UNHAPPY NEW YEAR FOR THE EURO?

Op Ed by Dr Rory Knight

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JOONGANG
SUNDAY

JoongAng Sunday is the Sunday edition of the leading Korean language daily newspaper JoongAng Ilbo. It is one of the three largest newspapers in South Korea. The paper also publishes an English edition, Korea JoongAng Daily, in alliance with the International New York Times.

2017 is likely to see major upheaval in the Eurozone with significant knock-on effects for Korean trade and investment. To date, the Euro and the European Single Market have together represented an ambitious and in part successful project. Life has been much easier for the Korean visitor arriving in Europe. Koreans arriving on Schengen visas have enjoyed trouble-free travel, moving effortlessly across borders without let or hindrance. The ability to exchange the Won for just one currency valid across all Eurozone states, has saved much money and time. Many Koreans will have forgotten the dark days before the Euro when multiple visas were required and Wons needed to be changed into a plethora of different denominations like the Deutschmark, Franc or Lira.

On the trade front, Korea currently enjoys a top ten trading partner position *vis-à-vis* the EU, and the EU-South Korean Free Trade Agreement is entering into its sixth year with more than $100 billion per annum of goods and services traded between the two areas. In short, the EU has become a market of considerable importance to Korea in both imports and exports, and any turmoil in the Euro will have major consequences for the Korean economy generally and for many Korean companies individually.

No Wriggle Room Allowed

Turmoil, though, is inevitable. The yawning gap between the economies of northern and southern Europe is now placing an unsustainable strain on the rigidities implicit in the Eurozone. Inflation, unemployment and deficits are all significantly higher in the south. These are both cause and consequence of the trade imbalances between Germany and the rest of the EU which has resulted in a massive build-up in reserves in Germany and deficits swelling elsewhere. In the absence of the Euro most of the southern European nations would have seen a dramatic devaluation of their currency to accommodate the economic divergence and bring their economies into equilibrium. The straightjacket of the Euro has left little wriggle room in the eyes of the ruling elite and only one policy response: austerity.

The most striking result of this has been the political and financial chaos in Greece, which in recent weeks was once again withheld bail-out funds. The upcoming 2017 elections in several European countries including Italy, France and Germany will very likely see populist candidates coming to the fore touting nationalistic solutions to the local ills of the Eurozone. This situation has been further exacerbated by the tensions arising from the political mishandling of Europe's migration crisis.

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In short, the Euro is coming under unsustainable strain, and something will have to give. There are three possible future scenarios, each of which presents problems. The first is that Europe pursues full fiscal integration and puts in place the fiscal and monetary architecture needed for the Euro to operate as a proper currency. This scenario is both impossible in the short-term and improbable longer-term. The second scenario is that the Euro stumbles as now and the Eurozone economies somehow muddle through. This is possible only if there is a significant economic up-turn. The third and most likely scenario is that the Eurozone itself fragments.

Arriverderci Roma?

In 2017 it is highly likely that one or more countries will exit the Euro and revert to their former national currencies. The departure from the Euro of a major economy such as Italy would be a body blow to the European project though not necessarily a fatal one. The EU might even be strengthened by the resultant flexibility. An Italian departure would result in a devaluation for Italy of around 30% to 40%. This outcome would be highly beneficial for the Italian economy, not only making Italy an even more attractive destination for Korean holidaymakers but increasing Italian imports to Korea.

The Euro's Hidden Face

The Euro was introduced with the aim of forging of Europe into a single political entity. Citizens of different member states by becoming familiar with a common Europe-wide currency would feel a tighter sense of fraternity, which in turn would accelerate integration – that noble if distant ideal. Presently the EU represents a formidable economic entity with a combined GDP of over $17 trillion, second only to the United States. It has its own flag and its own anthem but it does not yet have a real single currency of its own.

