Emergence of Euro as an International Currency and Its Implication for India—A Study

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Abstract : Euro represents the most significant change of our generation in the European trading environment. The Euro is (or at least has the potential to be) the first full-fledged rival to the US dollar in more than half a century. Step by step, the dream of "Europe without frontiers" is being realized. It has far-reaching implications for the world economy. The world's newest currency may become its most powerful. In terms of trade volumes, the Euro will be bigger than the US dollar in the long run.

Key words : Euro; globalization; GDP; differential pricing; reserve currency.

1. Introduction

Euro, the world's newest currency, may become its most powerful currency. From risk-management to globalization, India will have to quickly learn to adapt to the new world of Euro finance. In terms of trade volumes, the Euro is expected to be bigger than the US dollar in the long run. All globally involved Indian corporations will therefore have to become Euro-centric.

The advent of the Euro has the frame of reference for India Inc.'s deals and dealing with the rest of the world. It will re-map our export markets, restructure our global operations and reorganize our financing plans. Euro has united 17 countries—Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Greece, Slovenia, Cyprus, Malta, Slovakia and Estonia–into one fiscal superpower and mega market. A potential challenger to the hegemony of the US dollar over foreign exchange transactions of every kind, it has given birth to a financial system that accounts for a fifth of the global economy and world trade, not to mention the planet's largest reserves of gold and other currencies.

Issued and administered by the European System of Central Banks–comprising the European Central Bank, headquartered in Frankfurt, and the 17 National Central Banks of the member countries–the Euro will need new strategies to manage our foreign exchange exposure, to hedge our financial risks, and to reallocate our resources.

The 17 Euro-countries are the collective destination of 24% of India's exports, and the source for 27% of its imports. Accounting for the lion's share of global GDP and trade, the Euro will attract increasing investment and transactions. It will convert Europe into a single market for exports and single sourcing-point for imports. A single currency will lead to uniformity of prices for products and services across the continent. Hedging and risk-management will become less complicated as only the Euro will have to be considered. The substitution of 17 currencies with one will lower foreign exchange transaction costs considerably.

Crucially, the Euro is likely to bring stability to many locally volatile or relatively untraded currencies—such as the Italian Lira or the French Franc. Earlier, such volatility made trade with those countries dangerous for Indian companies, but that barrier will now disappear.

Change in the internal dynamics of the 17 countries will affect both the nature and the volume of India's exports to, and import from, them. For instance, if the Euro leads to greater economic growth in the region, there will, obviously, be greater demand for products and services, spelling an opportunity for globally involved companies from India.

The Euro will also lead to price transparency across Europe. This would enable Indian importers from EU to strike the best bargains. On the other hand, a common currency would imply transparent pricing and quick comparison. This would force the exporters to adopt the practice of uniform pricing in the EU. Therefore, the surplus arising out of differential pricing would be wiped out.

Today, 320 million people in 17 countries use the Euro, which now rivals the importance of the US dollar in the world economy. This is an outcome that few would have predicted with confidence when the Euro was launched. How can we explain this success and what are the prospects for the future?

2. Objectives and Methodology of the Study

The objectives of the study are as follows :

- To understand the process of emergence of Euro
- To look into the possibilities of the Euro currency becoming an International Investment and Reserve currency for India

This study is both descriptive and empirical in nature for which both secondary and primary data have been collected. Secondary data have been collected from available research publications, government and semi-government publications, as well as reputed journals. Relevant materials have also been collected from Internet.

Primary data have been collected through Sources Questionnaire and Interview Schedule, prepared in consultation with academicians and practitioners. Finally, after collecting, tabulating and analysing the data we have made our concluding observations.

