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ADVENT OF EURO
IMPLICATIONS FOR INDIA

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AND
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FOREWORD

Robert Triffin declared it to be the most important development in the history of international monetary policy, since the de-linking of the US Dollar from gold in 1971. Martin Feldstein conjured up a vision of even war, as and when it came. They were referring to the "euro", the common currency of the majority of the European Union members, scheduled to make its debut on 1 January 1999.

The European Union has come a long way from the days when the European Common Market was initially set up. The advent of euro will signify the final step in a series of measures taken by a group of nation states, in their integration process, short of forming a single Government. Eleven of the fifteen European Union member-states have opted for the euro as their common currency.

Euro will be the first ever multinational currency to be managed by an independent Central Monetary Authority. Whether it will be a success, only time can tell. There are definite potential advantages which will accrue to the countries opting for the euro, in terms of higher competitiveness, lower transaction costs and increased consumer welfare. The potential risks arise mainly out of the asymmetrical shocks that may come about, due to the divergent nature of the economies of the Member States.

Euroland, the term used to refer to group of the eleven countries opting for the euro, is India's single largest trading partner. For historic reasons, the bulk of India's trade with Euroland, with the exception of Germany, is conducted in US Dollars. The introduction of the euro will open up choices to Indian exporting firms, in terms of their invoicing strategy. However, to take a decision on the switchover from the Dollar to the euro, will need detailed and careful appraisal on the part of Indian export firms.

This paper has analyzed the possible implications of the introduction of the euro, in terms of both an invoicing currency and a reserve currency. Euro is the first currency which, from its birth, will have the strength to emerge as an international currency and possibly even compete with the Dollar in all spheres in course of time. These developments are of great concern to Indian policy planners, bankers and export/import firms.

I hope this study will help all of us to understand many of these complex issues and arrive at appropriate strategic decisions.

K. DHARMARAJAN
DIRECTOR GENERAL

New Delhi
December 1998

ADVENT OF EURO
IMPLICATIONS FOR INDIA

B. Bhattacharyya and *Vinayak N. Ghatate*

Introduction

The process of economic integration in Europe is going to enter the final stage when the European Monetary Union (EMU) becomes a reality with the introduction of the euro on 1 January 1999. Since 1979, the European Monetary System and the launch of the ECU helped the member-states in broadly stabilizing the exchange rates among most of the member-states. However, it was felt that the final objective of a single market required a greater deepening of the financial integration and complete freedom of movement of factors of production. The Treaty of the European Union (EU), which came into effect on 1 November 1993, provided the framework for free movement of all factors of production, convergence of national economic policies and a single currency before the year 2000.

Though there have been strong doubts regarding the ability and commitment of the member-states to achieve the target, set in the Maastricht Treaty in the beginning, the scenario, few months before the euro is set to be launched, is quite encouraging. The average rate of inflation in the EU is now below 2 per cent in almost all member-states. The average government deficits declined from 6.1 per cent of GDP in 1993 to 2.4 per cent in 1997. Despite strong recessionary pressures in a large part of the world, the EU is on the growth path. The GDP growth rate has risen to 2.7 per cent in 1997 as against 1.8 per cent in 1998. The rates are expected to be higher at 2.8 per cent in 1998 and 3.0 per cent in 1999.[1]

The euro Time-table

In EU, eleven member-states out of the fifteen have ultimately been selected to become members of the EMU, after an evaluation of

TABLE 1

MAASTRICHT CRITERIA

Ready, willing and able?

Maastricht criteria	*Debt as % GDP*		*Deficit as % of GDP*		*Inflation (%)*		*Long-term interest rates*	*ERM membership*
	1997	*1998*	*1997*	*1998*	*1997*	*1998*		
EU	60.0	60.0	3.0	3.2	3.2	3.2	7.7	
Austria	66.1	64.7	2.5	2.3	1.1	1.5	5.6	Yes
Belgium	122.2	118.1	2.1	1.7	1.4	1.3	5.7	Yes
Denmark	65.1	59.5	-0.7	-1.1	1.9	2.1	6.2	Yes
Finland	55.8	53.6	1.1	-0.3	1.3	2.0	5.9	Yes
France	58.0	58.1	3	2.9	1.2	1.0	5.5	Yes
Germany	61.3	61.2	2.7	2.5	1.4	1.7	5.6	Yes
Greece	108.7	107.7	4.0	2.2	5.2	4.5	9.8	Yes
Ireland	66.3	59.5	-0.9	-1.1	1.2	3.3	6.2	Yes
Italy	121.6	118.1	2.7	2.5	1.8	2.1	6.7	Yes
Luxembourg	6.7	7.1	-1.7	-1.0	1.4	1.6	5.6	Yes
Netherlands	72.1	70.0	1.4	1.6	1.8	2.3	5.5	Yes
Portugal	62.0	60.0	2.5	2.2	1.8	2.2	6.2	Yes
Spain	68.8	67.4	2.6	2.2	1.8	2.2	6.3	Yes
Sweden	76.6	74.1	0.8	-0.5	1.9	1.5	6.5	No
UK	53.4	53.0	1.9	0.6	1.8	2.3	7.0	No

Source: European Commission.

their performance as per the Maastricht Treaty parameters (Table 1) in May 1998. The UK, Denmark and Sweden have decided to opt out in the beginning. Greece as of now does not fulfil the convergence criteria but hopes to join in 2001.

The countdown for the launch of the euro has started. The sequence of events is shown below.

Year	*Date*	*Event*
1998	04 May	European Summit chose the euro members. Fixed bilateral exchange conversion rates.
1998	31 December	Conversion rates into euro fixed.
1999	01 January	EMU is launched. European Central Bank takes charge of monetary policy. Member currencies become denominations of the euro.
2001	01 January	Greece expected to join.
2002	01 January	Euro notes and coins introduced.
2002	01 July	National currencies cease to be legal tender.