The financial crisis of 2008 exposed the Euro's true identity - that it is in reality merely a fixed exchange rate agreement operating among different European nations. Furthermore, it revealed that this fixed exchange rate agreement exists within a woefully incomplete architecture – the vital missing structures being an integrated fiscal system, a Europe-wide depositary insurance scheme and a single integrated regulatory system and a single independent central bank Although the European Central Bank exists, it effectively operates subordinate to the EU's national central banks.

While fixed exchange rate regimes have often been used in various parts of the world, they rarely weather major economic crises. An example is the ERM, the European Exchange Rate Mechanism that preceded the creation of the Euro and led to the ignominious withdrawal of sterling on 'Black Wednesday' in 1993. In fact, fixed exchange rate regimes are more often cause rather than cure of financial crises - as is evident currently within the EU.

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Seeing the Euro as a fixed exchange rate agreement rather than a single currency, equips one to distinguish more clearly the cause of problems and thus identify possible solutions. The rationale for fixed exchange rate agreements is that they eliminate the uncertainty and volatility inherent in floating exchange rates. This, according to the argument, not only lets citizens to go on holiday without the costs of changing money but reduces the risks inherent in cross-border activity and thereby encourages trade and investment between countries. These were the arguments used for introducing the Euro. But they are spurious.

Shooting the Messenger

The attribution of risk to fluctuations in exchange rates is a prime example of blaming the messenger and failing to grasp the underlying message. Fluctuations in exchange rates reflect genuine uncertainties about the performance of individual economies and as such provide important signals for the allocation of resources. Fixed exchange rates jam this vital source of information without removing the underlying risks and resulting in grotesque misallocation of resources as market participants oscillate this way and that reacting to the wrong signals. Hence, the Greeks thought they were massively wealthier than they were and overspent accordingly.

Paradoxically, fixed exchange rates actually undermine integration. As a general rule, businesses tend to hedge against long-term currency risk by transferring sourcing and manufacturing to local markets and balancing the costs and revenues in their currencies. In the absence of such strategies economies of scale inevitably mean that more nationally centralised sourcing and manufacturing approaches prevail. The upshot is an overall reduction in foreign direct investment.

Brace Yourself, Korea?

So what are the implications for Korea? It currently has a trade deficit with the EU, the most recent annual trade figures showing imports of some $60 billion from the EU and exports of $49 billion from Korea to the EU. The resultant deficit of $11 billion is not, however, evenly spread across all EU countries. There tends to be a surplus with the southern states of the EU (with the exception of Italy) and a deficit with the northern ones. All this has to be set against the background of a weakening Euro which has lost some 20% of its value against the Won over the last two years.

Even without fragmentation in the Eurozone many are predicting the Euro will continue to lose ground against the dollar in 2017 and soon fall below parity. Overall, Korean exports to the Eurozone will become dearer and Eurozone imports to Korea correspondingly cheaper. The overall impact on Korea's trade deficit with EU could go either way. Certainly, if European consumers respond by buying fewer Korean products the deficit will widen. But if European appetites for Korean products continue unabated while European imports to Korea get cheaper, it might well shrink.

A Euro crisis in 2017 is also likely to reduce the European direct investment in Korea. This currently runs at around $43 billion a year. Although a reduction might not hurt much in aggregate, it could have a significant impact on individual businesses. The corresponding Korean direct investment in Europe is around $20 billion. Korean businesses therefore should analyse their markets and investments carefully and calibrate plans accordingly. As an example, Italian product prices are currently inflated by the strength of the Euro while the opposite is true of German products. If Italy left the Eurozone these prices would fall and Korean importers of Italian goods and services, including tour operators, would benefit accordingly.

So the picture is by no means one of uniform gloom. As the late, great international investor Sir John Templeton said: 'Trouble is opportunity'. Upheavals in the Eurozone will undoubtedly bring in their wake unforeseen and perhaps unpredictable opportunities for Korean business.

What is certain is that 2017 will be a watershed year both for the Euro and the EU. And, who knows, in the wake of Brexit Europe may yet see further political withdrawals from the Union. But these would open a Pandora's Box of challenges dwarfing even the problems currently confronting the Euro.

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