3. The Road to the Euro

Background to the EMU

Economic and Monetary Union (EMU) in Europe refers to the movement towards economic and monetary unification in the European Union, with the ultimate goal of introduction of a single currency. The process of economic integration in Europe began with the creation of European Economic Community (EEC), through the Treaty of Rome in 1957. The six founder members were Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Subsequent to the signing of the treaty, a common market was set up in Europe with common tariffs in member countries. Over the next few decades, the six-member EEC evolved into the present twenty-seven member European Union (EU). The EU countries included Denmark, Ireland and United Kingdom (which joined in 1973), Greece (which joined in 1981), Spain and Portugal (which joined in 1986), Austria, Finland and Sweden (which joined in 1995), Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia (which joined in 2004), Bulgaria and Romania (which joined in 2007) apart from the original six EEC member countries.

The objectives of the European Union include:

- Creation of an area without internal frontiers
- Strengthening of economic and social cohesion
- Establishment of economic and monetary union, including a single currency

The genesis of monetary integration in Europe can be traced to 1981 when the proposal to create the European Monetary Fund was considered, but did not fructify. In 1986, the member States of the European Community ratified the Single European Act, which led to the establishment of the EMU Committee in 1988.

The EMU was launched in 1989 with the publication of the EMU Report. A year later, the study report 'One Market One Money' argued for a single currency in Europe, which provided the broad contours of the present Euro. This was also Stage-I of the EMU. The idea of single currency acquired legal dimensions with the signing of the Treaty on European Union (Maastricht Treaty) in 1992. The Treaty was ratified by most EU members, a year later.

Stage-II of the EMU started in 1994 with the establishment of the European Monetary Institute (EMI) in Frankfurt. The EMI, along with the European commission has done most of the necessary groundwork chartered out by the provisions of the Maastricht Treaty. Stage-II is manifested by a ban on central bank financing of public deficits and closer monitoring of the economic and fiscal policies of the members. The most important event of this phase has been the selection of the eleven founding members of EMU at the special summit in May 1998.

Stage-III began in 1.1.1999 with the formal launching of the Euro. As ratified by the European Council meeting of May 2, 1998, with effect from 1.1.1999, the exchange rates of the currencies of the 11 member countries vis-à-vis Euro will be fixed irrevocably and hence, also the bilateral rates between the participating countries. On 1.1.2002, Euro notes and coins will be introduced and the national notes and coins will be progressively withdrawn from circulation.

For the transition phase between 1.1.2002 and 30.6.2002, there will be a period of dual legal tender status for euro and national currencies. On 1.7.2002, the legal tender status of the currencies participating countries will be formally withdrawn. Euro will stand as the only legal currency in the Euro Zone.

The Maastricht Treaty and the EMU

The Treaty of the European Union (Maastricht Treaty) was signed on February 7, 1992 by the heads of states of what were then the 12 member states of the European Union. The treaty came into force on November 1, 1993. The treaty lays the foundation for the economic and monetary union in Europe. It includes seven titles, protocols and a final act. It covers provisions amending the Treaty, establishing the European Economic Commission, as also other provisions, such as those for common foreign and security policy and for co-operation in the fields of Justice & Home Affairs. The protocols provide for detailed statutory provisions, including those for the ECB and the ESCB.

Convergence Criteria

The key to the monetary union is stipulated in the Article 109j (1) of the Treaty, which lays down a convergence criteria that the member-states need to fulfil so as to qualify for joining the EMU at Stage-III. The criteria are presented in the box given below. The Maastricht Treaty also makes it obligatory for the members-state to make necessary legal provisions to ensure independence of their central banks.

Convergence Criteria as laid down under the Maastricht Treaty	
PRICE STABILITY Average inflation rate during last 1-year should not have exceeded the inflation rate of the three member states with the lowest inflation rate by more than 1.5%.	LONG-TERM INTEREST RATES Average nominal interest rates on long term government bonds or comparable securities during last 1 year should not have exceeded 2 percentage points that of the average of the three best performing in terms of price stability.
EXCHANGE RATES The currency must have fluctuated with in the EMS bands for last 2 years with out severe tensions and member must not have devalued its currency's central rate on its own initiative.	GOVERNMENT DEFICITS GFD/GDP must be less than 3.0% or declining towards that level.Public Debt/GDP ratio be less than 60% or approaching that level.

