

ANDBANK RESEARCH  
Global Economics &  
Markets

**MACRO & MARKETS**

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**Working paper.**

**About Mr. Draghi's fallacy & the fate of the Euro**

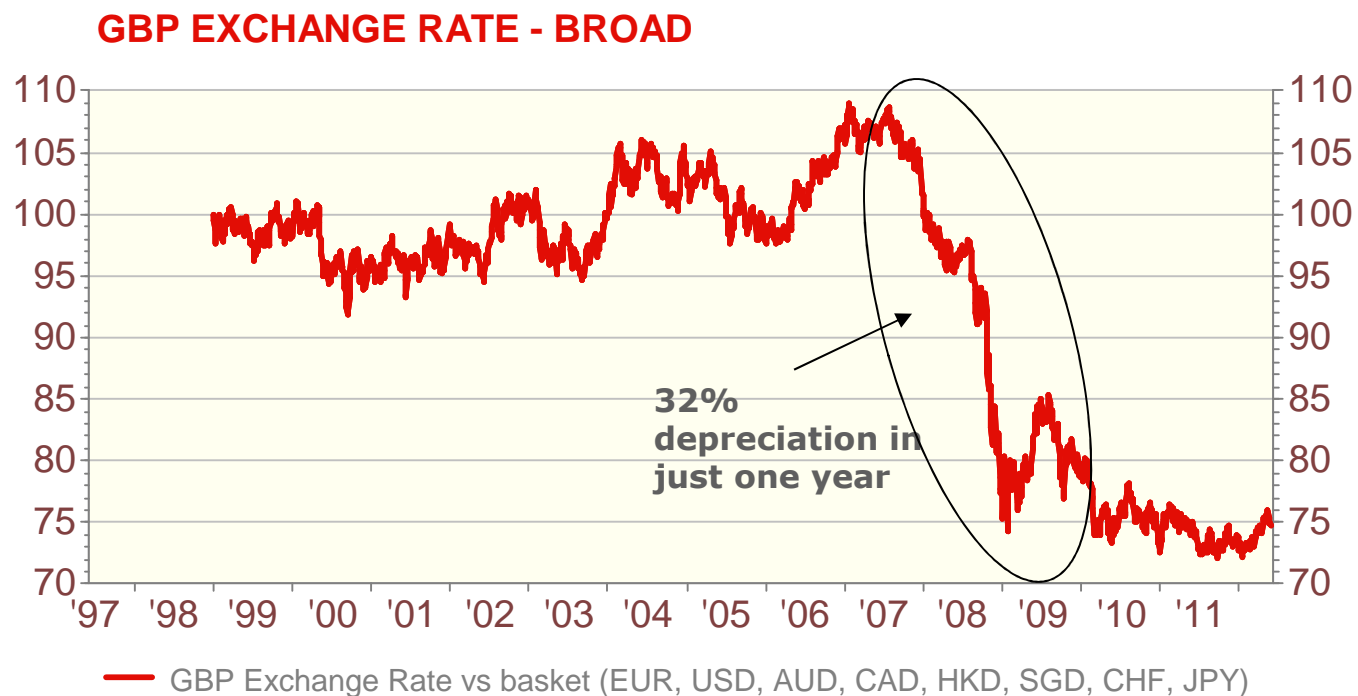
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*One of the greatest fallacies in economics is to believe that devaluations lead to an improvement in exports and therefore in the national economic conditions.*

*The reality is quite different. The devaluation processes are in most cases neutral from a current account perspective. What is more, devaluations often signal a worsening current account for the nations adopting them. That is because devaluations are not really a cause, but a consequence.*

