

The effects on UK business if the euro fails

What would happen to business if the euro met its demise? Phil Thornton reports

Phil Thornton, Financial Director 27 Aug 2010

A few years ago, anyone talking about the breakup of the euro was dismissed as a fanatic. The consequences of the currency of the union disintegrating were so terrifying that for most people, the idea of such a disaster was unthinkable: countries defaulting as they were forced to revalue their euro-denominated debts into fragile new versions of their own currencies, triggering mass insolvency among financial institutions, a sharp rise in borrowing costs and a long, deep depression crowned with soaring inflation as the new currencies slumped. No fun.

In 2010, the notion that the single currency could really, really meet its end has become a frighteningly mainstream hypothesis. Capital Economics, the consultancy headed up by influential economist Roger Bootle – the man who foretold the death of inflation in the 1990s – now says he thinks the chances of a collapse of the single currency within five years are more than 50 percent.

That is backed up by the fact that half of the 440 chief executives and heads of banks surveyed earlier this year by the Economist Intelligence Unit agreed that there is a greater than 50 percent chance of one or more countries exiting the euro by 2013 – 36 percent believe there is a one-in-four chance of a complete breakup.

Death of a bad idea?

Naturally, there are those who have always thought the single currency was a bad idea. Brian Chester, client finance director at FD Solutions, a company that provides interim finance directors, thinks the euro was doomed from day one.

Capital Economics blames not only the well-exposed problems of sovereign indebtedness and continued fragility of the world economy, but deeper, more fundamental issues around a lack of competitive muscle and structural economic weakness in the eurozone.

“It seems obvious the current situation is not sustainable,” says Jennifer McKeown, European economist at Global Economics.

So what would happen if the eurozone split into potentially warring economic factions? Where would that leave sterling?

The potential impact on the banking sector, which has sucked up billions of euros worth of Greek debt, is much talked about. But what about non-financial firms?

For Mark Luby, managing director of Manchester-based European Braking Systems (EBS), a wholesaler, it is a truly scary prospect. EBS exports between £3m and £4m a year out of a turnover of £10m. The majority of those orders go to the eurozone – from where EBS derives half of its imported parts.

“It frightens me just to think about it,” says Luby. “It would affect me dramatically. It’s the biggest current concern for this business.”

Luby believes small UK businesses like his own are vulnerable to currency swings, highlighting the slump in the euro from €1.30 to €1.10 to the pound.

“Within the space of three months we have seen a price increase of 13 percent,” he says. “If we were to change back to individual currencies again, it would be frightening. For a start, 75 percent of our cost prices would change overnight.”

Currently, EBS deals in two non-UK currencies – the euro and US dollar – and pre-buys currency on the same day it places an order. While straightforward in euros, Luby fears it would become an expensive, complicated and logistical nightmare to try to do that in as many as 17 currencies – slowing business right down.

Another worry is what happens to the €2.5m of debts owed by European customers.

“Would we still be owed €2.5m or would that change back to other currencies of the countries that we supply to?” says Luby. “We could be massively exposed.”

Dramatic and traumatic

Mark Cliffe, global head of financial markets at ING, believes business owners are right to be scared. He thinks the impact of a breakup would be dramatic and traumatic.

Output in the former euro countries would slump anything from five and seven percent in the first year. This recession would drag its trading partners down: UK GDP would fall back by three percent.

“Europe is the UK’s largest trading partner, so a big fall in output in Europe would be very bad for UK industry,” says Ian Bright, a senior economist at ING.

The bank also echoes Luby’s concern about not being paid. Bright believes that without extended preparations for exit from monetary union, the risk of at least a temporary breakdown in payments systems would be enormous.

Douglas McWilliams, founder and chief executive of the Centre for Economic and Business Research (CEBR), one of the UK’s most visible and listened-to think-tanks and an adviser to a plethora of the biggest multinational companies, believes it is almost inevitable that the euro will split.

The collapse of the euro would cause headaches for finance directors in three key areas – treasury, business competition and supply chain. And forecasting would receive its final nail in the coffin.

“If a euro breakup did happen, the politics involved would make any planning useless,” says Andy Blackstone, a finance director and company secretary with Aim-listed advertising agency M&C Saatchi. “It would be something that was purely political – and that’s beyond my control.”

Neil Morling, group finance director at property consultant EC Harris, sees the impact at its worst on accounting systems. "I would undoubtedly flinch at the costs involved when the techies are let loose on my accounting systems," he says.

And business insurers would capitalise on the heightened sense of fear, making protection more costly.

"If the European monetary union is broken, we would be forced as insurers to continue to invest in narrower limits than in the eurozone," Henri de Castries, chief executive of insurance giant AXA, told German business magazine WirtschaftsWoche.

"But the business would be more expensive for the customer," he says. "And it would be less efficient for us."

Clearly, one option is to hedge out the risk of a collapse in the euro now. But as Douglas McWilliams says: "It is difficult to hedge because it is unclear when you should hedge." That has not stopped the level of euro/sterling hedging increasing rapidly in recent months.