Adherence to the convergence criteria set by the Maastricht Treaty as a qualification for inclusion in the European Union was closely monitored through regular semi-annual reports prepared by the European Commission (EC), the executive organ of the EU, and the European Monetary Institute (EMI). The Convergence Reports prepared by the EC and the EMI in March 25, 1998 recommended the inclusion of 11 out of 15 member states in the EMU. These 11 states were considered to have achieved a high degree of sustainable economic convergence. These are Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal and Finland. These countries were accepted by the EU Council as first wave of entrants ('in' countries) or the founding members of the EMU to be launched on January 1, 1999. Out of the remaining four countries, Greece is considered not to have met the necessary conditions for joining the EMU, while three other members of the EU—Sweden, Denmark and United Kingdom (UK) have exercised their rights under the Treaty not to participate in EMU for the time being.

Eight countries—Belgium, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Finland, have met the legal provisions on national central bank independence in accordance with the Maastricht Treaty. Others viz., France, Spain, Luxembourg and Austria have announced suitable legislation to bring about the required changes. Sweden is likely to consider these changes only at the end of this year due to legal compulsions. Denmark and U.K. are yet to ensure necessary legal changes for national central bank independence.

Costs and Benefits of EMU

Costs

Loss of Monetary Independence : With EMU national monetary autonomy will have to be surrendered to the supranational body (viz. ECB). This would mean loss of control over economic policy, loss of the right to alter exchange rate as an adjustment mechanism to correct balance of payment and loss of seignior age (i.e. the right to print money).

Loss of National Pride : Very often national currency is a symbol of national pride and economic success (like Deutschemark of Germany). Sacrificing national currency in favour of the single currency may be politically costly sentimentally provocative.

Cost of Conversion : These costs include cost of printing banknotes, minting coins, withdrawal of old currencies, changes in information technology and accounting system etc. a survey conducted by the European Banking Federation estimated such costs to be ECU 8-10 billion for the European banks.

Earning Loss for Banks : Single currency would reduce the earning of banks from foreign exchange transactions because erstwhile forex transactions would henceforth be treated as intra-union transactions. According to an estimate, potential loss of income for banks due to introduction of Euro may range from a minimum of ECU 9.5 billion to a maximum of ECU 14.4 billion.

Benefits

Savings in Transaction Costs : Single currency will reduce transaction costs due to currency conversion. With the elimination of exchange rate variability, hedging cost will also get reduce.

Lower Interest Rates : Consequent upon lower budget deficit, elimination of exchange rate risk and increased competition among banks-interest rates are expected to remain low.

Lower Inflation : The independent ECB will aim at price stability through a more concerted and credible monetary policy initiative resulting in lower inflation.

Increased Investment : Low interest rates would stimulate growth of investment in capital expenditure.

Better Allocation of Resources : Unrestricted factor mobility would facilitate allocation of resources to where returns are greatest.

Level Playing Field : Without a single currency, countries may be tempted to resort to devaluation in order to obtain trading advantage over others.

Pooling of Exchange Reserves : Internalization of intra-union trade would save member states around $ 200 billion in foreign exchange reserves—which may be put to more productive uses.

Integration of Markets : With the advent of single currency, imperfections in markets for products, services and factors will be eliminated resulting in lower prices and spread but higher volume and turnover.

Global Currency Status : Euro is all set to become a dominant global currency for transaction and investment purposes. As a reserve currency, it will only be next to dollar. There will be benefits accruing from holding of Euro as official reserve by external monetary authorities as also private holding of non-interest bearing Euro notes outside the union.

Faster Economic Growth : The cumulative effect of all these factors would encourage faster economic growth with corresponding increase in living standards and level of employment.

From the above it would be clear that most of the costs and benefits are not easily quantifiable. However, as against the costs- the benefits are many and they accrue over a much longer period. For example, cost of conversion is a onetime cost, while savings in transaction costs will be permanent.

4. Euro as an International Investment and Reserve Currency for India

A study was conducted to look in the possibilities of the Euro to become an international transaction (and reserve) currency and perhaps even replace US dollar as the most preferred currency for holding, for India.

