

The Great Leveler?

EMU and the Localization Industry

by Robin Bonthron, Fry & Bonthron Partnerschaft

The European Union's programme for implementing Economic and Monetary Union (EMU), often referred to simply as European Monetary Union, is likely to be the single most momentous economic event in post-war Europe. It will also have a direct impact on the global economy as a whole, and its effects will inevitably be felt most in those industries which depend on cross-border sales of goods and services, including the localization and language services sectors and their commercial and industrial customers. After assessing the current state of transition to EMU, this article looks at some of the most pressing problems which will face service providers and hardware and software manufacturers.

The current state of play

Despite the current tensions surrounding the timetable for the implementation of EMU, there can be little doubt that it will actually happen, and probably even on schedule. There are certainly serious reservations about which countries will qualify for membership of the euro area. In addition, a debate is raging about whether the eligibility criteria will have to be relaxed in one form or another to ensure that certain countries will be able to join.

One of the great ironies of EMU is that many of the countries which have been pressing strongly for EMU still do not meet all the criteria for membership: according to IMF forecasts for 1997, debt will only remain below the benchmark 60% of GDP in Luxembourg, Finland and the UK (and possibly France), while it will be more than double this figure in Belgium and Italy, two of the strongest backers of the drive towards EMU. With Italy's budget deficit forecast by the European Commission to climb to 3.9% of GDP in 1998, it will also fail another of the key Maastricht criteria (maximum 3% ceiling). France and Germany, too, are unlikely to meet the formal 3% deficit target, with French authorities forecasting a deficit of 3.4 - 3.6% in 1997, and the German figure likely to be within a similar range.

Recent statements by members of the new French government have only added to this insecurity, with premier Jospin arguing that when it comes to deciding which countries will join EMU in the first wave, political considerations should take priority over the agreements forged in the Maastricht treaty. This has reinforced fears that the original concept of a European Central Bank (ECB) monetary policy, governed by the Bundesbank's strict anti-inflationary stance, will be subordinated to political expediency, resulting in a "Camembert" currency (a euro as soft and runny as the French cheese...). However, it is only fair to point out that—apart from austerity measures leading to serious social unrest—the state of public finances which the Jospin government has inherited leaves little room for manoeuvre.

However, despite this well publicized confusion about the implementation of EMU, the entrenched positions of hard-line monetarists and the pre-election pledges of populist

politicians, the chances of EMU being postponed—or even dropped altogether—are now very remote. Too much political capital is at stake, and EMU is above all a political goal. The economic mechanisms necessary for its implementation are at all times secondary to the political will of the governments involved and the European Commission.

EMU Stage 3		
Phase A Starts 1998	Phase B 1 January 1999	Phase C 1 January 2002
<ul style="list-style-type: none"> • Confirmation of the start date: 1 January 1999 	<ul style="list-style-type: none"> • Final fixing of the conversion rates for the participating currencies 	<ul style="list-style-type: none"> • Introduction of euro banknotes and coins
<ul style="list-style-type: none"> • Decision in May 1998 on which countries will participate in EMU 	<ul style="list-style-type: none"> • Introduction of the euro in the banking sector (euro as "book money") 	<ul style="list-style-type: none"> • Withdrawal of national notes and coins
<ul style="list-style-type: none"> • Establishment of the European Central Bank 	<ul style="list-style-type: none"> • Bank transactions between companies possible in euro 	<ul style="list-style-type: none"> • Cash in euro
<ul style="list-style-type: none"> • Enactment of the implementing legislation 	<ul style="list-style-type: none"> • Euro is voluntary 	<ul style="list-style-type: none"> • Euro is compulsory

Figure 1: The Schedule for the Euro

On the basis of this assumption that EMU will happen as agreed in Maastricht and the subsequent EU summits, this article now looks firstly at some of the macroeconomic ramifications for Europe as a whole, and then examines the impact of EMU on the localization and language services sectors both within and outside Europe.

The Euro as an Anchor Currency

Stage 3B of EMU starts on 1 January 1999. On this date, the conversion rates for the participating currencies will be locked irrevocably and the euro will become a currency in its own right. Although euro notes and coin will not be introduced until 2002 (at the latest), the euro will start to be used immediately as a "book currency" in the banking system, and many businesses will use the euro as a parallel currency for accounting and billing purposes. This could have serious repercussions, which are discussed below.

The economic impact of EMU on the participating economies is more difficult to forecast: the potential risks involved are just as great as the potential benefits, and failure could result in an economic disaster of almost unthinkable proportions. Given the amount of political will that has been invested in EMU, however, and bearing in mind the billions which have already been spent by central and private-sector banks, as well as by commerce and industry in Europe, even the gloomiest pessimists must admit that the chances of a disaster being allowed to happen are slight.

