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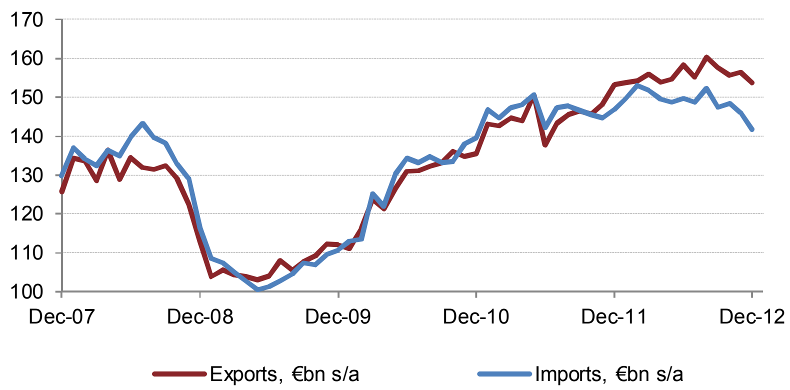
The EA currency war

Need for export-led growth brings exchange rate to the fore

2012 ended weakly for the EA in terms of economic growth. But in terms of exports, the year (seemingly) ended in style. The trade surplus (extra-EA trade in goods, seasonally adjusted) widened from €10.5bn in November to €12bn in December. This was the widest surplus on record, although that only means going back to January 1999. For 2012 as a whole, the EA trade balance was a surplus of €818bn, after a deficit in 2011 of €15.7bn. This fits in with other data that so far point to growth in at least part of the EA – notably in Germany – rebounding in 2013.

However, even on the export side there are three reasons to remain cautious about EA prospects and the strength of that rebound. First, although the trade balance has gone from a deficit of €4.4bn in June 2011 to the last December's €12bn surplus, exports have been trending down since August 2012, and the surplus only widened because imports fell by more, testifying to the weakness of EA domestic demand.



Second, judging by the EU business survey, export order book perceptions in industry are weakening in key countries like Germany and France and at best moving sideways in other major exporters like the Netherlands and Belgium and in the other two large EA countries Italy and Spain. Moreover, the *level* of export order book perceptions is as weak as it was in the autumn of 2008. Of the six largest EA countries, it is only in the Netherlands that export order books seem to be holding up reasonably near levels reached in the first flush of recovery in early 2011.

It may well be that this understates export prospects for 2013. If the US economy performs better than generally expected, EA exports should benefit. Similarly if emerging markets, notably non-EA central and Eastern Europe but also the Far East, do better than expected in 2013. However, this brings us to the third reason to be concerned, namely the strength of the euro.

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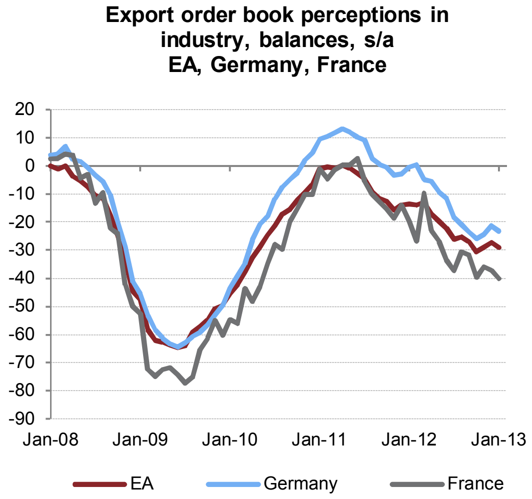

The euro has risen on the back of faith that the EA crises are over or at least contained. This is by no means clear, even though there is currently a lull. But what is clear is that the level of the euro is already hurting some EA countries, eg France, where the trade deficit widened in December (although it narrowed in Q4 as a whole). Obviously, no exchange rate will ever be absolutely 'right' – if it is 'right' on average, it will be 'wrong' at the margin and *vice versa*, and this is multiplied across countries and sectors in the monetary union. In a weak world where everyone hopes for export-led growth, there are currency wars going on *outside* the EA. But there is also a currency war going on *inside* the EA, if one fought in different ways. On the one hand, President Hollande has called for an active foreign exchange policy – code for a weaker euro. In some quarters, there is hope that euro strength, with its inflation-dampening impact, will induce the ECB to cut interest rates. On the other hand, Bundesbank President Jens Weidmann has said that a rising euro *alone* (emphasis added) will not trigger a rate cut and that the euro's strength is justified by the improved outlook. This does not rule out a rate cut, but it certainly seems to postpone it.

For the moment, the ECB is likely to toe the German line. Germany wants a strong euro and the ECB needs German support. However, if euro strength translates into weaker exports and domestic demand in the EA remains subdued, the pressure to do something – anything – to weaken the currency and improve the prospects for export-led growth, are likely to multiply. Either way, 2013 should eventually see euro weakness.

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