M&C Saatchi's Blackstone believes the fallout of a euro breakup could be contained and managed if its demise was well planned and executed, rather than a gradual decline.

"If the euro was dismantled in a stable way, then traditional hedging could cope. The big question is not whether it happens, but how it happens," he tells Financial Director. "The euro is a political beast and it is politics that will keep it together, or break it up. That would be a large mess – and it's really the mess that would be the greatest worry."

The subsequent difficulty for businesses is in anticipating what would emerge from the wreckage of the euro. Analysts such as Stephen Lewis at Monument Securities see the currency splitting into a "hard" euro area led by Germany and a "soft" euro tilted towards the southern states.

"One can imagine the Czechs feeling that their economy was so tightly meshed with Germany's that it should enter a union with a hard euro," he says. "Others might see themselves better aligned with a soft euro."

Large-scale devaluation

John Whiting, tax policy director at the Chartered Institute of Taxation, thinks a return to 17 different trading regimes would add to problems of accounting for profits and losses within each jurisdiction.

UK companies could also be hit by a devaluation of the currencies that emerge from the ashes of the euro, particularly in low value-added sectors such as textiles and basic materials, says CEBR's McWilliams.

"The currency movements could be very large," says ING's Bright. He sees Spain, Portugal and Ireland devaluing 65 percent against sterling, Italy depreciating 45 percent, France 40 percent and Benelux, Austria and Finland falling 30 percent against the pound.

“If the Italian, Greek, Irish and Spanish currencies fell relative to the UK pound, it would be very difficult for the few remaining clothing producers in the UK, for example. A lot of agricultural products could be imported a lot cheaper as well.”

A recession of the magnitude forecast by ING would impact companies that export to the eurozone as domestic demand crumples. A deep recession combined with a significant appreciation of sterling against the region would see export levels fall massively, possibly in excess of 25 percent.

Jonathan Michael, managing director of JMCL Consulting, which advises clients on procurement, says this would place a huge burden on companies.

“On a practical level, all contracts and agreements would need to be redenominated and massive implementation and reprogramming steps would need to be taken,” he says. FDS should take action now to protect themselves against that twin threat to orders and supply, Michael adds.

Bittersweet schadenfreude

By the same token, overstocking if you are servicing eurozone customers is a danger, as a double-dip recession will suppress demand, while over-reliance on a single supplier is a risk to be avoided by lining up contingent suppliers from outside the eurozone.

Shifting production out of the eurozone to cheaper, less unstable regions may become favourable for many companies at the same time, further accelerating any euro collapse – though that is the point at which some economists see parties including the International Monetary Fund stepping in.

It is worth remembering that there may be gains for UK companies that import as sterling rises – a bittersweet schadenfreude.

“One could argue there’s an opportunity there,” M&C Saatchi’s Blackstone says. “You could say that Spain now has clear labour, and high-quality labour – and you would still have free movement of labour in Europe. Fortunately, we’re sterling and most businesses are set up to be used to a sterling/euro exchange rate of €1.45, so we have quite a margin to go.”

There is also a feeling that, while the future of the single currency is in the balance, no one wants to say anything that tips it towards collapse.

This may explain why many companies and business organisations are not openly addressing the issue. The Institute of Directors (IoD) and the Confederation of British Industry, the leading employers’ organisations, have both stated that while a euro crisis would have major implications for British businesses, they don’t believe it is a pressing policy issue.

“There are serious problems, but I think there is a general sense that if it does break up it won’t be in the next year and that minds are focused elsewhere,” a spokesperson for the IoD tells Financial Director. Many of the FDs this magazine approached to discuss the idea of a euro collapse and its fallout declined to comment, seeing it as purely hypothetical – even

after the Too Big Too Fail years in which institutions no one could have envisaged would fall succumbed with unthinkable speed, and with lasting, global ramifications.

We found one naysayer. Mike Smith, finance director at Irish law firm Eversheds O'Donnell Sweeney, believes the system will survive.

"Whether we like it or not, the euro is embedded in the eurozone and the cost to a country of coming out would be so huge that it could not be worth it," he tells Financial Director.

"I say this as an ex-pat FD now working in the eurozone and in a country that has been tipped to come out of the euro. With the multi-speed economy in Britain, are we in danger of seeing sterling breakup? Perhaps we will see a new currency in Scotland or Wales or Lancashire," he says, tongue only slightly in cheek.

But that does not mean FDs should avoid planning for such a crisis. "Companies should be prepared on both a macro and micro level," says JMCL's Michael.

It could be some time until businesses will know whether Capital Economics' doom-mongering was right. At least this gives companies time to plan for the worst – unless they are too fixated on today's problems to prepare for the potentially much bigger ones of tomorrow.

Permalink: <http://www.financialdirector.co.uk/2268734>
www.financialdirector.co.uk/2268734

This article was printed from the **Financial Director** web site

© Incisive Media Ltd. 2008

Incisive Media Limited, Haymarket House, 28-29 Haymarket, London SW1Y 4RX, is a company registered in the United Kingdom with company registration number 04038503

Close this window to return to the website