12 Accounting Exposure and EMU

In many senses this was the easy part of exchange rate exposure, and the same goes for the impact of EMU. A German firm which has subsidiaries in, say, Spain and Portugal, today has an accounting exposure. This exposure will obviously disappear if all three countries take part in a monetary union. Similarly the basic issue is simple for firms outside EMU – a Swedish or US firm having a German subsidiary will have accounting exposure to the euro instead of to the D-mark.

The issue has been slightly more complicated for subsidiaries of Euroland firms located outside the euro area. Today the local currency has typically been the functional currency of the subsidiary – a British firm owned by a German parent will typically have kept its books in pounds. A number of firms have indicated that they want to change this. To the extent foreign subsidiaries do switch to using the euro as their functional currency there would be no accounting exposure for the euro parent. Of course this does not mean that there is no exchange rate exposure. If I have a firm that imports cars from Germany and sells them to Swedish customers, nothing would fundamentally change just because I expressed my balance sheet in euros. I have some costs in Swedish kronor, some costs in euros (D-marks) and my revenues in Swedish kronor. This will not change just because I tell my CFO do the book-keeping in euro – the economic exposure does not change. One may try to change the economic exposure: we will turn to that in due course. For a firm that has a very large share of its business in the euro zone it might make sense to have subsidiaries use euros as their functional currency. An example of a firm intending to change its accounting and economic exposures is Siemens. ‘Siemens said that while it does not want to pressurise customers or suppliers into adopting the euro, it wants seamless processing payments and receipts in the new currency. The company also intends to offer its UK workforce the option of being paid in euros, as well examining the possibility of paying its UK taxes in euros.’

In Sweden there has also been a discussion about Swedish firms that trade much with Euroland wanting to switch to having the euro as reporting currency – presenting their financial statements in euros,
having their equity denominated in euros, and paying their taxes in euros. The arguments for why this would be good are typically somewhat vague. One argument comes from rules regarding risks for investors. Many fund managers, for instance of pension funds, have rules saying that 80 percent, or some other specific share, of their holdings must be denominated in the domestic currency. If a firm wants to attract these investors it could thus be relevant to change reporting currency. There is an important caveat, however. The rules for the fund manager were presumably instated to limit the degree of foreign exchange exposure – as we have seen, book-keeping in euros does not in itself change the economic exposure, which does not go away just because we call it by another name. A further question of course is why fund managers should not be allowed to diversify internationally – not putting all the eggs in the same basket is one of the basic tenets of a risk-averse investor. Frankel (1996) provides a good discussion.

**RELATED ISSUES**

We will end this short chapter with some observations relating to accounting exposure. One such is that EMU is expected by many observers, to lead to increased European financial market integration. For instance, Paul de Grauwe (member of the Belgian parliament and well-known academic) writes, ‘EMU will dramatically increase the degree of capital mobility within the euro area. Today European capital markets are still relatively closed. Financial institutions and insurance companies in Germany, France and Italy hold an overwhelming share of their total portfolio (often more than 90 percent) in domestic assets. The complete elimination of foreign exchange risk following the introduction of the euro and the disappearance of regulatory constraints on “foreign” euro assets will change all that.’ The resulting enhanced depth and liquidity of European financial markets is expected to lead to firms using equity to an increasing extent instead of debt. Many also believe that the euro will lead to the introduction of new instruments. *The Economist* writes, ‘Another effect of the euro will be to create new financial markets. Outside Britain, Europe’s corporate-bond markets are anaemic. The euro will change this, as bond investors try to outperform each other on their understanding of credit risk, rather than currency risk. The development of a European