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‘Mexit’ should be good for Germany

Domestic demand is more important for German exports than exchange rates

One of the enduring myths about EMU, frequently trotted out to argue against any country leaving, is that the cost for the remaining countries, particularly for Germany, would be appallingly high. Germany, so the story goes, has benefited tremendously from EMU. By improving its own competitiveness relative to those of its euro area partners, Germany has increased its exports to them. If they – Greece, Spain, whoever – left the single currency, they would devalue their currencies and become more competitive, thus hitting Germany with a double whammy. Not only would they no longer buy German goods, they would also compete with German exports elsewhere.

Perhaps. Except that this argument doesn’t hold. We can first dismiss the idea of exports competing with Germany. With the possible exception of Italy, none of the southern European countries really compete with Germany in their export mix; and even in the case of Italy (e.g., cars) the competition is limited. So even if all Mediterranean countries left EMU – here dubbed ‘Mexit’ – the impact on German exports elsewhere would most likely be minimal.

But, actually, much of this story is wrong in any case. Yes, German exports to other euro area (EA) countries have increased since EMU began. But exports to non-EA countries have also increased; and by more. Bundesbank data show that total nominal German goods exports rose by 140% from January 1999 (when EMU Stage III began with the ‘irrevocable locking of exchange rates’) to September 2008 (when the Great Recession began); and risen only slightly since then (151% in August 2012 compared with January 1999). Exports to EU countries (including EA) rose by 123% from January 1999 to September 2008, and have since slipped back to stand 99% above their January 1999 level; while exports to EA countries only rose by 110% to September 2008 and most recently had slipped back to 75% above their level of early 1999. In other words, while exports to EA countries rose, exports to non-EA EU countries rose by more; and exports to non-EU countries rose even faster.

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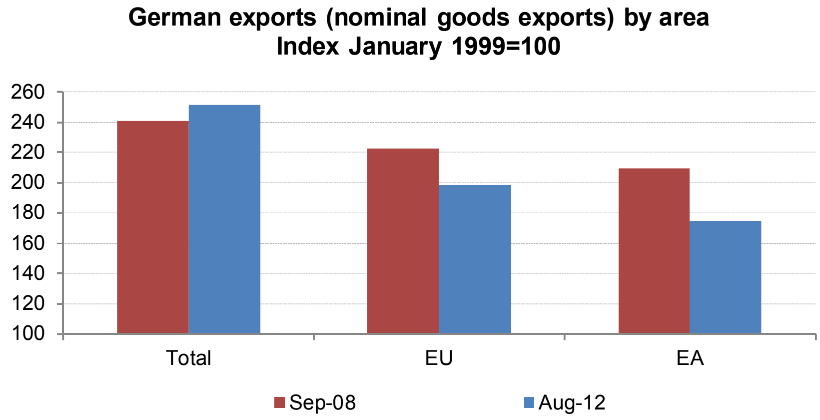
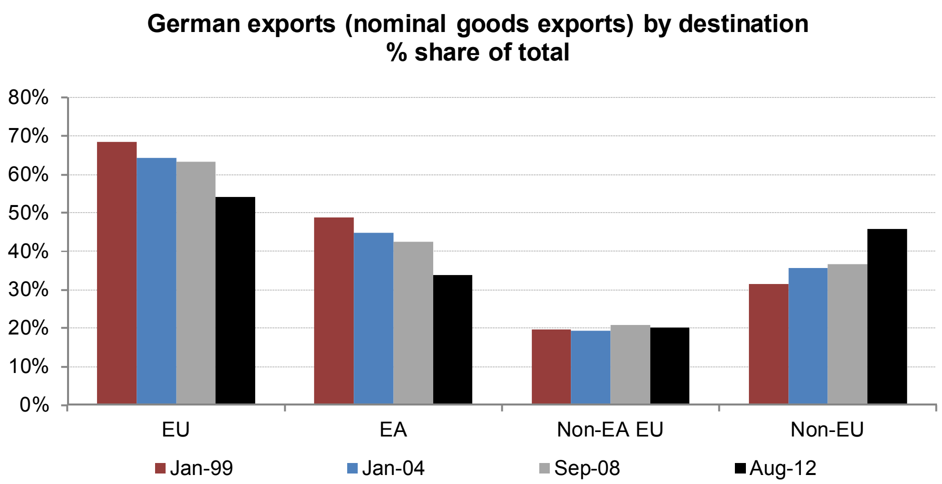


