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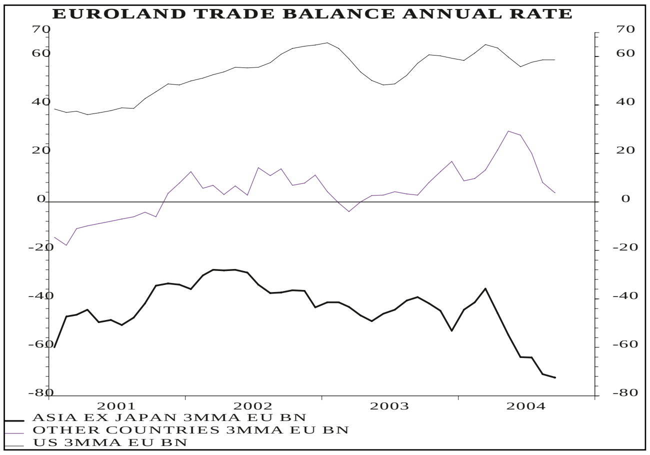
GFC Economics

Daily Commentary

Trade Problems In Euroland

In the last couple of weeks, the European authorities have stepped up their protests at the euro having to take more than its fair share of any currency adjustment against the US$. Their ire has been directed at both America and China. The Euroland economy remains unhealthily dependent on foreign demand, and can ill afford a further appreciation of the euro while domestic spending remains as depressed as it is. However, neither the US nor the Chinese are likely to heed the pleas of European finance ministers, and a renewed appreciation of the euro looks more than likely over coming months. This will further undermine European competitiveness and compound the deflationary threat posed by the mounting trade deficit with China. Net exports are, as a result, unlikely to make up for the continuing weakness of domestic demand. The Euroland economy remains vulnerable to any slowdown in the global recovery in the second half of the year.



Trade Turns To A Drag

Net exports were a major factor driving the recovery in Euroland GDP growth from 0.5% y/y in 2003 to a high of 2.1% y/y in Q2 last year. But they have also been the main force behind the slowdown in the economy since then. Trade knocked a full 0.7% off q/q GDP growth in Q3, and there is no sign of any recovery in Q4. In fact, the Euroland trade surplus fell in November to EU2.8bn s.a., its lowest level since July 2001. The deterioration since the summer has been caused by continued strong gains in imports at a time when export growth has ground to a halt.

Part of the recent narrowing in the surplus just reflects the hike in the oil price. The trade surplus with 'other countries', which includes OPEC, has narrowed substantially since the spring. However, Asia exc. Japan has been the biggest factor behind the deterioration. The extent of the 'China' problem, however, is open to some debate. The monthly European seasonally adjusted trade numbers do not give a complete country break down. All the same, there is a breakdown for the cumulative numbers year to date. These show that Euroland's trade deficit with China in the ten months to October widened to EU41.1bn from EU32.0bn over the same period in 2003. Euroland's overall trade surplus actually increased by EU9.0bn to EU67.1bn over this period (the narrowing in recent months followed a sharp improvement earlier in the year). The mounting problem with China has not been due to a slowdown in exports, which were up 16.3% y/y. The trouble is that imports surged 22.7% y/y and are now over twice the value of exports. Even in the unlikely event that export growth were to keep pace with import growth from now on, the deficit will continue to expand.

All the above, however, is based on European data and there is a large discrepancy between these numbers and the Chinese trade figures. The same problem - but on an even larger scale - exists with the US-China bilateral trade deficit. According to the Chinese numbers, China's trade surplus with the European Union only widened to EU20.8bn in the ten months to October, from EU12.1bn the previous year. The European data, by contrast, shows the EU's deficit with China much higher at EU62.6bn, up EU10.8bn on a year earlier. The Chinese figures imply there is less of a pressing need for a revaluation of the remninbi and, at the margin, make it all the more unlikely the Chinese can be coerced into revaluing their currency any time soon.

