

Research

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Euroland: Can exports ignore the euro?

- The strengthening of the euro poses a serious risk to Euroland's exports in 2008. However, it is worth recalling that the euro has not strengthened as much on a trade-weighted basis. Also, the more subdued development in unit labour costs will neutralise some of the competitiveness deterioration stemming from the stronger euro. Finally, large exposure to fast growing markets also supports exports.
- This means that Euroland is set to lose only a little of its share on export markets throughout 2008, and Euroland exports are thus set to grow only a little slower than global imports. Unless global trade falters one should not expect exports to drag down Euroland's growth dramatically in 2008.
- Moderate export growth will be one of the key ingredients in assuring a soft landing for Euroland through 2008, as tight financing conditions and negative real wage growth will dampen the domestic economy further. Tight financing conditions will dampen Euroland's business confidence gradually throughout most of 2008, but business confidence could easily rebound in the short term if sentiment effects related to the credit crisis fade.
- The strength in Euroland's exports is primarily related to Germany. Germany's export miracle over the past few years has mainly been driven by cost improvements. Germany will continue to outperform the rest of Euroland also during 2008.
- Moderate export growth could keep the ECB sidelined for a long time. On a 3-6 month horizon risks are still skewed towards further rate hikes, as global industry could push up business confidence. However, on a 12-month horizon they may start to be skewed towards rate cuts if the credit crisis continues and if the US economy keeps on posting only moderate growth.

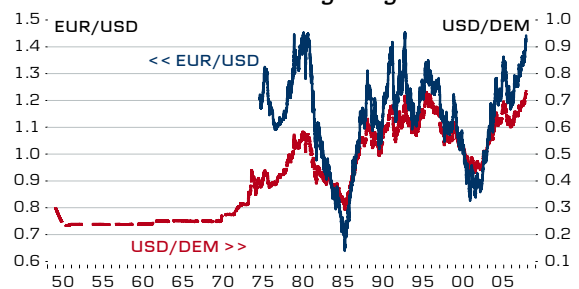
Euroland's exports still going strong?

Is EUR/USD a good export indicator?

The euro has strengthened vis-à-vis the US dollar to close to its strongest level in more than 30 years¹. And the old D-Mark is now at its strongest level ever since the Second World War.

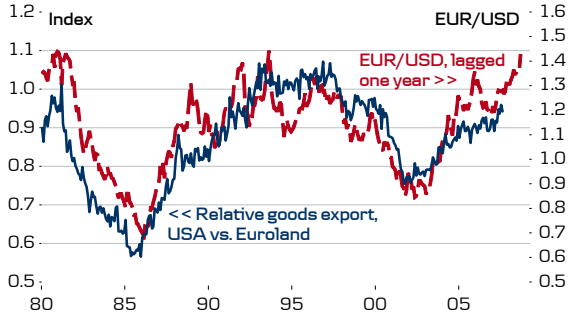
¹ Before 1999 using the ECU and before 1979 the EUA.

Euro close to historical highs against the USD



While the stronger euro partly reflects a robust European and German economy it has raised many questions whether the favourable development in German and Euroland's exports can continue. After all, EUR/USD has historically been very important to the relative strength in exports across the Atlantic.

FX important for relative exports' performance



Competitiveness intact

However, one should remember that it can be wrong to focus on EUR/USD alone. There are several reasons for this:

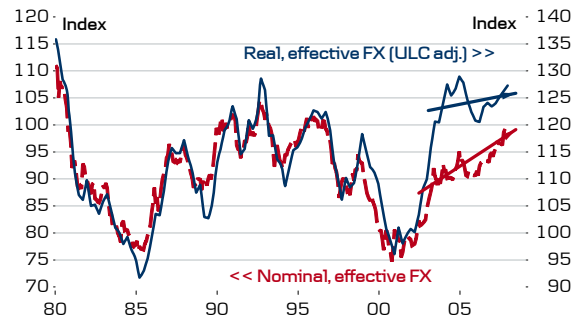
1. EUR/USD may not be representative for the general FX movements in the sense that the trade-weighted exchange rates may move differently. In the chart below we show that the nominal, effective euro has not strengthened as much as EUR/USD.