## The idea of the “competitive” devaluation is a fallacy in the current global context.



Source: Andbank

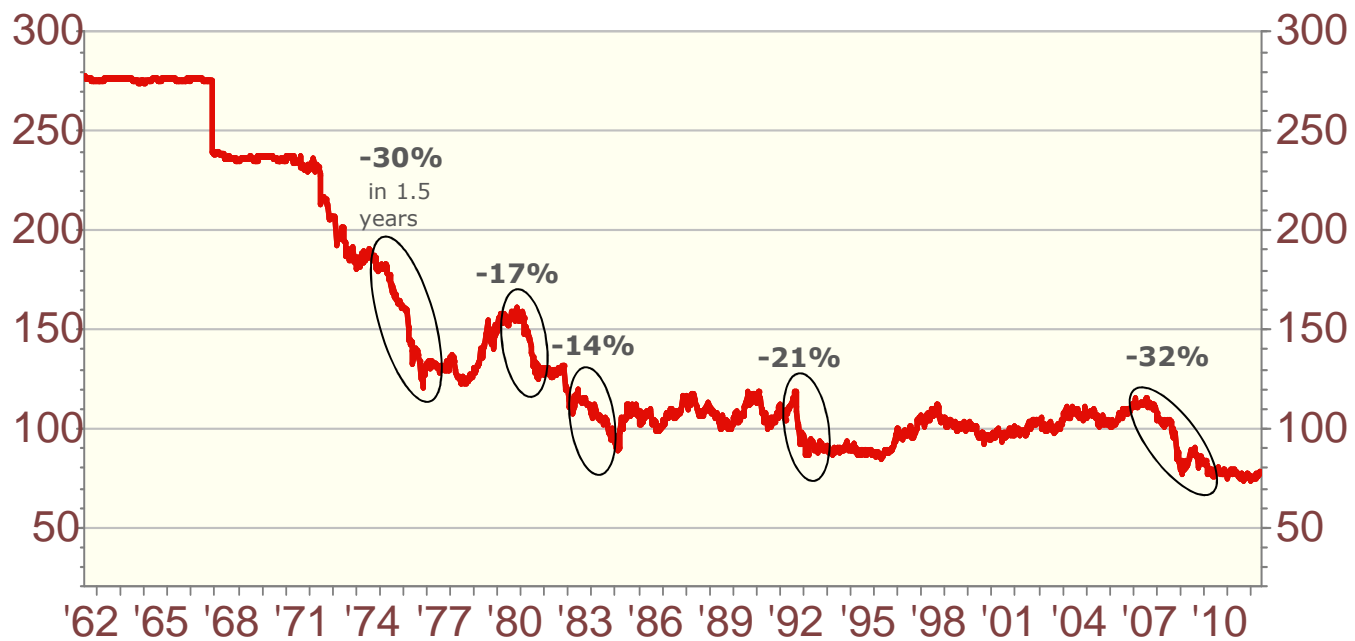
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For example ...  
UK allowed sterling to depreciate a 30% against its major trading partners since late 2007 ...

... and the recent devaluation, seen in perspective ...

... has been the quickest and vigorous devaluation in modern British history.