The bilateral conversion rates fixed on 4 May 1998 would be used for finalizing the rates on 31 December 1998, the day on which these rates would get locked. The bilateral rates as on 4 May are given in Table 2.

TABLE 2

BILATERAL EXCHANGE RATES FOR ONE DM

Austria	7.03552	Shilling
Belgium/Luxembourg	20.6225	Franc
Finland	3.04001	Markka
France	3.35386	Franc
Ireland	0.402676	Punt
Italy	990.002	Lira
Portugal	102.505	Escudo
Spain	85.0722	Peseta
Netherlands	1.12674	Guilder

Source: CBI, *News Bulletin* (July/August 1998).

The rules provide that on 1 January 1999, ECUs will get automatically converted into euro on a one-to-one basis. On that date, these bilateral conversion rates will get finally locked in. The final conversion rates would be calculated as follows.

The value of the ECU on 4 May 1998 was 1.97420 DM. To find out the new exchange rates, the value of ECU on 1 January 1999 has to be considered. Let it be assumed that on 1 January 1999,

1 ECU	=	1.9800 DM
1 ECU	=	1 euro
1 euro	=	1.9800 x 3.35386
	=	6.6406428 French franc

The value of the euro in terms of the national currencies will be formally calculated on 1 January 1999. ECU will stand withdrawn from that date. The transition phase of euro also begins on that day and will end in July 2002, when it becomes the only legal tender. The monetary policy will be conducted in euro beginning 1 January 1999. Financial transactions between the European Central Bank, the national Central Banks and the high street banks will also be in euro. All European Stock Exchanges will also use euro.

National currencies and notes will be used till 30 June 2002, which means everyday transactions will continue as before. Transfer payments can be made in euro w.e.f. 1 January 1999 by companies and individuals, on request. Coins and currency will be introduced on 1 January 2002. On that day all bank accounts will be converted into euro accounts. The euro and national currencies will be used side by side. This practice will continue for a six-month period. On 1 July 2002, at the latest, the national currencies and coins will lose their legal tender status. Thus, euro will become the only legal currency.[2]

Some Facts on euro

The euro is the name given to the single currency of the EMU. The word "euro" is neither a prefix nor an abbreviation. The official abbreviation of the euro is EUR, which will be used for all financial and commercial purposes, just as GBP (pound sterling) and DM

(Deutsche mark). The graphic symbol for the euro looks like an E with two horizontal parallel lines across it. It was inspired by the Greek letter epsilon, referring to the cradle of European civilization and the first letter of Europe.

The euro currency will be issued in seven denominations, viz. 500, 200, 100, 50, 20, 10 and 5. The designs are symbolic of the European architectural heritage. Windows and gateways dominate the front side of each bank note as symbols of spirit of openness and cooperation in EMU. The reverse side depicts a bridge from a particular age as a metaphor for communication among the people of Europe and between Europe and rest of the world.

There will be eight euro coins, denominated in two and one euro and then 50, 20, 10, 5, 2 and 1 euro cents. One euro is divided into 100 cents. Every euro coin will carry a common European face, which is a map of EU against a background of transverse lines to which the stars of the European flag are attached. On the obverse, each member-state will decorate the coins with their own motifs.[3]

Legal Framework

The legal framework for the introduction of euro comprises two regulations:

- Council Regulation (EC) No.1103/97 of 17 June 1997 (OJ No. L 162, 19/06/1997. 001) based on Art 235 of the EC Treaty
- Resolution of the European Council of 7 July 1997 (OJ No. C 236, 02/08/1997 P. 0007 - 0012), based on Art 109 (4) of the EC Treaty

The major principles having substantive importance for business enterprises are:[4]

(a) The euro will be substituted for the currencies of the participating member-states at the fixed conversion rates applicable from 1 January 1999 [Articles 2 and 3 of the 109L(4) Regulation].

(b) As from 1 January 1999, every reference in a legal instrument to the ECU is replaced by a reference to the euro at a rate of one euro to one ECU (Article 2 of the 235 Regulation).

(c) Where in a legal instrument reference is made to a national currency unit, this reference shall be as valid as if reference were made to the euro unit [Article 6 of the 109L(4) Regulation].

(d) The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate a legal instrument. However, as the freedom of contract is respected, this provision remains subject to anything, which parties may have agreed (Article 3 of the 235 Regulation).

(e) As from 1 January 1999, any amount denominated either in the euro unit or in the national currency unit of a given participating member-state and payable within that member-state by crediting an account of the creditor, can be paid by the debtor either in the euro unit or in that national currency unit [Article 8(3) of the 109L(4) Regulation].

(f) In the legal framework, the fundamental principle applicable during the transitional period is that acts to be performed under legal instruments stipulating the use of one of the units — the national currency unit or the euro unit — shall be performed in the stipulated unit unless otherwise agreed by the parties [Article 8(1) of the 109L(4) Regulation]. This rule ensures that economic agents will only have to use the unit to which they have agreed. However, economic agents may feel obliged to deal with the euro before the end of the transitional period for competitive reasons because customers may require invoices in euro, or for logistical reasons, to avoid a high risk "big bang" conversion to euro on 31 December 2001.

(g) Article 8(3) of the 109L(4) Regulation enables debtors to settle their debts in book money by making a payment either in the euro unit or in the national currency unit. Banks are under an obligation to convert such payments into the unit of account of the creditor.

(h) When an enterprise only maintains a bank account in the national currency unit, receipts in euro must be converted into the national currency unit. The euro regulations do not sufficiently address the issue of charging for the conversion of amounts between the national currency unit and the euro unit.

(i) Article 4 of the 235 Regulation lays down the conversion rules for the euro:

   (i) The conversion rates shall be adopted as one euro expressed in terms of each of the national currencies of the participating member-states. They shall be adopted with six significant figures (counted from the left and starting with the first non-zero figure).

