversal in short EUR/USD positions (see *IMM Positioning Update*). On 6-12M we still see EUR/USD in 1.17 as a trade deal and positive growth momentum in China should give EUR/USD a nudge higher.

Chart 5. Central banks in two camps



Source: Macrobond Financial

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Jens Nærvig Pedersen, Senior Analyst.

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None.

Date of first publication

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