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The Impact of the Euro on the International Financial Equilibrium

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From its creation, in 1957, until now, the European Union (EU) has evolved from a free trade area to a single market, now becoming an economic and monetary union.

On 1st of January 1999, 11 countries, members of the EU, formed the Economic and Monetary Union (EMU) – the most advanced form of economic integration among independent states. These countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxemburg, The Netherlands, Portugal and Spain. Greece had not accomplished any of the convergence criteria. Sweden met 3 criteria, at that moment, but it had never participated in the European Monetary System, and during the last few years (e.g. 1996-1997) its currency had suffered strong fluctuations. England and Denmark used their «opt-out» clause, postponing the moment for adopting the euro.

The emergence of the EMU affects not only its members, but the other states too. More than that, its existence has a strong influence on the evolution of the international monetary system and on the equilibrium of the international financial markets.

Once the single currency was launched, the members of the EMU passed automatically a single monetary policy – elaborated and implemented by the European Central Bank (ECB). Although the euro coins and banknotes will not be available before 1st of January 2002, the economic agents can have accounts in euro, and can use the single currency for their transactions. On the financial markets the euro already replaces the 11 currencies of the countries members of the EMU.

In order to function well, the EMU needs macroeconomic policies co-ordination. A special attention is needed regarding the exchange rates policy (elaborated

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by the European Council), the monetary policy (elaborated by the ECB) and the national budgetary policies.

The opinions expressed by economists, regarding the new currency, were divided among suspicion, lack of trust, and optimism. Many specialists considered that the euro has all the premises to become a strong international currency, able to compete with the American dollar.

During the Conference on the Economic and Monetary Union (EMU) and the International Monetary Fund (IMF) on 7th of March 1997, Philippe Maystadt, Finance and External Trade Minister of Belgium and President of the Interim Committee of the IMF said that the EMU creation marked an important point in the international relations, being an inedited event in the history of the IMF.

In the same speech, Philippe Maystadt presented the most important consequences of the emergence of the EMU on the present international monetary system.

Most probably, the EMU existence will make the passage from an international monetary system based on the American dollar to a system based on two, may be three international currencies (the American dollar, the euro and eventually the Japanese yen).

Although members of the EMU, the European countries which have chosen the euro will continue to be – at least for a while – independent members of the IMF instead of forming a single member.

Practically, although the monetary policy and the exchange rates policy are established at a supranational level (by the ECB and by the ECB together with the European Council), the members of the EMU are still distinct entities.

The decision to form a single member, with a single quota, would mean giving up on their sovereignty and it is not likely to happen. It would be difficult for the European countries to achieve a consensus on this regard. Moreover, by taking this decision, the members of the EMU would loose a part of their votes in the IMF (the 250 votes given to each member – the EMU, as single IMF member would have 250 votes – plus votes for its quota – instead of 2750 votes belonging to the 11 members of the EMU at the present. If the quota remains the same in the two cases, forming a single member would mean a 2500 votes loss).

According to the surveillance procedure, the IMF will continue the bilateral consultations which each of the EMU members, but there is a need to have consultations with the European institutions involved in elaborating the economic and monetary policy too (the ECB, ECOSOC and the European Council).

It's not likely for the EU to need credits from the IMF in the near future. Still, if this would be the case, it must be clarified first if the IMF can give credits to support the EU, which is not itself one of the IMF members. If the answer would be positive, one question still remains, regarding the amount of resources available for the EU.

According to the Articles of Agreement of the IMF, the membership of the IMF is given individually to each state, but until now each state had its own currency. Now the situation has changed, and the IMF must find a solution for it.

There has been monetary unions before, but not single currencies. Now for the first time a single currency of a group of IMF members can become a strong international currency.

Since 1980 the Special Drawing Rights (SDR) were based on 5 currencies: the American dollar, the German mark, the sterling pound, the French franc and the Japanese yen. As it can be seen, from these currencies three are European currencies and two of them (the German mark and the French franc) are to be replaced by the euro.

This way, the EMU emergence imposes reviewing the SDR composition. In order to use the euro among the currencies the SDR is based on, there are some principle and evaluation problems that must be solved first. It must be correctly established the position of the euro in the international monetary system.

The solution found may not be the best. After the 1st of January 1999 the composition of the SDR changed. The euro took the place of the German mark and the French franc, its percentage being the cumulated percentage of the two currencies.

In the following table is presented the composition of the SDR before and after the euro was launched, in other words before and after the modification on 1st of January 1999 (*see table no. 1*).

It's natural to wonder what would happen if the euro became a strong international currency, and which would be the consequences of this new situation on the international financial equilibrium – would the international financial system be more stable, or on the contrary, would the euro increase the financial instability and the volatility of the exchange rates?

P. Artus elaborated a number of models and wrote many studies on the chances the euro has to become an international currency, the evolution of the demand and

TABLE NO. 1
The SDR composition before and after 1st of January 1999

Before 1st of January 1999		**After 1st of January 1999**	
Currency	*Percentage(%)*	*Currency*	*Percentage(%)*
USD	39	USD	39
DEM	21	EUR	32
JPY	18	JPY	18
FRF	11	GBP	11
GBP	11		

(Source: Statistiques Financières Internationales – IMF, March 1999)

supply of euro on the financial markets and the impact of the euro on the international financial equilibrium.

The EMU will have various effects on the structure of the international financial markets, the most affected being the monetary and financial markets – even more affected than the exchange markets.