One of the most important goals of EMU is to complete the transition to a single market for goods and services of all kinds in Europe, eliminating the residual exchange rate risk which still exists. The result will be an extremely powerful economic block (much more powerful than the fragmented and volatile status of the European Union today), whose currency will eventually rival the dollar as a major reserve currency. This will have a substantial—and surely beneficial—effect on the countries surrounding the euro area. It will increase the internal pressure on the "pre-ins", first and foremost the UK, Denmark and Sweden, to join EMU as soon as their economies and domestic politics will allow. (Although the new British government is cautiously favorable towards EMU, it too has recognized the fact that the UK economy is around two years out of sync with the other mainstream European economies, and that to join before a greater degree of convergence has occurred would put the British economy at a serious disadvantage.)

The effect of EMU on other neighboring economies will be just as great. Non-EU members such as Norway and Switzerland will start to see the euro being used as a parallel currency, a trend which is likely to be even more pronounced in the countries of Central and Eastern Europe. Here, the creeping dollarization of some economies will be reversed, and the local currencies will be pegged to the euro (in the same way that the Czech authorities recently switched from a dollar benchmark to the Deutsche Mark). Taken together with the ambitions of many of these countries to join an enlarged European Union as soon as possible, this development will be a further factor contributing to the rise of the euro as a third "global" currency (along with the dollar and the yen) used not only for trading, but also for fixing cross rates in foreign exchange operations.

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The consequences are far-reaching: whether your company is operating within the euro economy or selling into it from outside, you will probably need to start pricing your goods and services in euro, particularly if you are selling to other businesses. To put it into its simplest terms, quoting prices in euro will give your company an edge over competitors using national currency pricing (e.g. dollars). Apart from the cost factor, however, this will pose a number of crucial pricing questions (discussed below) which will have to be solved at the latest before Stage 3B of EMU takes effect on 1 January 1999.

The Cost of EMU

The introduction of the euro as a book currency on 1 January 1999 means that for financial and business-to-business transactions, many companies in the euro area will quickly adopt the euro as a parallel currency to their own local currency. One of the arguments put forward by proponents of EMU is that this will reduce transaction costs, but the overall cost savings will not necessarily be immediately apparent.

Firstly, the need to maintain accounts in parallel currencies will necessary increase accounting and administration costs, especially as most public-sector agencies (including tax authorities) are unlikely to switch to euro-based accounting until the last possible moment. The cost of constantly converting into and out of euro, for instance

bank charges, must also be taken into account. Secondly, major expense items (for example payroll accounting) will still be denominated in the local currency, and companies will only really benefit from a euro-based economy if they conduct substantial cross-border transactions within the euro area. However, the fact that many companies (especially, but not exclusively the larger ones) will switch to a parallel accounting system will force their suppliers to follow suit, regardless of where they are based.

As far as software is concerned, the cost of EMU goes further than converting accounting, cash management, sales and inventory management systems (a process which most major business software vendors have already initiated). Manufacturers of standard office solutions will also have to develop patches for their localized European software, and the euro symbol (reproduced in the box below) will have to be added to the character set repertoire. Much legacy financial data will also have to be converted.

The Pricing Dilemma

It is in the area of pricing goods and services that the problems of EMU become more fundamental for the individual company, or even business-critical. A number of factors are involved here, including conversion, rounding and truncation, price thresholds and price transparency.

Conversion, rounding and truncation

The national currencies will be converted into euro at a fixed rate using six significant figures, for example EUR 1 = DEM 1.90342 or ITL 1,911.24. These conversion rates may not be rounded (up) or truncated (down), and there will no inverse rates (e.g. DEM->ITL) derived from the conversion rates. Instead, conversions from one national currency into another ("cross rates") will first be converted into euro. This euro amount must be rounded to not less than three decimals, and is then converted into the other national currency. Here is an example of converting ITL 100,000 into DEM, based on recent ECU rates:

ITL 1,911.24 = EUR 1
ITL 100,000 = EUR 52.322053
rounded to 52.322
DEM 1.89342 = EUR 1
DEM 99.067521 = EUR 52.322
ITL 100,000 = DEM 99.07

Price thresholds

For market pricing purposes, rounding is supposed to follow standard commercial practice, but this may not always be feasible or desirable. Take the example of the DEM/EUR rate shown above, and suppose that the DEM price quoted for a localization job is DEM 63,500. Applying the "six significant figures" rule, this gives a euro price of EUR 33,537.197. However, prices for large contracts are commonly quoted in even amounts, normally multiples of 100 or 1,000. These figures represent psychological price thresholds. In the retail trade, they are reflected in the "1.99" or "15.49" prices commonly seen for dollars, DEM, FRF, GBP, etc. In our example, however, cutting the euro price to a straight 33,500 represents a loss of EUR 37.197 or around DEM 70.43. While this may be a small sum in itself, spread over a year's sales it could make a not insignificant dent in a company's income.