For the purpose of the study, questionnaires were administered and interviews were conducted to get information on the research objective. Further, two types of questionnaires were administered respectively to:

Category A : The Indian exporters, corporate and business houses with trade interests in the EU

Category B : The Indian National banks and private banks dealing with Euro accounts.

In this study the sample size was 30 for category A and 15 for category B. We have used Convenience and Non-probability sampling.

Every study conducted may have certain shortcomings and unfortunately ours is also a similar case. A few errors may have crept in despite our best efforts to avoid them but it is expected that still our study and findings are very much relevant.

- An error may have occurred due to the samples taken not conforming to the actual population; this is because the sample is a convenience sample.
- Personal bias of the interviewer might also have crept in, some cases, while interpreting the respondents.
- Certain questions which are not properly responded by the respondent.

Findings and Analysis

A. Indian Exporters, Corporate and Business Houses

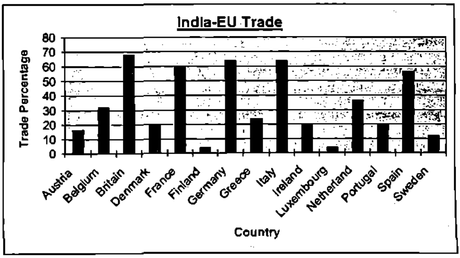
- The EU is India's largest trading partner accounting for one-fourth of her imports and exports. Total EU-India trade increased from Euro 9,975 million in 1991 to Euro 25,644 million in 2000, registering an impressive growth rate of 157%. Both, EU exports to and EU imports from India roughly doubled the same period. After five years of healthy growth between 1994-99, EU trade in 2000 grew by a robust 26%. The EU countries are among the largest investors in India.

From the study, among the EU countries, Britain, Germany and Italy emerged as the preferred major trading partners.

Details of the respondents trade with the EU countries expressed in percentage is given in the following table

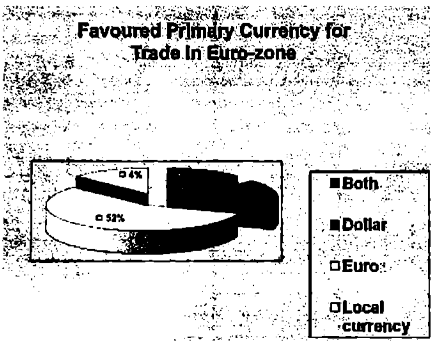
Country	% of respondents
Austria	16
Belgium	32
Britain	68
Denmark	20
France	60
Finland	4
Germany	64
Greece	24
Italy	64
Ireland	20
Luxembourg	4
Netherlands	36
Portugal	20
Spain	56
Sweden	12

The data may be represented the graphically as follows :



- 52% of the respondents used only Euro as the primary currency for transaction in the EU, while 36% transacted in the USD only. 8% of the respondents used both the Euro and USD for their transactions with countries in the EU while 4% of the respondents used some other currency such as the British Pound for trade transactions.

This reflects that Euro is replacing the local currencies and the USD as the main billing and invoicing currency in the European Union. Companies are probably finding that the advent of the Euro is simplifying trade producers



- *Euro is already in use during trading.* This was evident as a whopping 84% of the respondents said that they were already transacting in the Euro. Though the percentage of the trade in Euro varies widely but a cluster of 10–30% of the trading in Euro emerged from the study.

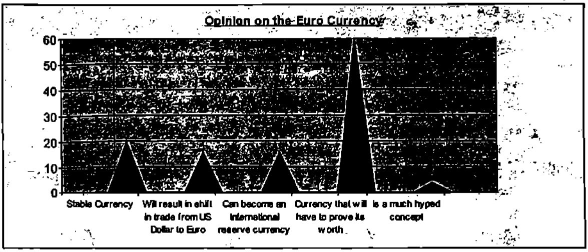
This reflects that Euro is a competitor to the USD in the Eurozone trading.

