

COMMENTARY

# Why deflation is good news for Europe

by Daniel Gros

**I**n today's global economy, there is no price as important as that of crude oil. More than 80 million barrels are produced (and consumed) daily, and a large part of that output is traded internationally. Thus, the sharp fall in the crude-oil price – from about US\$110 last year to around US\$60 today – is yielding hundreds of billions of dollars in savings for oil importers. For the European Union and the United States, the gain from that decline is worth about 2-3 per cent of GDP.

For Europe, the benefits of cheap oil might grow over time, because long-term gas-supply contracts are to a significant degree indexed to the oil price. This represents another advantage for Europe, where prices for natural gas were, until recently, several times higher than in the US, which had been benefiting from lower-cost shale energy.

But many observers have argued that cheap oil also has a downside, because it exacerbates deflationary tendencies in the advanced countries, which already seem to be mired in a low-growth trap. The sharp fall in oil prices, ac-

ording to this view, will make it even harder for these countries' central banks to achieve the 2 per cent annual inflation rate that most have targeted in fulfilling their price-stability mandate.

The eurozone, in particular, seems to be in danger, as prices are now falling for the first time since 2009. This deflation is bad, it is argued, because it makes it harder for debtors, especially in the troubled economies of the eurozone's periphery (Greece, Ireland, Italy, Portugal, and Spain), to pay what they owe.

But this fear is unfounded, because it is based on a misunderstanding. What matters for debt-service capacity is the debtors' income, not the general price level.

As oil prices fall, households' real (inflation-adjusted) income should rise, because they do not have to spend as much on fuel and heating. Lower oil prices make life easier, not harder, for highly indebted households in the US or the eurozone periphery. Falling consumer prices should thus be viewed as a good sign.

Most manufacturing enterprises will also benefit from lower energy costs, improving

their ability to service their debts. This, too, is particularly relevant in the eurozone periphery, where the non-financial sector accumulated too much debt during the credit boom that preceded the 2008 global financial crisis. Moreover, though most of the savings implied by lower energy costs might initially show up in higher profits, over time, competition will force companies to pass on some of these windfall gains in the form of lower prices or higher wages.

This is another important consequence of cheap oil: lower prices make it more difficult to judge the point at which wage pressure becomes inflationary. Because wages can increase to a greater extent without fuelling inflation, the US Federal Reserve Board might be inclined to delay hiking interest rates, which it is now widely expected to do this summer.

Public finances should also benefit from the deflation engendered by lower oil prices. Government revenues depend on the value of domestic output, not only consumption. Though lower oil prices depress consumer prices, they should boost production and overall GDP.

Absent large price changes for raw materials,

the consumer price index evolves along with the GDP deflator (the price deflator for the entire economy). But that will not be true this year, because consumer prices are falling, whereas the GDP deflator (and nominal GDP) is still increasing. This should lead to solid government revenues, which is good news for highly indebted governments throughout the industrialised world, but particularly for the eurozone periphery.

The fall in (consumer) prices that the eurozone is experiencing should thus be seen as a positive development for all energy importers. The eurozone periphery, in particular, can look forward to an ideal combination of low interest rates, a favourable euro exchange rate, and a boost in real incomes as a result of cheap oil. In a deflationary environment, lower oil prices appear to make it more difficult for the European Central Bank to achieve its target of an inflation rate close to 2 per cent. In reality, lower oil prices represent a boon for Europe – especially for its most beleaguered nations. PROJECT SYNDICATE

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The southern German town of Konstanz. If the German government has a mission or a vision, then it is to do its part to ready Europe for the 21st century. PHOTO: REUTERS

## The eurozone crisis: Why Germany insists on structural reforms

By Klaus F Zimmermann

**I**n the global debate about the Eurozone crisis, Germany has come in for a lot of criticism. The German position has been described as engaging in a "morality tale" (aimed at forcing other countries to pay back their debts). Alternatively, it is regarded as a display of "nationalism" (by just pursuing narrow Germany's interests) – if not as practising "hegemony" (by seeking to impose a German model onto the rest of Europe).

I am struck by how much these descriptions – juicy as they are in purely journalistic terms – miss what really drives the German government. To see what the real driving force is, just ask yourself this question: Why do Germans talk so much about the need for structural reforms in Europe?

German policymakers are painfully aware that, among the advanced economies, there is one major country where structural reforms – such a touchy matter in Europe – really are not a political issue. That country is the United States.

The US has the immeasurable advantage that embracing change on an ongoing basis is simply built into its national DNA. Nobody there is asking for permission to engage in it. Change is simply happening all the time. Much of the same is true in many of the dynamic emerging markets, especially in Asia. But like it or not, those are realities Europe has to contend with.

Next, ask yourself why Germany is so insistent on pursuing structural reforms in Europe. Because without them, Europe's mostly ageing societies are going to be woefully unprepared for the future. That would have a definite negative impact on Europe's growth in the future.

This explains why, from the German perspective, the current battle over Europe's economic future is not at all about Greece. Nor is it about the debt issue or "austerity". The underlying challenge is much larger than reform issues in one small country or implementing proper budgetary controls.

