Economy

Germany, currency manipulator!

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A little statement here, a tweet there, with each passing day it is becoming clearer that the new US government intends to intimidate ALL of its trading partners with more or less explicit protectionist threats. Yesterday, it was Germany's – and by extension, the Eurozone's– turn to feel the wrath of one of Donald Trump's main economic advisors, Peter Navarro. In the world of real facts, it will be difficult to prove that Germany is pulling the strings to obtain a massively undervalued euro (viewed as an implicit Deutsche Mark). In the world of "alternative facts" anything is possible.

Death by Germany?

Peter Navarro is the author of a book "*Death by China*", published in 2011, which accuses China of unfair practices in the trade and monetary spheres. He is also the co-author of Donald Trump's economic programme[1]. All of which has earned him, amongst other qualities, the privilege of being appointed by Donald Trump as head of a new entity, the National Trade Council (NTC), to implement this programme. The goal of the NTC is to advise Donald Trump on "*innovative strategies in trade negotiations" and "develop trade policies that shrink our trade deficit, expand our growth, and help stop the exodus of jobs from our shores*".

The latest target is Germany, accused of exploiting the massive undervaluation of the euro to its advantage[2]. Nobody is fooled by this. It is less a case of proving a manipulation of the euro – which is also, incidentally, the currency of eighteen other countries, apart from Germany – than of using the intimidation strategy which is already a hallmark of the new US administration. The aim is to divide Europe (note Donald Trump's repeated encouragements in this respect to Theresa May) or weaken its core, Germany (note its attacks on the German Chancellor).

Let's pretend to take Mr Navarro literally and ask ourselves whether Germany is manipulating "its" currency. To determine this, the US Treasury department is publishing twice a year a report on the foreign exchange policy of the US' major trading partners. This focuses on whether these countries have intervened in the currency markets with a view to obtaining an unfair competitive benefit in international trade[3]. This report has been published since 1989, but since last year, the Treasury is obliged to provide a statistical analysis of the FX policies[4]. For this, three criteria must be examined.

- Having a significant bilateral surplus in its trade exchanges with the US: this is the case if the surplus exceeds the $ 20bn mark, i.e. 0.1% of US GDP. In October 2016, in the latest report published, seven countries met this criteria: China, **Germany** (chart lhs, p.2), Japan, Mexico, South Korea, Italy and India.
- Having a material current account surplus: this is the case if the surplus exceeds 3% of GDP. Five countries are identified: **Germany**, Japan, South Korea, Taiwan and Switzerland. (China is not far off)
- Conducting persistent unilateral intervention in the currency market: this is the case if a country has bought (net) foreign exchange, repeatedly, for an amount of at least 2% of its GDP. Two countries were recently targeted: Taiwan and Switzerland. (China has been selling currency reserves massively over the past two years).

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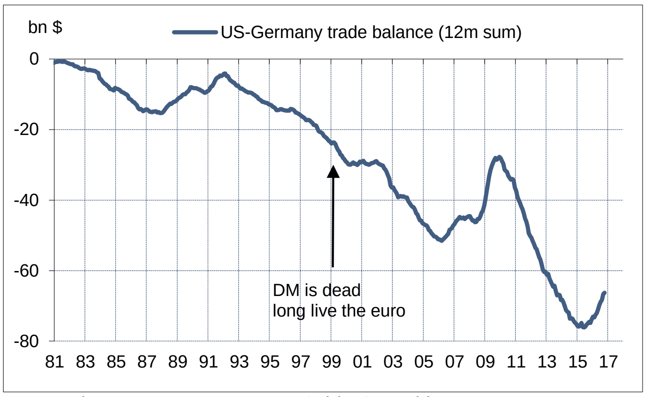
[1] *Navarro & Ross (2016), "Scoring the Trump Economic Plan:Trade, Regulatory, & Energy Policy Impacts", 29 September.*
[2] *"Trump's top trade adviser accuses Germany of currency exploitation", Financial Times, 31 January 2017.*
[3] *Omnibus Trade and Competitive Act of 1988.*
[4] *Trade Facilitation and Trade Enforcement Act of 2015.*

For the time being, no country in the world meets all three criteria. However, as soon as a country meets two of these criteria, it is included in a "monitoring list". China, Japan, South Korea, Taiwan, **Germany** (and, by extension, the Eurozone) and Switzerland are currently included in this list.