Trade-weighted euro not strengthened as much as EUR/USD indicates



2. Even the trade-weighted euro may not be representative for overall competitiveness if costs and productivity develop differently across countries. In the chart below we show that the real, effective euro has been stable over the past couple of years (using unit labour costs to adjust for productivity and costs).

Real, effective euro has been broadly stable since 2004



The emerging markets factor

3. Even the cost and productivity adjusted trade-weighted euro may not correctly reflect relative export opportunities if the composition of trading partners is unevenly distributed with respect to import growth. In these years, Euroland may be better exposed to emerging markets than the US. Taking into account the excess export market growth for Euroland (Euroland export market growth less OECD export market growth), we obtain a better measure for what could be called relative "export opportunities", see charts below.

Exports increasingly going to emerging markets



Export opportunities better than competitiveness suggests



4. Finally, one also has to take into account that Euroland's exports probably have a larger exposure to capital goods demand

than the average OECD country. The current global expansion seems to be characterised by stronger investments than usual during expansions, and somewhat softer consumer demand than normal during expansions. To the extent that this continues, it will also serve as supportive to Euroland's exports. However, this effect is probably not large, and it may also be captured by the emerging market effect.

To summarise, EUR/USD is probably not a precise and robust indicator of Euroland's export opportunities going forward. In fact, there are reasonable arguments indicating quite different conditions for Euroland's exports during 2008. If global growth is stable, the charts above even suggest that the opportunities for Euroland's exports during 2008 may be roughly as good as in the past three years.

Some cautionary remarks

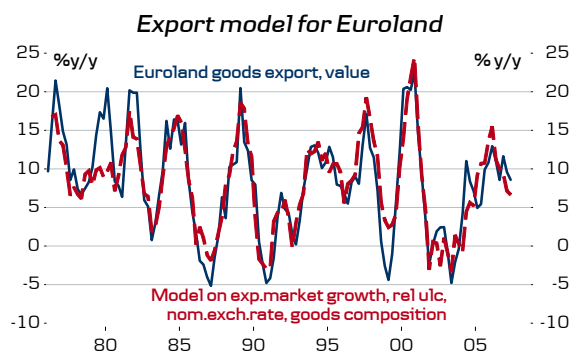
There are a few reasons to be cautionary about these results.

1. Using unit labour costs may not be an accurate measure to adjust for cost competitiveness. Say, if US growth rises, US productivity will tend to rise and US unit labour costs tend to fall. It is likely to generate a rise in Euroland's exports, but not in US exports per se. In other words, unit labour costs may be endogenous and not correct to use.
2. Many global commodities are priced in USD, and therefore EUR/USD may play a larger role for Euroland exports than the trade-weighted EUR would suggest.

A model for Euroland exports

Export growth close to trend

Below we seek to take into account all the factors that determine Euroland's exports and ask what we can expect for 2008. To this end we estimate the yearly change in Euroland's goods export (value based) in the period 1975-2006. In the chart below we show the model, which performs reasonably well and is fairly stable over time.



The following variables turn out to be very significant:

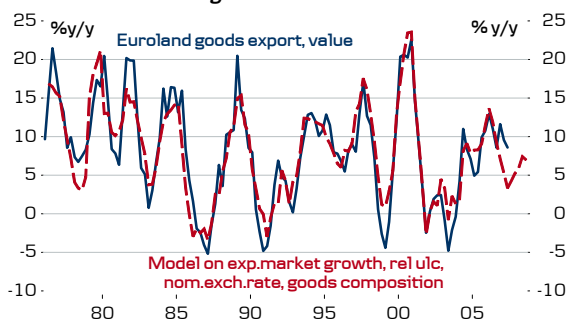
1. Euroland's export market growth (that is import growth among trading partners)
2. The trade-weighted euro
3. Relative unit labour costs (Euroland compared to its trading partners)
4. Relative export prices beyond that captured by relative unit labour costs and the trade-weighted euro.

We can use the model to forecast export performance for 2008 using a few assumptions. We assume that:

1. EUR/USD strengthens to 1.50. The trade-weighted euro strengthens by the same relative pace (compared to EUR/USD) as over the past couple of years
2. Relative unit labour costs develop as over the past couple of years
3. We use OECD forecasts for export market growth for 2008. It may be too optimistic on old trading partners but it may also underestimate the weight of emerging market trading partners for Euroland's exports.

