

The QE retreat

Mario Draghi faces easing dilemma as strong euro sparks concern

ECB looks to scale back QE, one of the chief props of eurozone recovery



Mario Draghi has to reconcile ECB hawks' suspicion of quantitative easing with doves' worries about a hasty winding down of the programme © AP

YESTERDAY by: Claire Jones in Frankfurt

European travellers preparing to jet off to sunnier climes have something smile about: the [euro](#) has risen 6 per cent in a year against the dollar, boosting its buying power abroad.

Not only has the currency hit a two and a half year high against the greenback, it has risen 5 per cent against a basket of currencies in just three months.

But at the Frankfurt headquarters of the European Central Bank, the single [currency's strength](#) has become a headache at a highly sensitive time.

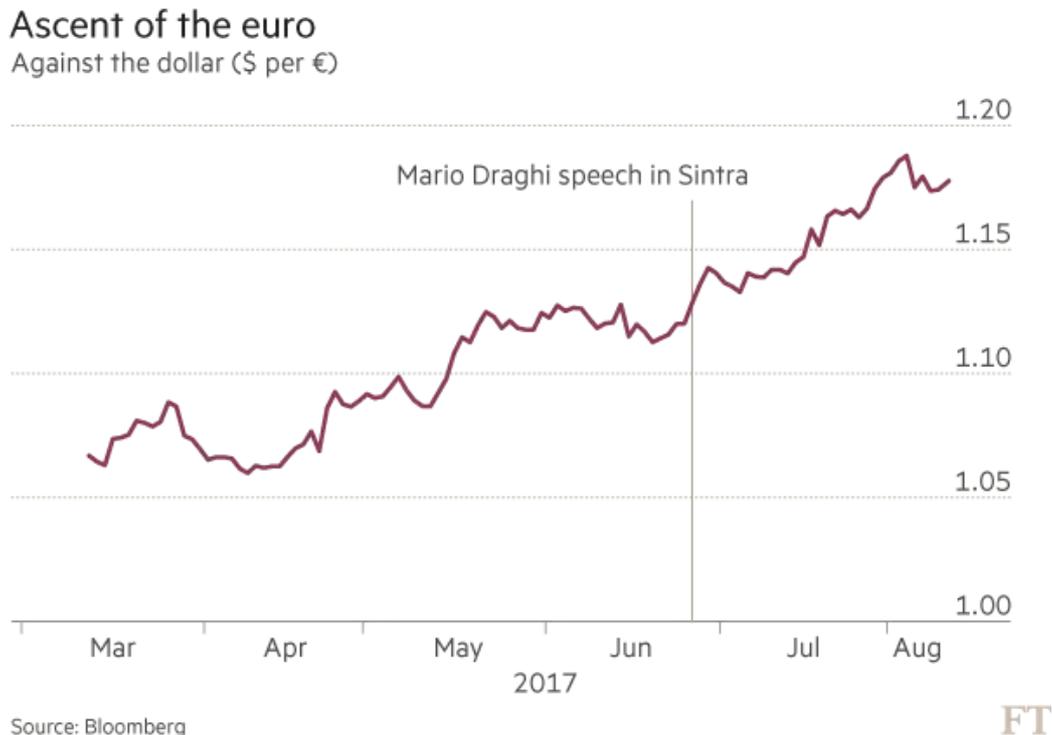
A stronger currency means holiday makers can not only buy more abroad, but also pay less for imports when they return home, thus depressing prices in the eurozone. It could also dampen global demand for European exports, weighing down the region's economic recovery. In what could be a blip or a sign of more significant developments, [German exports fell](#) unexpectedly in June.

“Our exports are becoming more expensive and the demands on our [companies'] competitiveness are increasing,” said Ilja Nothnagel, trade expert at DIHK, the confederation of German industry and commerce.

Such worries come at a difficult time for the ECB, just as it is about to begin deliberations on scaling back its landmark [quantitative easing programme](#), one of the chief props of the eurozone

recovery.

The issue is one of the most momentous of Mario Draghi's tenure, as he seeks to reconcile ECB hawks' suspicion of QE with doves' worries that any hasty move to wind down the programme could be counterproductive.



The ECB president has already faced difficulties in explaining why the bank is considering reining in the €60bn a month of asset purchases when inflation is still stubbornly below its target of just under 2 per cent.

