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THE EURO AS 'PARALLEL CURRENCY' 1999-2002

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PUBLISHER: European Parliament
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AUTHORS: TEPSA - Trans European Policy Studies Association
BRUXELLES

EDITOR: Ben Patterson
Directorate General for Research
Economic Affairs Division
Tel.: (00352)4300-24114
Fax: (00352)4300-27721
E-Mail: GPATTERSON
Internet: gpatterson@europarl.eu.int

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EXECUTIVE SUMMARY

On 1 January 1999, EMU (Economic and Monetary Union) started with eleven Member States and the euro became the national currency of each of them.

For the duration of a transitional period up to 31 December 2001, and though the old national currencies have ceased to exist, their respective national currency *units* are retained as non-decimal *sub-units* of the euro *unit*. This unit - one euro - is also divided into one hundred cents, its other *sub-unit*.

During this period, making payments or signing contracts etc. in euro or in a national "currency" are, from a legal point of view, both a use of the euro: in the first case, in the euro unit itself; in the second case, in one of the euro's national sub-units.

The principle "no obligation, no prohibition" applies to the use of the euro unit: everybody is free to use it but nobody is obliged to do so. But, as euro banknotes or coins are not available in the transitional period, the euro's use as a means of payment depends on the availability of euro payment services offered by the banking sector

At the end of the transitional period - i.e. from 1 January 2002 onwards - the national sub-units cease to exist. All references to them in legal instruments - laws and administrative rules, payment instruments (except banknotes and coins), contracts etc. - automatically become references to the euro unit at the applicable conversion rate. Euro banknotes and coins will be progressively introduced and those in the national denomination withdrawn within a period of six months maximum. The precise timing and modalities are to be fixed by the national authorities.

Part 1: THE TRANSITIONAL PERIOD.

The rationale of the transitional period is to allow the changeover to the euro to proceed smoothly, in accordance with the needs of all involved *(see Chapter I).*

Thus, for some sectors there was a need for an immediate changeover in January 1999. This was the case for the financial sector. The ECB (European Central Bank) was to conduct its monetary policy only in euro from the start of EMU. Moreover, the Governments of the participants were to issue their new debt in euro and convert the outstanding stock as well. Thus, the euro zone's money market, exchange market, bond- and stock markets had every interest in being ready for a "big bang" changeover on that same date.

Many large corporations also had an interest in the early adoption of the euro as "base" money for their operations.

Citizens, for their part, were expected to display some inertia towards the euro's use.

Faced with these somewhat conflicting demands, the principle "no obligation, no prohibition" had to be implemented in a way which responded, as much as possible, to each of them.

A. Facilitating the use of the euro

Major obstacles had to be addressed.

- National laws, regulations, contracts etc. imposed the use of the national currency. This severely limited the possibility to opt for the euro.

- There were practical problems in applying the "no obligation, no prohibition" rule. How could one reconcile the wish of one party to use the euro unit with the other party's insistence on the use of the euro's national sub-unit?

These obstacles were to a large extent overcome by:

1. The flexibility provided by the Regulations on the introduction of the euro.

These Regulations *(see Chapter II)* gave the national authorities the option to replace the national unit by the euro unit in organised wholesale markets and in clearing- and payment systems. This was duly done and allowed the switch-over to the euro of the money- bond-, equity- and exchange markets right at the start of EMU.

The Regulations also allowed the banks to "intermediate" in the payment circuit: i.e. make the necessary conversions so that a customer can give his bank a payment order in euro which the receiving bank then pays out to the beneficiary by crediting him for the countervalue in his national unit account.

2. The euro-friendly approach of the EMU Member States.

The Public Administrations *(see Chapter III)* of the EMU participants will continue to use their national currency unit for their internal accounting and budgets until the end of 2001. The Netherlands, for their part, have opted for a gradual changeover.

All EMU Member States, however, offer their enterprises and self-employed the choice between the euro unit and the national unit for the bulk of their financial communications and financial flows with their Public Administrations. The areas covered are:

- establishment or re-denomination of a company's capital,
- statutory and other financial reporting,
- communication of obligatory statistics,
- company accounting,
- tax payments,
- payments of social and national insurance charges,
- fiscal audits,
- written proofs for tax declarations.

Many Member States link the euro option to the company's adoption of the euro as its accounting unit. Some do not allow the use of the euro for tax declarations and declarations of social and national insurance charges.

For individuals, the range of euro options is more limited.

Euro-supportive initiatives have also been taken by the European Commission and by the national Authorities. Thus, three Commission Recommendations of 23 April 1998, endorsed by the Ecofin Council, dealt with the issues of:

a) Banking charges on conversion to the euro.

Standards of good practice were proposed: i.e. on the charges for the conversion of payments in the transitional period and for the conversion of accounts at the end of this period; and on transparency (correct conversion rate and all charges shown separately).

b) Dual display of prices and other monetary amounts.

Leaving these matters to be settled at the national level, the Commission nonetheless insisted on: counter-values in dual displays to be calculated at the exact conversion rates, rounded to the nearest euro cent, unambiguously displayed. To avoid overload, dual displays might be limited to the final price.

c) Dialogue, monitoring and information.

This heading groups agreements between trade and consumers' organisations on dual pricing, initiatives by large corporations to facilitate the changeover by SMEs, installation of Observatories to monitor the changeover to the euro, awareness-raising and targeted information, training of teachers and the preparation of teaching material.

On June 30, 1998 the associations representing the distribution sector, tourism, the craft industry and the SMEs signed an agreement with the consumers organisations on a voluntary code of conduct on dual pricing.

3. The euro services offered by the banking sector.

Keen on securing their share of the euro market, banks and other financial institutions made the necessary preparations so as to offer their customers a broad range of euro products right from the start of EMU *(see Chapter IV).*

In particular, the banks adapted their account management and statements, the latter indicating, for information, the balance in euro if the account is held in the national unit and *vice versa*.

Most payment services in local units have also been made available in the euro unit.

For the exchange of banknotes, banks have followed the Recommendation made by the Commission: the "spread" quotation was abandoned and replaced by a separate identification of the conversion rate and of the charges applied. As a result, the charges that banks used to lump together with their exchange risk in the "spread" between buying and selling rates are now explicit. This, however, has given the impression that banks were charging new costs.

For cash withdrawals abroad from ATMs (Automated Teller Machines), the same practice is followed: spread abandoned, charges individualised. Pricing schemes have been changed. On the whole, withdrawals have become less expensive everywhere, except for very small amounts in some countries.

As to domestic cheques, they are essentially intended for domestic use. Different format, language, legislation, absence of transborder truncation, collection charges, etc. explain why they are not not readily accepted abroad and why charges are high when cashed in at a foreign bank. This applies also to the newly created domestic cheques for making payments in euro.

The situation is different for the eurocheque, which is a standardised product suitable for both domestic and trans-border use.

Payments by cards (credit cards, debit cards, etc.) continue to grow fast. Banks will continue to promote them because they are less expensive to process than cheques and card fraud is easier to detect. The possibility to pay in euro with a bankcard depends on the euro-capability of the POS (Point of Sale) terminal. Their adaptation is underway but progress differs from country to country, depending on the number of terminals to be adapted or replaced.

E-purse cards were initially developed to serve small payment needs at the domestic level: grocer, parking meter, public telephone, etc. Interoperability between the various national schemes will most likely be achieved by the end of the transitional period thus ensuring their cross-border use.

The national payment systems for Credit Transfers and Direct Debits have both been adapted to the euro, but at the domestic level only.

Work is underway on the development of a pan-European direct debit scheme.

On cross-border credit transfers, bank charges have been reduced. But the elimination of the exchange risk is the only cost-reducing component in the cross-border operations of national credit transfer systems, which remain fundamentally non-compatible. As a result, these transfers - mostly low value payments - are, on the whole, still being processed through "correspondent banking" networks.

Time and resources are needed to improve this situation, but market forces will accelerate the pace of change.

B. The Transition to the euro in the non-financial commercial sector

The corporate sector *(see Chapter V)* has been largely supportive of EMU as it removes the exchange risk and improves the macro-economic environment through lower interest rates, price stability and sound public finances.

Studies and surveys have revealed that companies' reaction to the introduction of the euro have depended on:

- *company size*: companies with more than 200 employees are nearly all preparing for the changeover; under 20 employees, very few do so;

- *internationalisation effect*: awareness is greater in exporting companies and in those facing competition in their home market;

- *departments concerned*: most companies view the changeover as an accounting and financial issue. Major implications such as the commercial consequences of price transparency and of increased cross-border market access are largely neglected. This is a serious deficiency which highlights the need for a targeted communication campaign;

- *geographic location*: substantial differences exist between countries as to the degree of their companies' information on preparation for the changeover;

- *sectors of activity*: the retailing and other service sectors, such as tourism, are among the most concerned about future market evolution. Indeed, tourists have already started to pay in euros by credit card and at least one large tourist business publishes a dual price list and proposes payment in euro by credit card. During the first quarter of 1999, the percentage of euro payments ranged between 2.5% and 7.5%, according to the country of origin.

Among the obstacles to the use of the euro, a major psychological one is the lack of euro coins and banknotes, which dampens the sense of urgency. The "no compulsion, no prohibition" principle also encourages a "wait and see" attitude. As a result, the updating of IT software is running late.

Moreover, the euro's implications in terms of competition are not perceived by most companies.

Incomplete euro options offered by the Public Administrations are a handicap. Indeed, in some countries social security declarations still have to be presented in the national denomination.

The single currency reveals the absence of pan-European cross-border instruments. Delays and processing costs, the differences in laws on bank- and financial guarantees are frustrating to small companies and to the public.

This unsatisfactory situation should be remedied:

- not by more information - SMEs are swamped with it - but by direct contacts. Large firms can play a major role in raising awareness of the smaller companies: e.g. the experiments by Siemens and Auchan;

- Public Administrations and, in particular, the local Administrations should play a key role in encouraging the use of the euro by companies;

- solutions should be found to the present cross-border payment problems.

C. The use of the Euro by the citizen

For most citizens of the euro-zone, the birth of the euro was above all a media event. Indeed, nothing in their lives changed as they went on using their demoted currencies as before, ignoring the fact that they were actually handling sub-units of the euro, their new currency *(see Chapter VI).*

1. Starting hiccups

Concern has nevertheless surfaced in two consumer-sensitive areas:

a) *the cost of exchanging euro zone banknotes.*

Following a Recommendation of the European Commission, banks no longer quote buying/selling rates for dealing in euro zone banknotes and presently charge a separate fee on top of the fixed conversion rate.

The elimination of the exchange risk has brought down these fees compared to the previous spread; but the extent of the reduction which, moreover, varies between banks and even more so between countries, was a disappointment and a cause for concern at the Commission and the European Parliament.

Legally speaking, the euro zone banknotes are, in a material form, national sub-units of the euro. Moreover, they are liabilities of the ESCB (European System of Central Banks) and, in accordance with the Treaty, each national central bank exchanges, on its premises, banknotes issued by the other participants against local banknotes at par: i.e. at the fixed conversion rate and without cost.

However, because of the small number of central bank branches, the general public still has to rely on his bank "next door", which is certainly entitled to levy a "handling" charge for acting as a "stand-in" for its central bank.

Consequently, each central bank should assume a managing and cost-sharing role in supplying its local banks with any of the euro zone banknotes requested and take over their excess holdings. The objective should be low bank charges for the exchange of banknotes all round.

b) the cost of making cross-border payments in the euro zone.

Bank customers have started to complain about the high charges levied on their cross-border payments within the euro zone.

Though banks did upgrade the various national retail payment systems enabling them to handle, *at the domestic level*, euro payments alongside those in the national unit, they did not ensure the interoperability of these systems so as to give them a *cross-border* capability. The result has been that cross-border retail (i.e. low value) payments within the euro zone, whether in the euro unit or in any of its national sub-units, are still mainly being processed through the time consuming and expensive "correspondent banking" networks.

Banks are aware of the need to remedy this situation. The end of the transition period would seem the obvious deadline to aim at. But it might be ambitious as, for the banks, there is hardly a business case to be made for setting-up a cross-border system whose fees would have to be brought in line with the charges presently levied on the subsidised domestic transfers. Alternatively, the latter could be raised.

