MARKET COMMENTARY

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Europe got poorer as terms of trade have crashed

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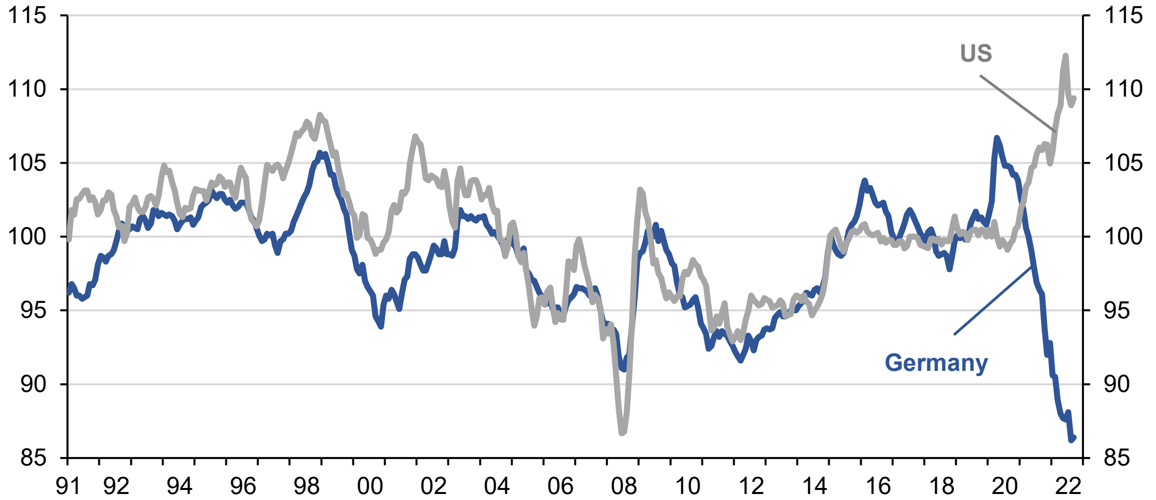
Since April 2020 Germany's terms of trade have been a free fall. This is the ratio of the indices of export to import prices: over the past two and a half years, export prices have been up 26%, but import prices by 56%. As a result, the terms of trade have declined by no less than 19%, the third largest reduction since the war – the other instances were March 1972 to January 1974 and October 1978 to August 1981. Similar things have happened to the other countries of the euro area.

At first glance this appears to be nothing to worry about, but it means that the economy's real disposable income has decreased – one unit of exports buys increasingly fewer imports. It is as if you could, 2½ years ago, buy 500 barrels of oil for each BMW you sold abroad, but now you get only 400 barrels. The standard of living in the car exporting country has gone down. In America, by contrast, the terms of trade had actually increased by 9.4% over the same period. They had a positive effect on the country's real disposable income, just as in all economies where export prices have lately increased more than import prices (Russia, OPEC, Norway).

terms of trade*)

2015=100



*) the ratio between the index of export prices and the index of import prices

sources: Bundesbank, Federal Reserve; own calculations, design & research: Uwe Richter

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The terms of trade effect can also be described in different terms: from Q1 2020 to Q3 2022 Germany's real GDP has modestly increased by 1.7%, reflecting CORONA and Putin's war, while, in volume terms, its national income had fallen by 5.0%, disposable household income by almost 4%, and hourly wages by 5%. Production was up, but the purchasing power of the population was down nonetheless. The winners in this process were foreign firms.

When unemployment is high, low and/or falling terms of trade are a good medicine: they improve the price competitiveness of the economy, stimulate exports, reduce imports and thus create jobs. The situation in Germany is quite different, though: since the labour market remains robust and inflation is very high, stronger, not weaker terms of trade are needed. They would hold down inflation and force business to move up the value chain and offer products which can be sold abroad, not because they are cheap but because they have features such as good quality and style which make them price insensitive, in good times and bad. In the long run, it is not in the interest of a high-wage country to gain and maintain market share on the basis of low prices. Rich Switzerland shows how it can be done.

Germany is of course part of a currency union and has not much influence on foreign trade prices. Even so, there are ways to strengthen the national terms of trade, such as relatively high wage increases (which lead to an appreciation of the German euro) or policies which boost productivity and growth. The latter is a longer-term project and requires things like a higher labour participation rate, easier access for foreigners to the German labour market, a better professional qualification of the labour force, including life-long learning, a stronger promotion of R&D, government investment incentives (for renewables, for instance), more competitive markets and, last but not least, a fair distribution of wealth and incomes.

Modernizing the structure of the economy is in any case the *camino real* into a better future, especially at a time when a deep recession is looming while disruptive technologies and processes demand innovative responses. Euro assets are not as attractive as they could be. Growth policies can do wonders on the demand and supply side of the equation.

Incidentally, the steep decline of the terms of trade, the huge increase of import prices in particular, has a big impact on Germany's balance on current account. For many years, the surplus was in the order of 7 to 9 percent of GDP but has now moved toward zero and could soon turn into a deficit. It is not a big deal that the country, once a major net exporter of capital, may become a net importer – the US have been in that position for decades.

Long-term, an aging society would do well to return to current account surpluses and thus, net, to growing the stock of foreign assets. Germany remains the world's number 2 in this regard, behind Japan. This has the welcome side effect that the annual income from these assets, ie, workless income, is now reliably in the order of 4% of GDP – in the wake of the euro depreciation this ratio might soon be even higher. Weak terms of trade can thus have a positive macroeconomic effect after all.

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About Wermuth Asset Management

Wermuth Asset Management (WAM) is a Family Office which also acts as a BAFIN-regulated investment consultant.

The company specializes in climate impact investments across all asset classes, with a focus on EU "exponential organizations" as defined by Singularity University, i.e., companies which solve a major problem of humanity profitably and can grow exponentially. Through private equity, listed assets, infrastructure and real assets, the company invests through its own funds and third-party funds. WAM adheres to the UN Principles of Responsible Investing (UNPRI) and UN Compact and is a member of the Institutional Investor Group on Climate Change (IIGCC), the Global Impact Investing Network (GIIN) and the Divest-Invest Movement.

Jochen Wermuth founded WAM in 1999. He is a German climate impact investor who served on the steering committee of "Europeans for Divest Invest". As of June 2017, he is also a member of the investment strategy committee for the EUR 24 billion German Sovereign Wealth Fund (KENFO).