### GBP EXCHANGE RATE - BROAD (ex-eur) - Index100 Base dat

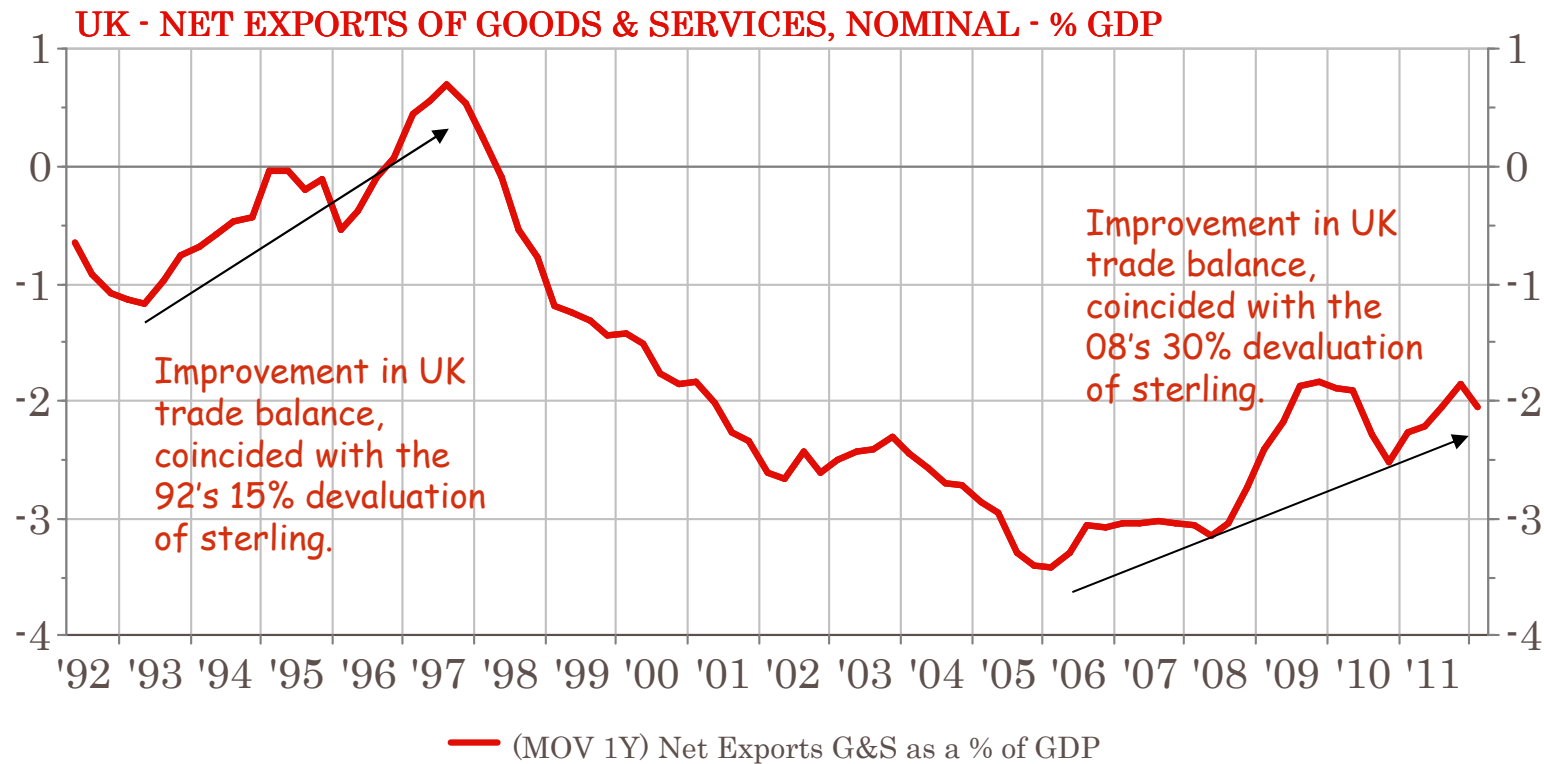


— GBP Exchange Rate vs Basket (USD, AUD, CAD, HKD, SGD, CHF, JPY)

Source: Andbank

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**Yes. When seeing some improvement in the external sector coinciding with devaluations, people's perception is that "such devaluations work well".**



