CAPITAL & ECONOMICS

Why What Happens To The Euro Matters To The World Economy

OVERVIEW

After an unsteady few years of being knocked about by economic and political shocks, the euro has been showing its muscle. The eurozone – the 19 countries that use the European single currency – is enjoying a sustained period of economic recovery and unity. And this is being reflected in the currency markets: At the beginning of September 2017, the euro appreciated to its strongest level against the dollar in two and a half years — although it has dipped slightly since then.

As Tapan Datta, Head of Asset Allocation, Aon, observes: "Brexit and general political uncertainty in France and Italy caused people to worry about the economic health of the Eurozone. This sentiment has shifted."

In the first three months of the year, economic growth in the eurozone was more than twice as fast as in the U.S. This was followed by a strong second quarter, in which growth was up 0.6 percent year-on-year. In fact, since the beginning of 2013 the eurozone has kept pace with the U.S., with real gross domestic product (GDP) per head rising at the same rate. In the meantime, employment levels in euro countries have risen: By the second quarter of 2017, a record 155.6 million people were in work.

All this good news can be traced back to 2012, when eye-wateringly high debt levels in countries including Spain, Italy and Greece threatened to split the single currency. Amid this chaos, in stepped Mario Draghi, President of the European Central Bank (ECB), who promised to do "whatever it takes" to save the euro. This included introducing negative interest rates, ultra-cheap loans and a massive trillion-euro bond-buying – or quantitative easing (QE) – program.

Now amid this recovery, the ECB is considering what to do with its monetary policy. One misstep and the eurozone's economy could be destabilised. And it's unnerving the currency markets: By just mentioning that the bank was having preliminary discussions on reining in QE, Draghi saw the value of the euro leap against the dollar. And when he announced in October that QE would be around for a bit longer – albeit at a slower pace – the single currency hit three-month lows.

What do movements in the euro and a shift in monetary policy mean for businesses operating in and trading with the eurozone?

IN DEPTH

A Test To Trade

While the rise of the euro is seen as a gauge of a healthy economy, it also means that countries outside the eurozone have to pay more for the region's goods – prompting a reassessment of import and export strategies. "Companies – and overall economies – tend to evaluate exchange rates and overall currency fluctuations as it relates to imports and exports," says Stuart Lawson, CEO, Aon Credit International EMEA. "There is a balance they look to achieve so that goods needed are purchased at a favorable rate."

To complicate matters, the impact of a strong euro on exports is felt differently across the eurozone. "When it comes to Europe, there's a difference between the German euro, the Italian euro and the French euro. Each eurozone country's economy reacts differently to the exchange rate depending on what they export, where their production base is, and where they source their raw materials or end goods. In the German case, the euro remains extraordinarily cheap, while in the French and Italian cases it looks more expensive," explains Datta.

Exporting In The Eurozone

Germany

The weakness of the euro has been beneficial to German exporters, helping drive demand from the U.S. and Asia. Exports account for almost half of the country's economic output, and rose 8 percent year-on-year to €103.7 billion in July 2017. This has also meant that the country's trade surplus has continued to grow, standing at $300 billion, or 8.3 percent of GDP, at the end of 2016 – the world's largest.

During this period of strong export growth, Germany's manufacturers have reinforced their competitiveness. One move has been to strengthen their integration in global value chains – locating different stages of a production process in different countries. By doing this, and also outsourcing labor-intensive tasks to outside the eurozone, German companies have lowered costs and made themselves more resilient to currency fluctuations.

France

French companies, on the other hand, are more wary of the rise of the euro. Between 2011 and 2016 French exports decreased at an annualized rate of 1.043 percent, from $574 billion to $485 billion. However, overall exports have marginally increased this year – driven by growth in its pharmaceutical and oil and gas sectors.

The country's largest export sectors – aeronautics and machinery – suffered a slight decline in the first half of 2017, but have since rebounded. Many of France's biggest exporters are large multinational firms that are less susceptible to currency fluctuations and more reliant on the economic growth of their trading partners.

Italy

Italy is widely seen as the country that could be most heavily impacted by a strong euro. In comparison to Germany, a large proportion of Italian companies' manufacturing costs are local, meaning they don't benefit from an improving exchange rate lowering the overall cost of production.

However, export growth has been the main driver of Italy's recent economic improvement, with the Italian Ministry of Finance predicting that exports will increase 4.8 percent this year compared to 2016.