   (ii) The conversion rates shall not be rounded or truncated when making conversions.

   (iii) The conversion rates shall be used for conversions either way between the euro unit and the national currency units. Inverse rates derived from the conversion rates shall not be used.

   (iv) Monetary amounts to be converted from one national currency unit into another shall first be converted into a monetary amount expressed in the euro unit, which amount may be rounded to not less than three decimals and shall then be converted into the other national currency unit. No alternative method of calculation may be used unless it produces the same results.

(j) The conversion and rounding rules do not specifically describe the conversion from a participating national currency unit to a third currency (a currency that is not taking part in EMU). Where a quotation between a third currency (for example, the US dollar) and a national currency unit (for example, NLG) is no longer available the conversion should be performed as follows.

Conversion from US$ to NLG: The US$ amount would first have to be converted into a euro amount by application of a US$/EUR exchange rate. The intermediate euro amount would then be converted into a NLG amount by using the conversion rate.

The Path towards A Single Currency

The concern with exchange rate management manifested itself when Common Market got established in the early 1950s, though Monetary Union was not on the agenda, when it was first proposed in 1962. The turmoil caused by the revaluation of DM against the French franc compelled Willy Brandt, the then German Chancellor, to push the idea of a monetary union. The Werner Report, which took up Brandt's idea, proposed the idea of establishing a single currency in 1980. The European Heads of State approved Werner Report in 1971, but no progress took place due to the collapse of the Bretton Woods System. The European answer to exchange rate management was to introduce what came to be known as "snake in the tunnel", which had a less than credible existence, with France, Italy and the UK joining and leaving. As a result, the European Monetary System came into existence in 1978. In March 1979, all member-states, except the UK, joined the exchange rate mechanism (ERM) which bounded the exchange rate volatility within 2.25 per cent of the central rate on either side. But ERM also failed to provide exchange rate stability with France and Italy devaluing their currencies several times. The idea of a single currency and monetary union then got a strong push from the Delors Report, which was commissioned in June 1988. Delors Report led to the Maastricht Treaty in early 1992. However, a strong speculative attack on ERM in September 1992 led to the departure of the Lira and Sterling. A year later, the exchange rate band was increased to 15 per cent on either side of the central rate. This experience of managing the exchange rates led to the belief of the majority of the EU member-states that the only long-term solution to exchange rate stability was to create a single currency. And the idea of euro was born. However, the acceptance of this idea was not universal. There is strong doubt in the UK on the desirability as well as on the feasibility of a single currency. As is known, the UK, Denmark and Sweden have decided not to join the EMU in the first round.

Though the euro is now destined to arrive on 1 January 1999, there are some genuine concerns on how the euro will actually work. An appraisal of these concerns is necessary before the benefits of a single currency can be evaluated against those risks.

Robert Mundell can be cited as the godfather of the concept of a currency transgressing national frontiers when he wrote his seminar paper on optimal currency areas in 1961. The basic thesis of the paper was that if a single currency is used across borders, there will be substantial potential gains in terms of reduced exchange risks, less investment risks and greater price transparency. A single monetary authority could also conceivably bring about sustained price stability. These benefits have been estimated at 0.5 per cent of GDP for the EU.[5] Against these gains, there are risks as well. First and foremost, the governments will lose their access to the traditional economic policy instruments. It will not have the right to follow an independent monetary policy nor an exchange rate policy. Even fiscal policy instruments can be used only up to a point because of the restrictions put on the amount of borrowings a government can make.

The real economic dilemma in such a scenario will arise out of what is normally called as asymmetric shocks. If a part of the Union has to suffer more because these instruments cannot be used as other parts of the Union are not in a similar economic position, there is bound to be both political and economic problems. It may be useful to quote a longish passage from *The Economist* study:[6]

> The (optimal currency area) theory concludes that for a currency area to have the best chance of success, asymmetric shocks should be rare, implying that the economies involved are on similar cycles and have similar structures. Moreover, the single monetary policy should affect all the constituent parts in the same way (....through similar transmission mechanisms). There should be no cultural, linguistic or legal barriers to labour mobility across frontiers; there should be wage flexibility, and there should be some system of stabilizing transfers.

It does not take an economic professor to see that none of these conditions are met in the EU. There are geological and structural

CHART 1

STRUCTURE OF THE EUROPEAN CENTRAL BANK

President

Directorate

- Vice-President Admn & Legal Services and Middle Office
- Economics & Research
- Operations and Controlling & Organization
- International & European Relations, Payment Systems and Prudential Supervision
- Statistics, Banknotes and Information Systems

National Central Bank Presidents

- AUSTRIA
- BELGIUM
- FINLAND
- FRANCE
- GERMANY
- IRELAND
- ITALY
- LUXEMBOURG
- NETHERLANDS
- PORTUGAL
- SPAIN

differences among the EU economies and interest rates operate in different ways. Europe has experienced several big asymmetric shocks in the past decade, including the unification of Germany and collapse of Finland's trade with the former Soviet Union. There is little or no labour mobility among the member-states and wages are notoriously rigid. Moreover, there is little enthusiasm for an expansion of the EU budget to allow for big fiscal transfers.

Though the summary itself is quite harsh, it has not mentioned one of the greatest uncertainties related to the euro, viz. the competence of the European Central Bank (ECB) to manage the monetary policy for all the member countries. The assurance has been sought to be given by ensuring the independence of the ECB and an almost single point mandate of maintaining price stability. However, the unseemly fight on the appointment of the first President of the ECB cannot be considered as a pleasant and confidence-building precursor of the future.

Since the future of euro, as a both EU and international currency, will depend upon the credibility of the ECB, it may be worthwhile to consider the structure and functioning of ECB at a little greater detail. The organizational structure of the ECB and its functioning are depicted in Charts 1 and 2. The constitution of the ECB is sufficiently strong to make it politically independent.