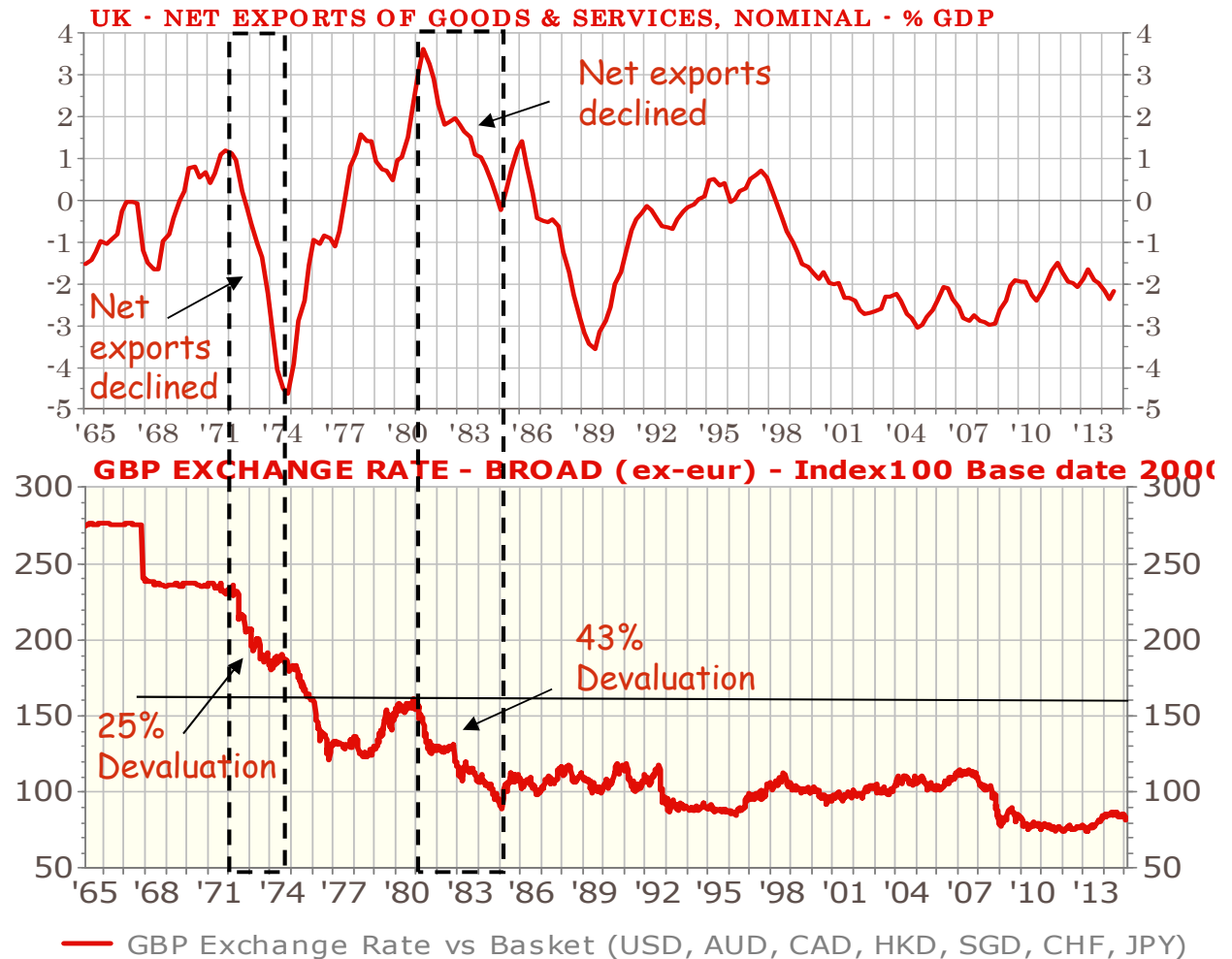
Source: Andbank, UK Office for Nation Statistics

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**Then, why do we cast doubt on the effectiveness of devaluations?**

**1<sup>st</sup>:** Seen in perspective, you may also realize that devaluations, not always translates into improvements in external sector...

... and this, at least, suggests some doubts about the effectiveness of devaluations.



