THE EURO: HOW IT IS EFFECTING INTERNATIONAL BUSINESS

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ABSTRACT

On January 1, 2002, a new currency was introduced in 12 European countries. The new common currency was to make trade among countries easier and was to improve the economic conditions of these countries. Has the Euro lived up to its promise? Are companies finding it easier to engage in international trade? This paper explores the costs, benefits, and promises of the Euro. It includes interviews with four European business people to gain their perspective on the effect of the Euro 18 months after its introduction.

INTRODUCTION

Researchers, business people, and economists predicted that the monetary union of twelve European countries would have a significant impact on international business in Europe and around the world. This single market brings together 300 million consumers [11] and the 15 countries have a combined GDP of $7.8 trillion, annual exports of $857 billion, and imports of $938 billion [9]. How have companies reacted to this market and new currency? One survey found that only two-thirds of large European businesses had developed a strategy to adapt to the new market while most small business had devoted little management time to even consider the effects of this new market [11]. Numerous benefits of a common currency have been identified and include lower costs, decreased currency exchange risks, and increased penetration in markets. However, costs include new wage bargaining structures, increased competition, and the potential for decreased profits. What has actually happened in the international business environment since January 1, 2002?

This paper identifies the costs and benefits of the Euro to businesses, summarizes the impact on United Kingdom and United States companies, and includes interviews with four European business people and their first hand experience with the Euro.

BENEFITS AND COSTS OF THE EURO

Companies should realize savings from decreased costs in exchanging currencies and hedging costs and eliminating exchange rate uncertainty. The European Commission has estimated that costs savings could be 0.4%-0.5% of the EU GDP per year [5] [11]. Also, reduction of the exchange rate risk should result in lower real interest rates which will lower the cost of investment. The EU Commission estimates a total savings of 0.7%-1% of EU GDP per year [11].

A common currency will result in price transparency among consumer goods as it will be easier to compare prices of products throughout the European Union to determine the best place (country) to buy. Increased competition leads to lower prices, lower information costs, and savings to European consumers [5] [6] [11]. However, the EU Commission estimates that savings may only be 0.3% of EU GDP per year [11]. An increase in trade and sales will allow companies to reposition products through global branding, increase advertising to achieve brand differentiation, restructure pricing structures, or re-package products to change quantity or volume [11]. Lower prices will force managers to identify ways to reduce costs, thus improving efficiencies. It is expected that smaller companies will have greater competition from larger companies and may be subject to hostile takeovers [11].

It is possible that a change in financing and investment opportunities may occur. Traditionally, European companies rely on bank loans for financing. Monetary union will open new opportunities for corporate financing and make it easier for investors to diversify their risk into other markets resulting in a lower cost of capital [5] [6] [11]. There is even some speculation that the Euro may develop into a strong, or preferred, reserve currency [6] [9].

A major cost of the common currency market is the loss of national economic policy tools. The Maastricht Treaty established the European Central Bank (ECB) in Frankfort that is to be independent and objective. However, its main instrument is setting interest rates and it is questionable if this tool will be sufficient [5] [11]. Monetary policy will affect each EU country differently due to differences in borrowing rates, taxes, local economies, business cycles, and wage rates. There is concern that changes in monetary policy may double the size of national recessions [11].

Greater labor mobility and more wage/price flexibility were expected after the introduction of a single currency. However, wage rigidity is prevalent in European countries and labor mobility is three times lower in Europe than it is in the United States. Labor mobility between countries remains low because of language barriers, cultural differences, and non-recognition of qualifications [11]. Although the development of European-wide collective bargaining is encouraged by the EU Commission, it may be limited to certain groups of workers that possess desired skills or highly mobile labor such as managers, construction workers, and younger workers. European-wide collective bargaining would allow workers more opportunity to harmonize non-wage terms such as training and promotions [11]. Wage differentials will be more transparent thus pressuring companies and governments for more wage convergence. Already wages in Spain and Italy have substantially increased between 1970 and 1990. This could result in inflation and increased unemployment [11].

Finally, there is concern that a common monetary market and greater European governance will erode national differences of language, culture, cuisine, and people. In an attempt to maintain cultural heritages, Regulation #1 of the European Union states that the official language of each member country will be accepted as a working language in all EU institutions. Today there are eleven official languages and the EU employs about 4,000 full time interpreters [9].

EFFECTS OF THE EURO ON U.K. AND U.S. BUSINESS

The United Kingdom has chosen not to adopt the Euro at this time and the European Union is a major market for many United States businesses. What affect has the new currency had on businesses in these two major world powers?

United Kingdom banks charge a fee to businesses to convert Pounds for Euro, thus putting U.K. business at a disadvantage compared to their EU counterparts. Also, businesses must absorb the currency exchange risk that their EU competitors no longer have to deal with for intra-EU transactions. The tourist industry has already experienced the disadvantages of visitors having to pay the costs of exchanging currency and this can deter visitors to the U.K. The United Kingdom is experiencing higher interest rates than countries in the euro-zone which has brought on a recession in the manufacturing and agriculture sectors [10].