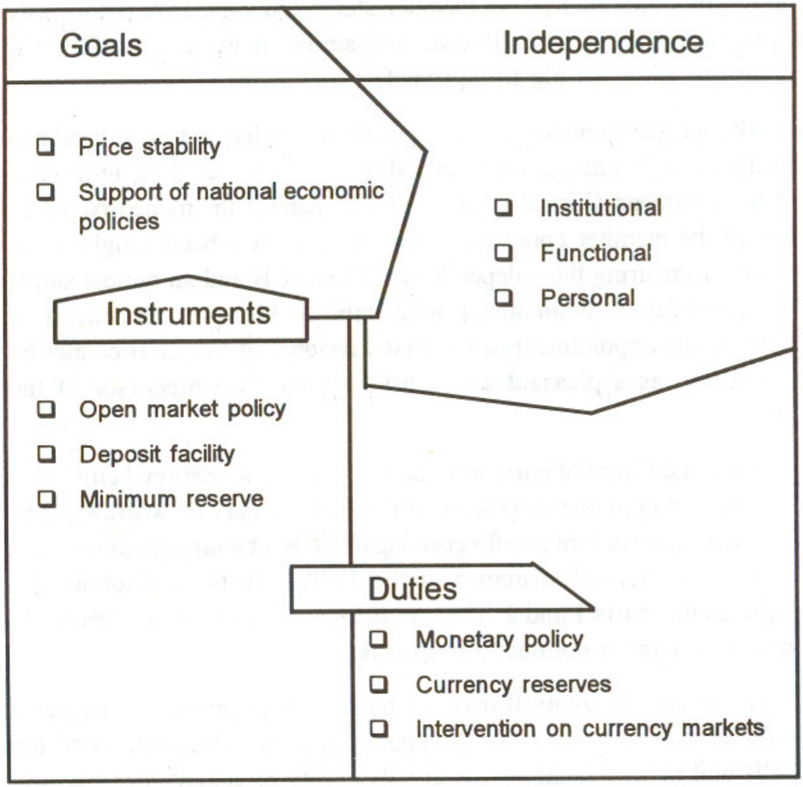
However, that by itself may not be enough to ensure its long-term stability and credibility. In the short term, the effectiveness of the ECB will be benchmarked against its ability to achieve the inflation target. Unlike many other central banks, the ECB will decide its own target. It has basically two options: *first,* it may set a direct inflation target. *Second,* it may bring to achieve a money-supply target. The possibility is that, given the difficulties in Union-wide data on money supply, it may opt for the former. The instruments ECB may use will comprise reoperations against recognized collaterals. ECB will also offer a deposit rate. It is also expected to impose reserve requirements.

What are the perceived weaknesses of the ECB? There are several:

First, it is going to be a very lean organization. Its total staff strength is around 500 at the Headquarters, compared to 20,000 for the

CHART 2

STABILITY GOAL OF THE EUROPEAN CENTRAL BANK



Bundesbank and 16,000 for the Bank of France. This is due to the greater degree of decentralization in the ECB regime. Some fear that this decentralization will make the National Central Banks averse to give away power than what is absolutely obligatory.[7]

Second, though the ECB has plenty of autonomy, it lacks accountability. ECB is only to report to the European Parliament — a process which is not designed to be very effective. It has no supervisory authority that will monitor its spending such as the US Federal Reserve submitting its budget to the US Congress. Some experts believe that while giving autonomy to a Central Bank may help insulate short-term monetary policy management from political compulsions, it is equally necessary to introduce systems for accountability and transparency. It has been observed that credibility of a Central Bank gets established over a period. The ECB will, however, have no learning period. It will have to be error-free from day one, which by any standard is going to be a fairly difficult task.

> "Monetary policy in Europe will be moving from a period of existing price stability into the unknown. Under these conditions, the best aid to stability is a combination of transparency and accountability, two features the ECB conspicuously lacks.....
>
> If the ECB fails to achieve the objectives laid down for over a reasonable period of time, ... policy makers (should) have at their disposal some method of sanctioning the Bank. At present, there is no mechanism for policing the ECB Board ..... Nor can the Bank's occasional reporting to the European Parliament ..... be seen as a seriously constitutional check. Of more immediate concern .... is the lack of transparency written into the bank's Statutes." [8]

ECB votes will not be published nor the minutes of the discussions will be released for many years. If in future, discontent starts growing on the efficacy of ECB's decisions, it will be difficult to justify the rationale of the decisions taken. There is a danger, therefore, that at that point of time, policy decisions will be taken directly by the politicians or at the least, there will be pressures to change ECB's constitution. "The present degree of accountability cannot survive the pressure that is sure to come. There is a danger of moving from too little accountability to too much politicization. That would end all hopes of a stable euro".[9]

Benefits of A Single Currency

Despite such misgivings, if the majority of the EU members has opted for a single currency, it is because the perceived benefits outweigh the risks. The benefits can be conceptualized in five distinct categories.

(1) Industry and Trade

The benefits of the single market will get optimized when the currency becomes one. Transaction costs will come down substantially on cross-border transactions. It will bring to an end the exchange-rate fluctuations amongst the participating countries. Low inflation rates and interest rates will reduce the uncertainties related to investment decisions. Elimination of exchange risks will make the firms more competitive initially within the EMU and subsequently, if proper actions are taken, they will be better prepared to face global competition.

