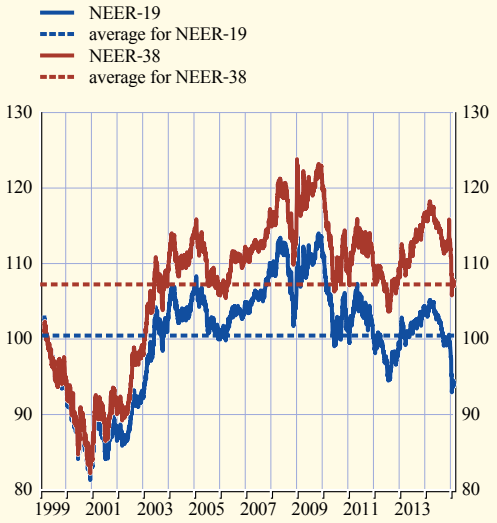
Box 3

RECENT MOVEMENTS IN THE EFFECTIVE EXCHANGE RATE OF THE EURO

The nominal effective exchange rate (NEER) constitutes a useful aggregate measure of the exchange rate fluctuations that affect economies through their trade links, as it combines the various bilateral rates vis-à-vis individual trading partners into a single indicator. For the euro area the two most relevant NEERs are calculated with respect to a narrow and a broad set of trading partners, comprising 19 (the NEER-19) and 38 (the NEER-38) countries respectively.[1]

Chart A Nominal effective exchange rate of the euro (NEER-19 and NEER-38)

(index: Q1 1999 = 100)



Source: ECB.
Notes: The latest observation is for 20 February 2015. "Average" refers to the average since 1 January 1999.

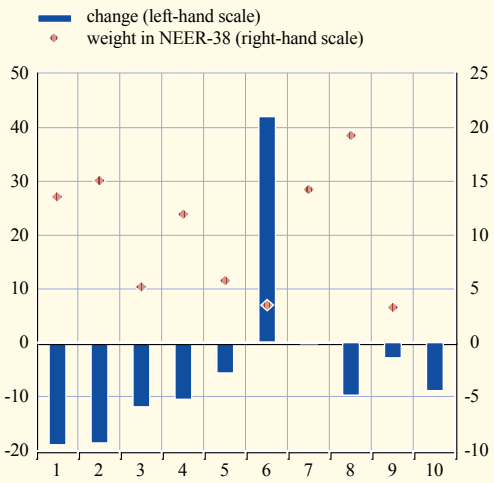
The NEER of the euro has experienced large swings since the outbreak of the global financial crisis. From a longer-term perspective, such large movements are not unusual and had also been observed before the crisis (see Chart A). The euro temporarily fell to a low in summer 2012 in the context of the euro area sovereign debt crisis. As confidence returned, following the ECB's announcement of Outright Monetary Transactions, it rebounded and strengthened continuously until May 2014. Changes in market expectations regarding the ECB's future monetary policy stance relative to that of other major central banks then initiated a period of weakening of the euro, during which the different NEERs, as well as many bilateral euro exchange rates, fell to levels close to (NEER-38) or below (NEER-19) their longer-term averages.

From its post-crisis peak in early May 2014 to its low on 23 January 2015 the broad-based NEER weakened by around 10%, although it has stabilised in recent weeks with the return of capital inflows following the ECB's announcement of its expanded asset purchase programme after the 22 January 2015 Governing Council meeting (see the "Financial developments" section). However, the overall decline since May of last year masks a divergence in the evolution of the different bilateral exchange rates. Decomposing this change into individual contributions (see Charts B and C) shows that while most major currencies contributed to this downward movement, the intensity, persistence and timing of the bilateral patterns differed considerably.

1 The weights, which combine information on both imports and exports, reflect the importance of different countries in euro area trade in manufactured goods (see also Schmitz, M. et al., "Revisiting the effective exchange rates of the euro", *Occasional Paper Series*, No 134, ECB, Frankfurt am Main, June 2012).