Of the respondents, 12% did not trade in Euro. Some of the reasons cited were Euro as a currency was yet unstable, their clients/suppliers preferred to deal in USD or in the local currency.

- *64% of the respondents said that Euro will appreciate while, 24% of them felt that the Euro will depreciate.*

This sentiment could be on account of the slowdown in the US economy expanded at its slowest pace in eight years in the second quarter of this year and the effects of the attacks in New York which have resulted in the Euro steadily against the dollar.

- *Though Indian companies are already trading in Euro in a major way, yet, 60% of the respondents felt that Euro, as a currency will have to prove its worth.* 20% of the respondents said that Euro is already a stable currency.. 16% of them felt that Euro will result in a shift in trade from US dollar to Euro, and they also mentioned that it can become an international and reserve currency for India. Only 4% said that Euro is a much-hyped concept. (Some of the respondents opted for more than one option to the question)



These reflect that the instability of Euro is a cause of concern and that a stable Euro will make it more credible outside the Euro-zone and make it more recognizable as a preferred currency for financial transactions. This will also bring about a gradual increase in the Euro's role as a reserve currency for India. In the medium run, the Indian monetary and financial system will remain dominated by the USD as a reputation for price stability takes time to acquire and the European Central Bank (ECB) has to develop a track record before The Indian Central bank shifts to Euro on a large scale. Nevertheless, the Euro has the potential to become the reserve currency for India.

- The currency changeover to *Euro has provided unique opportunities for Indian companies to work on their existing systems to increase their external competitiveness for trading in the unified Euro-zone.* 44% of the respondents said that the required changes in their legal instruments involved new contracts being drawn in Euro as the trading currency. 20% said that their organizational restructuring included changes in cash handling systems, while 8% mentioned the requisite software changes in their Electronic Data interchanges systems.
- *Among the benefits of Euro trading, 39% of the respondents ranked the elimination of foreign exchange rate risk as the most important benefit.* With the currency risks no longer existing more investment options have been emerging in Euro land. 30% ranked increased investment and funding opportunities due to increased price transparency as the next important benefit. The Euro has allowed Indian traders to the Eurozone to consolidate

banking relationships, thus enabling them to invest money more efficiently. Indian companies have been able to centralize their European accounting operations, thereby reducing administrative costs. The benefit ranked third was the reduction in transaction costs and business costs by 23%. The introduction of the Euro and the resulting elimination of intra-European currency conversion charges have been and will continue to be a significant source of saving for those companies which regularly deal in several currencies. A larger corporate debt market was ranked as the least important benefit of trading in Euro by 8% of the respondents.

With the reduction in foreign exchange rate risk, Euro has the potential to be a strong currency. Exporters can look forward to increased trade and new markets in those countries of the EMU, which previously had volatile currencies. This has tremendous marketing implications for Indian firms, looking for alternate market to the US.

- *Among the problems of trading in Euro, 62% of the respondents ranked the volatility of Euro vis-à-vis the US dollar as the most important risk.* The dollar is by far the main billing currency and even more so, the currency of capital market activities. Nearly half of world exporters are still dominated in dollars. A single monetary policy for 12 countries in different stages of their economic cycles could adversely affect the stability of the Euro in the long run emerged as the next important risk and was ranked so by 31%. The least important risk that emerges was the uneven effects of a single currency on different sectors of business by 7% of the respondents.
- *The sectors that emerged as the ones likely to be most positively affected in the year to come are the manufacturing and the industrial sectors.* The Indian IT companies can also look forward to Europe as an alternate market to the US for the software exports. New areas for FDI to India from Europe could be in infrastructure, telecommunications and food processing.

B. The Banks

- Among the banks surveyed, *all the national banks and private banks have been taking adequate steps for the handling of Euro since 1999* by opening Euro deposit accounts. Other steps taken include the training of staff in cash handling systems and repeated publications and circulars on Euro from time to time. 92% of the banks mentioned modifications in their existing computer systems to include Euro as a currency.