(2) Consumers

Consumers will benefit from greater transparency. Since during the transition period, prices will simultaneously be shown in both euro and a national currency, price comparison on cross-border transactions will become easier. Subject to the differences that would continue due to different levels of local taxes and costs of doing business at different locations, there will be pressures to get prices equalized throughout EMU. The single currency will, therefore, promote unification of the goods and services markets. The euro will lastly herald the birth of the "European Consumer" whose purchasing power will be guaranteed by the stability of the single currency.[10]

(3) Capital Market

All government debts will henceforth be in euro. All stock-markets will also use euro. The arrival of the euro will lead to a single European financial market which will roughly be equal to that of the USA.[11] The conversion of sovereign debt into euro will create a single market in which the bond issued by the national governments will virtually be interchangeable.[12]

The integrated financial market will be able to deliver specifically tailored products and services at more competitive rates. There is, however, a possibility that there will be a squeeze on the profit margin of the banks. Furthermore, concentration in the banking industry is expected to rise.[13] Last year, there had been considerable restructuring of the European banking industry. These include take-over by Dutch ING group of Belgium's Banque Bruxelles Lambert and a merger of two German banks, Bayerische Verinsbank and Bayerische Hypo-bank. Impact of the EMU will be profound and is infact already being felt. Some banks have started using synthetic euro products and others, like ABN Amro, have started quoting US$ against the synthetic euro. Most have concrete plans to introduce interest rate futures and options from January 1999. It is reported that a "grey" market is already functioning,[14] but more substantive impact will be felt in the long term. Banks stand to lose their pre-eminent position in financing industries to the securities markets. The euroland bond market will rival America's and so will its stock markets. Capital market reforms should result in lowering of the cost of capital as well as improve allocational efficiency. Since the ineffective capital market is considered as a major reason behind the high rate of unemployment, this may be a long-term solution.[15]

European capital market will eventually get restructured into a Pan-European source of capital. European equity market is currently an amalgamation of relatively isolated small markets with high degree of volatility. The value of all outstanding equities in the EU stood at only US$2.3 trillion in 1996 which is about one-third of the corresponding US amounts. By removing exchange rate risks, euro will facilitate movement of capital across national markets and easy comparability of financial asset prices. A similar pressure will work on the debt market. Currently, the European bond markets are heavily concentrated in high-grade bond. With the elimination of currency risks, the market will tend to differentiate issues more on the basis of credit risks, thus opening the European markets to a wider group of borrowers and also making these more integrated with the global investment market. The euro will increase the importance of the private capital market and reduce the importance of bank in the aggregate credit allocation.[16]

(4) Labour Market

Whilst the EMU countries have made rapid progress on several fronts, the weakest point continues to be the high rate of unemployment. The unemployment problem in the EU is the outcome of several factors such as overregulation of the labour market, excessive social safety net provisions, high tax rates and also inefficient capital market. The euro will indirectly help more towards a lower level of unemployment. Without access to the exchange rate policy instrument, in future, the government will have to stress reform of the micro-economic provisions that are protecting the employed, partly at the expense of the unemployed. Equally important, there will be direct effects arising from the increase in transparency of pricing in the labour market, which will foster increased awareness of Europe-wide labour market conditions, increase labour mobility and create pressures for convergence in pensions, unemployment benefits and taxes on labour.[17] Even under fixed exchange rate systems, there is a transaction cost as currencies will have to be converted. These costs will disappear with the emergence of euro. The costs associated with keeping accounts/balances in several currencies will also go away. In-house costs for managing treasury functions, accounting functions and cash management will get substantially reduced. Costs of documentation will also come down. Business travel will become cheaper. Now a traveller tends to lose substantially when he has to change his cash holdings as he moves in the EMU countries. The savings will be to the extent of spreading between the buying and selling rate of currencies.

(5) Global Financial Market

Since the gradual weakening of the British pound sterling as a reserve currency, dollar has been the cornerstone of the global financial structure. Especially, its role as the premier reserve currency to the Central Banks and as an invoicing currency for cross-border transactions has been very high for the last five decades. Advent of euro can bring about a change, albeit slowly, to this effect. This change can be facilitated by the gradual relative decline in the economic strength of the USA, using the rest of the world as the benchmark. Before the World War-II, the USA produced one-third of the global output. It was a net capital exporter and had a huge trade surplus. It held two-thirds of the global gold stocks. Now its share in world output is down to 22 per cent, its trade deficits are large and endemic, it has earned the dubious distinction of being the most indebted nation in the world. It is, therefore, important for the health of the world's financial system that a second major currency emerges in the scene, not as an alternative to dollar, but as an addition.

The euro as an International Currency

The euro will be the first currency in the world, which will be multinational and not backed by the reserves of one country. Its strength will depend upon the combined economic might of the euroland countries. Facts suggest that euro has more than a modest chance to emerge as a leading international currency. Some relevant data are shown in Table 3.

TABLE 3

COMPARATIVE DATA ON EU, USA AND JAPAN

	EU	*USA*	*Japan*
Share in world GDP (%)	18	22	11
Share in world exports (%)	20.2	16.8	10
Share in world imports (%)	17.8	20.0	7
Forex reserves (US$ bn.)	320	60.7	206
Population (mn.)	373	266	126

The above data clearly indicate that Europe has the potential to be an international currency. A currency, if it has to have a global role, must necessarily perform three functions in cross-border transactions. These are: (a) as a unit of account, (b) as a means of payment, and (c) as a store of value. More specifically:

- It will be used as an invoicing currency not only for bilateral trade but also for third country transactions.
- It will be kept as a part of the foreign currency reserves by a large number of central monitory authorities.
- It will form an important component of private investment portfolios.

Other countries will be interested in using a currency for such purposes only if the following necessary conditions hold:

- There must be confidence in the political stability of the countries issuing the currency.

- The currency must have markets that are broad with a large assortment of stable and high-yielding short term financial instruments as well as well-developed secondary markets, substantially free of capital controls.[18]
- The country must have a record and potential of low inflation as otherwise it will lead to an erosion of wealth held in that currency.

