Quo Vadis U.S. Dollar — Consequences for Transatlantic Trade

For three years the exchange rate of the euro against the dollar has traveled a one-way street - upwards. The correction in exchange rates that is currently taking place gives German industry some breathing room at best, but does nothing to solve the fundamental problems.

The fact is that last year as well the euro constantly scaled new peaks. Since reaching its lowest level at the end of the year 2000, it has appreciated in value against the dollar — even allowing for the recent correction — by approximately 40 %.

At the same time, the euro has also strengthened against the Japanese yen, the South Korean won, the Hong Kong dollar and the currencies of Central and Eastern Europe

- in some cases even more than against the dollar. It is this “blend of circumstances” which is obviously causing concern to many companies. In all these cases, the soaring euro does nothing to promote the much longed-for economic upswing.

In this context, I would like to focus on **three aspects**:

1. The significance of the weak dollar for German industry

2. The question of how companies react to changes in the exchange rate environment

3. The economic policy steps that should be taken as a result of the exchange rate problem.

Firstly: what does the weak dollar mean for German industry?

The exchange rate question has traditionally been of great importance for German industry. After all, more than a third of added value is exported.

It is true that this high export ratio is moderated by the fact that Germany now sends 45 % of its exports to the euro region, where exchange rates are stable. This was also one of the major reasons for the establishment of the European Monetary Union.

But there remains a substantial proportion of exports which is sensitive to exchange rate fluctuations:

- 11 % of our exports go to the USA, and around 20 % to the dollar region.

- The massive drop in Germany’s business with the US amounting to 10 % in 2003 proves how strongly exports react to the current weakness of the dollar. The price competitiveness of German industry has suffered badly in recent years.

In my opinion, the argument that the current euro-dollar exchange rate is at about its long- term average and price competitiveness has to some extent remained unchanged fails to be convincing.

- It is true that present currency relations roughly correspond to those that were in place when the euro was introduced at the beginning of 1999.

- Yet since then the economic environment in which German firms operate has fundamentally changed. In 1999 and 2000, German industry was experiencing a phase of economic recovery. Today the domestic economy is sluggish. At the same time, the pressure of global competition has been stepped up still further. A few years ago the strength of the euro was easier to cope with.

German industry’s hopes are now pinned on the global economy, as is the case so often at the start of a period of economic recovery. The extent to which Germany will benefit from the vigorously expanding US economy crucially depends on the international competitiveness of German products and services.

The frequently mentioned “pain threshold”, which is supposed to generally apply to an appropriate euro-dollar rate, does not exist.

The “pain threshold”, to adopt this expression, differs widely from company to company and is also highly product dependent:

- Suppliers of niche products, such as in the field of specialized mechanical engineering or certain segments of the automobile business can perhaps shrug off the increase in value of the euro with comparative ease.

- In contrast, firms with standard products which are exposed to the biting winds of international competition have a huge problem with a weak dollar.

Experience shows that when there is a sustained increase in the value of the euro against the dollar of around 10 %, German exports drop by around I %.

At present, German exports are more or less just ticking over. What is more, company earnings are coming under tremendous pressure. Many enterprises are only able to maintain their market shares by cutting prices. But there are limits, and the limits are visible.

Above all, the main impact is being felt by the sectors which are heavily export-oriented, such as automobiles, mechanical engineering and pharmaceuticals. At present, there is hardly a company listed on the Dax, the leading German stock index, which is not lamenting the adverse effects on its results due to the exchange rate situation.

The situation is no better with regard to medium-sized industry in Germany, quite the reverse, in fact. As a rule, medium-sized firms have few opportunities to adopt globalized strategies to cover themselves against undesirable exchange rate risks.

It is not only exports which suffer from the effects of a sustained dollar weakness. Competition from imports is also increasing. In particular, low-cost suppliers from abroad benefit from the competitive advantages exchange rates offer. But even in the capital goods sector, manufacturers from Japan, for example, (machine tools) are able to significantly undercut German competitors. Imports from the Far East are increasingly ousting German suppliers.

One person’s benefit is another person’s loss, or vice versa, you might say.

So indeed there are quite a few companies which benefit from the current weakness of the dollar:

- The tourism industry is one example of a clear beneficiary of the appreciation of the euro, as are naturally all those sectors which derive a cost benefit from the cheap dollar but have their main market in the EU and/or Germany.

- However, the cost reductions resulting from the strength of the euro, for example in the case of imported primary products, can rarely offset the downside of a strong euro with regard to exports.

