The euro crisis and the retail sector

In light of the uncertainty in the eurozone, retailers must watch their investments carefully.

Stefan Niemeier and Eckart Windhagen

In early 2012, McKinsey published an analysis of the euro crisis that detailed and quantified the many benefits of European monetary union and outlined some serious flaws in the eurozone's design and execution.[1] Since then, the threat posed by the crisis appears to have greatly dissipated. The European Central Bank's Long-Term Refinancing Operation has distributed more than €1 trillion in three-year loans to more than 800 banks, providing relief to a beleaguered financial system. The European Stability Mechanism has also provided a lift. European national budgets are on the mend; the total deficits of the five countries generally thought most at risk—Greece, Ireland, Italy, Portugal, and Spain, or the GIIPS countries—have declined from €260 billion in 2010 to an estimated €150 billion in 2012. Europe's politicians have begun to strengthen the union's institutions, for example, by creating the Single Supervisory Mechanism.

Perhaps the best news of all is that the imbalances in Europe's economies—the differences in growth, investment, and wages that are usually addressed by monetary policy but are now beyond the reach of countries within the fiscal union—are beginning to reverse course. The exhibit shows the balance of trade among European countries and their trading partners; the differences in the balance of trade among the GIIPS countries and their northern neighbors are becoming less noticeable.

[1] "The future of the euro: An economic perspective on the eurozone crisis," mckinsey.de, January 2012.

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However, some cracks in the eurozone have only been patched over. While deficits are coming down, total debt levels appear unsustainable. Austerity budgets are not proving as successful as hoped. Our analysis of economic projections from the International Monetary Fund and the latest set of fiscal targets, embodied in the "fiscal compact,"[2] suggests that these targets will be quite difficult for some countries to achieve.

As a result of prolonged uncertainty, investment as a share of GDP has declined sharply; in Italy and Spain, investment is now at the same level as in the mid-1990s. Unemployment continues at record levels, and private consumption is withering. Indeed, many believe that the crisis is now reaching its decisive phase.

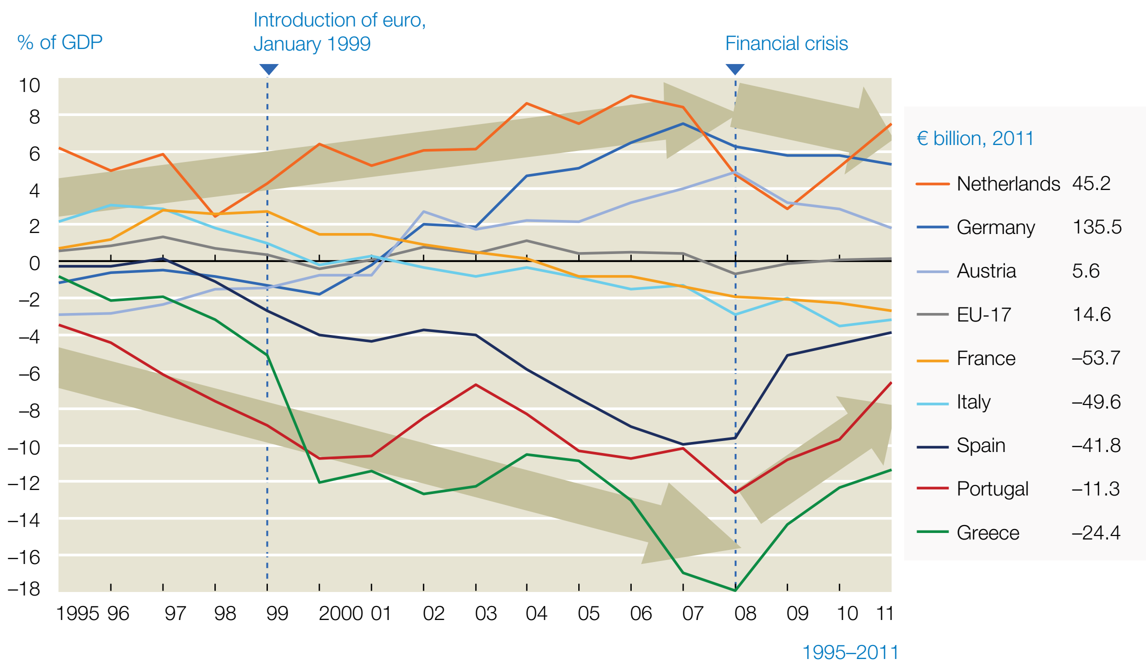
While a number of scenarios are still in play, it appears that some kind of stabilization is most likely. But each nation's path to a stable future—and, consequently, the actions that retailers should take—will vary considerably. In the countries most affected by the crisis, retailers must find a new economic model, as lost revenues cannot be countered adequately by cuts in operating expense: rents are fixed in the medium term, and stores need a minimum number of

[2]The Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union, signed in March 2012 and since ratified by most signatories.