While the political stability of the euroland as a whole is not in doubt, its long-term commitment to euro is anybody's guess. More importantly, the credibility of euro will largely be dependent on the ECB's future performances, as has been observed earlier. There will, therefore, be a period of wait and see. But with the exception of unemployment, other economic parameters signal a strong euro. Over the last 17-year period, the EU has grown at about the same rate as that of the USA. It is expected to grow by about 2 - 2.5 per cent this year which is reasonably good. External sector is enjoying a huge surplus and inflation is at a historically low in several euroland countries, such as 1.0 per cent in France, 1.6 per cent in Italy, 1.8 per cent in Germany and 1.9 per cent in Spain.

The euro as an Invoicing Currency

Most currencies are used for their own trade and, therefore, their shares are broadly proportional to the country's share in world trade. The difference in these two shares can be taken as a surrogate of the third country usage of a currency as an invoicing currency. Historically, British pound in the 19th century and the early 20th century and US dollar since then have served as the principal invoicing currencies in the world. However, during the last two decades, the importance of US dollar has started declining as can be seen from Table 4.

With the introduction of euro, these shares will change, basically at the cost of dollar. The EU accounts for about 20 per cent of world exports. This trade is almost certain to be invoiced in euro. Amongst the euroland countries, DM is currently used for a third country invoicing currency almost to the extent of 6 per cent of world trade. If euro can replace DM for this part of world trade the initial usage of euro as an invoicing currency can approach almost 30 per cent of

TABLE 4

DISTRIBUTION OF TRADE INVOICING

(%)

Currency	*1980*	*1992*	*1996*
US dollar	56.4	47.6	47.0
Deutsche mark	13.6	15.5	15.7
French franc	4.5	6.3	6.5
Japanese yen	2.1	4.8	4.9
British pound	-	5.5	5.7

Source: EU Commission and Hartmom, quoted in Subramaniyam, Dixit & Roy, *EMU, Europe and India*, RBI (1998).

world exports. Subsequently, use of euro can be predicted for trade between the euroland and the so-called pre-in countries, excluding the UK, which may continue to use Pound sterling as the invoicing currency. Further, it is very probable that several East European countries, which are negotiating to enter the EU as members, will opt for euro, at least for their trade with the euroland. This will be especially true of the fast-track countries, comprising Czech Republic, Hungary and Poland. Bulgaria and Estonia have already declared that they would switch to the euro-peg. The trade of these countries with the EU already constitutes the bulk of their foreign trade and, therefore, the advantage of using euro as the invoicing currency is substantial. Currently, most of these are tied to DM.

TABLE 5

TRADE WITH EU AS PERCENTAGE OF TOTAL
(1997)

Country	*Trade with EU*
UK	53.5
Sweden	55.5
Greece	45.7
Denmark	66.7
Poland	48.5
Czech	45.3
Hungary	54.2

Note: 1997's average exchange rate have been used to convert US$ into ECU.

Subsequently, euro has the potential to be used in those African countries, which have now strong linkages with France. Some Mediterranean countries may also opt for euro as their trading links with the EU are fairly strong and there are possibilities of a EU-Mediterranean free trade area.

The Asian trade is mostly invoiced in US dollar. However, the relative importance of trade with the USA has been declining as intra-Asia is assuming more importance. If euro proves to be a strong and stable currency, it is possible that a part of trade, currently invoiced in US dollar, may get switched to euro in Asia as well.

The euro as a Reserve Currency

Though its share is coming down over the years, US dollar continues to account for two-thirds of world's official foreign exchange reserves (Table 6).

TABLE 6

COMPOSITION OF WORLD OFFICIAL RESERVES
(Excluding gold)

(%)

Currency	*1980*	*1996*
US dollar	68.6	62.7
DM	14.1	14.9
Yen	4.4	7.0
French franc	1.7	1.7
ECU	-	1.7
Others	7.5	9.6

Source: IMF.

To what extent, euro may substitute US dollar or other currencies?

It is obvious that though some changes can be expected, that will most probably be in the medium term. Before a shift takes place, the Central Banks would like to be assured of the strength of the euro. Further, the strength of a currency does not necessarily influence its inclusion in a country's official reserves. For example, French franc appreciated by about 37 per cent relative to US dollar since 1985. But it represents less than 2 per cent of world's forex reserves. Even the DM which appreciated still more, accounted for about 19 per cent of the global reserves, at its peak, and has since declined to 15 per cent in 1996. Despite the strong performance of Japan in world trade, yen never accounted for more than 9 per cent of world official forex systems. The conclusion of the Conference Board appears to be correct:[19]

> The euro is not likely to challenge the US dollar as reserve currency... as long as European trade surpluses are growing and until European capital markets effectively compete with US markets. A growing trade surplus means that the supply of European currency in the global economy is shrinking. Moreover, the narrow breadth of European capital markets restricts the availability of euro-based securities for purchase.
>
> For a currency to assume significant reserves status, the region must be willing to run a neutral-to-deficit trade balance and have security markets of sufficient size so that the currency can be exchanged for return-bearing assets. At the moment, euro appears to be on course towards a relatively strong currency but one that is of limited significance.

