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Double whammy of EUR appreciation and slow recovery of foreign demand hampers Eurozone recovery

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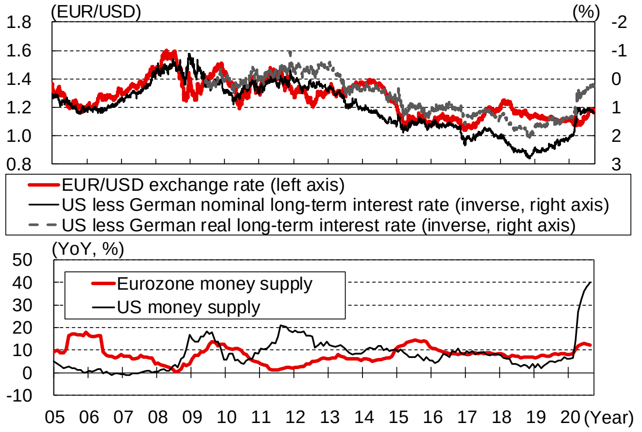
The euro has been depreciating against the US dollar since 2018 owing to rocky Brexit negotiations and Italy's financial issues amongst other factors. However, the euro started to appreciate against the dollar from around the middle of the year as a result of the COVID-19 pandemic (Chart 1 upper). The reasons for this were a shrinking of the gap between the US and Germany's long-term interest rates brought about by the large-scale monetary easing undertaken by the US, such as interest rate cuts. On top of this, the money supply in the US rose sharply due to the effects of various policies in response to the pandemic. This led to an awareness of an excess supply of US dollars (Chart 1 lower). In addition, anticipation of prolonged monetary easing by the US and expectations of financial stability owing to the agreement of an EU recovery fund by the European Council in July are also thought to have led to euro buying.

Currently, the export of goods by the Eurozone is recovering at a slow pace. Looking ahead, it is expected to be some time before the global economy – particularly developed countries – returns to pre-COVID-19 levels, which means the recovery pace of exports will likely remain sluggish. Under these circumstances, there are concerns that euro appreciation will weigh on the recovery of corporate profits by way of further pressure from exports. The Eurozone's corporate sector is heavily reliant on foreign demand and its gross operating surplus generally moves in line with exports (Chart 2). It is possible the slow recovery of exports will have a substantial impact on fixed capital formation due to the pressure on corporate profits.

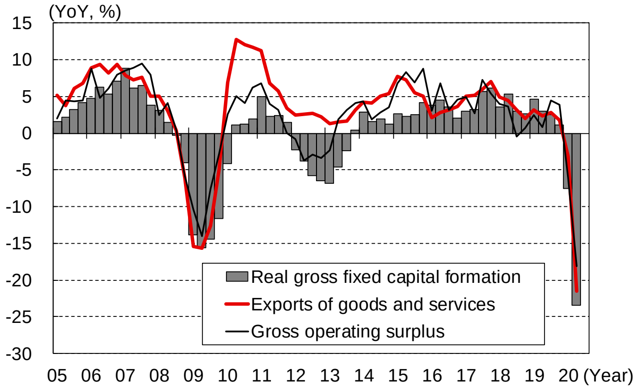
After the European Central Bank (ECB) meeting of the Governing Council on 10th September, President Christine Lagarde expressed a cautious attitude about euro appreciation, saying the ECB will monitor it carefully. This suggests the ECB is not only concerned about downward pressure on prices, but also a further slowing of the pace of recovery in the corporate sector. Although the euro is currently being discouraged from soaring higher by increased uncertainty surrounding the trade negotiations after Brexit and the accelerated pace of COVID-19 infections across the continent, the US Fed's policy rate will remain at current levels until 2023 according to an FOMC projection, which means the situation could easily lead to US dollar selling. Given that the ECB's capacity for easing is tight and the measures it can take are limited, if the euro continues to strengthen, it will be important to keep an eye on any downward pressure on corporate profits and fixed capital formation from the double whammy of a slow recovery of foreign demand and currency appreciation, and whether this slows the recovery of the economy as a whole.

Chart 1: EUR FX Rate, Difference in US and DEU Long-Term Interest Rates, US and Eurozone Money Supply



Source: Bloomberg, ECB, FRB, MUFG Bank Economic Research Office

Chart 2: Eurozone's Gross Fixed Capital Formation, Exports and Gross Operating Surplus



Note: "Gross operating surplus" is value added from production activities less compensation of employees, consumption of fixed capital and net indirect taxes
Source: Eurostat, MUFG Bank Economic Research Office

Translation by Elizabeth Foster

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