The "fee issue" should not, however, be considered by the banks only from the cost side. There is also a revenue side as people, encouraged by the banks, abandon banknotes and coins and switch to bankcards and electronic purses as means of payment. This leads to an increase in both the number of bank accounts and in the average amount of their balances. In conclusion, by making these payment systems available, banks increase their revenues as it enables them to lend a larger volume of positive account balances and charge debit interest on those in the red.

2. The Citizen's use of the Euro in the Transitional Period

Ideally, citizens should use this period for a progressive changeover to the euro so that, on 1 January 2002, the only changeover to be completed would be the exchange of banknotes and coins.

Even if it is unlikely to materialise, a major reason to press this case is the time and effort it will take for everybody to acquire a "euro" price memory and value scales. In other words, the citizen-consumer will not only have to memorise completely different euro prices for his habitual basket of goods and services but, what is even more difficult, he will also have to relate these new prices to one another i.e. assess their "value" differences.

Dual pricing will help. Following the voluntary dual pricing agreement of 30 May 1998, between the consumers organisations and the professional associations from the distributive trade, tourism, craft and SME sectors, dual pricing is being progressively introduced.

Yet dual pricing alone may not be enough. Indeed, if the consumer goes on to pay in his national unit, the euro price tag is unlikely to catch his full attention. It certainly will if he wants to pay in euro.

Whether this will be the case depends on:

- *The willingness of the signatories of the 30 June 1998 agreement to accept, beyond posting dual prices, to be paid in euro as well.* Obviously, euro payments are accepted by financial intermediaries such as banks, stockbrokers, insurance companies etc. With some exceptions, Public Administrations and Public Utility Companies do so as well.

- *The availability of specific euro means of payment*. The most helpful - i.e. euro banknotes and coins - are not available. Cheques are, but that implies carrying two chequebooks. Specific euro payments can be made by bankcards if the payment terminal individualises the unit in which the amount is to be paid: euro *or* national unit. But usually they indicate the amount in both units.

- *The citizen's motivation to pay in euro*. This is the main stumbling block. Indeed, citizens are free to pay in the national unit until end of the transitional period. In fact, sheer habit and the absence of a clearly perceived advantage of paying in euro may induce most of them to do just that. The fear of confusion is also an obstacle: e.g. carrying two chequebooks.

It is of course possible that some categories of the population may rapidly become familiar with the euro. This could be true, for example, in the case of those living in border areas or those professionally involved in trans-border activities such as tourism and transportation etc. or in companies or even sectors which operate on a euro basis: e.g. agriculture and its derivative industries.

However, the larger part of the euro zone's population, by sheer habit and absence of a compelling motive, is likely to stick to its familiar currency, thus facing a distressing "big bang" at the end of the transitional period.

This glum prospect has generated a wealth of information/communication activities by the European Commission, the National Authorities, financial intermediaries, consumer organisations and others representing specific population groups. The methods employed include brochures, newsletters, dedicated fax and phone numbers, e-mail, the Internet and TV spots.

Moreover, pilot projects have been set up by the Commission to deal with groups in need of specific modes of communication: the elderly, people with sight- or hearing deficiencies, population groups in economic difficulties.

Nonetheless, one is bound to conclude that the changeover to the euro by the citizens has not taken-off yet. And, regrettably, least of all in the payments area where it matters most in acquiring a euro price memory and value scales.

More information alone will not be sufficient to improve this situation. More targeted communication might motivate many; but to bring the the general public to choose the euro in preference to his familiar national unit, incentives will be needed. If these are not successful, dual price display might stay with us for a long time after the end of the transitional period.

Part 2: THE INTRODUCTION OF EURO NOTES AND COINS

From 1 January 2002 onward, euro banknotes and coins will be put into circulation and the national notes and coins withdrawn. About 12 billion euro banknotes and 50 billion euro coins will be at hand to carry out this changeover *(see Chapter VII).*

Key issues in this momentous operation are:

1. Bank charges

The Commission Recommendation of 23 April 1998, on standards of good practice, stipulates that banks should convert their customers' "household amounts" of notes and coins free of charge. Those intending to do otherwise should duly inform their customers, but there are no indications that banks would do so. In Spain charges are prohibited by law and similar prohibitions are on "stand-by" in others.

However, though the banking sector concurs with the "no charge" premise, it expects the central banks to share the burden and the cost of the operation.

The definition of "household amounts" is left to the banking sector in most countries or fixed by law in others. Amounts vary between no limit (Finland, Luxembourg, Spain) and □250 (proposed in the Netherlands).

It should be noted that the exchange of banknotes by non-bank customers is still an open question. Fees are charged for exchanging banknotes of other euro zone countries.

2. Dual circulation of banknotes and coins

The Regulation on the introduction of the euro stipulates that the period of dual circulation of legal tender banknotes and coins in both euro and the national unit should be limited to six months, at the most. This may be reduced by national law.

The approach adopted - tentatively for most - differs from country to country. The Netherlands aims for a four week period. Others (Austria, Belgium, France, Germany, Ireland and Luxembourg) foresee 6 weeks/3 months. Still others are conducting feasibility studies. Lately, a consensus seems to be emerging on a maximum period of two months.

3. Logistical issues

a) Front-loading

This means supplying specific economic sectors with a stock of euro notes and coins before 1 January 2002. For example:

- to banks, which may thus offer their customers the possibility to withdraw euro banknotes from their ATMs as of 1 January 2002;

- to retailers, enabling them to give change in euros as from that same date;
- to consumers: “starter kits” might be made available before the 1st. January 2002 (although the notes and coins could not at that stage be spent), much as tourists can obtain foreign exchange before travelling abroad.

Such measures would undoubtedly speed-up the changeover.

The ECB agrees with the proposal of front-loading banks and retailers. A period of one to three months in advance of "E-day" is considered as adequate. However, legal arguments and the risk of premature circulation of euro notes and coins are obstacles to front-loading for consumers.

b) Security, transport and storage capacity

13 billion banknotes and 50 billion coins represent about 13,500 and 250,000 tons and a bulk of respectively 80,000 and 500,000 containers. These figures illustrate the importance of front-loading.

In all countries additional transport capacity is necessary. Various options are under discussion, but no decisions have been taken yet.

- Banks expect their central banks to bear the costs of the additional transportation and security.
- One proposal to reduce risk and transport is the invalidation of the national banknotes on the premises of the private banks.
- Another might be a campaign to encourage the handing-in of national coins before "E-day".

c) Adaptation of ATMs (Automated Teller Machines)

At the end of 1998, 140,000 ATMs were installed in the euro zone. It is estimated that 70% of all euro banknotes will be distributed through them. Rapid conversion of ATMs is therefore a prerequisite for a rapid changeover.

Overnight conversion will take place in Austria, Belgium and Germany. The others have opted for a more gradual approach and, consequently, a less rapid changeover.

Part 3: THE INTERNATIONAL DEVELOPMENT OF THE EURO

The birth of the euro has raised hopes by some, and fears by others, that it might, sooner or later, challenge the U.S. dollar's position as the dominant international currency.

Any attempt at addressing this issue can only be tentative. Indeed, a currency's international status is not granted by official fiat but results from concurrent choices made by public and private operators world-wide.

Many currencies quite naturally play an international role as the invoicing and payment unit of *their* countries' foreign trade. Among the industrialised countries, the U.S. succeeds best in doing so. But most of the world's 200 or so countries cannot impose their own currencies in payment for their imports and may even want their exports to be paid, not in their own currencies, but in a more reliable or usable foreign currency, such as the U.S. dollar.

This is, in fact, what is meant by the "international" role of the dollar: its use *between* third countries in a way similar to its use *within* the U.S.

Indeed, the dollar, which at the domestic level is used as a unit of account, means of payment and store of value, performs the same functions between countries for both their private and public sectors :

- the *private sector*: invoicing and payment in dollars of their export/import of goods and services with countries *other* than the U.S.; holdings of dollar assets such as deposits, bonds, etc.;

- the *public sector*: dollar "anchor" for their currencies' exchange rate (fixed-, or sliding peg); choice of the dollar as the intervention currency on their exchange markets; dollar as main reserve currency of their central banks.

Moreover, beyond its use *between* countries, the dollar may also be used *within* a given country. The most popular form of this so-called "dollarisation" is the parallel use of dollar banknotes in some emerging economies. Its most extreme form - under consideration in Argentina - is the adoption of the dollar as the national currency.

A. The international role of a strong euro.

Though still dominant, the international role of the dollar has been on a declining trend as the DEM, Yen, Pound sterling and FRF also assumed an international role. On the eve of the introduction of the euro, the DEM had become an important international currency, though mainly at the regional level as the central currency of the EMS: anchor-, intervention- and reserve currency for the other participants. The ECU also developed a role as international currency, at least until the widening of the ERM fluctuation margins in 1993.

On 1 January 1999, the euro instantly became an international reserve- and intervention currency by inheriting the role held so far by the DEM, FRF and the ECU *(see Chapter VIII).*

Looking beyond this starting level, the prospects for the euro's further development are promising.

A major prerequisite is economic weight. The bigger a country, the larger its GDP and the larger its share in world trade On this score, the euro zone compares rather favourably with the U.S. Its population numbers 290 million against 278 million; its GDP amounts to □5,500 billion as against □6,800 billion; and it accounts for 18% of world exports as against 15% for the U.S.

The existence of large, diversified and liquid financial markets in euro also play a key role in the latter's international development. A promising start took place on 4 January, 1999 when EMU's money-, bond- and stock markets began operating in euro. Much more so than the former fragmented national markets they will attract foreign borrowers, lenders, issuers and other operators alike.

Of course, monetary policy also matters. The ECB's constitutional mandate to ensure price stability will result in a low-inflation euro zone (defined as below 2%). Achieving this target on a durable basis will require a coherent policy-mix between the single monetary policy and the national budgetary policies of EMU's Member States under the umbrella of the Stability and Growth Pact. Depending on the credibility of this happening, another prerequisite for the development of the euro as a major international currency will be met.

The inertia to change might nevertheless handicap the euro's development. Indeed, the more a currency is used in international transactions of all kind, the more useful and inexpensive it becomes for other potential users. The dollar possesses this so-called "network" advantage.

B. Specific areas of the euro's further development

If EMU constitutes the euro's home base, its development is being nourished, right from its start, on a much wider base.

1. The euro's use by the "PRE-INs" and by third countries

An immediate contribution to the euro's international development will come from the "PRE-INs", until their participation in EMU enlarges the euro zone proper[1] *(See Chapter IX).*

For the "PRE-INs" the euro is not just another foreign currency. Thus, for Denmark and Greece who joined the ERM (Exchange Rate Mechanism), the euro has become their exchange rate anchor and plays an increasing role as intervention and reserve currency

The private sector of the "PRE-INs" is likely to be affected as follows:

[1] Greece plans to join by the year 2001. The entry of Denmark and Sweden will be decided by referendum. No date has as yet been fixed. Last February, the U.K. Government declared its intention, in principle, to apply for membership in the next Parliament, possibly around May 2001. Pending a favourable outcome, followed by intensive preparation, entry could be envisaged at the beginning of 2004.

- exporters to the euro zone will have to adapt to the euro-induced lower price environment, while importers will benefit from it;

- both exporters and importers will be less able to impose their own currency in price listings, invoicing and payment. This increases their exchange risk exposure;

- dual pricing and payment is likely to develop in the retail sector, starting in tourist centres, and expanding when euro coins and notes are introduced in the "INs".

The "domestic" use of the euro - i.e. its use *between* residents of the "PRE-INs" - will also develop as local multinationals may decide on an early changeover to the euro. A recent survey found that a number of big U.K. exporters will encourage their U.K. suppliers to use the euro.

The development of the euro in the "PRE-INs" is facilitated by the accommodative stance of the financial sector and of the National Authorities - especially so in the UK where the financial sector has adapted its payment and settlements systems so as to enable the City of London to participate in the global euro interbank, foreign exchange and bond markets on an equal footing with their competitors in the euro zone proper (*see Chapter IX*).

For the time being, banks in the "PRE-INs" are more particularly interested in providing euro services to their corporate clients. Of course, accounts in euro are also available to private customers as they are in any other foreign currency. But their number has remained small so far and the use of the euro by private individuals is likely to remain limited given the exchange risk. This could change if/when the decision is taken to join EMU.

The countries of Central and Eastern Europe are nearest to the euro zone. Many of them are candidates - or aspiring candidates - for accession to the EU. In this perspective, Hungary and Poland plan to peg their currency to the euro possibly before the end of the year. Currency-board countries like Bulgaria and Estonia will replace the DEM by the euro as their anchor currency and Lithuania's exchange rate peg combines dollar and euro on a 50/50 basis.