Rather, it is about how to make Europe's economies more flexible – via structural reforms. If the German government has a mission or a vision, then it is to do its part to ready Europe for the 21st century.

A key ingredient in that regard is the need to reduce the public sector's share of national GDP. That, too, is a task that is adopted in direct response to considering the US economic model and in view of the challenge from Asia.

Of course, none of these reforms can be formulated or applied in any cookie cutter fashion. Every country has its own peculiar mix of legacy issues to contend with (notably including Germany, which must continue on its own reform path).

Accordingly, contrary to an oft-heard argument in the international debate, very few decision makers in Germany actually think that other countries ought to apply "the German model".

What is relevant about the German experi-

ence is the political dimension: If the continent's largest economy has accepted the need for reforms (and acted on it), then it is wise for all of its European partner nations to do the same. The good news is that many have done so.

It is also appropriate for Germany to be clear about expressing the need for those nations who lag behind in the effort to do their homework – just as other nations point to Germany's weaknesses. Everybody needs constructive criticism and use it as motivation. The alternative, putting one's head into the sand by sticking mindlessly to ways of managing an economy that are plainly out of whack, is a recipe for disaster.

Advocating for the need for change in Europe due to global realities is the very antithesis of nationalism. Doing so also has nothing to do with any hegemonic attitude on the part of Germany. If anything, it is leadership by example. And it certainly is no morality tale. It simply is the reality in which Europe has to operate – now that we have a truly global economy.

None of that means making short shrift of the balanced social model Europeans have come to appreciate. For example, Germany's approach to codetermination in industry – that is, involving the workforce in management decisions – has proven to be a pro-competitive force. Crucially, it has made German companies more nimble in reacting to global circumstances.

In conclusion, the German government's focus is neither on "Germanising" the rest of Europe nor is it on "Americanising" or, for that matter, "Asianising" it.

Given that rigid labour market structures mainly hurt the young generations, EU member governments have the clearest – and democratically legitimised – incentive imaginable to shape up. Breaking up those outdated structures is nothing that is to be done "for the Germans" – but first and foremost for these nations' own sake, especially to improve the lot of young people in the crisis countries.

For that to happen, the key issue is to unravel the sweetheart deals among favoured groups in society (usually older, usually from the establishment) that are no longer affordable. Nations who fight necessary change do so at their own peril.

Succeeding in that battle is the best way to ensure that Europe has a common, prosperous future and is positioned to contribute its share to global growth in decades to come.

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# Loss of market confidence here – just look at cases such as Sino Construction

The question is not why the company's share price recently collapsed – but why it has taken so long. Are there more such cases to come? BY MAK YUEN TEEN

**O**n March 2, Sino Construction's share price closed about 15 cents down from its previous trading day's closing price of 26.5 cents on Feb 27 – a fall of 55.8 per cent. The following day, its share price halved again to close at six cents. By March 9, its share price had fallen to 5.4 cents – a total fall of about 80 per cent over just six trading days.

I have been following developments at Sino Construction since Feb 5 when I was alerted to a clarification issued by the company. The clarification was in response to a query from the Singapore Exchange (SGX) that certain information about the company which appeared in a Business Times article the previous day ("Sino Construction unit in renewable energy venture", Feb 4) had not been previously announced or disclosed.

In its response, the company said: "The statement that 'To date, more than 150 sites have been identified as commercially viable for the project' in South Korea, was not made by the Company or persons authorised by the Company."

"The quote in the article stating that 'the company plans to work with the South Korean government on a long-term fixed price contract for power produced out of its biofuel power plant' was incorrectly attributed to the Company's non-executive chairman, Mr Andy Chee. Mr Chee did not make this statement."

My curiosity was piqued when I learnt that on Nov 19, 2014, the company had issued a rather similar clarification of another BT article ("Sino Construction turning itself into a global coal resource player", Nov 19), again in response to an SGX query that certain statements attributed to its non-executive chairman had not been previously announced or disclosed.

### SIMILAR INCIDENTS

In this clarification, it referred to the statements that were correctly attributed to the chairman and added: "The rest of the comments in the Article, whether related to the Company or not, were not made by the Company or persons involved in the management of the Company."

It is, of course, possible for a news report to get the facts wrong or make an incorrect attribution, but I was surprised that two such similar incidents had occurred. I wondered about the source of the information that the company was now distancing itself from. If that information did not come from the company, its chairman or someone authorised by the company, where did the report obtain the information from?

As I looked at the company's announcements, I found that it had a remarkable number of queries from SGX – at least 16 queries from March 2014 till now – relating to unusual trading activity, media reports, disclosures and announcements.

Something appears to be amiss with the company.

Sino Construction also had a raft of senior management and board changes over a short period of time, and a board profile that, to me, was unusual given the company's business. Sino Construction's main business is building construction and civil engineering, conducted through key subsidiaries based in China.