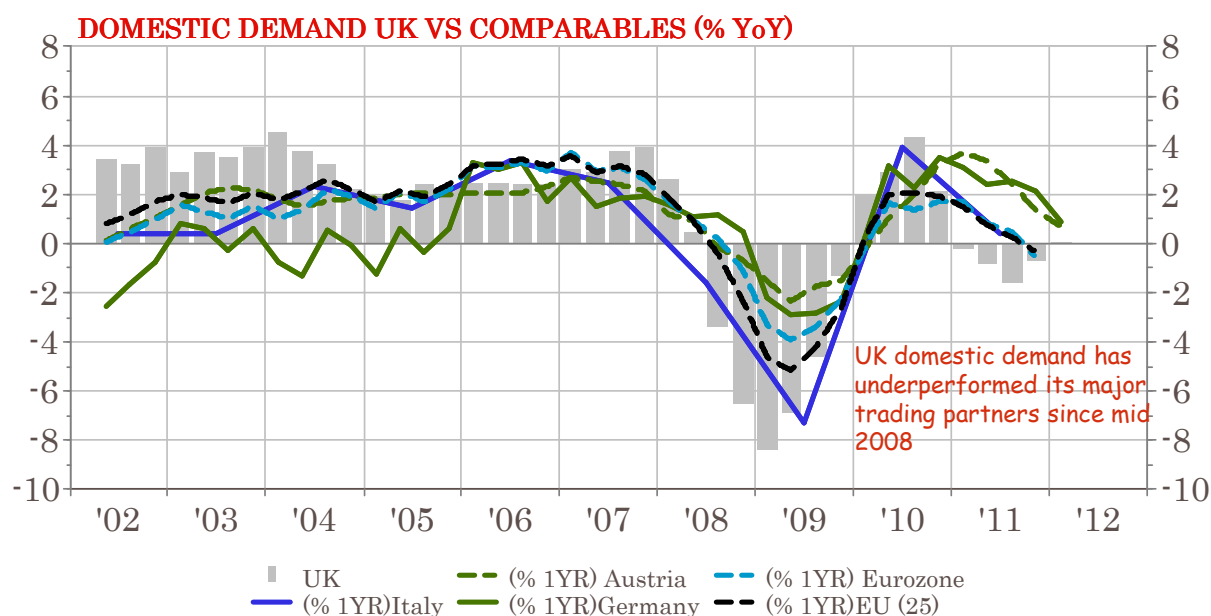
Source: Andbank

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## 2<sup>nd</sup>: A substantial share of the positive adjustment in trade balance came from the “Demand Side”, and not as a consequence of devaluation.

As the BoE stated: “Empirical estimates suggest that the impact of changes in demand on trade, is typically stronger than the effect of changes in prices”.

Indeed, Demand effect in the UK is three times more powerful than the exchange rate effect\*



Source: Andbank, Eurostat, ISTAT, Polish CSO, German Fed. Stat

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- ✓ Put simply, the recent gains seen in UK Trade Balance coincided with a 30% devaluation period, but was mostly explained by domestic factors (strong decline in demand) and not by devaluation.
- ✓ **Strong decline in demand** led to a fall in imports and thus, to a significant improvement in trade balance.

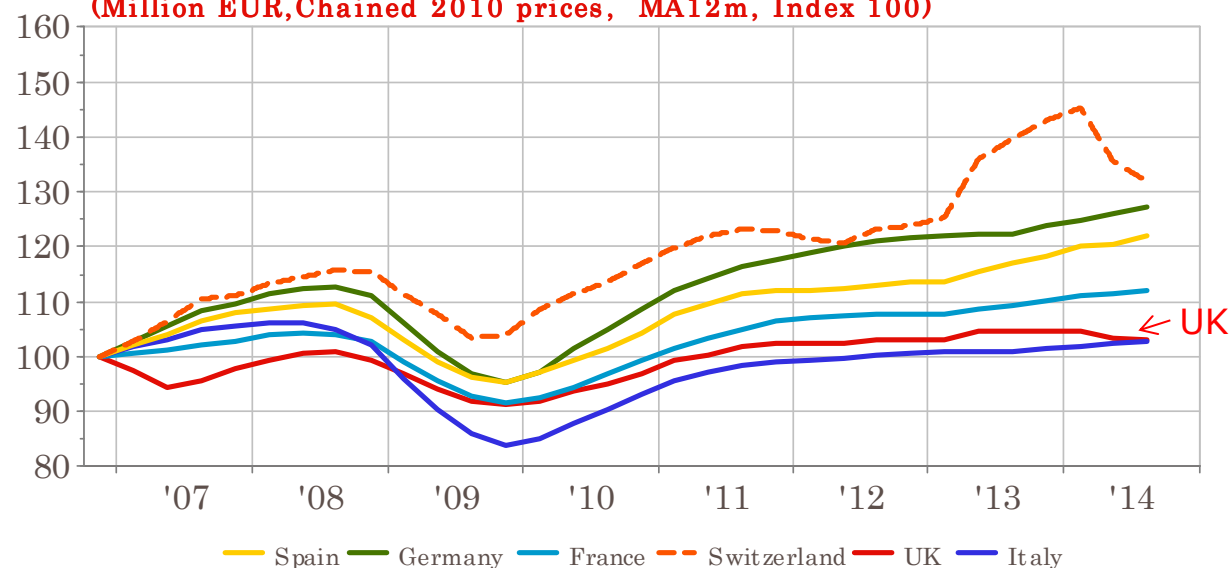
\* Gavekal, April 16, 2012.