As to the Mediterranean countries - *inter alia* Egypt, Turkey, Israel, Lebanon, Tunisia, Morocco, Jordan and Algeria - the bigger part of their trade is with the EU but, with rare exceptions, such as Tunisia and Morocco, trade invoicing is mainly in US dollars. It is also the case for their external debt and their foreign exchange reserves. This is likely to change for many of them. It has done so already for the African countries of the French Franc zone which are now linked to the euro.

Latin America and Asia, given their close links with the dollar and, for the latter also with the Yen, represent a more difficult challenge for the euro. However, as the globalisation of the industrial and financial sectors progresses world-wide, a diversification movement in favour of the euro can be expected to happen in those regions as well.

2. The euro's entry onto the international financial markets

The euro's entry on the international bond market has been a resounding success *(see Chapter IX).*

In the first quarter of 1999, international bond issues in dollar and in euro matched each other in market share: both stood at 44%. This result is remarkable as, before EMU, the combined issues of its participants never exceeded 36%.

Beyond it performance in volume terms, the following positive developments should also be mentioned: an increase in the number of issues of 1bn euro and more, which bodes well for the market's liquidity; an increase in the number of corporate issues, sign of an accelerating trend towards disintermediation; more newcomers on the issuer side while on the investor side an increase in Japanese buying was noted. U.S. demand remained stationary.

On the exchange markets, another noteworthy development is taking place: the euro is becoming a "vehicle" currency. In other words, the euro has started being used as a "go-between" in the buying/selling of currencies on the exchange markets. Today this is still very much a U.S. dollar prerogative.

C. The Euro and the International Monetary System

Given the comparable economic weight of the U.S. and the euro zone, the euro/dollar rate is the exchange rate that will matter most in the International Monetary System *(see Chapter X).*

This prospect challenges EMU's Member States and the ECB in two respects:

1. Defining the euro zone's external monetary policy stance.

Up to the creation of EMU, the Members of the EU had often cause to remember the quip by a former US Secretary of the Treasury:

> *"The dollar is our currency, but your problem".*

Indeed, in those days, a dollar outflow from the U.S. went straight into the DEM, pushing it up and leaving Germany's partners in the ERM with the thankless task of pushing up their own currencies by means of exchange market interventions and interest rate hikes in order to preserve their link with the DEM.

Today, things look differently. A dollar flow into the euro zone pushes up the euro but, sharing the same currency, all EMU participants move up in unison. In contrast to the position with the ERM, their monetary stance is not distorted.

An additional feature needs also to be stressed: intra-euro zone trade has become local trade. Only EMU's trade with third countries is still exposed to exchange risk. But exports to these countries represent only 13% of EMU's GDP. For the US this figure is slightly less. The use of the euro as the invoicing currency for exports should further reduce EMU's foreign exchange exposure and put it quasi on par with the US. Consequently, not only the US but also EMU might very well display some detachment *vis à vis* movements in the euro/dollar rate.

This, however, is only true in relation to current payments. Capital movements, which represent the bulk of exchange market transactions, could significantly amplify exchange rate movements. Consequently, the two zones should stand ready to address together the risk of mutually detrimental misalignments and excessive exchange rate volatility.

2. The representation of the euro zone in international monetary institutions.

At the end of 1998, the European Council agreed on the modalities of the euro zone's Representation in the Group of Seven (G7), the International Monetary Fund (IMF) and in missions to third countries. The proposals concerning the G7 - the ECB and the Presidency of the euro-11 Council would both be involved, with the Council assisted by the Commission – were, however, not accepted. The U.S., in particular, objected to any increase in the number of European representatives. In consequence, modified proposals were made in mid-1999.

These difficulties arise from, and illustrate, the reluctance of EMU Member States to adapt the format of their international Representations to the institutional changes brought about by EMU.

Moreover, whatever its format, a euro zone Representation, speaking for eleven countries, should be able to present a common view on the points at issue. This is a tall order, but an essential one if the EMU Member States want to have a greater say in international economic and monetary matters.

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Tables and Figures

I. GENERAL INTRODUCTION

On 1 January 1999, the euro became the currency of eleven Member States of the European Union: i.e. Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. On that same day, the national currencies of these countries ceased to exist.

Factual evidence, however, seems to contradict this latter statement. In daily life, the national currencies continue to be used very much as before, even if the euro may be visible on price tags and euro payments a possibility for those with a bankcard.

True enough, this "coexistence" is the main feature of the present transitional period, which should facilitate a smooth changeover to the euro by all involved. However, one should be clear about the nature and specifics of the "parallel" use of the euro and the national currencies during this three-year period.

First of all, it must be stressed that, on 1 January 1999, the euro effectively became the one and only *currency* of each of the participants in EMU. The *unit* of value of this currency is *one* euro, in the same way as one metre is the unit of length of the metric system. And as one metre is subdivided into 100 centimetres and 1000 millimetres, so is *one* euro subdivided into 100 cents and, for the duration of the transitional period, into

40.3399 BEF (Belgian Franc)
40.3399 LUF (Luxembourg Franc)
1.95583 DEM (German Mark)
166.386 ESP (Spanish Peseta)
6.55957 FRF (French Franc)
200.482 PTE (Portuguese Escudo)
1936.27 ITL (Italian Lire)
13.7603 ATS (Austrian Schilling)
2.20371 NLG (Dutch Guilder)
0.787564 IRL (Irish Pound)
5.94573 FIM (Finnish Markka)

In other words, in each participating Member State, the national currency has ceased to exist as a currency but, for the duration of the transitional period, its currency *unit* has been retained as a non-decimal *sub-unit* of the euro *unit*. Because of this status, any amount denominated in a national monetary unit has a legally valid "equal value" in the euro unit (and *vice versa*) at the applicable conversion rate.

Of course, in such a regime some guidance must be given to enterprises and citizens on the use they can, or are obliged to make of the euro unit and/or its national sub-units - all the more so since the aim of the transitional period is to achieve a progressive and orderly changeover to the euro.

At the Madrid Summit of December 1995, it was decided to apply the "no obligation, no prohibition" principle to the use of the euro during the transitional period.

Everybody would be free to use it, but nobody would be obliged to do so. Thus, during this period, contracts could be denominated in euro provided the parties involved agreed and the existing legal rules allowed the use of a currency unit other than the national one.

At the time when this general ruling was announced, it seemed to favour the ongoing use of the national currency units rather than promote the growth of the euro. Indeed, left unchanged, existing national laws and regulations would routinely have continued to impose the use of the national currency unit. This, in many instances, would have made recourse to the euro impossible, even between parties that would otherwise have been willing to do so.

Moreover, since in the transitional period euro notes or coins are not available, the very usefulness of the euro would depend on whether or not the banks would be willing to adapt their payment systems and related instruments - cheques, transfer orders , debit and credit cards, etc. - so as to put the euro, as "book-money”, on a par with its national sub-units for making payments.

In short, unless the legal restrictions existing at that time were lifted and euro products and means of payment were made available by the financial sector, the "no obligation, no prohibition" rule could not, by itself, generate a significant and growing use of the euro during the transitional period.

Fortunately, at the start of EMU, a generally level playing field had emerged. It was the outcome of a chain of mutually reinforcing decisions taken by the major actors involved in the implementation of the changeover to the euro.

It had already started in May 1995, when the European Commission claimed that a "critical mass" of euro operations should be generated at the very beginning of EMU.

In December of the same year, the Madrid Summit decided that, as from the starting date of EMU:

- monetary policy was to be defined and executed in euro by the European System of Central Banks (ESCB), as well as the conduct of its foreign exchange operations;

- the public authorities of the participating Member States were to issue their new debt in euro.

The first of these decisions presented the banking sector with an important challenge. Indeed, how could the wholesale interbank markets of the participants continue to function - each in its respective national monetary unit - when they were to become a single global market in which the ESCB intervened to add or withdraw liquidity exclusively in euro?

The response was not long in doubt. Today, we see that all short term borrowing and lending between banks of the euro zone - no matter where they are located - is made in euro and settled through the euro based TARGET (Trans European Automated Real time Gross Express Transfer system) and EBA (Euro Banking Association) payment systems. The identical short-term interest rates which prevail throughout the euro zone are a tribute to the satisfactory functioning of the euro-based interbank market.

The second decision challenged the financial market participants. Some governments, keen to secure for their paper a prime place in the nascent euro bond market, were quick to announce their intention, not just to issue new bonds in euro, but to re-denominate their stock of outstanding bonds in euro as well. Of course, other countries followed suit and, as has been witnessed since the start of EMU, the bulk of the public debt of all participating Member States has now been redenominated and is traded in euro. Since government bonds occupy a dominant position in the bond markets of the participating Member States, a switch from the national currency to the euro as the currency to run these markets was almost a foregone conclusion.

On top of that, given the close links between bond markets and stock markets - same membership, same payment and clearing systems - the decision to switch the pricing and trading of bonds to the euro was quite naturally adopted by the stock markets as well.

As a result, with the interbank and exchange markets, stock- and bond markets operating in euro, the Member States' changeover to the euro of their financial wholesale markets was completed as of the beginning of EMU.

For its part, the corporate sector had started lobbying in favour of unrestricted access to the euro during the transitional period. Its motives for doing so were obvious. Many European-based corporations with production and servicing units scattered in a number of Member States had an interest in stopping the use of the various national sub-units of the euro, and adopting the euro unit itself as their "base" currency for the whole of their operations: pricing, invoicing, payments, accounting, salaries, tax reporting and payments, and so on. The rewards would be greater transparency and efficiency, time and cost savings.

However, corporations could hardly proceed that way unless:

- first, national laws and regulations which imposed the exclusive use of the national currency unit were amended so as to offer a choice between the national unit and the euro; and

- secondly, banks were willing and able to offer their clients a product line in both the national and euro unit. In addition, in executing payment orders, banks had to be prepared to intermediate i.e. reconcile a payer's order in euro with the beneficiary's wish to be credited in the national unit, and *vice versa*.

The national authorities willingly obliged and proceeded - some to a greater extent than others - with the appropriate changes. Consequently, on 1 January 1999, the existing national laws and regulations, instead of imposing the continued and exclusive use of the national currency units, offered the choice between this unit and the euro unit in a wide range of uses.

As for the banks, they did not have much choice. Invoking a "no obligation" i.e. refusing to offer euro services during the transitional period, had never been a realistic option. In fact, anticipating increased competition in the wake of the creation of the single currency area, they accelerated their preparations so as to qualify in the eyes of their clients as regular "euro" banks offering them, right from the start of EMU, the broadest possible range of euro products.

These introductory remarks make the point that the potential for the euro to develop in the euro zone during the transitional period hinged on two major factors:

- first, the extent to which the national authorities abstained from invoking the "no compulsion" principle for themselves and the extent to which they were willing to implement the various pro-euro options provided by the Council's Regulations on the introduction of the euro; and

- secondly, the number and variety of euro services which the financial intermediaries of the participating Member States - i.e. banks, bond and stock markets, insurance companies, etc. - made available to their clients.

In fulfilling these prerequisites, national authorities and financial intermediaries have effectively given enterprises and, to a large extent, individuals as well the freedom of choice, either to stay in the national currency unit or to switch over to the euro, partially or completely, anytime from 1 January 1999 onwards, in accordance with their perceived best interest.

The chapters that follow will

- summarise and comment on the Community Regulations on the introduction of the euro;
- analyse the scope of the changeover by the Public Administrations;
- describe the euro payment services provided by the banking sector;
- present a survey of the transition in the non-financial commercial sector;
- assess the actual and expected changeover by the citizens;
- comment on the issues involved in the exchange of national bank notes and coin for euro notes and coin; and
- analyse the euro's potential as an international currency and its place in the international monetary system.

II. THE LEGAL STATUS OF THE EURO: AN ANNOTATED SUMMARY

The main provisions of the legal status of the euro[2] relevant for the purpose of this Study are the following:

- On 1 January 1999, the euro became "the" *currency* of each Member State participating in EMU, replacing their respective national currencies. This currency's *unit* is *one* euro. By being the currency of each participant, the euro is the *de facto* currency of the euro zone, an open-ended group of countries[3].

- As of the start of EMU, all references to the ECU become references to the euro on a one-to-one basis. The outstanding ECU bonds have thus become euro bonds.