Exhibit

The competitive imbalance between north and south is on the mend.

Current-account balances with the rest of the world,[1] 1995–2011



[1]Net exports of goods and services + net primary income from the rest of the world + net current transfers from the rest of the world.

Source: Annual macroeconomic database of the European Commission's Directorate General for Economic and Financial Affairs; McKinsey analysis

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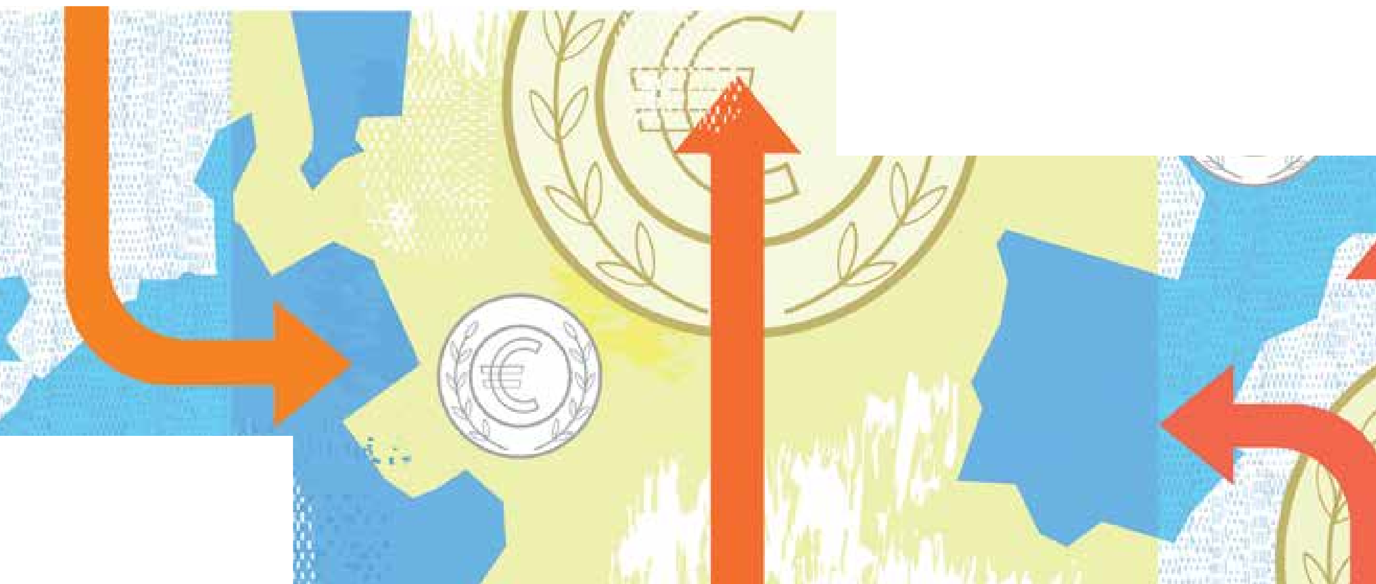

workers to operate. Given these conditions, retailers face some serious questions. Should a multicountry retailer pull out, difficult though this might be because of long-term leases? Should it perhaps sell a majority stake to a local entrepreneur, with options to later sell the rest or buy it back? If it chooses to stay, what can it do to benefit from the "down trading" that pinched customers now practice? Can it attract those customers by changing its assortment mix or by expanding its private-label offerings in lower price points? Can it selectively downsize the store network and shift sales from the shuttered stores to its online channel?

Less affected countries face a long but more assured path to recovery. But consumer spending may not drive top-line growth in the near future.

In these circumstances, retailers must consider questions such as how to win in a stagnating market while contending with the ongoing shift from physical to online retail. To what extent should they redirect capital expenditure away from expansion or refurbishment of the physical-store network to digital channels? Do they have the right balance of capital expenditure (that is, long-term bets) and operating expenditure (which provides shorter-term agility)?

In every eurozone country, two concerns are paramount. First, consider the risks associated with the supply chain. Nonfood retailers source a significant part of their goods from outside the eurozone and thus are exposed to significant exchange-rate risks. Second, this uncertainty and the current volatility in exchange rates call for a clear strategy on whether and how to hedge this risk.

Hope for the best but prepare for the worst: that's sage advice at any time, and especially when the stakes are as high as they are in the eurozone. A good way to start thinking about the issues is with a boardroom discussion, followed by a series of scenario-based planning sessions that use the company's cash flows, product movements, and relationships to generate an understanding of the precise implications for the company in every scenario.

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