The main problem with which German industry is currently confronted is of a dual nature:

- high production costs in Germany as a business location

- combined with lower earnings from the dollar region and Asia have the effect of slashing margins and/or market shares.

I would now like to come to my second point:

How do German enterprises react to the change in the exchange rate environment?

Many enterprises, especially most of the larger companies, have hedged their exchange rate risks, although as a rule only partially (around 30 — 50 %). Only a few companies take action to secure complete protection against foreign currency liabilities.

In the case of most medium-sized firms, it is not usual practice to hedge foreign exchange risks. They simply lack experience in this field. Here the drop in the value of the dollar really hits home.

Quite a few companies have made intensive efforts in recent years to get into shape through cuts in costs, financial consolidation and restructuring as part of their efforts to increase their ability to withstand adverse exchange rate fluctuations. These efforts are being pursued resolutely. However, it is getting more difficult to withstand the pressure on prices and earnings applied by exchange rates.

In any case, a significant portion of the costs incurred in Germany as a business location cannot be directly influenced by companies themselves. Labor costs are one example.

Here there is a special responsibility which must be shared jointly by politicians, unions and management. Otherwise, the clear trend towards shifting segments of production and operations to foreign countries with lower costs will continue to gather momentum.

The international division of labor makes it possible for businesses not only to improve their efficiency but also to reduce exchange rate risks.

In the ranking of countries in which German industry prefers investing, those countries are at the top of the list which

- offer corresponding market opportunities,

- show clear cost advantages and

- (what is becoming increasingly important) contribute to minimizing exchange rate risks.

In the period from 1999 to 2002, the USA alone accounted for a gigantic average annual investment volume of 27,7 billion euro

— boosted, it must be said, by the tail wind provided by the wave of mergers during that time. It is true that currently more is being invested in building up production plants in Eastern Europe and in Asia, especially in China — for very good reasons. Nonetheless, the USA still occupies the number one spot in the list of countries where German firms are present.

Shifting production abroad helps to preserve the international competitiveness of those parts of the enterprise remaining in Germany.

Yet increasing investment in production facilities abroad is only a symptom, not the cause, of sluggish growth in Europe and Germany.

This brings me to my third question:

Which economic policy steps should be taken as a consequence of the current situation in the foreign exchange markets?

In my view the main reason for the present weakness of the dollar is to be found in the high US current account deficit, aggravated by inadequate flows of capital into the United States.

The so-called “base account” for the USA, as economists call the combination of current account and capital account, has steadily deteriorated since the end of the year 2000. In turn, the bottom line of the base account has a close correlation with the euro-dollar exchange rate.

So what is to be done? It is certainly not my intention to give the American administration or the FED unsolicited advice.

But without the removal of the enormous imbalances in international trade the exchange rate problem will continue to be acute.

Above all, the huge discrepancy between savings and investment must be eliminated. This applies not only to the U.S., but also to Europe and Asia. Yet we should not harbor any illusions: the process of adjustment will only progress gradually. In the meantime speculators will have a field day.

Higher interest rates in the USA and a rate cut in Euroland could contribute to stabilizing the euro at a competitive level. In any case, such a step by the European Central Bank would certainly be justifiable both in terms of stability policy and with regard to the present state of the economy. However, we cannot expect miracles from a change in the interest rate spread in favor of the USA.

From time to time calls are heard for intervention in foreign exchange markets. I do not consider this to be expedient, not only because it runs counter to our basic philosophy. It is also inappropriate at the present time.

I simply cannot imagine that the American Administration, in what is also an election year, would happily toss away the "dollar bonus" and allow itself to get involved in a coordinated intervention aimed at boosting the dollar.

I can also appreciate very well the position of our American allies when, for the foreseeable future at least, priority is given to a dollar exchange rate at around its present level:

- There is a price to be paid for combating international terrorism and the Europeans also have to pay this price on the exchange rate front.

- Incidentally, Europe and Germany also benefit from the substantial economic boost coming from the USA.

For me there can be no question: Europe must and can make its contribution to more stable exchange rates. In particular, Europe must do more to strengthen demand at home. This is a major cause of the "dollar problem". And here the ball is very much in Germany's court.

There can be no doubt that the German government's "Agenda 2010" has invigorated the process of reform in Germany. The job is now to continue the structural reforms with zest and zeal.

I am sure that this kind of "division of labor" on both sides of the Atlantic could contribute to guiding the dollar into smoother waters. In my view, there is no need for a new "global currency architecture", a vision conjured up by some voices today.

Thank you for listening!