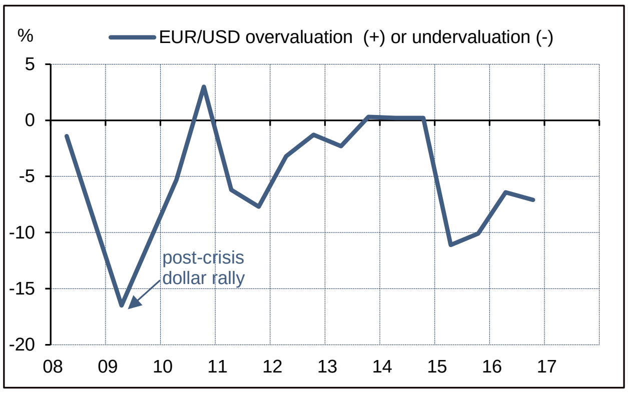
There is a degree of ambiguity in knowing who is responsible for the Eurozone's foreign exchange policy – if indeed there is a Eurozone FX policy (we have our doubts). The Ecofin council, which brings together the Eurozone's finance ministers, and the ECB are involved. The only times the ECB intervened in the currency market, was to support the euro. This dates back to the beginning of the noughties when the euro was approaching 0.80 against the dollar. To the best of our knowledge, there has been no declared intervention from the ECB aimed at weakening the euro. We would add - which is obvious to anyone with any understanding of how monetary policy is conducted in the Eurozone - that the ECB does not follow the orders of German authorities. Were this the case, we would have to acknowledge that the Germans have hid their hand well by repeatedly criticising for years, every major monetary policy initiative taken by the ECB, from LTRO to QE to zero interest rates and negative rates!

What about the question of the euro's undervaluation? Estimating a currency's fair value is a tricky exercise in itself, but the problem is compounded for the euro. The Eurozone is made up of countries characterised by heterogeneous profiles in terms of living standards and, therefore, competitiveness. There are certainly different fair values for the member states. A usual approach is to estimate purchasing power parity, i.e., the exchange rate which enables, for one monetary unit, to buy an identical basket of goods in two different countries. The OECD estimates the current PPP level at around 1.30€/$, vs 1.20€/$ ten years ago (with the difference stemming from the inflation differential over this period). From this perspective, the euro is undervalued to the tune of around 15% at present. Another approach seeks to calculate the exchange rate which would balance external positions. We would cite the work of the Peterson Institute[5] here, which shows an undervaluation of the euro of around 7% at present vs an equilibrium value in the region of 1.18€/$ (chart rhs). The currency market is often characterised by movements which in a few months, sometimes in a few weeks, alter the parities by considerably greater magnitudes. **It is hard to say that the euro's undervaluation is massive, and even less so that it is the result of a manipulation. The decline in the euro/dollar exchange rate in 2014-2015 has more to do with oil price trends (oil countershock) and with the monetary policy differential (business cycle gap) than with anything else**.

US-German trade balance



Under- or overvaluation of the euro/dollar



Sources: Thomson Reuters, PIIE, Oddo Securities

Of late, if there is one government in the world which is giving the impression of seeking to "manipulate" (verbally) its currency downwards, it is the US. The economic policy sought by Donald Trump's administration, whether a fiscal stimulus or protectionism, encourages dollar appreciation in the longer term. Whilst this is negative for the US economy, which is easy to understand, it is perhaps the strategic wisdom of this policy which should be called into question, more than the bases of international trade. That said, we cannot rule out the possibility of other remarks coming from the White House and the Treasury affecting the dollar's value, resulting if not in a durable weakening of the dollar, in any case in making it more volatile.

[5] *See Cline (2016), "Estimates of Fundamental Equilibrium Exchange Rates", PIIE Brief, November.*

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