THE EURO AT PARITY WITH THE USD: IMPLICATIONS FOR THE GLOBAL ECONOMY

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The Euro (€) has fallen to parity with the US dollar (USD) for the first time in 20 years, having depreciated by 12% since the beginning of 2022. The Euro reached a record high of almost $1.60 in 2008. The current weakening of the Euro has resulted from a combination of formidable challenges facing the Euro Area (EA) including economic disruptions caused by the Covid-19 pandemic and Russia's war against Ukraine; and a general strengthening of the USD against practically all other currencies. The strength of the USD has been driven in turn by the Fed's rate hikes and quantitative tightening needed to fight inflation reaching 9.1% in June. The fallouts from the pandemic and the war in Ukraine have exacerbated the effects of the US-driven tightening of financial conditions—all together imposing a huge economic burden on many countries.

The Euro Area—and Europe in general—have been hard hit by Russia's invasion of Ukraine and the subsequent Western sanctions against Russian entities. In particular, the EU ban on oil shipments from Russia and the shutdown of the Nordstream gas pipeline to western Europe, probably beyond the scheduled 10-day maintenance period, have had a visible stagflationary effect. The EA growth estimates have been cut to 2.5% this year and 1.9% in 2023. By contrast EA inflation has accelerated to a decades-high of 8.6% in June. The weakening Euro has complicated the inflationary outlook, making the tasks of the ECB more difficult. With its first policy rate hike—likely to be of 25 basis points—scheduled for the July 20-21 Board meeting, the ECB has been perceived as lagging behind other major central banks, in particular the Fed which has already tightened by 75 basis points. Consequently, the ECB may have to take stronger-than-expected actions now to regain credibility.

Moreover, the withdrawal of ECB monetary stimulus has led to widening spreads of government bond yields of peripheral members such as Italy and Greece against core members such as Germany. For example, the Italy-Germany bond spread has widened to 215 basis points at present, after staying below 120 basis points for most of 2021. As a result, at its July Board meeting, the ECB will consider a staff report on a Transmission Protection Mechanisms (TPM) aiming to stabilize peripheral-core bond spreads. However, it is not clear how purchasing peripheral government bonds to stabilize peripheral-core spreads can interfere with the ECB efforts to tighten monetary policy to bring high inflation under control. Today's circumstances are completely different from the 2010-2011 period when low inflation allowed then ECB President Mario Draghi to promise "to do whatever it takes" to stabilize inter-EA spreads and the Euro. Fighting inflation and stabilizing peripheral-core spreads may become incompatible goals for the ECB at present.

Also it is not known if any conditionality will be attached to the use of such a mechanism to support a member under stress; or the TPM will be used automatically whenever peripheral-core spreads reach a certain magnitude. In the latter case, the ECB will have transformed itself from a central bank dedicated to keeping inflation low and stable to one aiming to keep bond yields of the most heavily indebted member government close to those of the most credit-worthy member with the lowest debt/GDP ratio. This is something hardly recognizable in the Maastricht Treaty!

Another problem confronting the EA is the economic slowdown in China due to a series of lockdowns in response to surges in infection of the Covid-19 Omicron variants. China's growth estimate for 2022 has been cut to 4.3% from the official target of about 5.5%. The slowdown of the EA major export market together with rising energy prices have led to a sharp turnaround in the EA goods and services trade balance, from a surplus of €71.7 billion in the first four months of 2021 to a deficit €85 billion in the comparable period this year.

Alongside the weakening US economy whose growth estimate for 2022 has been cut to 2.3% by the IMF, the slowdown of Europe (with the EU accounting for 14% of world trade) and China (15% of world trade) have negatively impacted the export demand for other countries, especially emerging market and developing countries (EMDCs). At the same time, rising US interest rates and a strengthening USD have led to a net outflow of almost $40 billion of international portfolio capital from emerging market countries in the past four months , according to the International Institute of Finance. The net capital outflow amid higher interest rates have tightened financial conditions in those countries already experiencing significantly slower growth—the EMDCs are likely to suffer cumulative output losses (relative to pre-Covid trends) of 33 percentage points in 2020-2024, compared to losses of 22 percentage points for the world as a whole.

Of special concern is the fact that many EMDCs are on the verge of a "historic cascade of defaults" with a quarter-trillion of USD of sovereign debt already in distress. In addition to countries going through debt restructuring negotiations like Zambia, Chad and Ethiopia; and those in defaults such as Venezuela, Lebanon and Sri Lanka; market attention has focused on El Salvador, Ghana, Egypt, Tunisia and Pakistan. This wave of sovereign debt defaults will have negative spillover effects on EMDCs, adding to their already formidable difficulties.

In short, the Euro at parity with the USD reflects not only the unique set of difficult challenges facing the EA, but also the fall-out from rising US interest rates and strengthening USD needed to calm inflation in the US. This makes it difficult for the EA and other countries, especially emerging market and developing countries, to undertake their own policy measures to counter the looming stagflation and recession threats.

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