Germany’s external trade – driven by demand or by the exchange rate?

No. 108, 18 April 2016

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The exchange rate and its movements receive great attention in economic policy debate with regard to their impacts on a country’s exports and imports. This is also reflected in the determination of economies’ price competitiveness, which is often measured using the real effective exchange rate. This method ignores other factors that affect exports and imports, particularly demand from the domestic and foreign markets. Empirically, this narrow view of the situation can hardly be justified. The fact is that demand is the determining factor of external trade.

Not quite as clear as often argued...

The conventional wisdom is that a currency depreciation boosts exports, which positively impacts the current account balance and economic growth in general. In the short term, however, the import value in domestic currency increases so that the current account balance deteriorates (or the export value in foreign currency decreases in an equivalent measure – with the same effect). The balance of trade and current account does not improve until demand for exports, which now cost less from the perspective of other countries, rises sufficiently.

A change in demand, on the other hand, has an immediate effect. This may seem so trivial that it does not play a major role in public debate. Furthermore, the exchange rate responds to the domestic economic situation and, if applicable, its monetary policy. Demand from abroad, however, is outside the range of influence of domestic economic policy.

...but true for Germany nevertheless

Empirical studies on the impacts of the exchange rate on current account balance and growth of real gross domestic product thus yield ambiguous results (see Konjunktur- und Wachstumsmotor Wechselkurs? (The exchange rate – a driver of economic dynamism and growth?), Focus on Economics No. 90, in German).

For Germany the studies determined a rather positive response of exports to a currency depreciation and a rise in demand. Figure 1 shows this as well. A stronger increase in real exports on the previous year tends to be associated with a stronger real effective depreciation. This correlation is, however, not so unambiguous anymore since the economic and financial crisis. The relatively strong depreciation between early 2014 and mid-2015 was followed by a rather subdued increase in real exports.

On the other hand, near perfect quarterly synchronisation exists between growth rates of real exports and indicators for demand from abroad – measured either by incoming orders for German industry from abroad or the export value-weighted growth rates of real gross domestic product in the destination countries of German exports.

German import growth, by contrast, hardly responds systematically to changes of the real effective exchange rate. A synchronisation between the rates of increase of the real effective exchange rate and real imports cannot, therefore, be identified either (Figure 2).

However, a strong correlation does exist with domestic demand – both with the volume of orders for German industry from domestic buyers and with their domestic use overall.

Figure 1: Exports and their determinants

Variation on previous quarter, normalised to a mean value of 0 and one standard deviation.


Figure 2: Imports and their determinants

Variation on previous quarter, normalised to a mean value of 0 and one standard deviation.