Germany depends on weak euro

Much rests on People's Bank of China

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German exporters, under pressure as a result of a slowdown in several key trading partners, must be hoping the renminbi's expected incorporation into the IMF's special drawing right leads to a firmer Chinese currency. The rise in the renminbi against the euro – up 76% over the past seven years – has greatly helped German companies' Asian competitiveness, a significant reason for Germany's hitherto booming China-bound exports.

This in turn has helped power the country's overall positive economic performance since the financial crisis. A reversal in the wake of China's economic slowdown would damage Europe's largest economy. Conversely, a further shift towards monetary easing and an extension of quantitative easing by the European Central Bank, widely expected for 3 December, would send the euro lower – a further boost for Germany's export-led economy.

The renminbi's decline in August, after China's exchange rate liberalisation moves, was one of the factors weakening the German economy, which grew only 0.3% in the third quarter, less than expected, in line with the generally lacklustre performance of the euro area. In coming months, the scandal surrounding the falsification of diesel emission data at Volkswagen may further impair the 'made in Germany' label – a further drag on the German economy.

Threats of devaluation from China were a strong reason behind a 5.9% fall in German exports in August compared with July. The month saw a marked decline in sales to China – Germany's fourth largest foreign market.

Already in July German exports to China were down 8.9% from the year before, contrasting with the immediate post-crisis years when sales of German manufactured goods to Asia helped Germany weather the general problems of the euro area.

In 2007, the year before the Lehman Brothers collapse, German trade was much more tilted than today towards the larger countries of the euro area. More than 60% of the surplus was with Italy, Spain and France. German banks provided low-cost credit to sustain European demand for German goods, a 'vendor financing' strategy that allowed Germany to consolidate its position as Europe's industrial giant.

The environment changed and intra-European trade endured a sharp downturn with the crisis of the peripheral economies. German banks became far more risk-averse towards weaker member countries, leading to lending freezes and a big rise in redemptions.

While southern Europe's output fell and unemployment rose, German industry quickly switched the export drive to countries outside Europe. The weaker euro and the ECB's expansionary monetary policy raised Germany's surplus with non-euro area economies, with the US as well as China accounting for large increases.

Since the ECB's quantitative easing started to loom into view in summer 2014, the euro has depreciated by 20%, providing further fuel for German industry. Other countries like France, Spain and Italy, which trade far less with China, have recorded much smaller increases in exports and have been less significant beneficiaries of QE. In contrast to Germany, these countries still have trade deficits with China.

With the Chinese economic slowdown under way from the beginning of 2015, and the euro starting to firm again in mid-2015, the German economy has suffered a setback. The future depends partly on central bank' efforts to influence exchange rates. The People's Bank of China has increased banking liquidity, while the ECB may announce an extension of QE next month. At a time when the US Federal Reserve seems likely to raise rates in mid-December, that could prompt a further euro decline, providing further German stimulus. As a result of the China syndrome, the German economy has become progressively dependent on a weak currency: an unusual and somewhat unsettling development.

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