A report by Banca d'Italia suggests that the Italian economy has finally adapted to life under the euro. It points to how Italian exports were initially hit by three factors: a rise in domestic prices due to the new fixed exchange rate; competition from low-wage emerging markets, such as China; and the fact that the country has a large number of small and medium-sized (SME) exporters, who were slow to adapt. The economy has since become more specialized, focusing on sectors that are less vulnerable to competition from emerging economies and producing goods which have a strong Italian brand and reputation.

The Netherlands

A strong euro has so far had little impact on Dutch exports (rising 9.4 percent year-on-year in July 2017). The country is the third-largest exporter in the eurozone, deriving more than two-thirds of its economy from exports and benefitting from the port of Rotterdam's position as a global trading hub.

Exports continue to perform well, the result of the growth of several major trading partners and the strong competitive position of the Netherlands. However, a negative factor for the growth of Dutch exports is the pressure on imports in the U.S. and the U.K., both key trading partners. The pound's depreciation, in particular, is making Dutch products relatively expensive for households and businesses in the U.K., which could reduce demand.

Ireland

One of the first countries to be rescued in the eurozone's economic crisis, Ireland has turned around to become the fastest-growing European economy since 2014, with the value of exports steadily rising throughout this period. The Irish economy – albeit significantly smaller compared with Germany, France, Italy and the Netherlands – is projected to grow at a sustainable pace in 2017 and 2018. GDP is forecast to grow around 4.5 percent in 2017, with medical and pharmaceutical products remaining the key driver of the country's export industry.

However, Ireland is highly exposed to the British economy. The U.K. is the second-biggest market for Irish exporters and sectors such as agrifood, chemicals and electronics will suffer the most from a further depreciation in sterling against the euro. Much will depend on the final outcome of the Brexit negotiations.

The Shadow Of Brexit

"On top of general currency fluctuations, Brexit has added another level of uncertainty to trade – for the U.K. itself and for the rest of the world that does business with the U.K.," says Lawson.

One key driver of the euro's strength has been the decline of the pound since the U.K. voted to leave the EU in June 2016. Since the announcement, sterling has fallen by more than 14 percent against the euro.

For U.K. companies that has meant their exports have become substantially cheaper. Unsurprisingly, exports from the U.K. to the EU have increased over the last year, up 45 percent to France and up 21 percent to Germany year-on-year to June. However, after a rapid increase in the second half of 2016 following the referendum, total exports have since declined in the first two quarters of 2017. The slump in the pound has also had an impact in the U.K., triggering higher-than-expected inflation and a fall in consumer spending.

As Datta notes, Brexit is a cross-border issue that will play out in future trade agreements and affect key trading partners. "Current exchange rates don't necessarily impact the U.K.'s main partners," says Datta. "What's top of the mind is market access to the U.K. in a hard Brexit scenario."

A Strong Euro: An Issue, But Not The Big Issue?

The euro's upward momentum shows no sign of abating. With the ECB preparing to push back on its bond-buying program and investors looking to put money into a resurgent Europe, the currency's valuation will most likely continue to rise.

This will put pressure on businesses in the single currency area. So far their growth has remained robust, but there are numerous political and economic risks around the corner. These range from the deep-seated problems in Italy's banking system, to the risk of another property bubble in Ireland, to the international impact of Germany's trade surplus, which has provoked frustration from some of its key trading partners, such as the U.S.

Despite these threats, the most successful eurozone exporters have shown that they can weather currency fluctuations by diversifying their production process across multiple countries, by outsourcing the most labor intensive work, and by following a global sales strategy.

Ultimately, no currency's position lasts forever, and there may be bigger matters on the minds of European importer and exporters. "The fact is currencies move in big ranges," says Datta. "They move from being very cheap to being very expensive. The issue is less about monetary fluctuations and more so about global and political uncertainty. Brexit is just one example in which market access to an entire economy is called into question."

“The current level of the euro clearly does not prevent our companies winning market shares, being strong, performing and competitive, and exporting” – Pierre Moscovici, European Commissioner for Economic and Financial Affairs

“Geopolitical risks, a slowdown of the U.S. or U.K. economy and a deflating eu(ro)phoria could dent the strong growth momentum” – Carsten Brzeski, Chief Economist Germany, ING Bank

FURTHER READING

- Soaring Euro Heaps Pressure On Exporters As ECB Ponders Taper – Financial Times, September 14, 2017
- Euro Area – Economic Forecast Summary – OECD, June 2017
- Will Euro Appreciation Derail The Eurozone Economy? – Wells Fargo Securities, 28 September, 2017
- How To Ride The Currency Roller-Coaster – The One Brief, Aon, 2017

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