European Strategist: 2017

Economic Barometers:
Euro Area Inflation Rate and $/€ Bilateral Exchange Rate

As your team’s newly hired European strategist your responsibilities are to follow the European economy and financial markets. You are to monitor evolving expectations about policy actions by the European Central Bank (ECB). You will need to think about Southern Nation austerity efforts, European real economy momentum and the effects of changing energy prices on euro area inflation.

You are to forecast the bilateral exchange rate between Europe’s common currency and the U.S. dollar. You have inherited your firm’s old forecast, and they shared the consensus expectation. As of today, you are in print predicting that at yer-end it will take 1.02 dollars to buy one euro. In addition, you expect euro area inflation will subside a bit, and the December to December headline reading will by 1.5%.

As a European strategist you must be ready to participate in class discussions, and be ready to answer questions about current developments relating to the European economic scene and to the path for European inflation and the $/€ exchange rate.

Barometer #1: The Dollar/Euro Exchange Rate

In order to have an opinion about the $/€ exchange rate, you will need to reflect upon developments in the USA as well as in Europe. What are the current opinions about the U.S. dollar? Since the end of World War II, the dollar has been the world’s core unit of account. The global reserve system uses the U.S. dollar as the main reserve currency and instrument for international payments. The Euro, the relatively new currency introduced in January of 1999 is the official currency of 17 out of the 27 member states of the European Union. It is used by over 330 million Europeans—a bit larger than the population of the United States.
Over the past several decades, following the fall of the Soviet empire, in the late 1980s, the United States was viewed as the lone super power. Post 9/11, U.S. military efforts to confront terrorist threats, de facto, placed the U.S. in the role of global policeman. Sharp shifts in the value of the U.S. dollar, in that regime, sometimes reflected major geo-political developments. Today, however, President Trump has rejected this framework. ‘America First’ also appears to mean ‘policing no mas’. This has left the Western world somewhat at a loss to imagine how things will unfold. Not so in Russia and elsewhere in the east. Bold pronouncements about renewed Russian strength have emerged. This has put pressure on Euro area nations.

Beyond geo-political dynamics, interest differentials and tax and trade policy are now in a deep state of flux. The ECB is expected to keep super easy monetary policy in place for the foreseeable future. The U.S. Fed is expected to raise interest rates throughout 2017 and 2018. In normal times this would suggest a climbing dollar versus the euro. But Trump doctrine says trade deficits must be made to fall, and currency traders fear a Trump reaction if the dollar makes a meaningful move higher.

**Barometer #2: The Euro Area Inflation Rate.**

The ECB has failed to hit its 2% inflation target for more than 3 years. This has reflected the weak recovery, the super high jobless rate in many southern nations and the plunge in energy prices. Over the past 6 months, however, the snapback for the price of oil has lifted headline inflation. Will inflation fall back, if the effects of the jump for oil prices are not repeated? Is there any hope for a stronger Euro area economy lifting employment and steadying demand and core inflation?