On Feb 9, the company announced the appointment of a new executive director, the 40-year-old Drew Ethan Madacsi. The new executive director was a resident of South Africa, whose recent experience was in private consultancy involving "varying senior management functions over

varied industries included retail, maritime, mining and strategic planning" and some specific experience in the coal industry. Mr Madacsi was considered by the board to be suitable because he has the requisite experience in the minerals and resources markets.

The announcement also stated that Mr Madacsi has no prior experience as a director of a listed company although the company reassured the market that it "will arrange for Mr Madacsi to attend seminars and courses conducted by the Singapore Institute of Directors on the roles and responsibilities of a director of a listed company".

Then on Feb 18, the company announced that its other executive director, Lim Tiong Hian (who was appointed only in June 2014) and its non-executive chairman Andy Chee (who was appointed as a director only in May 2014), had both resigned "due to other personal commitments".

### SOLE EXEC DIRECTOR

Before Mr Madacsi had the chance to attend those seminars and courses, he suddenly found himself as the sole executive director. The rest of the board now consists of three independent directors, none of whom appear to have experience in the business. One is the chief financial officer of a Malaysian listed company whose main business is the provision of telecommunications network services. Another is the chief executive officer of a consulting firm specialising in training and coaching. The third is a principal consultant and managing partner of a boutique agency specialising in public relations and communications – somewhat ironic considering the issues that the company was having with its disclosures and media reports.

In November 2014, William Joseph Condon, a non-executive director, had resigned "due to other personal commitments". Mr Condon, who was an executive director until June 2014, had been appointed to the company only on Dec 16, 2013.

In March 2014, the executive director who preceded Mr Condon relinquished his role to oversee the group's operations in China. That same month, its 31-year old financial controller had resigned "to pursue other career opportunities". By now, one would think that investors would have rushed for the emergency exit. However, the market did not blink, as its share price remained unchanged at 28 cents with the latest departures of the executive director and non-executive chairman.

Then came more bad news. On Saturday, Feb 28, at 12.04 am, the company issued an announcement containing the double whammy of a "profit guidance" indicating an expected loss for FY2014 and an extension of time to release its unaudited results for FY2014. One of the reasons given for the extension of time was that the company's management team and executive directors who were responsible for FY2014 had left, and as Mr Madacsi was new, he needed to become acquainted with and to finalise the financial statements. There appears to be no proper handover and no proper systems in place. Well-governed companies do not scramble to get their financial statements in order when there is senior management turnover. This latest announcement triggered the collapse in the company's share price.

Sino Construction's troubles actually started much earlier. In February 2014, it had announced that it had recorded losses for three consecutive financial years. In December 2013, two of its independent directors had resigned. This followed the earlier resignation of another independent direc-

tor in February 2013. This means that all the current independent directors are relatively new to the company. It also had disclaimers of opinion from its external auditors Ernst & Young for FY2012 and FY2013, a change of external auditors (to Moore Stephens), delays in holding of AGMs, discrepancies between audited and unaudited results, and repeated queries. The financial controller who resigned in March 2014 had actually already resigned in February 2013 according to its announcement (but the earlier resignation had obviously been withdrawn).

This was also not the first time that Sino Construction's share price had taken a big hit. A BT article on April 4, 2014, ("Sunshine beyond penny lane") reported that the company had been queried by SGX after its share price fell 39 per cent, apparently as part of a general tumble in penny stocks. This broad fall in penny stocks apparently followed the announcement earlier that week about an investigation by the Commercial Affairs Department (CAD) involving at least seven companies and 11 individuals on suspected trading irregularities in the shares of Asiasons Capital, Blumont Group and LionGold in October 2013. The plunge in share price occurred despite the report saying that "there was no apparent link between Sino Construction and the companies involved in the investigations". One trader was quoted as saying that "the sharp drop sparked unfounded speculation about possible ties to the investigation subjects".

The latest executive director, Mr Madacsi, has in the past weeks been trying his best to put on a brave front. He reportedly said that he was "unfazed by the fresh plunge in share prices", that it was "simply a knee-jerk reaction", that "structurally, nothing in the company has changed", and that "honestly, I can't be worried about what the stock is doing on a daily basis". ("Sino Construction dives after profit warning", BT, March 3). When the share price took a further hit, he told BT ("Sino Construction shares takes another hard knock", March 4) that he "continues to be unfazed by the plunge in the company's share price" and that "those simply not interested in the long-term growth of the company will take differing views". Given the litany of problems in the company, the reaction was far from "knee-jerk" – if anything, it was long overdue. The latest loss and the delay in reporting just confirmed to the market that the company is in a mess.

### STRATEGIC ALIGNMENT

The company wasted little time in unveiling its "FY2015 growth strategy" on March 4, which involves a "strategic realignment for growth". This "strategic realignment" involves "returning to the company's core competency in construction while moving up the value chain to asset ownership and energy generation" and "repositioning the Company's interests in the commodities sector". The market was unconvinced, as the share price continued to fall.

The question in Sino Construction's case is not why the share price recently collapsed – but why it has taken so long. If stakeholders are wondering why there is a loss of market confidence here, they need to look no further than at cases such as Sino Construction. Investors must be concerned as to whether there are more such cases to come.

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