- A transitional period runs from 1 January 1999 up to 31 December 2001. During this three- year period:

  (i) The national currency *units* continue to exist as *sub-units* of the euro *unit* which is also divided into 100 cents. It follows that any amount denominated in a national sub-unit has a legally valid equivalent in the euro unit at the irrevocably fixed conversion rate correctly applied, and vice versa. Thus, a sum of □356.25 and 696.76 DEM (i.e. 356.25 x 1.95583) represent identical values, alternatively expressed in the euro unit and in its German sub-unit. In other words, the euro unit and the national sub-units (called national monetary units) are units of the same currency, the euro.

  (ii) All legal instruments - e.g. contracts, leases, insurance, etc. - which, at the start of EMU, are denominated in a national monetary unit must be discharged in that unit. Similarly, prevailing laws and other regulations which impose the use of the national currency (e.g. the obligation to keep a company's books in the national currency) remain in force, in the sense that the euro's sub-unit - i.e. the national monetary unit - has to be used.

  (iii) The "no obligation, no prohibition" rule applies to the use of the euro. Everybody is free to use it but nobody can be obliged to accept it. Consequently, parties to a new contract have to agree on the euro unit or the national monetary unit. Once the choice made, all acts (prices, invoices, payments, etc.) have to be made in the chosen unit. However, because of the rather extensive compulsory use of the national monetary units mentioned under (ii) above, it is unlikely that the " no...no" rule could, by itself, have raised the euro's use beyond a case by case affair.

  (iv) Fortunately, the euro legislation allows the national authorities to take the measures necessary to:

[2] Regulation n° 11O3/97 of 17 June 1997. (O.J. n° 369 of 7.12.1997, p. 8) and Regulation n° 974/98 of 3 May 1998.

[3] The term "euro zone" fits the legal reality better than "Euroland".

- replace the national monetary unit by the euro unit as the denominator of *outstanding* public debt. This provision was introduced during the legislation's drafting stage when it became clear that an increasing number of Member States wanted to move beyond the mere issuing of *new* debt in euro;

- allow the adoption of the euro unit as the unit of account of organised wholesale markets and of clearing and payment systems. This created the legal basis for the changeover to the euro, as of 1 January 1999, of the participating Member States' stock- and bond- markets and of their interbank payment systems;

In addition, this legislation also imposes the following rules to payments made by credit transfers within the euro zone:

- a debtor who has a bank account in the national currency unit, can discharge a debt denominated in euro by issuing a payment order in euro. His bank will take care of the conversion: i.e. debit his account for the euro's counter-value in the national unit.

- at the other end of the chain, the beneficiary of a euro payment who keeps his account in the national unit will be credited by his bank in that unit. Here again the bank automatically makes the conversion, without having to ask the beneficiary if this is what he wants.

In fact, this compulsory payment scheme was introduced in the euro Regulations at the request of the banking sector itself. After the Dublin Summit of December 1997, banks were making preparations in earnest for an EMU start in 1999; but, in most countries, banks were loath to accommodate a potentially huge demand for euro accounts alongside the existing national currency accounts. This would have compelled them to establish, at considerable cost, dual currency account- and payment systems with a useful life of a couple of years only i.e. up to 31.12.2001, the date on which all national currency accounts have to be closed down.

The rules on credit transfers simplify matters considerably for the banks and also for the account holder: the payer's and payee's single bank accounts, whether they are in the euro unit or in the national sub-unit, will do for payment orders in either of these two units.

Actually, this bank "intermediation" represents also an essential prerequisite for the euro's development in the transitional stage. It makes the "no obligation, no prohibition" rule workable at the payments level: enterprises and individuals who want to switch to the euro for their in- and out- going payments can proceed to do so even when making payments to those who want to go on using the national unit and, consequently, also keep their account in that unit.

(v) Measures, other than those mentioned above, which *impose* the euro in the transitional period can only be taken by Community legislation. This is less restrictive than it sounds. Indeed, it leaves open the possibility for any individual Member State to change its national laws and regulations so as to allow the optional use of the euro i.e. offering a choice between the national unit and the euro unit.

(vi) Bank notes and coin in the national monetary units remain legal tender within their respective territories for the duration of the transitional period. There is no obligation to accept them outside the issuing country.

4. The transitional period comes to an end on 31 December 2001. As of 1 January 2002:

(i) National monetary units cease to be sub-units of the euro and all references to national units are to be read as references to the euro unit at the applicable conversion rate. This means that laws and regulations imposing the use of the national currency are from the on to be read as imposing the euro unit and that outstanding contracts in the national unit automatically become euro contracts. This replacement of the national units by the euro unit does not alter the continuity of any existing legal instrument. All the other terms of running contracts remain valid and enforceable.

(ii) Euro bank notes and coin are introduced as from 1 January 2002. They will have legal tender in all participating Member States. This is a compelling reason why they have to be introduced simultaneously by all participants as from that date. A latecomer would simply face an inflow of coins and notes issued by the others.

The method and timing - maximum 6 months - of the withdrawal of the national banknotes and coin, is to be decided by the national authorities. But it is already generally accepted that the withdrawal should take place in a much shorter time span. A two-month period seems likely to emerge as a compromise between the interests of the retailers who, for obvious reasons, want the shortest possible period and the general public and the vending machine operators who want a much longer one.

The more controversial idea, recently floated by some, of bringing forward the date of introduction of the euro notes and coin has not generated support.[4]

[4] It has also been specifically rejected by the Commission (*see Report to the Council on the Transitional Period for the Introduction of the Euro*, COM(1999)174 of 7 April 1999). [*ed.*]

III. THE CHANGEOVER TO THE EURO BY PUBLIC ADMINISTRATIONS AND OTHER OFFICIAL INITIATIVES

Already before the start of EMU, quite a few European multinationals, banks and export-oriented SME's had indicated their desire to proceed with a full changeover to the euro at the start of EMU or shortly thereafter. In most countries, this was legally impossible: existing laws and regulations required capital, accounting and reporting to be denominated in the national unit and taxes and social security contributions to be paid in that unit as well. Moreover, the Madrid Summit had decided that the national authorities could not impose the euro for public sector operations until the end of the transitional period (that is, 31 December 2001).

However, if the public administrations could not *oblige* the economic agents to use the euro before 31 December 2001, they were at liberty to grant, as of January 1999, the *optional* use of the euro unit. This meant giving the private sector operators the freedom of choice between the national unit and the euro unit as the denominator for their communications and as payment instrument for their financial flows between themselves and the Public Administrations. The Belgian changeover plan published in mid-1996, granting the private sector the option to use either the national unit or the euro unit for these operations and many more, set a precedent soon followed by the other Member States.

Since then, all Member States participating in EMU have adopted a changeover legislation which has granted, as of January 1999, the optional use of the euro for most, if not all, the financial flows between the private economic agents and the national public administrations.

As national administrations experienced different degrees of difficulty in implementing the various euro options, however, the field covered by these options is not totally identical. Moreover, the public administration changeover schemes which define the euro's place in the relations between private economic agents and the administration are to be seen in the wider context of the various national changeover scenarios. They address country-specific problems in the use of the euro, confirm sectoral agreements or define the rules applicable to relations between professionals and the general public on issues such as bank charges on the euro, length of the dual pricing period, procedure for the local exchange of the banknotes of other participants during the transition period.

In the sections that follow an overview will be given of the extent of the national public administrations' changeover to the euro and of the additional euro supportive initiatives taken by the Community and the national authorities.

1. The changeover to the euro by the national Public Administrations

This section describes the use made of the euro within the various national public administrations themselves and the extent to which they accept to deal in euro at the initiative of enterprises and self-employed and of individuals.

1.1. The euro's use within the Public Administrations.

In all but one participating Member State, public administrations will continue to use their national unit for their internal accounting and budgets, including the national budget, until the end of the transitional period. The Netherlands represent a partial exception: the internal accounting is being adapted gradually as of 1.1.1999. It should also be noted that most decided to publish statistical data in euro alongside those in the national unit.

1.2. Euro options for enterprises and self-employed.

All participating Member States offer their enterprises and self-employed the choice between the euro unit and the national unit in the following areas:

- establishment or re-denomination of a company's capital,
- statutory reporting,
- other financial reporting,
- communication of obligatory statistics,
- company accounting,
- tax payments,
- payments of social and national insurance charges,
- fiscal audits,
- written proofs for tax declarations.

The irrevocable decision to adopt the euro as the company's accounting unit is in many countries a prerequisite for the choice of the euro option in the other areas.

Not all Member States allow the optional use of the euro for:

- tax declarations,
- declarations of social and national insurance charges.

Though most do offer the choice between the national unit and the euro, a few countries - i.e. Germany, Austria, Portugal - impose the use of national currency up to 31 December 2001.

1.3. Euro options for individuals.

National attitudes are mixed. In quite a number of participants i.e. Belgium, Germany, Italy, Luxembourg, the Netherlands, Austria and Finland, the public administrations accept tax declarations and tax payments in euro In the cases of France, Ireland, Spain and Portugal, they impose the national unit for tax declarations. However, with the exception of Spain, tax payments in euro are admitted in these countries provided the banking sector ensures their conversion in the national unit for credit on the Administration's account in that unit.

This overview shows that, contrary to the initial expectations, all national public administrations have adapted themselves in time so as to enable enterprises, professionals and - in most countries - also individuals to initiate, during the transitional period, the changeover to the euro at the moment of their choice.

This uniformly euro-friendly approach by the public administrations is more than mere coincidence. It has been driven by the view that trailing behind while others moved forward would have saddled their business sector with a serious competitive disadvantage in the euro zone.

2. Euro-supportive initiatives by the Commission and by the National Authorities.

The more important practical aspects of the euro's use in the transition period have been studied by the European Commission with the help of qualified consultative groups. Their findings are reflected in three Commission Recommendations, accepted by the Ecofin Council of 2 May1998. They dealt with the following issues:

2.1. Banking charges on conversions to the euro

a) A standard of good practice is proposed to the banks concerning:

i) practice that is considered legally required

- no charge for the conversion into the euro unit of incoming payments in the national unit which have to be credited on a euro account. The same holds for an incoming payment in euro to be credited on an account in the national unit;
- no charge for the conversion of accounts in the national unit into the euro unit *at the end* of the transitional period;
- no differences in charges for banking services in the euro unit as compared to identical services in the national unit.

ii) recommended practice

- no charges for the conversion into the euro unit of outgoing payments to be debited from a national unit account and *vice versa*;
- no charges for the conversion of accounts in the national unit into the euro unit *during* the transitional period;
- no charges for the exchange by their customers (i.e. account holders) of "household amounts" of national banknotes and coin for euro notes and coin after January 1, 2002. Banks should quantify the "amounts" by volume and frequency.

b) Transparency

Banks should clearly show they correctly apply the conversion rates and indicate, separately, any charges. Their customers should have prior information on whether or not their bank applies the standards of good practice and on the charges they will have to pay. These charges should also be identified on bank- and card- holder account statements.

c) Implementation

The standards of good practice should apply as of January 1 1999. Banks should inform their customers whether and to what extent they intent to implement them. A "conversion symbol", if considered appropriate, should be worked out and displayed at the national level.

c) Other recommendations

The national authorities should consider the case of the exchange, in the final period, of national notes and coin for euros by citizens without a bank account.

2.2. Dual display of prices and other monetary amounts

A widely-shared consensus exists on the merits of dual pricing before and after the end of the transitional period on 31 December 2001. It familiarises consumers, retailers and service providers with the euro prices, helps the citizens to develop a euro-based scale of values and reassures about the neutrality of the changeover by allowing a price control. It was nevertheless also felt that legislation at the Community level would not be the best way to ensure consumer information and protection, nor the need to minimise the costs of the operation.

Leaving these matters to be settled at the national level, the Commission nonetheless made recommendations on the following :

a) A standard of good practice:

- The counter-values in dual displays must be calculated at the exact conversion rates.

- A minimum standard of accuracy: i.e. rounding to the nearest euro cent.

- The avoidance of confusion: dual displays must be unambiguous, easily identifiable and clearly readable.

b) Adherence to the following basic provisions:

- No uncertainty should exist between, on the one hand, the unit - e.g. the FRF - in which the prices are set and in which the total amount payable is going to be calculated and, on the other hand, the unit - the euro - in which the counter-value of prices is displayed for information purposes only. (N.B: the "base" unit is not necessarily the national one. It could very well be the euro unit for a distribution chain that has made a general changeover to the euro. This is bound to happen progressively as the end of the transitional period approaches).