The euro as an Investment Currency

The euro will integrate the separate national financial markets with a huge expansion in both volume and liquidity. The scale will also result in reduced issuance costs. As an international portfolio currency, euro will benefit both from the substitution and size effect. The former refers to the fact that euro will replace the European national currencies, which are currently being used for international financial deals. The share of the European currencies in international bond portfolio has been estimated at 37 per cent in 1995. As to the latter, the euro-denominated bond market will become one of the largest in the world because all new government debt will be issued in euro. In addition, all outstanding debt is also going to be re-denominated by most countries, notably by Germany and France in January 1999. The size and depth of the euro bond market is expected to bring down the cost of using bond almost to the level of US dollar denominated bond markets.[20]

The euro: Strong or Weak Currency

This is the most hotly debated issue though the burden of argument appears to be in favour of a strong euro. It is also expected to appreciate *vs*. US dollar. The reasons behind these expectations are the following:

(1) Bulk of the official reserves of the euroland countries is currently held in US dollar. With EMU coming into existence, a large part of these reserves will no longer be necessary, as intra-EMU trade will no longer need US dollars for intervention to stabilize currencies of countries participating in EMU. It is, however, difficult to estimate the amount rendered surplus. Estimates vary from zero to $200 billion. However, the amount may not be too high if the Central Banks decide to hold on to a large US dollar reserve to support the credibility of euro.[21] In addition, there can be a switch to euro from dollar by other Central Banks. Some private portfolio managers also may effect a similar switch. Combined effects of these have been estimated as a one off transfer from US dollar to euro ranging from $500 billion to $1 trillion.[22]

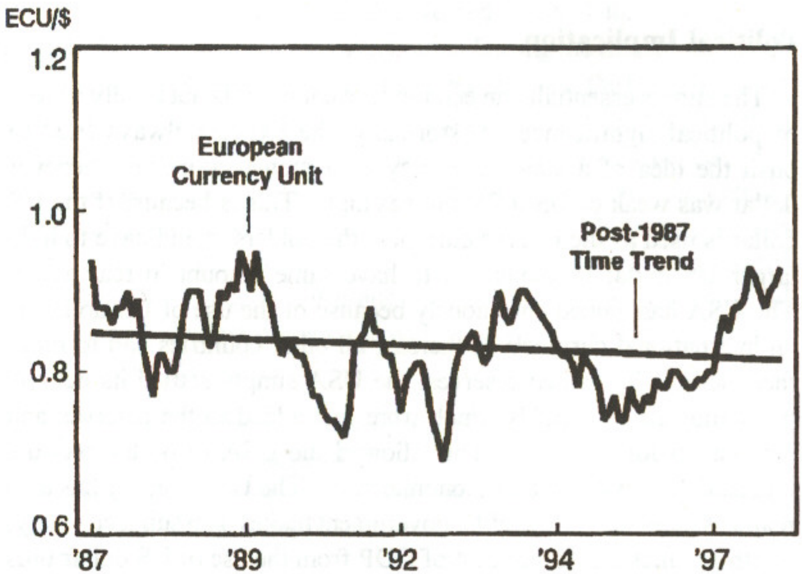
(2) The USA has huge current account deficits. The euroland recorded, on the other hand, a surplus of more than $175 billion in 1997.

(3) The track record of the European Currency Unit (ECU) since its introduction in 1979 reveals that ECU has generally appreciated against dollar (Chart 3). The ECU's strength can to a large measure be attributed to the DM, the anchor currency. DM has more than one-third weight in the ECU basket of currencies. It is expected that euro will behave in the same way as ECU.[23]

(4) European Central Bank has ruled out exchange rate targeting. Its monetary policy objectives will be mostly determined by domestic considerations. This will be more so because the average share of exports in GDP for the euroland countries

CHART 3

THE ECU HAS BEEN IN ROUGH PARITY TO THE US DOLLAR SINCE ITS INCEPTION



Source: IMF, The Conference Board.

will fall to less than ten per cent. Currently, it is more than one-third for several member-states.

The counter arguments are as follows:

(1) The international portfolio managers may not effect the switch if this reduces the value of their assets.

(2) The size of the world forex transactions, amounting to more than $1 million a day, can easily absorb the estimated one off switch mentioned above.

To conclude, the future of euro like that of any other currency will depend upon

- Market sentiments
- Growth prospects of the euroland

- Track record of European Central Bank
- Assessment of euro by Central Bankers
- Mix of fiscal and monetary policies on both sides of the Atlantic.

Political Implication

The euro is essentially an economic event but it is not totally devoid of political significance. Historically, the EU has always tried to push the idea of a single currency or a monetary union whenever dollar was weak or US inflation was high. This is because if the US dollar is used as the reserve currency, the holders would have to hold larger US dollar holdings just to have same amount in real terms. The USA has gained enormously because of the use of US dollar as an international currency. Whereas, all other countries had to retire their deficits by owned reserves, the USA simply settled its deficits by writing its own IOUs which were just added to the reserves and not put up for payment. This allowed the USA to be the world's largest debtor without any economic pain. The US Treasury has also reaped seignorage (the profit a government makes on issuing currency) worth as much as 0.5 per cent of GDP from the use of US dollar bills in other countries.[24]

For the first time in post-World War-II period, a credible alternative to the US dollar is coming up, as an international currency. In a world of extreme volatility of any currency, including US dollar, it is good for the health of the international financial system to reduce dependence on a single currency. Some experts believe that emergence of euro may ultimately lead to a tripolar financial world, comprising US dollar, euro and the yen. "It is probable that monetary union in Europe will provoke steps towards an Asian monetary bloc, spearheaded by Japan, China or the members of the ASEAN".[25] In fact, Malaysia has already advocated such a step by calling for dollar-less trading within the region.

Implications for India's Foreign Trade

The euroland is the largest trading partner of India. It accounts for 22.7 per cent of India's exports and 21.3 per cent of India's imports in 1997 (all exchange rate conversions are based on 1997's annual average rate).

However, a substantial part of India's trade with the EMU countries is currently invoiced in US dollar. Even though globally, slightly lower than 50 per cent of trade is invoiced in US dollar, this ratio is estimated to be above 80 per cent in India. During the transition period, i.e. between 1 January 1999 and 31 December 2001, the basic principle behind the usage of euro is "no compulsion, no prohibition". Indian firms exporting to and importing from the EMU countries have the right to deal or not deal in euro. However, this right is only theoretical. If the European buyers demand that in dealings with them, euro has to be used, Indian exporters will have little choice. Further, since from 1 January 2002, euro is going to be the only legal tender, instead of waiting till the last moment, it will be advisable to get adjusted to the euro from the beginning.

