

## FX Briefing

5 June 2009

### Highlights

- ECB leaves refinancing rate unchanged at 1.0%
- ECB staff revise growth forecasts down significantly
- Latvia wants to maintain peg to euro, but under massive pressure to devalue

### ECB goes into wait-and-see mode

Since rallying at the end of last week, EUR-USD has been moving sideways for the most part, hovering around 1.42. Towards the middle of the week, the euro's attempt to breach 1.43 was thwarted by some disappointing indicators from the US and guarded comments on the economic outlook from Fed chairman Ben Bernanke. The impending release of the US labour market report could have played a part too.

At the moment, currency turbulence in eastern Europe, currently focused on the Latvian lats, is supporting the euro to some extent. Against the backdrop of a dramatic economic collapse, the lats, which has a fixed exchange rate against the euro, has come under increased pressure to devalue. The Latvian government is having to make drastic budget cuts (which have already been passed in the first reading and are due to be introduced on 17 June) before receiving the next tranche of the bailout loan (over €1.4bn) from the EU and the International Monetary Fund. Speculation came to a head this week after a failed bond auction. Furthermore, a government adviser had said that devaluation of the Latvian currency was just a matter of time. Both the central bank and the government have, however, emphasized their determination to keep the peg to the euro, and at Thursday's press conference, ECB president Jean-Claude Trichet himself supported maintaining the currency peg. The turbulence around the lats is having a widespread impact. On the one hand, because Estonia and Lithuania in particular are not much better off either. Hungary and Poland – both in a difficult budget situa-

tion and with high current account deficits – are also feeling the repercussions. On the other hand, because devaluation could prove risky for the banking system in Latvia and the whole of the Baltic region. Swedish banks too are heavily exposed here, which is reflected in the Swedish krona's marked weakness. Only a few days ago, the Swedish Riksbank, with the help of the finance ministry, increased its foreign currency reserves in order to have sufficient funds at its disposal again.

#### ECB: end of easing for the time being

The ECB has left the refinancing rate on hold at 1.0%. President Trichet's comments at the press conference indicate that the ECB sees no necessity for further interest rate cuts or additional unconventional measures at the moment. The ECB governing council regards the current interest rate level as "appropriate" and growth and inflation risks as "balanced".

The sideways movement of monetary policy is in direct contrast to the assessment of the economic environment. The ECB governing council admits that the economic outlook has deteriorated significantly in the last three months, both in the eurozone and world wide. According to the statement, the contraction in economic activity will continue until the middle of next year, when a gradual recovery is expected to set in. The ECB staff projections envisage real GDP at around -4.6% this year, and falling by a further 0.2% next year (middle of the range). Prices will continue to be dampened by weak demand for some

time to come. The staff projections see the inflation rate at a mere 1% in 2010 – significantly below the ECB’s stability target.

The ECB council meeting did not have a sustained impact on the forex market. Shortly before the meeting, EUR-USD had dropped well below 1.41 for a time, only to climb back to 1.42 after the decision had been announced. The short end of the yield curve reacted differently, however; it shot up. Yields on 2-year Bunds rose by almost 20 points to 1.59, the interest rate advantage over the equivalent US Treasuries widened by more than 10 points.

The ECB’s policy stance – the end of monetary policy loosening, at least for the time being – should fundamentally support the euro. In the

longer term, things will depend on whether the ECB’s economic projections prove to be correct or not. In our view, action still needs to be taken. On the basis of the ECB projections, the output gap will increase during the whole of the forecast period, and presumably even longer. Thus the deflationary impetus will not only continue, but actually intensify. At the same time, the inflation rate will remain below the stability norm. Against this backdrop, we still see a possibility of further monetary loosening, even if this is not acute at the moment. EUR-USD could thus suffer a setback, despite the fact that the sharp increase in US government debt and the growing need for US current account correction are structurally against the dollar.

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## Key indicators and important events

Country	Indicator / Event	Release date	Forecast (in % mom/yoy)	Prev. period (in % mom/yoy)	Comments
EU	Eurogroup/Ecofin	8/6			
GE	Industrial new orders / Apr	8/6	-1.0 / -34.1	3.3 / -33.1	
GE	Trade balance and current account / Apr	9/6	€10.0bn €8.0bn	€11.3bn €10.2bn	
GE	Industrial production / Apr	9/6	-0.5 / -20.8	0.0 / -20.3	
US	Trade balance / Apr	10/6	-\$29.0bn	-\$27.6bn	
US	Fed’s Beige Book	10/6			
EMU	ECB Monthly Bulletin	11/6			
EMU	Industrial production / Apr	12/6	-0.8 / -20.1	-1.6 / -18.9	
US	UMI consumer confid. / Jun	12/6	68.0	68.7	
World	G7 finmin meeting	12-13/6			

## Money and foreign exchange market quotations

	Spot vs. EUR	Change vs. EUR	Interbank offered rates		
	05/06/09	in % week-on-week	1 month	3 months	6 months
EUR	–	–	0.93	1.27	1.48
USD	1.4173	-0.5	0.32	0.63	1.20
JPY	137.31	-1.6	0.24	0.51	0.71
GBP	0.8812	-0.9	0.67	1.26	1.47
CHF	1.5189	-0.4	0.20	0.40	0.54
SEK	10.9447	-2.3	0.76	0.99	1.32
PLN	4.5538	-1.8	3.95	4.64	4.79
CZK	27.053	-0.6	1.85	2.22	2.41
CAD	1.5604	-0.4	0.33	0.63	1.06
AUD	1.7595	0.3	3.26	3.50	3.79
NZD	2.2250	-0.5	2.89	3.14	3.31
SGD	2.0510	-0.8	0.34	0.44	0.56
ZAR	11.4209	-1.9	8.25	8.00	8.25

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