- Overloading price labels with figures should be avoided. Dual price displays on individual products may be limited to the final price, and to the total amount on cash register receipts from retailers, department stores and others.

- Dual pricing for information purposes is one thing; accepting the euro in payment is another. Those practising dual pricing should clearly indicate whether they also accept euro payments. This could be done by means of a logo.

c) Implementation.

In the Commission's view, dual pricing will greatly facilitate the changeover to the euro by consumers and employees. It should therefore be applied early on to benchmark indicators such as bank statements and bills from utility companies: power supplies, public transportation, telephone and T.V. charges, etc. At the retail level the introduction of dual pricing should be progressive, its pace determined by the capability and perceived interest of the professionals to respond favourably to actual or anticipated consumer demand.

2.3. Dialogue, monitoring and information to facilitate the transition to the euro

This third Commission Recommendation is addressed to the Member States and to a broad range of associations representing business, banking, trade, and consumer interests.

a) Dialogue.

Trade and consumer organisations are asked to conclude agreements on standards of good conduct on dual pricing. Large businesses should facilitate the changeover of SME's *inter alia* by giving prior notice before issuing or requesting invoices in euro. They should also accept that their suppliers' invoices continue to show prices in the national unit alongside the euro prices.

c) Observatories and monitoring.

The Member States are invited to set up Observatories to monitor the transition to the euro and the fairness and transparency of professional practices. They should also provide guidance to sources of information, mediation and assistance to citizens.

d) Information and training.

SME's face specific difficulties in their changeover to the euro. Awareness-raising and targeted information, consultancy and advice should be made available by the professional organisations, *inter alia* chambers of commerce, to assist them in their preparations.

In the educational field, Member States should involve all forms of education and training in the information drive on the euro, starting with the information and training of teachers and the preparation of teaching materials.

3. Follow-up at the European and national levels

Some Member States anticipated the Commission's Recommendations in their own changeover plans; others strengthened some of its provisions in their legislative measures on the changeover. Thus, conversion rules with a higher degree of precision were enacted in Belgium, Spain, Ireland and Portugal. In France, the law upholds the legal validity of payments which have been rounded according to the Community's rules. In Belgium, France and Italy, the government has been allowed to regulate dual pricing if it considers the voluntary approach unsatisfactory.

So far, dual pricing is governed by an agreement at the European level. On 30 June 1998, the associations representing the distribution sector, tourism, the craft industry and the SME's signed an agreement with the consumer associations regarding a voluntary code of conduct on dual pricing, certified by a "European label". The professionals who subscribe to this code assume the following commitments:

- the dual price, the total amount to be paid and the conversion gadgets shall be in accordance with the official rules on conversion and rounding;

- the payment in euro - when accepted - entails no additional cost as compared to a payment in the national currency;

- information on the use of the euro must be available;

- dual pricing must cover a minimum of goods and services as of 1999 and a majority of these by July 2001. It shall be maintained until July 2002.

- employees, dealing with customers, must trained so as to be able to answer basic questions on the euro;

- customers must be informed about the possibility to pay in euro.

The single, easily recognised "European label" is allotted to any professional who subscribes in writing to these commitments. This quasi-automatic membership makes an *ex post* control necessary. The Observatories could be involved. Transgressors would face prosecution under the laws on deceptive advertising.

It should also be mentioned that the European Banking Federation has announced that its members will follow the Recommendation of the European Commission on banking charges on the euro.

IV. THE USE OF THE EURO IN PAYMENT SYSTEMS

1. Introduction

The banking sector fully endorsed the "Commission Recommendation of 23 April 1998 concerning banking charges for conversion to the euro" (98/286/EC). One of the central recommendations was that banks should convert, without charge, accounts from the national currency unit to the euro at the request of the account holder during the transitional period (Phase B). At the start of Phase B, it became clear that - although most banks were able to offer this service - the demand for such conversion on the part of both consumers and businesses was very limited indeed.

A limited number of essentially larger corporations decided - as a matter of policy - to switch to the euro as early as possible for accounting and billing purposes. These are still exceptions to the rule, but they may have a catalytic effect on other enterprises that have a customer or supplier relationship with them, as these large companies may have the clout to require that billing be carried out in euros.

It is expected that the large majority of retail customers, at any rate, will wait until the end of Phase B - that is, the end of 2001 - before converting their bank accounts into euros, as there are no direct and tangible advantages to switching to the euro at this early stage. There are several other very good reasons for this behaviour, too. People in general are loath to change their habits and will only do so if no other alternative remains. Most consumers' wages are still paid in the national currency unit; taxes will continue to be calculated in the national currency unit; and most shops will not offer dual price displays during the first period of Phase B.

Finally, it could be argued that the need for conversion is not urgent, because bank accounts actually function as multi-currency accounts. It is perfectly possible to make or receive payments in euros from or to bank accounts kept in the national currency unit, and this at no extra charge from the bank. These are standards of good practice defined in Article 2 of the April 1998 Commission Recommendation (98/286/EC). The conversion without charge of incoming payments from the national currency to the euro and *vice versa* during the transitional period is considered a legal requirement. The conversion without charge of outgoing payments from the national currency to the euro and *vice versa* during the transitional period - though not legally required - is considered a recommended practice. The use of these multi-currency bank accounts is transparent as far as the customer is concerned, as the account statements always contain information concerning the original currency unit of the transactions on the account.

In this chapter, a review is given of the euro payment services the banking industry is already offering or intends to offer shortly during the transitional period. The European Banking Federation (EBF) carried out a survey in 1998 of the national banking associations in all EU Member States, in order to provide an overview of the banking industry's preparations for Phase B. As far as payment services are concerned, most 'in'-country banking associations responded that most services provided in the local currency unit will also be provided in euro. In all Member States, individual banks offer a wide range of publications concerning the practical implications of the introduction of the euro, and this practice will be continued throughout Phase B.

2. Payment instruments

2.1. Cash

2.1.1. Exchange of national banknotes for foreign banknotes

Although euro notes and coin will only be introduced as of 1 January 2002, the introduction of the euro in 1999 has brought certain immediate benefits to the general public. Exchange risk between 'in' currencies has been eliminated by the fixing of the official conversion rates between all these currencies and the euro by the end of 1998.

However, the costs related to exchanging notes are very diverse and exchange risk is only one of them - and a very minor at that. The European Monetary Institute (EMI) had estimated in 1997 that this should reduce the cost of exchanging 'in' currency national notes by 5 to 20%, as this was the estimated cost banks charged their customers in order to cover their exchange risk. In many instances, the exchange risk had already all but disappeared in the run-up to the introduction of the euro. The other cost elements relate to transport, security, insurance, distribution, storage, the handling of notes, market liquidity cost and the fact that banks need to hold on to cash that does not generate interest income. The introduction of the euro did nothing to change any of these cost elements.

The introduction of the euro coincided in most EMU countries with a change in the way banks charge for exchanging notes. This was a direct result of the implementation by the banks of Article 3 of the Commission Recommendation (98/286/EC). This deals with transparency, and states that banks should show clearly the application of conversion rates in accordance with the provisions of Regulation (EC) No 1103/97, and should identify any charges which have been applied separately from the conversion rate.

This new approach differs greatly from the former common practice, whereby banks used to charge for their services through the use of a spread: that is, the difference between bid and offer rates; and it gave rise to immediate public outrage. Charges that the general public was previously not aware of are now explicitly disclosed. This created the impression that banks were charging new costs to their customers in order to make up for their loss of income following on the introduction of the euro, whereas in reality it was only a different – and more transparent - way of showing the same charges.

In fact, the EBF was able to show during a hearing held by the Committee on Economic and Monetary Affairs and Industrial Policy on 16 February 1999, that in all participating Member States costs to the consumer for exchanging national notes had gone down significantly. Some cases *were* reported where banks appear actually to have increased their charges related to the exchange of notes, but the EBF has declared that it is ready to examine any complaints of wrongful charging by its member banks.

The Commission's DGIV launched a surprise inquiry in February 1999 against eight banks in four Member States on grounds of suspicion of unlawful price-fixing agreements concerning the charges for exchanging notes. The results of this inquiry are not in yet.

2.1.2. Cash withdrawal abroad from ATMs

Again, nothing has changed during Phase B except that exchange risk has disappeared from such transactions. This has, however, prompted banks to review their pricing schemes for this service, which differ from Member State to Member State and from bank to bank. In all cases, the spread that was charged before the introduction of the euro has disappeared. This transition did not attract much attention from the media in those Member States where banks formerly already charged a minimum flat fee combined with a spread (and in some cases a separate percentage fee based on the amount of cash withdrawn) - e.g., Germany and Italy. In some Member States (e.g., Belgium), however, banks introduced a minimum flat fee when they dropped the spread charges and this got negative press coverage, as it actually made withdrawals of very small amounts somewhat more expensive. On the whole, however, cash withdrawals at ATMs have become less expensive everywhere.

2.2. Cheques

2.2.1. Domestic cheques

Some confusion exists concerning the possibilities for the cross-border use of domestic cheques denominated in euros. The European Commission is concerned about the high cost of the cross-border use of these cheques compared with the far lower charges levied for their domestic use. The misunderstanding lies in the fact that a euro-denominated cheque is not by definition a cheque that can be used in the entire euro zone: it is and remains a payment instrument that is essentially intended for domestic use for a multitude of reasons.

Each country has its own legislation on cheques, which is not applicable abroad. Regarding security, provisions also differ from one country to the next. For historical reasons, the formats and technology used are different. Cheque-books are issued in the national language of the issuer and, when a cheque is drawn, the amount in words on the cheque has to be written in the issuers' language. All these distinctive characteristics explain why, allowing for exceptions, cheques are not readily accepted by retailers abroad. Indeed, not only do retailers bear the major risk of being left with unpaid cheques or being the victims of fraud - as their own bank will not guarantee payment - they will also be faced with important collection charges. Cross-border truncation of cheques does not exist, which means that cheques have to be presented physically to the issuing bank. This entails significant costs for handling, transport, security and delays in payment, for instance. All this makes domestic cheques which have been accepted abroad very expensive to process.

Should efforts be made to standardise the applicable national laws and the existing formats and technology, so promoting cheques as an international means of payment? The answer must be: 'No'. The use of domestic cheques varies widely between Member States. In 1997 France, Ireland, Italy, Portugal and the UK accounted for 87.5 % of all cheques used in the EU. In other Member States, cheques are a marginal payment instrument that have made way for more advanced vehicles such as debit and credit cards. These are both cheaper to process and offer more security in an on-line environment. *Per capita* use of cheques in 1997 in

Austria, Belgium, Finland, Germany, the Netherlands and Spain did not exceed ten cheques[5]. It would be unacceptable for the banking sector in these Member States to make significant investment in order to reintroduce the use of cheques, which are now perceived as an out-dated means of payment by a majority of consumers in those countries

2.2.2. eurocheques

These are a product of Europay International and are standardised cheques suitable for both domestic and cross-border use. These payment instruments are guaranteed by the issuing bank up to a maximum amount of €200, provided the proper requirements are fulfilled.

Again, this is a product in decline: its use is decreasing in favour of payment cards that can be used at either ATMs or POS terminals, or both. This trend is being encouraged by banks' communication and pricing mechanisms, which encourage consumers to use fewer cheques. In Norway and Sweden, even eurocheques are no longer accepted as a valid means of payment. The Dutch banks have decided not to accept euro-denominated eurocheques for cash advances during Phase B and to terminate acceptance entirely in 2002, when euro notes and coin are introduced. They have also recommended that merchants should not accept euro-denominated eurocheques during the transitional period. The Commission's DGIV has announced that it intends to open an enquiry concerning this decision by the Dutch banks, as it suspects unlawful collusion in this matter.

The question remains, however, whether the eurocheque has a future after the introduction of euro notes and coin. Credit cards are already well established as an international means of payment. By 2002 international debit cards should be widely accepted by merchants throughout the entire EU, the introduction of euro notes and coin will render tedious exchange operations unnecessary, and consumers who are in need of cash abroad can always fall back on extensive networks of ATMs.

It is obvious that the banking sector will continue to promote the use of cards, to the detriment of cheques, as even the internationally standardised eurocheque is far more expensive to process than card payments and - in an on-line environment - card fraud is far easier to detect than cheque fraud.

