The Art of (Currency) War

• Implied vol in EUR/USD sees nothing to disrupt calm
• EUR strength not a benign issue for ECB
• Could the ECB feasibly pull out all the stops?

Implied volatility in EUR/USD is pointing to one of the quietest periods on record this coming month. But the relative calm belies what is a potentially pivotal period for currency markets.

With the Fed building towards its first rate cut in over a decade, the ECB may feel that ensuing strength in the EUR is hardly in keeping with eurozone economic fundamentals.

Certainly, the very possibility of a sustained phase of USD weakening could not be considered a benign issue by the ECB Council. But just what the Bank is willing to do to pre-empt this possibility is another matter.

After all, the US Treasury has a more convincing track record than its European counterparts when it comes to the ‘benign neglect’ of currency – a part reflection in the euro era of the ECB Council’s often starkly-divergent, vested interests which have complicated any unified position, and certainly a timely one.

The very possibility of a

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Newswatch

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2. German inflation revised higher for June; French inflation unchanged >
sustained phase of USD weakening could not be considered a benign issue by the ECB

For the moment, the chorus line of Council officials that have sung from a similar hymn sheet this past week points to a shared belief in action sooner rather than later.

But, could the ECB feasibly pull out all the stops?

Certainly, the rhetoric has conveyed urgency: Benoit Coeuré, for example, said at the weekend that accommodative policy is needed “more than ever”. Klaas Knot, a hawk, said that “it is indisputable that inflation remains too low”.

However, a piecemeal return to stimulus is unlikely to be deemed fit for purpose given the limited success that the ECB’s existing and prior policy measures have had in cajoling inflation.

Hence, whether the rhetoric equates to immediate policy action is one thing; whether the ECB can satisfy the market quite another.

On occasion, the ECB has cried wolf, so to speak, and most famously in 2015.

A piecemeal return to stimulus is unlikely to be deemed fit for purpose

EUR/USD was trading just a few pips north of current levels on October 22, 2015 when Mr Draghi announced that the Bank was “open to a whole menu of instruments” in order to “do what we must to raise inflation as quickly as possible”.

This statement saw EUR/USD lose 6.8% before it arrived at its post-launch lows of 1.054 in early December.

However, what happened then provides a salutary lesson for Mr Draghi and his successor in 2019: on December 3,
2015 the ECB Council simply failed to live up to expectations – QE was extended, but the deposit rate cut on reserves was minimal and the pace of bond buying remained the same.

The EUR leapt a staggering 3% on the day and by the following April had risen a further 7.5%. Meanwhile, the collapse in inflation expectations was equally pronounced: the ECB’s favored 5-year/5-year inflation swap rate collapsed from highs of 1.81% as Mr Draghi spoke, to around 1.25% the following summer.

Whether or not more ‘sceptical’ members of the governing Council can sign up to the kind of response alluded to this past week remains to be seen – there is hope maybe, although things are seldom that straightforward.

Either way, these are the questions to be pondered once the dust settles on two weeks dominated by a focus on US monetary policy.

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