Implications of the introduction of euro on India's foreign trade can be conceptualized under two broad categories, i.e. at the economy-wide level and at the enterprise level. At the level of the former, the following can be identified:

The most primary effect of euro will be on the reduction of transaction costs for trade within euroland. As a result, intra-EMU trade will get a fillip. This also means that sourcing within EMU may become more cost-competitive compared to sourcing from outside, especially if the foreign suppliers do not deal in euro.

The euro is also expected to increase the export-orientation of the small enterprises, which so far have found managing complex foreign exchange risks to be a barrier. With euro, this barrier will no longer exist. It is, therefore, expected that a larger proportion of intra-euroland trade will originate in the small industry sector.

What will be the combined effect of these perceived developments on India's export prospects?

(1) The impact is expected to be essentially negative. The sectors which would be affected are difficult to identify without a detailed micro-level analysis. *A priori*, the affected sectors will comprise those, which have intra-EMU sources of supply and for which the current

competitive advantage for India is at the margin. Most probably, the textiles sector will get affected.

(2) Indian firms can expect intensified competition from the East European countries. As observed earlier, most of these will get anchored to euro or will switch to euro-invoicing. This will eliminate currency-risks for the EMU-based importers. In case the Indian exporters continue to use US dollar, this can result in trade diversion from India to the East European suppliers. India exports a range of products to EMU in competition with these countries. These products may get adversely impacted. Details of such product-groups can be found in an IIFT study.[26]

(3) Because of such competitive pressures, it will be advisable for the Indian exporting firms to get adjusted to euro-invoicing. There will also be pressures from EMU-based importing firms, especially those, which are planning to shift to euro early, for euro-compliancy. Already many European multinational firms have indicated target dates by which they would expect all their suppliers to be euro-compliant. For example, BMW, the German car company which owns the UK's Rover, has asked the latter to be ready, along with its core suppliers numbering 350, for the euro, w.e.f. 1 January 1999.[27] Some firms are following a two track approach. Nokia, the Finnish telecom giant, will switch all its accounting and reporting systems to euro on 1 January 1999. It has asked all its suppliers, subcontractors and clients based in Europe to adjust to euro. In Asia, however, Nokia has no plans to automatically change its dollar-based transaction to euro, because of lack of interest in the euro in this region. Siemens is adopting a similar strategy, while it will switch to euro quickly for intra-EMU dealings, it will begin with "dialogue and consultations" with its business partners outside the region on the changeover modality.[28]

It is obvious that those suppliers in India who are an integral part of the manufacturing systems will be the ones under severe pressure to switch, for example, the suppliers in the automobile sector. But if the switch is made quickly, this will work as an USP for the Indian vendors. Some firms, both large and small, in many countries of Asia are switching to euro precisely because this will offer a competitive edge over those who are not.

(4) Earlier in this Study, it has been observed that euro may appreciate against the US dollar. It is possible that euro may not remain constantly stronger than US dollar over a long time because in that case, the competitive strength of the EMU countries will get eroded, leading to lower exports and higher imports. Over a period of time, euro will, therefore, weaken. However, in the begining, euro is expected to be a strong currency. In such an eventuality, the Indian exports will get cheaper in the euroland. To what extent this will help the Indian exports will depend upon the price-elasticity of demand. A recent study[29] on India's exports to the EU, has found that 15 product-groups have price elasticity having values more than unity. These include: foodstuffs; fats and oils; plastics; wood articles; textiles; articles of stone; chemicals; base metals; vehicles; vegetable products; wood pulp; and pearls.

Product categories, which are found to be relatively price-insensitive, are leather, footwear, machinery, minerals, opticals and arms.

It is the former category of products that are expected to be benefited from a strong euro.

(5) The euro is expected to reduce transaction costs, greater integration of capital markets and result in a higher level of growth in the euroland. If the income level does rise, it should also result in additional imports, especially of those products that are income-elastic. The study, mentioned above, has also identified those export product-groups from India to EU, which are relatively income elastic. These are: minerals and vehicles. Unfortunately, India's export basket is such that a total export to the EU is income inelastic. Therefore, India does not stand to gain on this account.

(6) Large business opportunities are, however, emerging in the computer software field. The entire business process re-engineering involved in the introduction of euro is much more complex than the current large business associated with the Y2K problem. Indian firms which will take proactive measures can reap enormous benefits by providing integrated business solutions.

(7) The euro will result, as was observed earlier, in greater price transparency throughout the euroland. This is expected to give a push towards a uniform pricing strategy. So far, most firms have followed different pricing strategies for different markets. This may not be possible in future. The euro will not result in uniform retail pricing throughout the euroland because of divergent cost structure in doing business. Marks & Spencers, for example, have stated that they are not contemplating equalization of prices. The pressure to uniform prices will come from the higher end of the distribution channel, viz. importers, distributors, etc. Indian exporters will have to re-design their export pricing strategies accordingly.

(8) The euro changeover requires dual display of prices, one in national currency and the other in euro. This will necessitate several changes in the existing packaging and labelling requirements. At the most primary level, the contents of the label will have to incorporate the price information in euro. At a more complex level, the conversion of a national price into an euro-denominated price may create difficulty from marketing standpoint. This will especially be so when "psychological pricing" is considered critical. In extreme cases, retailing may need a change in package size to conform to the psychological barriers. How these problems are going to be sorted out is anybody's guess. What is certain is that the Indian exporters must have the flexibility to accept the changing requirements of EMU-based buyers.

(9) If euro becomes a strong currency, it will make India's imports from euroland costlier. However, if due to the greater integration, the European firms become more efficient, the exchange rate induced price rise may get neutralized by higher efficiency and productivity levels.

To conclude, the advent of euro is both a challenge and an opportunity for the Indian exporters. It is time that they get familiar with the intricacies of euro and work out systems and procedures to be euro-compliant as early as possible.

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