United States' firms are finding it easier to sell and source products in Europe, but only if they are prepared to deal in Euros. European businesses are pressuring both U.K. and U.S. suppliers to present their bills in Euros and assume the currency exchange risk [2] [6] [10]. In addition, firms may be requested to also provide price lists and quotes in Euro.

Firms in both countries are adopting dual accounting systems for trading in their national currency and the Euro. This has increased administrative costs in firms [10]. There is also a call for companies to review their operations to insure that they can fulfill legal and tax obligations in Euros [8]. It may be necessary for firms to consider setting up Euro-denominated bank accounts for receiving revenues and paying expenses in Euros. Companies may also consider expanding their European operations by moving some administrative duties to the EU [2].

On the bright side, a new single and very large economy opens many new opportunities for American companies. This is a good time for small and medium sized business to increase their presence in the EU. It is also a good time for large companies to expand. During the year 2000, more mergers and acquisitions took place in the EU than in the U.S. [8].

THE EURO IN 2003 AND BEYOND

What is the reality of dealing with a new common currency on a daily basis? Interviews with four European business people provide some insight.

Gondoliers in Venice, Italy belong to a union. This means that prices charged for gondolier rides are the same throughout the city. However, each Gondolier works as an independent business person and is dependent on his ability to sell rides to tourists in order to earn revenues. In interviewing one Gondolier, he indicated that on a daily basis using the Euro was easier to set prices. However, there is a high level of concern that differing economic policies among EU countries could create problems for local economies and local citizens.

Glass-blowing is specialty industry found on the island of Maurano in Italy. In an interview with a sales clerk at a glass-blowing factory, it was discovered that for many of the people of Italy the price of commodity products has increased. He indicated that local people often pay twice the price for products than they did when using the Lira. This indicates that although prices for goods may have become more equal throughout the EU, it is not always possible or sensible for consumers to buy from the country with the lowest prices.

Sonja is an independent jewelry designer and has her own store in Berlin, Germany. She purchases glass beads and glass supplies from companies in Italy and has found the prices for materials have increased substantially since the introduction of the Euro. She indicated that it is much easier to conduct business throughout Europe now, but prices of consumer products and the cost of living has increased. Sonja stated that the independent merchants in Berlin took the opportunity to raise prices of products when they converted from the Deutsche Mark to the Euro. Thus, prices may be inflated which has not helped the local economy in Berlin.

Dimitri is a Tour Director in Greece. He owned a restaurant on the island of Samos for seven years and then moved to Athens and trained to be a tour guide/director. He has found that since the conversion to the Euro last year, prices of local goods have risen, however wages have not increased by the same amount. Dimitri also stated that Greece and some of the other smaller EU countries have benefited greatly from the EU governance and the Euro. Money for many projects such as roads and hospitals has come to Greece from the larger EU countries. Many of the improvements have improved the quality of life -- better health care and easier access to parts of the country -- for the Greeks.

The Euro has not maintained a stable exchange rate with the dollar since its introduction. In January 1999, the value of 1 Euro = $1.17. In November 1999, 1 Euro = $1; in the fall of 2000, 0.885 Euro = $1; in June 2002, 1 Euro = 1$; and by June 2003, 1 Euro = $1.20. What is the effect of this most recent increase in the strength of the Euro to the Dollar? First, many EU exporters are losing market share in some world markets because the price of EU products has increased [1] and many EU businesses are experiencing a decrease in sales revenue [4]. Second, many foreign investors are concerned about the U.S. current account deficit. Analysts indicate that European investors pulled $70 billion out of U.S. assets in the past year. It is expected that the Euro will remain strong through 2004 [4]. Third, the cost of oil and other commodities priced in dollars is lower which gives European consumers more money to spend on other goods which helps local retailers [4]. Other effects from the strong Euro include reduced carry costs of dollar-based debt, lower inflation, and lower interest rates. However, companies may have had to fire workers to decrease costs in order to stay competitive and EU politicians may have to cut social spending [4].

Thirteen new member countries are in the application stage of being added to the European Union. These countries are: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria, Malta, Cyprus, and Turkey. It is expected that ten of the countries will be admitted as members prior to the European Parliament elections of 2004. There is concern that these new members could derail some of the gains made in Western Europe with the expected transfers of funding from Western European countries to the new applicant countries. Eastern European countries must meet the same criteria to enter the EU as the current 15 countries met. This means that each country must prove that they have met interest rate, inflation rate, budget deficit, and national debt criteria along with the development of a functioning market economy, laws regarding competition and human rights, and private ownership of business [3]. There are a number of benefits to expanding the EU: Peace and stability throughout Europe will provide greater security to all people; the addition of 100 million people to the marketplace will provide numerous opportunities to business; improved quality of life for citizens, especially in the Central and Eastern European countries; enrichment of cultural diversity and ideas; and a strengthening of the European Union's role in world affairs. It is expected that economic gains for the current EU members would be 10 billion Euros and new members would experience a 23 billion Euro gain in their economies. In addition, GDP growth for new members would be 1.3% to 2.1% and existing member countries would experience 0.7% growth in GDP [3].

REFERENCES (Available upon request)