Chart B Evolution of selected euro exchange rates and weights in the NEER-38

(percentage changes; percentages)

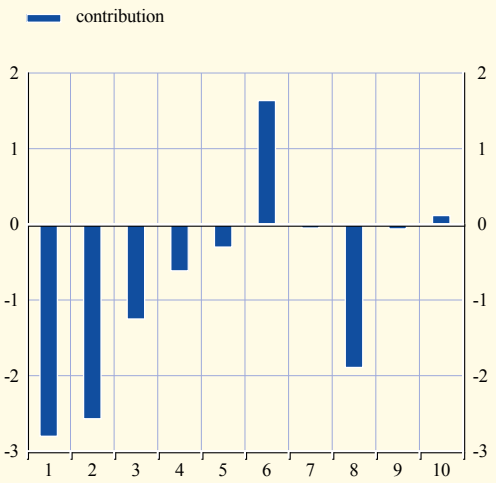


1 US dollar
2 Chinese renminbi
3 Swiss franc
4 pound sterling
5 Japanese yen
6 Russian rouble
7 CEE
8 EME
9 Commodity
10 NEER-38

Sources: ECB and ECB calculations.
Notes: "CEE" comprises the Bulgarian lev, the Czech koruna, the Croatian kuna, the Hungarian forint, the Polish zloty and the Romanian leu; "Commodity" comprises the Australian dollar, the Canadian dollar, the Norwegian krone and the New Zealand dollar; "EME" comprises the Hong Kong dollar, the Singapore dollar, the Korean won, the Indonesian rupiah, the Indian rupee, the Malaysian ringgit, the Philippine peso, the Taiwan dollar, the Thai baht, the Argentine peso, the Brazilian real, the Mexican peso, the South African rand and the Turkish lira. The chart covers the period from 6 May 2014 to 20 February 2015.

Chart C Contribution by currency to the change in the NEER-38

(percentage points)



1 Chinese renminbi
2 US dollar
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Sources: ECB and ECB calculations.
Notes: "CEE" comprises the Bulgarian lev, the Czech koruna, the Croatian kuna, the Hungarian forint, the Polish zloty and the Romanian leu; "Commodity" comprises the Australian dollar, the Canadian dollar, the Norwegian krone and the New Zealand dollar; "EME" comprises the Hong Kong dollar, the Singapore dollar, the Korean won, the Indonesian rupiah, the Indian rupee, the Malaysian ringgit, the Philippine peso, the Taiwan dollar, the Thai baht, the Argentine peso, the Brazilian real, the Mexican peso, the South African rand and the Turkish lira. "Others" comprises the Danish krone, the Swedish krona, the Algerian dinar, the Chilean peso, the Icelandic krona, the Israeli shekel, the Moroccan dirham and the Venezuelan bolivar. The chart covers the period from 6 May 2014 to 20 February 2015.

Looking at developments in bilateral exchange rates from May 2014 to late February 2015, half the fall in the NEER-38 was accounted for jointly by the US dollar. The dollar was supported by expectations of further diverging monetary policies in the euro area and the United States, market uncertainty in an environment of declining commodity prices and heightened geopolitical tensions (see Chart C). The dollar gained about 20% vis-à-vis the euro, as did the Chinese renminbi, which accounted for another quarter of the overall depreciation. In contrast to the steady weakening of the euro against these two currencies, the depreciation against the Swiss franc occurred abruptly, after the announcement by the Swiss National Bank on 15 January 2015 that it would discontinue its minimum exchange rate target of 1.20 Swiss francs per euro. The 20% depreciation of the euro vis-à-vis the Swiss currency, which has a weight of around 5% in the NEER-38, made up about one-tenth of the decline in the NEER-38. At the end of the review period the euro also traded lower against the Japanese yen, which was supported by declining risk appetite. The euro depreciated by around 10% against the pound sterling and the currencies of a number of emerging market economies.

The weakening of the broad-based NEER was mitigated by the euro's strengthening by around 40% vis-à-vis the Russian rouble, which came under marked pressure in the context of the tensions in Ukraine. The euro also strengthened against the Swedish krona over the review period, reflecting among other things the recent easing of monetary policy by Sveriges Riksbank (see the "Financial developments" section). The Danish krone, which participates in ERM II, was subject to appreciation pressures vis-à-vis the euro during this period. However, it continued to trade very close to its central rate within ERM II, as Danmarks Nationalbank purchased foreign exchange in the market and lowered interest rates on repeated occasions. The euro also remained relatively stable against the currencies of commodity exporting countries, which came under downward pressure as a result of declining oil prices, as well as against currencies of central and eastern European EU countries.