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The alternative is to round up the price to 33,550 or even 33,600. Either way, this represents a hidden price increase—however minor—which is unlikely to escape the customer's attention. Balancing the need to avoid euro conversion losses on the one hand, and to present "attractive" prices on the other, could be a serious headache for localization and language service providers. The situation is even more critical where smaller jobs or pricing units are concerned, for example a line price of DEM 2.50 or a word price of DEM 0.30. These translate into EUR 1.320362 and 0.1584434 respectively. While it might be possible to round up the latter to EUR 0.16/word, there would probably be pressure from the customer to round down the line price to EUR 1.30, representing an effective EUR 0.02 or 1.54% price cut. Applied to an annual sales volume of DEM 1 million, this means a shortfall of DEM 15,400, normally not enough to cause serious liquidity problems, but painful nonetheless.

There are no quick solutions to this problem, and conflict is bound to arise between vendors wishing to round prices up, and customers insisting on the opposite. One thing is clear, though: for companies operating on tight net margins (e.g. 5% or less), even a minor change in real sales revenue can have a disproportionate impact.

Price transparency

Writing in the Financial Times, Wolfgang Münchau argues that: "A single currency will make prices not just comparable across nations, but also more transparent. It will mean a far greater degree of price arbitrage across the EU...". It is clear that the price transparency resulting from EMU will affect both localization service providers and hardware and software manufacturers.

Service providers selling exclusively within a national market stand to lose most from EMU, as they will face all the expense of introducing the euro, but be unable to reap the benefits from lower cross-border transaction costs. In addition, they will face even greater price competition from other countries in the euro area. They will only be able to retain their market share by deepening their degree of specialization and/or expanding the range of services on offer. If they are unable or unwilling to do this, they could well be among the many SME casualties of EMU predicted by economists.

One of the current myths in certain parts of the language services industry is that price is not an issue at the high end of the market. Comfortable though such thoughts may be, they are remote from market realities, and service providers betting on them could well see EMU turn into a nightmare. However, as national economies converge, independent language service providers with competitively priced cross-border activities should gain from the introduction of the single currency and the accelerating commoditization of language services.



Selected resources

Useful Web-based information on EMU and the euro is available at the following sites:

*Bank of England: <http://www.bankofengland.co.uk/>

*EMU Business Awareness Campaign: <http://www.emuaware.forfas.ie/index.html>

Deutsche Bundesbank: http://www.bundesbank.de/index_e.html

*Deutsche Bank: <http://www.deutsche-bank.de>

Westdeutsche Landesbank: <http://www.westlb.de/>

European Commission: <http://europa.eu.int/euro/en/mainhi.htm>

Fédération des Experts-Comptables Européene:

http://www.euro.fee.be/language/en/english_home.htm#top

as well as at the Web sites of many financial institutions and public agencies throughout Europe.

* Features information specifically aimed at helping businesses cope with EMU

Figure 2: Online Reading List

Other factors such as the liberalization of the telecommunications sector, bringing with it faster and cheaper value-added telecoms services, will only serve to intensify the pressure on service providers too heavily oriented towards a narrow local market: if a product/service (e.g. localization, translation) is available elsewhere in the euro area at an equivalent quality level, but at a lower price, open market mechanisms dictate that in most cases, the more competitive price will prevail. Factors affecting the buying decision in other industries, such as transport and logistics costs, are largely irrelevant in the language services sector, where delivery of the finished product to the customer is often measured in seconds.

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Other Issues

Hardware and software manufacturers will also have to face the problem of price transparency, as it will be very difficult to justify price variations within the euro area. Hardware manufacturers will probably try to circumvent this effect by offering different configurations in different national markets, but there will be great pressure on software vendors to adapt a "one-price-fits-all" policy for all localized versions. With the single market reaching its conclusion, their ability to prevent parallel or "gray" imports will all but disappear, and any hidden barriers impeding the cross-border flows of goods and services within the euro area will be eliminated quickly.

The specific problems of companies domiciled within the euro area are too complex to discuss here. No mention has been made, for example, of the legal aspects, although these may be particularly opaque. All that needs to be said here is that the principle of continuity of contracts will apply, and that the introduction of the euro may not affect performance under any legal instrument. Larger companies with treasury operations will have to fundamentally review their hedging strategies to make them more flexible, and the problem of legal certainty as regards year-end closing and reporting (for example the "revaluation" of foreign currency items) is still unresolved.

Conclusions

The most important conclusion for the localization and language services sectors is that if your company operates within, or sells into, the future euro area, you must have a strategy in place by 1 January 1999 to deal with the problems and opportunities outlined above.

Most national governments in Europe are worried about the level of complacency about EMU currently prevalent in large sections of the business community, especially in SMEs. Now is the time to start developing an EMU strategy before it is too late: the reference resources listed in the box are by no means exhaustive, and should be regarded as a starting-point.

More information is available from banks, chambers of commerce and special government task-forces in the European Union. Outside Europe, central banks and international financial institutions should be able to provide information. The author would also welcome questions from LISA members about EMU and the euro.