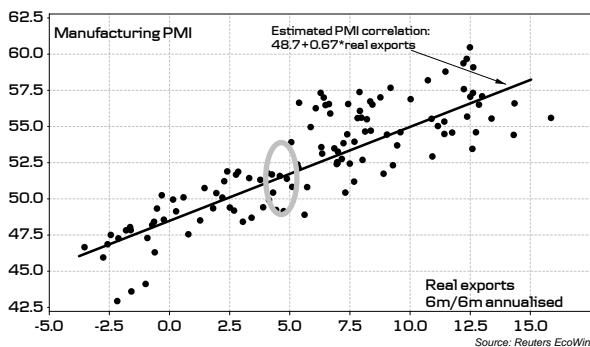
In the chart below we show the forecast, which indicates that Euroland's goods exports can grow some 6-7% next year. In real terms this corresponds to growth of some 4% - which is a little below trend growth over the past 15 years but still robust.

2008 export growth a little below long-term growth trend



When export growth is a little below trend it usually - but not always - translates into business confidence a little below trend. In the chart below we show that real annual export growth of 4% typically is consistent with manufacturing PMI hovering around 51-52. In other words, at a level normally consistent with the ECB on hold or adopting a weak easing bias.

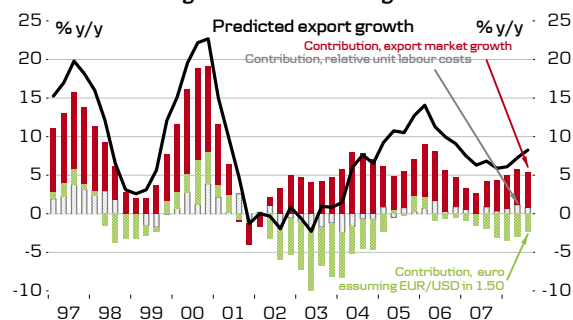
Moderate export growth often translates into moderate business confidence



Downside risks stem mainly from global growth - not the euro

Of course there are some downside risks to the economic outlook, and this could fuel a larger drop in export growth. However, the important point in this respect is that euro strength will be countered somewhat by favourable cost developments. Put differently, Euroland exports probably will not suffer significantly next year because of competitiveness. Only in case of a global downturn will Euroland's exports suffer strongly. In particular, exports to Eastern and Central Europe will be important, as it is currently driving about half of Euroland's export growth.

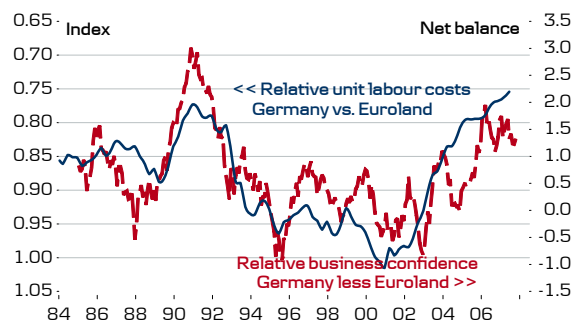
Unit labour costs compensate for some of the strength in the exchange rate



German outperformance to continue

The support from relatively lower domestic costs in Euroland stems primarily from Germany. Although wage growth is now rising in Germany, German competitiveness will continue to look better than in the rest of Euroland during 2008. This also means that German exports and German business confidence will probably continue to look better than its eurozone partners during 2008, see chart below.

The German export train to drive Euroland in 2008 as well



What will the ECB do?

The ECB was ready to tighten policy in September at a time when it predicted only trend growth. Since then direct inflationary pressures have probably risen as the rise in food and oil prices outweighs the strengthening euro, and as inflation expectations have risen.

If the ECB's scenario of trend growth is confirmed, and if the implicit tightening of policy in money and credit markets fades, the ECB will probably tighten policy again.

Earlier, we have argued that the "economic window" (high inflation and trend growth) for tightening would probably be half open until summer next year. We also expected the "financial" window (risk aversion on financial markets, Fed policy and the euro) to turn half open at the beginning of 2008. This combination would be the cocktail that would ignite further ECB tightening. However, recent

events show that the probability of this financial window opening before the economic window shuts down has fallen. The risk of the ECB remaining on hold has thus risen over the past couple of months.

The strengthening of the euro is a significant element in these changed risks, but the strengthening is probably not as bad as many expect.

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