  Currently, the banks are processing information both in terms of the local currency and the Euro. Systems are in place to take adequate care of any rounding off difference that may occur due to currency conversions.
- When asked to rank the risk of Euro transactions, *67% of the respondents felt that a single monetary policy for countries at different levels of economic cycles could adversely affect the Euro in the long run as the most important risk.*

This is supported by the fact that a single rate for the whole of euro zone, together with the strict limits on fiscal policy prescribed by the Stability Pact, will make the EMU zone unable to respond to economic problems that affect a part of the region. Without sufficient labour mobility or a political union that allows for fiscal transfers from wealthy regions to poor ones, the EMU is hard pressed to find instruments for counteracting recession that could occur within parts of the currency union. 25% of them ranked the volatility of the Euro vis-à-vis the US dollar as an important risk. 8% ranked the absence of clear on seignorage sharing and open market transactions as the least important risk.

- *Regarding the importance of Euro in the international monetary system, 42% of the respondents ranked the Euro's emergence as a preferred currency for financial transactions as the most important.*

  33% responded that it could be an alternative currency for bond issuers. 17% of the respondents ranked the emergence of Euro as an alternate currency to the dollar. 8% responded that Euro could emerge as a reserve currency for India.

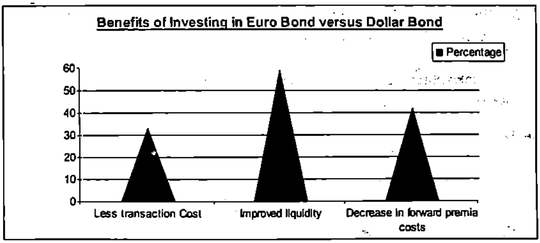
  The banks have expressed confidence in the Euro to take on the dollar in the international market. However, they have expressed their reserve on the Euro's ability to dominate the reserves of India in the short run.

- *59% of the respondents ranked improved liquidity as the most important benefit of investing in Euro-bond versus the dollar-bond.*

  This is supported by the fact that a large proportion of international bond and note issues are now denominated in Euros.

  According to the Bank for International Settlements, more than a third of such issues were in Euros in 2000. 42% ranked the decrease in forward premia costs as important benefit. 33% ranked lesser transaction costs as the least important benefit.

  (Some of the respondents opted for more than one option to the question)



Conclusion

The European Union will remain as one of the largest exporting zones in the world. This will boost the Euro as an international invoicing currency and means of payment. However, the preference of the EU main trading partners might shift to the Euro only when exchange rate variations are expected to be limited. The role of Euro depends, therefore, on international market preferences as well as on its ability to challenge the dollar in terms of liquidity and transaction costs.

Though the Indian companies are actively trading in Euro, they still feel that Euro as a currency will have to prove its worth before it can result in a shift in trade from the US dollar to Euro. The banks expressed their confidence in the emergence of the Euro as a preferred currency for financial transactions in the international monetary system. During personal interviews the sentiment that emerged from the banking sector was that though there is a unified monetary policy in the European Union there was a need to have clear unified policies on the budgetary and fiscal front.

Nevertheless both the sectors felt that Euro has the potential to be the reserve currency for India. However in the medium run, the Indian monetary and financial system will remain dominated by the USD as a reputation for price stability takes time to acquire and the European Central Bank (ECB) has to develop a track record before that.

Since the EMU presents new business opportunities, the Indian companies and banks are developing capabilities to tackle and effectively manage the changes not only in terms of Information Technology but also in accounting, tax, treasury, legal and most importantly the financial and other information systems which are used to support the company's and bank's business processes.

Despite the Euro's popularity as a currency for bond issuance, corresponding interest in the Euro on the investor's side is yet to be witnessed. The Indian business segment clearly wants to wait and watch the Eurozone's economies, its impact in the financial market and the Euro exchange rate before the official reserves of India can be denominated in the Euro.

As the Euro slowly continues to recover after the recent crisis, Indian exporters should wait to take advantage of the stronger Euro and expand their markets in Euro land. Particularly as the U.S stock market moves through corrections, US consumer spending will cool, so Indian exporters should be more aggressive in looking for European markets in future.

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