**3<sup>rd</sup>:** Despite the “theoretical advantage” of a huge devaluation, the UK external sector has not performed well relative to competitors.

From the start of 2008 (the inception of the “big devaluation”) ... UK exports have not managed to outperform European countries.

**In fact, the UK ranks among the worst!!**

**EXPORTS OF GOODS & SERVICES - UK Vs COMPARABLES**  
(Million EUR, Chained 2010 prices, MA12m, Index 100)

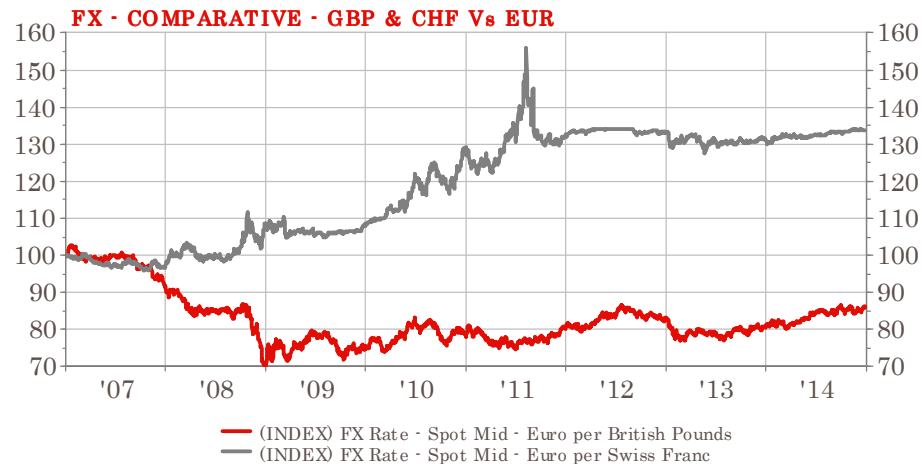


Source: Eurostat, Andbank

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## 4th: CHF and GBP have travelled in opposite direction ...



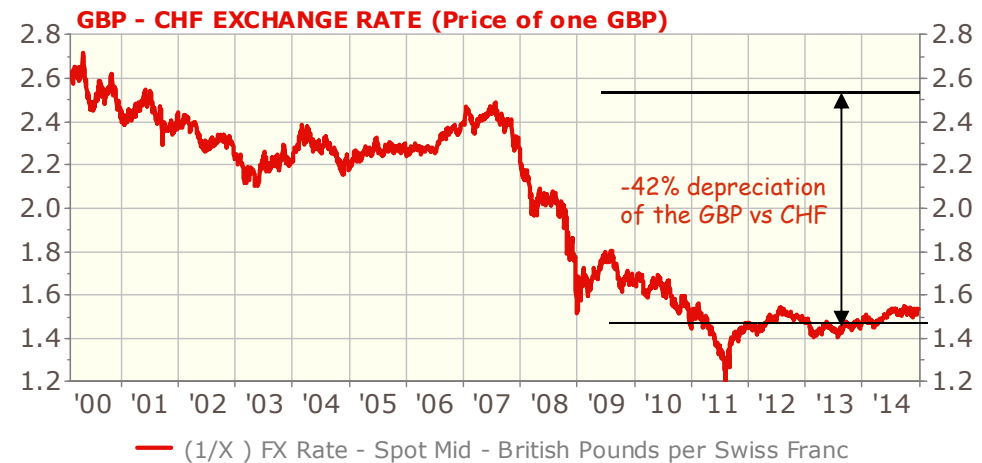
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The Swiss Franc has appreciated 35% vs EUR (in recent years) ...

... while GBP has lost a -15% of its value vs the EUR in the same period...