However, exports to other EA countries make up a very large share of German exports, so a lower growth rate is not necessarily a disaster. Unfortunately, this comforting truth is also not quite as true anymore. In January 1999, other EA countries took close to 50% of German goods exports; five years later the number was still 45%; but by August 2012, the number was down to 34%. The share of exports to non-EA EU countries has been relatively stable (although within the total there have been some substantial changes, notably the rise of Poland as a major market for German exports); so it is non-EU countries that have become more important export markets, notably China (up by close to 1200% since January 1999) and Russia (1100%), but also countries like Turkey (450%) and Brazil (200%).[1]



[1] Note that exports to EA countries are almost certainly overstated, since a significant share of German exports to Belgium and the Netherlands (together accounting for 10% of German goods exports) are for onward shipment through Antwerp and Rotterdam.

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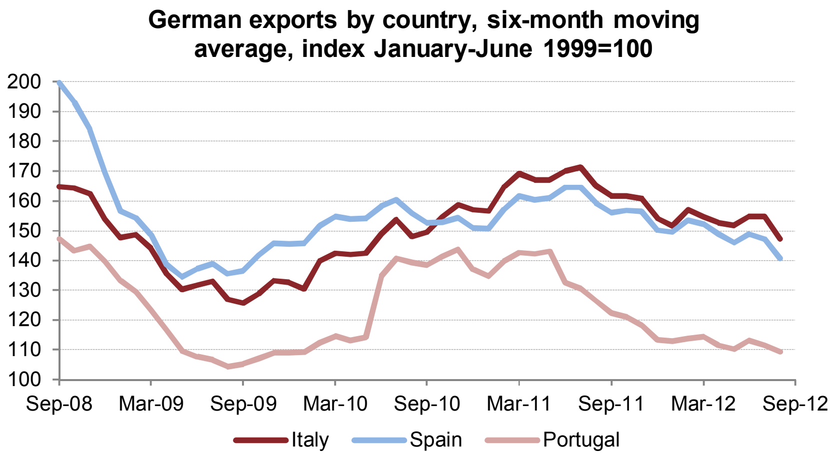
Of course, growth in the EU and the EA both was slower than in much of the non-EU world in the period examined. So it should not be surprising that the importance of German exports to non-EU countries has grown. However, there is a more important point to make. Few dispute that, if a country were to leave the EA and devalue, output growth would eventually pick up, initially led by exports and eventually feeding through into domestic demand. But comments tend to concentrate on the fact that the fall in the currency would hit exporters to those countries, notably Germany, badly. That ignores the case this would actually help reduce intra-EMU imbalances by narrowing the German current account surplus and the deficits of the southern European countries. (The latter is already happening, but mainly because of falling imports, less due to rising exports.) But there are two other key points. First, German exports to southern European countries have in any case been falling since the late spring of 2011, with little sign of a pick-up. This is unsurprising in view of the austerity imposed on these countries.



But, secondly and perhaps more importantly, German exports tend to be far more correlated with domestic demand in the relevant export markets, than with exchange rates. Using Eurostat data for domestic demand and effective exchange rates (and so far looking at France, Italy, Spain, Portugal and Poland as examples), the correlation between German exports to a specific country and that country's domestic demand is considerably higher than between German exports and the country's effective exchange rate. (E.g., correlating German exports to Italy with Italian domestic demand givens a r^2 of 0.5; running the correlation against Italy's effective exchange rate gives an r^2 of 0.2; for France the numbers are 0.7 and 0.05 respectively, for Poland 0.8 vs 0.3. Only for Spain is the r^2 reasonably similar, but even there the correlation with domestic demand is slightly higher.)

What this means, of course, is that Mexit – the exit from EMU of its southern members – need not be a disaster for Germany at all. On the contrary, if, by devaluing, the leaving countries can boost their output growth and hence their domestic demand, that should eventually be good news for German exporters.

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That the German currency would strengthen if someone leaves EMU has long been clear, whether this is a case of Germany leaving (possible but, in my view, unlikely, certainly for the time being) or of one or more countries leaving/being forced out. However, the implication of the above analysis is that German equities also should benefit, a point that generally seems to have been overlooked.

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