Citi Wealth

Asia Pacific *Regional Publication*

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February 20, 2025

FX Focus: EURUSD – Rate Differentials, Political Turbulence and Tariffs Form Headwinds for the Euro

FIGURE 1: FX Forecasts

Forecast (Jan 2025)	Spot	0-3m	6-12m	Long-term
EURUSD	**1.0500**	**1.0300**	**1.0500**	**1.0700**

Source: Citi Wealth Investments as of January 2025.

EUR continues to face multiple headwinds despite its recent recovery from a low of 1.0211 versus USD on February 3rd. The recovery has been largely based on optimism relating to a possible Ukraine – Russia peace deal orchestrated by the US and expected to result in a fall in euro area energy prices on the back of increased Russian gas exports. But the hurdles to such a deal are many and will take more time than currently expected.

Meanwhile, the EUR faces 3 headwinds over the near term:
(1) continuation of the widening of Fed versus ECB rate differentials during H1'2025 as the ECB exits restrictive territory due to the anemic euro area economic recovery while the Fed delays further rate cuts due to the resilience of the US economy.
(2) Political headwinds from an unstable government in France and possible political turbulence in Germany following federal elections in February.
(3) the threat of tariffs on euro area exports to the US.

On rates, the ECB still sees monetary policy as restrictive as "most measures of underlying inflation suggest inflation will settle at around the target on a sustained basis". The ECB also sees wage growth "moderating as expected and buffering the impact on inflation" and remains positioned to lower rates to "neutral" (~2.00%) by mid-year. Meanwhile, in its January 30th meeting, the Fed FOMC held the Fed Funds rate steady at 4.25 - 50% and saw no hurry on future cuts, describing policy rates in a "good place". The differing ECB vs Fed stance is likely to see short rate differentials widen substantially in favor of USD versus EUR during H1'2025.

Political headwinds from France also continue to cast a shadow over euro area growth following the toppling of the first minority coalition of PM Michel Barnier in December after only three months in office. The current French administration also faces a similar no-confidence threat. Meanwhile, Germany's political stability is also under the radar ahead of federal elections on February 23rd , compounded by the widening geopolitical schism between US and Germany as US officials seek to downplay EU's role in any Ukraine – Russia peace talks.

However, it is the threat of US trade tariffs on European goods that potentially poses the greatest headwind to EUR. Following the US announcement of a 25% tariff on all steel and aluminum imports, the EU has pledged to impose "firm and proportionate countermeasures". But EU exports of steel and aluminum into US represent only 15% of EU's total exports of steel and aluminum and just 0.2% of total EU goods exports. Yet, this is not the full picture as reciprocal tariffs are likely to be applied to a wider set of EU goods exports potentially worth 3.1% of euro area GDP resulting in a growth-lowering demand shock. US tariffs on China could also lead to greater redirection of Chinese exports towards Europe adding to disinflationary pressures. US – EU trade negotiations are currently in their infancy which potentially makes this the biggest story for EUR during H1'2025 (at least).

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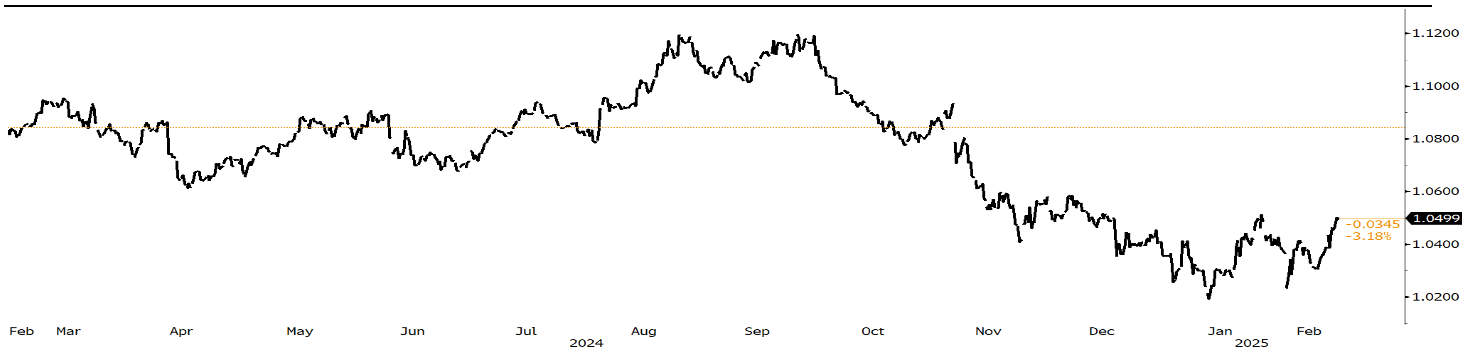
FIGURE 1: EURUSD's steady decline since September – end on widening rate differentials and pricing of the Trump trade



Source: Bloomberg, February 17, 2025.

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