It is very difficult to evaluate the effects of the euro on the international financial equilibrium. These depend on many factors, especially the changes in the European monetary policy and the behaviour of the non-European investors, the way they perceive the new currency. Still some remarks can be made.

Apparently, if the euro became a strong international currency, the international financial system would be more symmetric and therefore more stable. A careful analyse would prove the contrary.

As the main objective of the ECB is price stability in the EU, it is natural to suppose that the ECB would accord less attention to the external objectives – compared with the Bundesbank – and the consequence could be a higher volatility of the exchange rate between the euro and the American dollar – compared with the previous evolution of the exchange rate between the American dollar and the German mark.

This way we could assist to an increase of the exchange rates volatility in an international financial system based on two currencies.

In this case, the demand for euros, on the financial markets, would be weak and in the long-run the new currency would suffer a depreciation.

Most probably the ECB policy would be less restrictive as the German monetary policy before 1999 and there would be fewer ECB interventions for stabilising the value of the euro. This could mean a depreciation in the short-run and an appreciation in the long-run.

Until now there have been few ECB interventions and they did not have a remarkable result. From January 1999 until now, the euro suffered a significant depreciation compared with the American dollar.

During the first 5 months of its existence the euro lost more than 15% against the dollar. Although at the beginning it was thought the exchange rate euro/dollar would be the best indicator for the success of the single currency, it might not be a relevant indicator. It might have been an appreciation of the dollar against all other currencies more than a depreciation of the euro (for the same period, the euro lost only 3% against the yen).

If before the monetary unification, the non-European investors considered the European currencies relatively independent, their demand for euros would fall, because after the unification, the reason for having European stocks for portfolio diversification, no longer exists. If before, an investor had a number of different European stocks, in different European currencies – which lowered the portfolio risk – he will not change all those stocks for stocks in euro, as stocks in just one currency can't fulfil this role, i.e. of risk reduction.

Even if the euro will end the dollar monopoly of the international financial system, this evolution needs time.

Compared with Japan, or even the USA, the EU has some advantages, (e.g.: the largest population, the highest percentage in the world trade, the highest percentage of exports in GDP). Apparently, the euro has some privileges. Still, we must remember that only 11 countries, from the 15 EU members, will use the euro as their official currency, and the economic power of the other 4 countries (e.g. Great Britain) is important.

Another issue is that the euro is a new currency, which has to defeat the suspicions and the lack of trust before it can play an important role on the international markets.

We could say the euro has good enough conditions to become the second international currency. But the demand of the investors for euros is not enough – there must also be enough euros on the market. There we find another obstacle: the reduced external debt of the EU.

The analysis shows the following situation: since the beginning of the 80's the USA had a permanent and important deficit of its balance of payments; based on this deficit, the external debt of the USA has continually increased, although until 1995 the dollar suffered a depreciation and the interest rates for this currency were not higher than for other currencies. For the same period of time, the EU had a permanent surplus, following a policy oriented towards limiting and reducing the public debt. After 1993 the surplus of EU was even higher than the one of Japan.

The surplus of the EU has structural causes and most probably this situation will continue in the future, under the influence of several factors. The economic recession appeared later in the EU than in the USA in the 90s (1990 – 1991 in the USA, 1992 – 1993 in the EU). In Europe the population is older than in the USA, therefore the savings rate is higher in Europe. During the last few years, the investments rate increased in the USA, but there are no guarantees that this evolution will take place in the EU too, especially since it cannot be stimulated through an expansionist monetary policy.

For these reasons, the euro supply on the international financial markets would probably be very low, and most of the stocks in euro would be owned by the European investors, and therefore the euro supply for non-European investors would be even lower.

For the last few years the interest rates in the EU were lower than the interest rate for American dollars. The interest rate for the euro would probably be much lower than the one for dollars. Therefore, the demand of the non-European investors for euros would be low too.

The increase of the exchange rates volatility, stimulated by the ECB focussing mainly on the internal objectives of the monetary policy – prices stability – could be perceived as neglecting the external objectives and could contribute to reorienting non-European investors towards other currencies – their demand for euros decreasing even more.

If we analyse the situation of the central banks, we'll notice the European central banks hold much more foreign currencies than their needs. At the end of 1996 the foreign currency reserves hold by the European central banks were

406 billion USD (Japan had 217 billion USD and the USA 64 billion USD). The Bank of Japan was trying to increase its reserves in order to prevent the appreciation of the yen against the dollar. The situation of the USA is typical for a state which is not worried by the changes that can appear in the exchange rates of its currency.

The Central Banks outside Europe own around 70% of their foreign currency reserves in American dollars. Replacing the dollar with the euro in the reserves of these states would strongly influence the evolution of the euro and the international financial equilibrium. This change is unlikely to take place, because of its economic and financial costs.

As a conclusion, we may say that the supply and demand for the euro on the international financial markets, will be low during the next few years. A remark must be made: all previsions regarding the demand for euros have a high level of incertitude, because this demand depends on the way the non-European investors perceive the new currency.

The structure of the foreign currencies official reserves will remain the same for the short-run. In the long-run we could assist to an increase of the demand for euros, especially if the non-European central banks would decide to rise the percentage of the single currency in their official reserves.

If the euro became the second international currency, most probably the volatility of the exchange rates would be higher, being strongly influenced by the changes in the international trade, the changes of monetary policies of tierce countries and divergences of monetary policy between the EU and the USA.

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