2.3. Cards

Card payments are still the fastest-growing segment of cashless payment instruments. Their EU market share grew 8.3% in 1997 from 16.8% to 18.2%. All other cashless means of payment - cheques, credit transfers and direct debits - lost market share or remained at 1996 levels. The size of the cards' market share differs significantly from Member State to Member State. The largest shares (over 20%) are to be found in Belgium, Denmark, Finland, France, Greece, Portugal, Spain and the UK.

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[5] The figures cited in this paragraph are provided by the ECB. They do not, however, differentiate between domestic cheques and eurocheques

2.3.1. POS (Point of Sale) terminals

Whether a consumer can pay in euros with his card is largely determined by the capabilities of the available POS terminal. The situation varies widely between Member States.

In some Member States, POS terminals are owned and maintained by the banking sector or its subsidiaries. In this case, it is the banking sector that is fully responsible for the roll-out pace of euro-capable terminals. In other cases, POS terminals are owned by the merchants, who have to decide when to upgrade to euro-capable terminals. Euro-capability may have several definitions. In some cases, it means that the merchant is actually able to choose actively whether a payment is made in the national currency unit or in euros. In other cases, the payment flow is settled technically in the national currency unit, but the terminal has dual display capabilities, showing the amount to be paid both in the national currency unit and the euro. Other POS terminals are euro-capable in the sense that they do not show both amounts on the display, but print them on the payment slip after the transaction is finalised.

The task of rolling out euro-capable POS terminals is of course further conditioned by both the age of the existing POS-terminals and by the sheer number of terminals in place. Again, the situation differs greatly between Member States, as can be seen from figures published by the EBC concerning the number of POS terminals per million inhabitants. The average number in the EU was 7,146 in 1997. Spain had no fewer than 16,691 terminals per million inhabitants, while at the other end of the scale, Ireland had only 1,402.

How quickly euro-capable terminals are being installed also differs from one Member State to another. In those where merchants can choose whether to upgrade or not, there is as yet little demand for euro-capable terminals. Where they have the choice of carrying out payments either in the national currency or in euros, their pronounced preference is for the former.

2.3.2. Credit cards

Credit cards are the key example, demonstrating that the banking sector can move quickly to develop highly effective cross-border payment initiatives when there is a business case. Credit cards are well-established in all Member States.

Charging schemes for cross-border credit card use differ among the various Member States. In all cases, spread charges by the banks have disappeared. In some Member States - e.g., Belgium and Italy - consumers no longer pay any charges at all for euro zone cross-border transactions, which actually makes credit cards as cheap to use internationally within the euro zone as domestically. This is a trend that will probably continue, as individual banks in other Member States are already setting the pace in a competitive move to gain market share.

2.3.3. Debit cards

Debit cards started out in many Member States as purely domestic schemes, but the international card companies have worked very hard to promote their own internationally accepted brands. Acceptance of these international brands differs, depending on the scheme and the Member State concerned. It is fair to assume, however, that during the transitional period the international debit card schemes will finally achieve a breakthrough in all Member States and will be offered to consumers by all major banks.

This will allow consumers not belonging to the higher income brackets - who generally do not carry credit cards - to make card payments abroad, thus further diminishing the need for eurocheques and cash.

2.3.4. E-purse cards

E-purse cards are the latest development in card payment schemes. They were developed to service purely domestic payment needs: very-small-ticket payments at the local bakery, grocery shop, for parking meters, public telephone booths, etc. This led at first to strictly domestically-oriented initiatives, with competing and non-compatible technology. In some Member States, successful E-purse schemes were introduced (Belgium being a case in point, where in 1998 the number of E-purse transactions already exceeded the number of credit card transactions), which led to a drive to export this domestically developed technology. Which systems will ultimately prevail is hard to predict, as this is a purely market-driven issue.

The European Commission was very quick to stimulate the development of a pan-European E-purse, but only recently have standards emerged that should ensure interoperability between the different schemes in the relatively near future. There is still much doubt as to the merits of this product. Even now there are a significant number of non-believers in the business case for domestic E-purse schemes; but it can be safely assumed that by the end of Phase B interoperability between different schemes on a cross-border level will be achieved, but certainly not much sooner than that.

2.4. Cross-border direct debits

Most Member States have outstanding national direct debit schemes - which have been adapted for the euro. Although this is a mature payment instrument, the volume of transactions is continuing to grow steadily: at EU level, a 10.6 % increase was noted in 1997. In Austria, Germany, Ireland, the Netherlands and Spain, the total number of direct debit transactions is even higher than the number of card transactions in these Member States.

Cross-border payment volumes up to now, however, never warranted the development of a pan-European direct debit scheme. It has been researched off and on over the past few years, but without much success. At the moment, at least two working groups are studying the subject, one at ECBS, another at SWIFT. Again, it is all about standards, costs and revenues.

Yet there is another very important dimension to take into consideration: consumer protection. National law on the matter differs greatly from one Member State to another, and this constitutes a major impediment to developing a pan-European direct debit scheme. It is expected that a business-to-business direct debit scheme may be available to the market far sooner than a business-to-consumer scheme, because with the former the issue of divergent national legislation can be avoided.

2.5. Cross-border credit transfers

The general public tends to equate Cross-Border Credit Transfers (CBCTs) within the euro zone with Domestic Credit Transfers (DCTs). With the introduction of the euro, the only differentiating factor - namely that DCTs are labelled in national currency units and CBCTs are not - seemed to disappear. So, in the opinion of many, bank charges for euro-zone CBCTs should be substantially lowered, even to the level of DCTs.

The fact that the reduction in bank charges for CBCTs at the start of Phase B did not meet earlier expectations was cause for much criticism directed at the banking sector. The European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy held a hearing of market professionals on 16 February 1999. The EBF explained during this hearing that banks no longer work with spreads - thus effectively reducing the cost of the operation to the consumer - because of the elimination of the exchange risk due to the introduction of the euro. But it also noted that any further significant reduction in bank charges in the very near term was an unrealistic expectation, because the introduction of the euro has not yet essentially changed the way CBCTs are processed.

The fact is that CBCTs are far more complex and labour-intensive than DCTs. A lot of this complexity has to do with a lack of international standardisation. Domestic payment systems have been honed over many years into high-performance, highly standardised processes, which allow electronic Straight Through Processing (STP) of a very high percentage of all payment transactions submitted. This development was driven by the economic need to process a high volume of payments in the most cost-efficient way on a daily basis. The economic pressure to standardise commercial CBCTs was far lower, due to the far lower volume of payments that had to be handled. This volume is estimated at 1% to 3% of domestic volumes. The pressure from the consumers' side was equally low: most consumers never even make a single CBCT in their entire life and when they do - more often than not - they can do so by credit card at no extra cost. Nevertheless, many banks offer specially priced low-value euro-zone CBCT products to their customers.

The processing of CBCTs requires a significant number of extra steps compared to DCTs. First, data must be encoded. The major problem in this phase of processing is obtaining the correct information about the beneficiary of the payment: frequently the name or account number supplied by the principal is incomplete or simply incorrect. This necessitates costly manual repairs by the banks and thus leads to far lower STP rates than is the case with DCT processing. In DCTs, the beneficiary can in most Member States be identified through his standardised bank account number, but these data are by no means always available for beneficiaries abroad. The account structure differs from country to country. In some Member States – for eaxmple, Germany - a unique account structure does not exist. In other countries, account numbers are extremely long - as in France where account numbers contain 23 figures.

All this increases the risk of mistakes, which forces the bank to take extra precautions and build in extra controls. It is true that the ECBS has developed a blueprint for a pan-European uniform account structure (IBAN), which should diminish these problems. Most banks, however, have not found the time yet to implement IBAN, as they have had even more pressing priorities in the area of IT development: the introduction of the euro and the year 2000 have absorbed most IT resources over the past two years, leaving little time for other priorities. A limited number of banks have already implemented IBAN, but the majority aim to be ready by 2002 at the latest. Until then, IBAN cannot function as a market standard and its benefits cannot be reaped.

2.6. An International Payment Instruction standard

The ECBS is also working on an International Payment Instruction standard (IPI). This is a paper form enabling credit transfer instructions to be combined with cross-border invoices in order to facilitate automated CBCTs through the compulsory pre-printing of credit-side information by the beneficiary, the use of IBAN and the scanning capabilities of the document. The IPI is intended to be pre-personalised by the beneficiary, who is to send it to the ordering customer. The latter then only has to complete the information concerning the debit side of the payment. Again, this will be a huge step forward in standardising the processing of CBCTs, but the standard is only just out of the drafting phase and at this moment has no effect on the cost structure of processing CBCTs. In the process of driving down the costs associated with processing CBCTs, the developments that will have the greatest impact in the coming years will be the implementation of IBAN and IPI .

As a next step, the bank needs to obtain information from its client for balance-of-payment reporting purposes, and this information needs to be encoded, as well. All this requires extensive manual intervention by the bank. The information is required by the authorities for statistical purposes. Statistical requirements differ significantly between Member States, which means that simplified and detailed reporting thresholds vary, creating an un-level playing field for banks. In the UK, no systematic reporting requirements exist, only sample-based surveys. The banking sector has been demanding that reporting requirements be abolished for intra-EU payments - until now to no avail. Sometimes, reporting requirements are changed, forcing banks to employ scarce IT resources to adapt their infrastructure to meet these new demands, rather than to provide better services for the customer.

Next, the bank needs to determine what the routing of the payment should be, whether it should be processed through its own international network, through correspondent banking channels or through one of the many cash-clearing systems that have sprung into existence with the introduction of the euro. In order to route both the payment and the information concerning the payment, a number of SWIFT messages need to be sent. The unit cost for sending a payment through a pan-European clearing system is in most Member States significantly higher than the cost of sending it through a domestic clearing system. The issue of clearing systems is dealt with in more detail in the next section. But it should be clear that the cost charged by the clearing system to the bank is only a small element in the banks' cost of processing CBCTs.

As mentioned earlier, another element that works to the disadvantage of CBCTs is the volume of payments: when purely professional inter-bank CBCTs are not taken into account, the total volume of commercial CBCTs only represents about 1 % to 3 % of DCTs. As the payments business is essentially a fixed-cost business, it is obvious that given the sizeable investments needed to offer these cross-border services to the public, the unit cost of CBCTs is significantly higher than that of DCTs.

Finally, the belief that bank charges for DCTs can be compared with those for CBCTs is fatally flawed. In all Member States the banking sector heavily subsidises the processing of

DCTs. Nowhere does the consumer pay charges that are high enough to cover the costs banks incur for processing DCTs. DCTs are free of charge to consumers in many Member States, and in others the service is paid for by a comparatively low fixed price that also covers the service charges for current account maintenance. This relative lack of transparency obscures the fact that consumers who effect an important number of DCTs are subsidised by those who do not. In the current drive towards transparency, it does not seem wise to copy this system for CBCTs.

2.7. Cash clearing in the euro zone

In the previous section, it was shown that the cost charged by the clearing systems to the bank is only one of the many elements that account for the cost of a CBCT.

The popular impression that the advent of TARGET should have had a significant cost-saving effect for banks when effecting CBCTs for their customers is a false one. TARGET was never designed to handle commercial CBCTs. It is a cash-clearing system been designed specifically to support very-high-value payments requiring finality of payment - especially in the context of monetary policy payments by the ECB. Accordingly, the transaction cost per unit is relatively high.

In fact, the introduction of the euro and of pan-European clearing systems has made payment-routing decisions and liquidity management more difficult than before. Banks are still going through a process of learning how to adapt to this new environment, but this is of course a transitory process that will ultimately result in more efficiency.

The criticism that professional interbank CBCTs are well catered for through the new pan-European clearing systems, but small-value commercial CBCTs are not at the moment is, however, well-founded. Until the end of 1998, most banks considered the correspondent-bank route - as in the past - to be optimally suited for processing low-value CBCTs. This means that the introduction of the euro does not change anything for this type of payment, except that the exchange risk has been eliminated from the transaction and thus from the charges passed on to the consumer. The translation into national law of the EU Directive on Low-Value CBCTs, required by August 1999, should now further enhance the transparency of pricing, regulate the time to credit and the information concerning CBCTs.

The market is adjusting rapidly. Problems with routing payments cropped up during the first few weeks after the introduction of the euro and there is obvious excess capacity available in a number of pan-European cash-clearing systems. These have been decisive factors in the move by a number of clearing banks to close a many of their nostro accounts at correspondent banks and re-route their commercial CBCTs through cross-border clearing systems.

