

THEMATIC



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Foreign investors who are under-exposed to Eurozone assets, may want to reposition themselves on them, which would push the euro even higher. Mind the overshooting!

Is the euro’s rise a sign of greater resilience?

The complexity and fragility of European institutions have contributed to maintaining a specific political risk premium on European assets, including the euro. But institutions were ultimately strengthened when negotiators agreed in July to launch the New Generation EU package. The euro’s recent appreciation may be an early sign of decline in this “risk premium”. Foreign investors may therefore want to rebalance their portfolios in favour of Eurozone assets, which could push the euro higher. Should the euro appreciate too fast, the ECB would not stay on the side-lines.

The Eurozone strengthens through crises

The 2010s have been fraught with events that were perceived by markets as serious challenges for the integrity of the EU and Eurozone: after the sovereign debt crisis of 2011-12 came the Greek crisis of 2015, the Brexit saga, some nervousness before the 2017 French elections, and the tensions between Italy and the rest of the Eurozone following the 2018 Italian general election. These episodes, on top of low growth, and the perceived complexity and fragility of European institutions, contributed to maintaining a specific political risk premium over European assets.

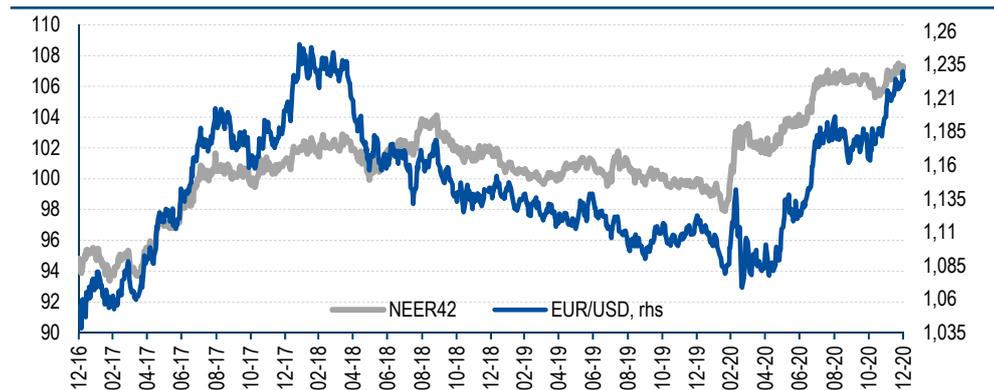
The Covid crisis was initially seen as another existential threat for these institutions as it brought border closures accusations of uncooperative behaviour and perceived insufficient solidarity among European countries. **However, after a few weeks of doubts, the “make” won over the “break”, and institutions were finally not weakened but strengthened** when negotiators agreed in July to launch the EUR 750 bn New Generation EU (NGEU) plan, which has been identified as a major new step in terms of fiscal solidarity. Indeed, by borrowing large amounts in the EU’s name, to be repaid in principle using the EU’s “own resources “ (new taxes), by distributing the larger part of these funds as grants, and by allowing their use partly for cyclical economic support, this new instrument is bringing European integration

beyond some of the previous “red lines” of Northern European countries.

In 2021, the political agenda seems less risky. The two main elections in the Eurozone will be in the Netherlands and Germany. They will deserve scrutiny (notably to gauge the strength of Eurosceptic sentiment, and because Merkel’s successor should at last emerge) but are very unlikely to result in political equilibria that could be perceived as bringing threats to Europe’s institutional integrity. On the positive side, while some frictions can happen over the actual deployment of the NGEU (expected in H2 2021), the political thrust behind this project is now very strong. **The cooperative approach brought by the Recovery Fund is likely to spill over to accelerate other institutional developments that have also seen progress** (such as the ESM and Banking Union) or have been initiated (the European “bad bank”) in 2020. Moreover, the EU and UK have just found an agreement eliminating the risk of a major bilateral trade shock in 2021, even though residual uncertainty persists over the deal’s implementation and provisions for trade in services.

Finally, the Biden Administration is expected to be more friendly towards Europe, in particular by adopting a more cooperative approach and abandoning Trump’s mercantilist approach. And the good news is that European “Eurosceptic” leaders will have much less support in this new administration.

1/ EUR/USD and Trade-weighted EUR Basis 100 on 31/12/2016 for NEER (lhs and rhs: proportional scales)



Source: ECB, Datastream, Amundi Research - Data as of 31 Decembre 2020

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The appreciation of the euro may be the price to pay for greater resilience

From the markets' point of view, **it is very probable that part of the European yield spread compression, and even part of the euro's appreciation since the summer of 2020 can be attributed to a diminishing perception of European "systematic", institutional risk.** A key question is now whether this specific European risk premium will compress further in 2021. International investors remain underexposed to European assets although this trend has started to reverse itself at the end of 2020 starting from a low base. But we've had similar episodes in the past decade, and this well entrenched underexposure is due mainly to low yields across the Eurozone bond markets and a lack of growth stocks versus the US or EM.

The trade-weighted euro has appreciated by 6% since the beginning of 2020. At USD 1.22-1.23, the euro is rather close to its fair value calculated on the basis of traditional valuation models (our forecast is 1.25 for end 2021). At this level, European companies have no real problems of competitiveness. As for exports, they will be more sensitive to the revival of global demand. In any case, the recovery will be driven mainly by domestic demand in 2021. But one thing is certain: **the euro's appreciation cannot be explained by the relative growth dynamic.** Eurozone GDP will not return to its pre-Covid level until the end of 2022 therefore one year after the US GDP.

That said, the progress made notably on the front of its institutions (Recovery Fund and banking union) will increase Europe's resilience to the shocks of the future. Foreign investors, who are under-invested in Eurozone assets, may want to reposition

themselves on them, which would push the euro even higher. In addition, **foreign CBs could seize the opportunity to rebalance their foreign exchange reserves in favour of the euro. The euro's recent appreciation may be an early sign of a decline in the «political risk premium» that has weighed on the single currency and European assets in recent years.**

... but mind the overshooting

The past decade has shown that the euro can soar without any link to growth (close to USD 1.50 in 2011 and 1.40 in 2014). However, not all countries are equally sensitive: peripheral countries (and France) have suffered more than Germany. **Eurozone policymakers must ensure the EZ is not the "victim of its own success" in the recovery phase, especially as the recovery is expected to be much slower in the southern countries (Italy and Spain).** There is little that governments can do. The ball is clearly in the camp of the ECB. This is all the truer as the inflation impact of the euro's appreciation is particularly unwelcome for the ECB. Indeed, the ECB found empirical evidence that it is when the euro appreciates rapidly that the impact on inflation is most pronounced. And Fabio Panetta stressed on 10 December that the euro's rise had already led the ECB to revise downwards its inflation forecasts for 2021 and 2022. **The ECB will therefore not let the euro jump without reacting. The most effective channel to stem a rise of a currency is that of interest rates.** The bar is probably quite high for the ECB to lower its deposit rate again. On the other hand, the ECB could soon start to explicitly mention this option to contain the rise.

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