... which resulted in an incredible depreciation (-42%) of the Sterling against the Swiss Franc! ...

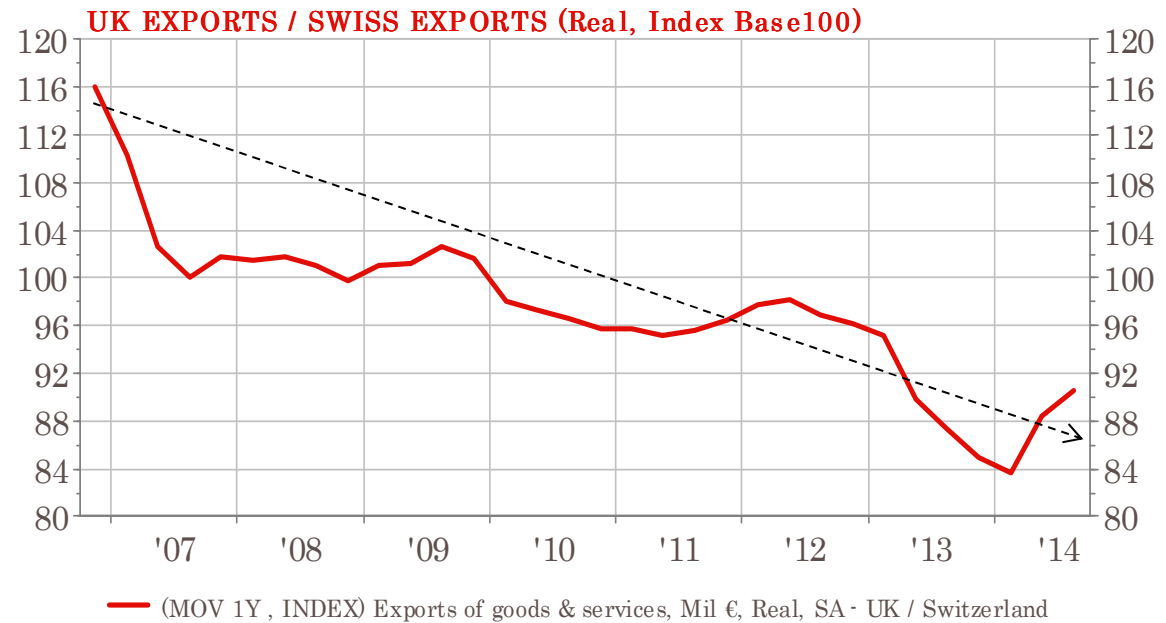


Source: WM/Reuters, Andbank

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**4<sup>th</sup>:** ... however, despite this tremendous “advantage”, the UK exporters has failed to outperform Swiss exporters.

... and that gives an extraordinarily clear indication of the **inherent limitations of devaluations.**



*Eurostat, Andbank*

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## Conclusions:

1. Devaluations not always translates into improvements in external sector (as has been demonstrated).
2. A substantial share of the improvement in the trade balance most often comes from the “demand side”, not from the effects of devaluation.
3. The coincidence in time with a devaluation, causes this **economic myopia.**
4. It is an empirical evidence that in some countries, such as the UK, despite enjoying the theoretical “advantage” of a tremendous devaluation, the external sector has not performed well relative to competitors.
5. “Competitive” devaluations” work well only ...
  - ✓ With a high level of savings (that help offset the non-progressive tax effects of devaluations)
  - ✓ If there is “similar” cost structure with competitors (no longer the case).
  - ✓ If there is a relatively low and stable level of energy prices and a low intensity in the use of energy (no longer the case of the Eurozone that supposedly could pursue devaluations).
6. Whoever is in charge of the monetary (and thus, the exchange rate) policy in the Eurozone, he is pursuing a blatant manipulation of the exchange rate in order to seek competitive advantages for the external sector. He will fail.
7. Even worse. **It will cause an outflow of capital** (projects now unviable with the new perspective for the exchange rate). This will cause **further declines in the value of the currency** (devaluations are a consequence, not a cause) while it will **reduce the potential GDP.**

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