It is to be expected that this development will gain momentum in the next few months and years. The pace of this development will only be conditioned by the flexibility of the individual banks' IT infrastructure and the resources available to make the necessary adjustments to this infrastructure. As the payments business is essentially a fixed-cost business, this development will drive down the unit cost of clearing through these pan-European clearing systems and this in turn will finally result in lower prices for the customer. Bear in mind, however, that it is not realistic to expect all this to happen overnight.

Another development frequently talked about nowadays is ACH-to-ACH linking as a solution for making CBCTs cheaper to process. ACH stands for “Automated Clearing House”. This solution consists in linking the domestic clearing systems in order to make it possible to use domestic clearing systems to process low-value CBCTs.

One of the problems with this line of thought is that every domestic clearing system has its own standards and communication protocols. Linking these systems poses complex technical problems and solving these will require significant investments, thus reducing or annihilating the one advantage these local systems have over the pan-European ones: namely that until now their unit transaction cost has usually been lower. An early experiment in ACH-to-ACH linking was carried out in 1993-94 by the Belgian, German, Italian and British bank sector and ended in failure, because of a lack of payments volume.

Another problem with ACH-to-ACH linking is that it creates interdependencies between different clearing systems - which were originally conceived as stand-alone systems - thus resulting in new systemic risks. This is precisely the current Achilles’ heel of TARGET, and the error should not be repeated when solving the current problems with low-value CBCT processing. As things stand, there is a need for fewer clearing systems rather than more.

3. Conclusions

The requisite systems are all in place to facilitate the transition to the euro for consumers. In most cases, all traditional domestic and cross-border payment services are available both in the national currency unit and in the euro at identical price levels, leaving the final choice up to the consumer in accordance with the principle of “no compulsion, no prohibition”. Extensive information campaigns concerning the practical implications of the introduction of the euro have been organised in all Member States by the individual banks prior to the introduction of the euro, as a competitive service to their customers.

During the transitional period, a number of logistical tasks still need to be performed or finalised, the roll-out of euro-capable POS terminals being the most obvious of these.

According to some, the introduction of the euro was not accompanied by a sufficient reduction in charges levied by the banking sector. Nevertheless, bank charges both for the exchange of notes and for CBCTs have been shown to be lower in all Member States. The introduction of explicit handling fees in compliance with the Recommendation by the European Commission - fees which previously had been charged to the consumer via the spread - gave the erroneous impression that banks were introducing new charges. In some cases, price increases have been noted, but mostly these involved very small transaction amounts which were priced slightly higher because of the introduction of minimum flat fees for a number of services with high fixed costs for the banking sector. The EBF has declared its readiness to intervene in individual cases if abuses are pointed out.

A number of important developments are emerging, which will certainly influence the pricing of CBCTs. The most important of these is the introduction of IBAN and IPI, which should significantly increase the STP rate for CBCTs. Banks are still adjusting their payment-routing practices based on their experiences during the first few weeks following the introduction of the euro. The most significant event here is that banks have started to re-route commercial CBCTs from correspondent-bank channels towards pan-European cash-clearing systems. It is still an open question which pan-European clearing systems will prove successful and which will not, but it is safe to assume that the winners will attract ever larger volumes of payments, thus decreasing the unit cost of transactions. Accordingly, the development of ACH-to-ACH links is uncalled-for, as it will not solve the problems perceived today. All this will take some time. It is not realistic to expect to reap all the benefits of the euro in the first few weeks and months after its introduction. Market forces will, however, drive the motor of change at a high speed towards greater efficiency and lower costs.

V. THE PERIOD OF TRANSITION IN THE NON-FINANCIAL COMMERCIAL SECTOR

While the smooth and successful conversion of the financial markets to the euro on 1 January 1999 carried banking and financial firms with it, this was not the case for the non-financial commercial sector. We shall therefore examine the following questions:

- How are euro-zone companies are reacting to the changeover to the euro between 1999 and 2002?

- What are, in this respect, the main issues for companies based in non euro-zone countries?

- What are the principal obstacles to using the euro during the transition period?

From a corporate standpoint the flawless launch of the euro on 1 January 1999 has generally been interpreted as a non-event. The conversion of stock exchanges has been perceived as a purely technical issue, undertaken by systems experts.

Although the euro is in place and is the sole currency of the Economic Monetary Union (EMU), it is only a “virtual” currency. The majority of users forget that when they issue an invoice in D-Marks or settle a bill in Pesetas, they are using the euro. The choice of dealing in euros rather than in national currency is merely a choice of *denomination*, not of currency.

The corporate sector has been one of the key driving forces behind the EMU process. Companies have been largely supportive of the process of closer monetary integration because it removes the uncertainty related to the exchange-risk factor thus enabling to reduce operating costs. Economic Monetary Union also leads to an improved macro-economic environment through lower interest rates, price stability and sound public finances.

Companies – essentially large multi-nationals – have been addressing their preparations for the euro as *a strategic business issue*. The early-movers set up euro projects as early as 1995, covering most departments and areas of the company. Some companies have started to use the euro, for example by displaying prices in euros, alongside those in the national currency unit. There have been some signs of price adjustments, in order to adapt to a more transparent environment, e.g. in the automobile industry.

The euro is also undoubtedly part of the explanation for some of the massive mergers which have occurred in recent months.

In addition, a great deal of staff training has been taking place.

However, the vast majority of companies continue to operate in their national currency units. There is not yet a sufficient critical mass of companies willing to deal in euros. Even where the euro is starting to be used alongside the national currency, it has not yet replaced it.

1. Companies' reactions to the changeover to the euro

In order to be realistic, we shall mostly use studies conducted after September 1998, although earlier ones are useful to identify trends. A list of sources can be found in the Bibliography.

1.1. The influence of company size

All studies reflect the major effect that company size has on the question: " Have you taken any decisions concerning the changeover to the euro "? The "NO" answers break down, according to the number of employees, as follows:

Table 1: The Influence of company size on preparations for the euro

Employees	*<10*	*10/50*	*50/250*	*250/1000*	*>1000*
% NO	41.5%	25.5%	12%	6.4%	1.2%

These figures only include companies, which have answered the survey. In practice, experience shows that *many small companies do not answer surveys*, while the larger ones, having studied the euro problem, are more inclined to answer. This skews the results. A typical illustration is the case of Italy where 93% of companies with less than 50 employees still have not been involved in any information or training about the euro, as of the end of 1998. Rather than using the above figures, it would be wiser to remember that, at the end of 1998, the situation may be characterised as follows:

- From 0 to 20 employees, very few companies are preparing for the euro.
- From 20 to 200 employees, about half are preparing or willing to do so.
- Over 200 employees, nearly all companies are preparing for the euro (i.e. a changeover plan is in preparation, even if it will not be implemented before 2001).

1.2. The internationalisation effect

Awareness of the euro is also much greater in companies which are already exporting or facing strong foreign competition in their home market.

1.3. Implications on the different company's departments

Companies, which have started to study the implications of the euro, tend to see it as a financial issue. Absolute figures differ from survey to survey, but the *ranking* is instructive:

Table 2: Implications of the euro: companies' perceptions

	Min/Max
Accounting/Financial	83/100%
Information Technology	60/95%
Competition/Marketing	12/87%
Personnel	21/73%
Purchasing	13/65%
Strategy	9/39%
Production	13/36%

If we look at the minima in this breakdown, we see that the technical aspects in accounting and information technology are dominant, while market considerations (sales, supplies and strategy for competing) are perceived as secondary, which should not be the case.

A survey from October 1998 showed that 4 out of 10 companies, which have started to study the changeover to the euro, still have no precise ideas as to the evolution of their basic price list or the information they will supply to their customers. The major implications of price transparency on market aspects are not yet sufficiently perceived.

Under these circumstances, it is not surprising that possibilities for rationalising purchasing are even less understood (38% of firms), and that only 27% think that the euro will make purchasing outside the euro-zone easier. And what about the companies that did not answer the survey?

We see, therefore, that *companies with less than 200 employees and no export activity ignore or neglect the significant changes in competition, which are going to occur in their market.* Of these, only firms operating in protected niches will not have to cope with surprises.

This cannot fail to be worrying and reveals a very wide gap between large and small companies, as far as scheduling is concerned. There is an obvious lack of communication between large companies and their smaller suppliers or customers. Communication campaigns by public or professional organisations must be pursued and adapted in order to increase the awareness of small firms. (See 3.1. below).

1.4. Geographical location

A comparison between 5 countries in the euro-zone based on a large number of companies (500 large and 500 medium size[6]) reveals substantial differences between countries for medium sized enterprises.

- As far as information is concerned, only Italian businessmen stand out as having, in their opinion, a tangibly lower level of information.

  Netherlands 98% Germany 90% Spain 87% France 85% Italy 62%

- As to the question: " Have you seriously studied all the consequences the euro will have on your company? ", France was the least involved, as of September 1998:

  Germany 92% Netherlands 91% Spain 85% Italy 75% France 71%

- " Have you implemented the necessary changes in the accounting system? " (in September 1998)

  Germany 68% Netherlands 67% Spain 59% France 48% Italy 45%

It should be noted that the 1999 FEE (Fédération Européenne des Experts-Comptables) survey appears to show an improvement in the preparation for the euro (in the case of companies, which answered the survey):

>90%	*: Germany, Austria*
85/90%	*: Belgium, Ireland, Luxembourg, Netherlands*
80/85%	*: France, Finland, Spain*
70/80%	*: Greece, Italy, Portugal, U.K.*
<60%	*: Sweden, Denmark*

But this might reflect only initial steps of preparation, maybe without implementation.

1.5. Sectors of activity

The level of concern about market evolution is substantially influenced by business sector:

Retailing	*66%*
Manufactured goods	*59%*
Services	*44%*

In the retailing and service sectors, businesses in contact with tourists are, and will be made, much more sensitive by their customers' questions during the next tourism season.

1.6. Special cases

[6] Between •20 and •120 million in sales.

1. Border areas

These are already handling payments in multiple currencies and should adapt to the euro very quickly.

2. Tourism sector businesses in high tourism areas

Considering the reduction of cross-border costs, it is obviously interesting for tourists to pay in euros by credit card, while residents still very rarely use the euro option. A large company in the tourism business, located in France, publishes a double price list, in Francs and euros, and proposes payment in euros by credit card. During the first quarter of 1999, it registered the following percentages of payments in euros by credit card:

From 7.5% to 5%: *Italy, Spain, Germany, Ireland, Austria*
From 5% to 2.5%: *Netherlands, Belgium, Portugal, Greece, Luxembourg*

Since the company is based in France, the figure for French customers is not significant. It is interesting to note the use of the euro by the following residents: Japan 2.1%, Australia 2%, United States 1.5%. The UK's position is particular, with 1.4% of payments made in euros by credit card.

3. Companies doing business in presently protected niches.

2. Countries not members of the euro zone

2.1. " Pre-in " countries

The four "pre-in" countries - Denmark, Greece, United Kingdom and Sweden - have very strong commercial links with euro-zone countries. Although companies in these countries are not members of the euro-zone, the euro will have substantial implications for them: as trading partners, and because these countries are candidates to join the euro-area. National governments have started campaigns aimed at informing companies on both aspects.

In the **United Kingdom**, the Government has stated in its changeover plan that administrative bodies will prepare for the euro over the next few months, even before a decision is made to join the EMU. This carries a strong message for companies. The Confederation of British Industries is active in assisting enterprises in their preparation for the euro. Public opinion has become more favourable in **Sweden** and **Denmark**, particularly since the financial crises affected these countries, whilst Finland, an "in" country, was protected. The **Greek** Government has indicated its intention to join the EMU in 2001 and introduce notes and coin in 2002. A national transition plan has been published and companies are intensifying their preparations, particularly in the tourism sector.

However, the level of company preparation is the lowest in these countries.

2.2. Countries outside the European Union

In countries outside the European Union, companies which have trade links with euro-zone countries consider the euro as a new foreign currency. For them, euro implications are essentially technical and limited to the continuity of contracts, information technology, invoicing, etc. At present, few companies have become aware of the consequences in terms of sales strategy, marketing or purchasing, except for large companies which see it as making their operations simpler.

The euro-zone capital markets also attract large multinational companies, which are looking to diversify their financing. In Hungary, the leading chemical company *Borsodchem* is using an European Depositary Receipt facility (EDR), allowing investors to trade its shares in euros. Russian energy groups such as *Gazprom* and *Lukoil, Estonian Telecom* and *the Polish Kredyt Bank* have followed suit. In Central and Eastern European countries, banks are preparing to offer euro services to large firms.