The buoyancy of the euro — and its possible impact on prices and competitiveness — makes his dilemma still more difficult. Analysts say it increases the likelihood that the ECB will wait until its October 26 meeting before unveiling its QE plans for next year rather than deciding at its next gathering on September 7.

“The appreciation of the currency is only adding to the ECB’s communications difficulties,” said Frederik Ducrozet, economist at Pictet Asset Management. “Even before the move, there was a strong case to wait beyond September.”

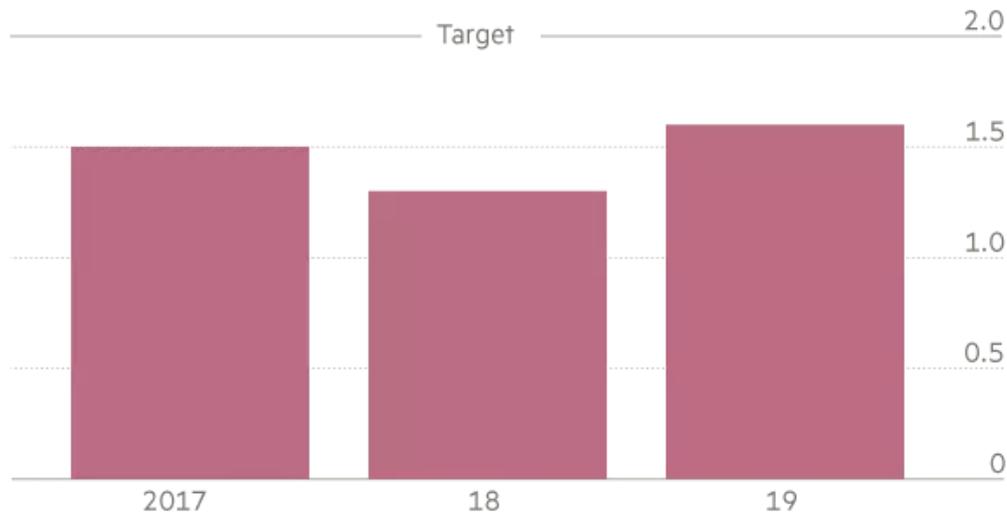
The rise in the euro, which reached \$1.18 on Friday compared with \$1.11 a year before, has been fuelled by factors such as the eurozone recovery — now growing at its fastest pace for five years — even as the dollar has been burdened by President Donald Trump’s troubles in pushing through his domestic agenda.

But the ECB’s decisions, deliberations and statements have also played an outside role in the euro’s valuation, creating the risk of a feedback loop in which the appreciation of the currency,

in part stoked by the bank, could deepen the challenges Mr Draghi faces.

ECB's June expectations for inflation

Harmonised Index of Consumer Prices (%)



Source: ECB

FT

One reason for the single currency's ascendancy is investors' suspicion that the ECB is more likely to tighten monetary policy by reining in QE than the US Federal Reserve would in similar circumstances.

Many investors contend that the sheer scale of purchases to date means the ECB must either reduce the pace or relax its self-imposed rules on what it can buy. Otherwise, they say, it risks running out of eligible assets.

Against such a backdrop, a mere reference by Mr Draghi to "reflationary" forces in a June speech in the Portuguese resort of Sintra was enough to trigger a surge in the euro by markets that saw his words as heralding an end to QE, although the central bank insisted its chief had been misunderstood.

Even when he sought to convince investors last month that the ECB was in no rush to rein in QE, the euro rose, partly because of market perceptions that the fundamental constraints on the bank remained the same.

Faced with such a dilemma, the bank may have to fall back on arguing that the strong euro's consequences for inflation and growth are less than feared.



ECB forecasts due in September are likely to show a fall in projected 2018 inflation because of the euro's rise but the bank's more important predictions for 2019 may be unchanged or only slightly affected, on the grounds that stronger growth will eventually lift inflation back to the ECB's target.

"The ECB can say that the labour market and investment climate have improved to a degree that the stronger currency will not derail the recovery," said Mr Ducrozet. "Though it remains to be seen whether the markets will buy it."

Ken Wattret, an economist at TS Lombard, a research firm, said investors need to look at the broader context. He noted that ECB monetary policy, which also includes negative interest rates, is extraordinarily loose by historic standards, and is likely to remain so for the medium term, irrespective of the currency's gyrations.

"That has to be the message from the ECB," Mr Wattret said. "Even without QE, monetary policy is going to remain extremely accommodative for a long time."

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