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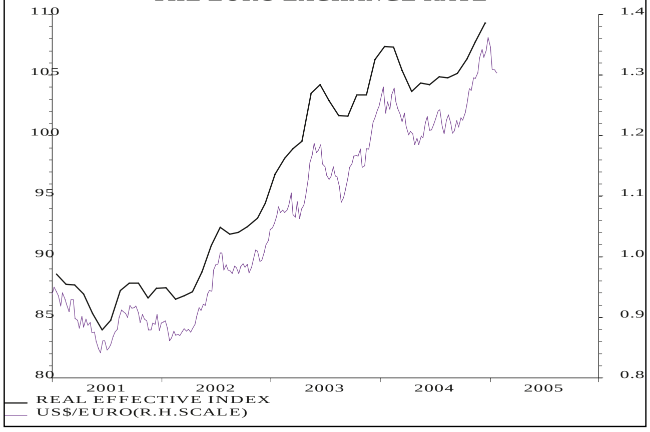
GFC ECONOMICS

DAILY COMMENTARY

While the surge in imports from China is undoubtedly a major threat to Euroland's trade surplus, it is not the only 'issue'. The rise in the euro has led to a significant loss in competitiveness. Between 2002 Q1 - when the euro started its ascent - and 2004 Q4, the euro's real effective index has risen by some 19%. This in turn has led to a cumulative loss in Euroland's export market share of around 5%, according to European Commission estimates. With exports to China accounting for only 3.5% of total Eurozone exports, China is clearly not the only problem here. The pace of the euro's appreciation has moderated since 2002 and 2003 H1, but the upward trend is clearly still in place. Indeed, even if the current correction in the euro were to continue and take the euro back down to US$1.25 from its January high of US$1.36, this fall would be no greater than the temporary retracements seen in spring 2004 and summer 2003.

Despite recent European complaints that Asia should be shouldering more of the decline in the US$ and that 'the adjustments for America's deficits should not be made through the foreign exchange markets', the US$ looks set to fall further. This week, the US Congressional Budget Office revised up its budget deficit estimate for FY 2005 to $400bn, partly as a result of the continuing drain of the Iraq war. The euro should remain one of the prime 'beneficiaries'. The forthcoming G7 meeting looks unlikely to contain any concrete move either by the US to support the US$, or China to revalue the remnimbi. In addition, the upward pressure on the euro will increase, now that central banks have started to diversify their reserves out of dollars into euros. Last, but not least, Euroland's trade surplus with the US continues to increase. It amounted to E50.3bn in the ten months to October and, superficially at least, would appear to justify further appreciation of the euro against the US$.

THE EURO EXCHANGE RATE



The loss of competitiveness within Euroland has varied substantially from country to country. The European Commission estimates that Italy, Ireland, Greece, Spain and Portugal have seen the largest declines since 2002 Q1, while Germany has only seen a slight deterioration. This divergence has in turn generally been reflected in countries' relative export performance. Italy and Greece have seen a cumulative drop in export market share over this period of as much as 20%. By contrast, Germany and - rather surprisingly - Spain actually saw a slight gain in market share. France, meanwhile, is in the middle of the pack, with a 10% decline. Germany's relatively good performance is, at first sight, reassuring in the sense that it has the most depressed domestic demand and so is in greatest need of support from external demand. In fact, the better export performance and weakness of consumer spending are intrinsically connected. The reason for Germany's improved competitiveness relative to the rest of Euroland is more to do with its lower wage inflation than a superior productivity performance. And of course, smaller wage increases are themselves the major factor behind the depressed state of German consumption. Thus, Germany's continuing international competitiveness is not quite the unmitigated good news it first appears to be. It has also not prevented the German trade surplus falling in November to its lowest level in a year.

All this suggests the Euroland economy will continue to struggle over the coming year. Domestic demand looks set to remain anaemic and, even if the recent trade deterioration looks overdone, net exports will not return to providing the boost they did back in 2003 H2 and 2004 H1. Deteriorating competitiveness will limit Euroland's ability to benefit from continuing strength in foreign demand over the next few months. And, equally important, it will leave Euroland all the more vulnerable to any slowdown in the global economy further out.