3. Obstacles to using the euro during the transition

One major psychological element is *the absence of notes & coins.* Its impact has not been measured, but has significant importance for a large number of small companies who are not fully aware of the euro. Whether consciously or not, since bank notes will not arrive until 2002, the reaction of many people is: “ I have plenty of time, I can wait... ”

3.1. Insufficient awareness concerning strategic impacts of the euro

The implications in terms of competition are perceived by only 34% to 48% of companies answering surveys. If those not answering are taken into consideration, at least three quarters of companies lack this awareness. Public bodies, chambers of commerce, professional organisations must pursue and intensify their communication efforts. Coming to the conclusion that written communication campaigns addressed to small and medium sized enterprises must be reinforced, would be an illusion. They are swamped with information and many pay it little attention. Other, more direct methods must be used, such as personal contact. In this respect, two experiments highlight the role large firms can play in raising awareness of small companies.

In the industrial field, SIEMENS contacted all of its partners (suppliers, customers, service providers) through a first mailing in the autumn 1997. Another mailing, in June 1998, informed them of its intention to switch its entire accounting system to euros, as of 1/10/99 and invited its partners to choose a date for switching to euros in their mutual operations. This date, with three months advance notice, will then be irreversible and valid for all companies in the SIEMENS Group. A project for a memorandum of agreement was enclosed with this mailing, thus allowing the partners to give a formal answer. A CD-ROM sent out in the same mailing, in the autumn 1998, reinforced the efficiency of this campaign. Several large European groups are proceeding in a similar manner.

For retailing groups, the problem of increasing suppliers’ awareness is more complicated due to the widely different nature of their suppliers. The range is vast from NESTLE or DANONE to a local corner shop. The store department manager, the warehouse manager and the buyer are the people who can make sure that all suppliers will be informed of the changeover plan, with necessary forewarning. The AUCHAN Group, after a questionnaire in November 1997 and a circular in October 1998, is training all its buyers through a learning game. This will permit them to *contact directly all suppliers* during 1999 and negotiations can be conducted during 2000 in order to get them ready in time. It became evident that small regional suppliers would not become aware of the problems without such direct contacts.

3.2. Stretching the changeover process over time

The impulsion given by customers and suppliers is diluted over three years. Known programmes for switching to the euro are significant, as early as 1999 for large groups. But, the action on the great number of small firms remains limited due to the " no compulsion, no prohibition " policy which encourages a "wait and see" attitude. As the calendar for the changeover cannot be changed, a dynamic method such as the one used by industrial or retail groups (Siemens, Philips, Fiat, Rhône-Poulenc, Auchan) is likely to have positive results if widespread.

3.3. Public administrative bodies

If euro options seem clear in matters of accounting or capital conversion, it is not the case for social declarations. Complete euro options offered by most countries represent a positive measure.

Beyond technical matters, public administrative bodies have a key role to play in encouraging the use of the euro by companies. But the 1 January 1999 deadline has passed, and the priority given to the euro risks fading away within the institutions concerned. There is thus a need for political authorities to reaffirm this priority, so that the three years transition period, from now to 2002, can allow progressively greater use of the euro by companies. Local public authorities, in particular, have a leading role to play with small and medium sized enterprises (see part 2).

3.4. Banks and means of payment

The vast majority of banks offer their customers euro payment instruments and euro accounts, as well as conversion facilities between the euro and the National Currency Units. However, banks have not been encouraging their customers to switch to the euro.

The press has given a negative image of the euro through often misleading information on bank transfer fees within the euro zone. Therefore, the use of the euro has been perceived as more expensive than the one for national currencies.

The single currency reveals *the absence of pan-European cross border payment instruments*. Delays and processing costs are prohibitive in some lines of business: the lack of a European clearing system, the differences in laws covering bank and commercial guarantees, the persistence of borders for credit cards, etc. All this contributes to delay the emergence of a single monetary area.

The European Commission is aware of this. Solutions are being prepared and should be implemented (see part 3). Not only small companies but also the general public at large will be frustrated when faced with such obstacles if economic solutions are not implemented.

3.5. Information technology (IT)

The more time passes, the clearer it becomes obvious that the updating of software is running late. At the end of 1998, the selection of completes IT solutions adapted to the euro and to the year 2000 is very limited.

VI. THE CITIZEN AND THE EURO

For most citizens of EMU's Member States, the birth of the euro was above all a media event, and little more. It could hardly have been any different. On Monday 4 January 1999, nothing in their lives had changed as compared to 31 December 1998. They were going about their daily business as before, paying their groceries, the barber, their metro fare, in short everything, with their "national" currencies, i.e. the franc, the lira, etc., obviously ignoring the fact that these currencies had become mere sub-units of their new national currency, the euro.

One should not complain. Suppose euro banknotes and coin had been introduced overnight – though this was never seriously considered? It would have resulted, on 1 January 1 1999, in 290 million bewildered people waking up in “Euroland”, a foreign country.

Instead of such a "big bang" a three year "coexistence" period started on that date. Its aim is to allow a user-friendly changeover to the euro by stimulating its increasing use by the citizens.

Some have argued that this period should be shortened. Early in 1999 the Belgian Government proposed bringing the deadline forward by several months. However, on 13 April, the Commission reported on this issue to the Ecofin Council and advised against any shortening, citing the time needed to produce the euro coins and notes, to complete the adaptation of information systems, and to carry the changeover of the public administrations. In addition, it drew attention to the risk of legal claims by the private sector and to the difficulty of agreeing on another deadline.

As things stand, the adoption of the euro by the citizen and its growing use during the transitional period will depend on:

- the citizens' perception that EMU delivers the benefits expected of the single currency: price transparency, low transaction costs and, more generally, price stability and improved growth and employment prospects;

- how successful the authorities, the financial institutions, the media, the businesses, the retailers, the citizen organisations, etc. will be in familiarising the general public with the euro and in promoting and facilitating its use in daily life.

1. Starting hiccups

Unfortunately, right from its birth, the euro has been wrong-footed in two citizen-sensitive areas.

1.1. The cost of exchanging euro zone banknotes

Concern has rapidly surfaced over the level of fees which, in most EMU Member States, local banks are charging to clients and others who buy (or sell) banknotes of another euro zone country.

Banks appear to be perpetuating past practice. They are treating these "foreign" banknotes, not as money, but as commodities sold at a mark-up price over the cost of dealing in them (holdings of foreign cash with zero revenue, staff time for handling, transport between branches, repatriation, insurance, provision for the exchange risk).

Up to the start of EMU, the banks' practice of quoting "buying/selling" rates for foreign banknotes bundled their costs and currency risk into one single item: the "spread". Today, the currency risk no longer exists between EMU banknotes; and, following the Commission's Recommendations, banks now charge a separate "fee" on top of the compulsory fixed conversion rates.

But this brought in the open the fact that, contrary to expectations, the banks' costs represented the bulk of the former "spread". The fees charged by banks for buying or selling EMU banknotes, though down on the former spreads, have done so to a varying extent and much less than expected. In some cases, increases have been recorded.

Not surprisingly, this has been ill-received by public opinion in the euro zone and, more particularly, by those who, for one reason or another - business, tourism, commuting, etc. - frequently need to exchange euro zone banknotes. Concern has also been expressed both by the Commission and by the European Parliament.

Though the charges levied by banks have generally come down, in some countries they have tended to increase for the smaller transactions (i.e. below €100). The main reason has been the combination of a percentage commission with a minimum service fee.

According to information available, bank charges vary considerably from country to country. They vary less from bank to bank in the same country.

Based on practical evidence, percentage commissions of 1.0% to 4.5% are being applied to the amount exchanged, with minimum fixed service fees ranging between €1.24 and €7.6. But a word of caution is necessary: as banks combine different fixed fees with different percentage commissions, comparing the total charge they levy on a given banknote exchange is often difficult to calculate.

Two countries must be singled out. First, Portugal's banks charge an exchange commission of 0.50% only, and a minimum fee of €1. Secondly, in Luxembourg no charges are levied on banknote operations below €1,000 (50,000 LUF by some banks). On larger amounts a commission of 0.50% is levied.

In general, charges are higher for non-bank clients i.e. tourists and others who exchange foreign banknotes against domestic banknotes or *vice versa*. Bank clients, for their part, usually buy or sell foreign banknotes by debiting or crediting their account.

In addressing this vexing issue, one should start by highlighting the change in legal status of the national banknotes due to their issuing countries' participation in EMU.

Up to the end of 1998, banknotes issued by EMU's future participants were legal tender[7] within their national borders only. Outside these borders, they became commodities and were treated as such. As of 1 January 1999, these banknotes represent - in a materialised form - money denominated in national sub-units of the euro. They have become part of the euro zone's money supply (M1) together with the bank deposits in the national denomination which - in a de-materialised form - are also part of it.

Today, banks convert their clients' national currency deposits into euro deposits and *vice versa*, at par and without cost. This conversion amounts to changing the denominator of *their own liabilities*

Changing national banknotes against other euro zone banknotes is a different matter. These notes are *central bank liabilities*. Who should be in charge of their exchange? The answer seems obvious: the central bank that issued them.

However, that answer needs to be qualified. Indeed, since the start of EMU, national central banks have become members of the European System of Central Banks (ESCB), whose Governing Council has the exclusive authority over monetary policy matters; and that includes the exchange of banknotes issued by the central banks of EMU's participants.

In fact, Art. 52 of the Maastricht Treaty Protocol on the Statutes of the ESCB and of the ECB says as much. It states that

> *"following the irrevocable fixing of the exchange rates, the Governing Council shall take the necessary measures to ensure that banknotes denominated in currencies with irrevocably fixed exchange rates are exchanged by the national central banks at their respective par values."*

Actually, the decision taken by the Governing Council instructs each EMU central bank to exchange, on its premises, banknotes issued by other participants against local banknotes, at par and without cost.

It comes somewhat as a surprise that the general obligation under Art. 52 is being applied by the ECB in a restrictive, one-way fashion: the exchange of other participants' banknotes against local notes, but not *vice versa*. As a result, the traveller to another country of the euro zone will have to exchange his national banknotes at the central bank's offices of that country in order to benefit from their costless exchange into local notes.

Obviously, considering its inherent "geographical" limitations, this facility will more particularly allow the local banks to off-load, free of charge, their excess holdings of foreign banknotes. But it can hardly be of use to the general public who still will have to rely on the bank "next door".

[7] Legal tender: a means of payment that cannot be refused by a creditor when tendered in discharge of a monetary debt, unless there is prior agreement to the contrary.

Although the private banks perform this banknote "exchange"[8] on a voluntary basis, they nonetheless act as "stand-ins" for the central banks by providing a public service which the latter, given the small number of their branches, are unable to discharge satisfactorily.

Banks are certainly entitled to levy a "handling" charge by doing the job for them. But, if the principle of a charge should not be questioned, its size may be cause for concern as well as the apparent indifference of the monetary authorities regarding the "price" euro zone residents have to pay for the exchange of their own euro sub-units.

In order to meet the legitimate expectations of the euro zone's citizens, the mix of central bank responsibility and private sector involvement should be translated into operational rules.

Some thought might be given to the following suggestions:

- national central banks should accept to take-in private banks' excess holdings of EMU banknotes against a euro credit in their books. *Vice versa*, they will supply them with the requested amount of any other EMU participant's banknotes against an equivalent euro debit. This procedure implies, of course, that each EMU central bank holds an adequate "stock" of its partners' banknotes. From a monetary policy point of view, this should not be a problem as banknotes only become money when they are put into circulation. And moving EMU banknotes from one ESCB bank to another is like moving them from one central bank vault to another.

  The central point is that this facility would allow the private banks to manage their foreign banknote holdings almost in the same way as they manage their national banknote holdings. Indeed, as a general rule, their clients "buy" their national banknotes by debiting their bank account. The reverse happens when national banknotes are turned in at the bank. Most of the "buying" or "selling" of foreign banknotes is done in exactly the same way, i.e. by crediting/debiting the customer's account. Consequently, the central bank facility outlined above should go a long way in reducing the cost for banks of handling other EMU countries' banknotes.

- A fair exchange "fee" should be agreed in each participating Member State between the central bank and the private banking system. Some costs (e.g. transportation) should be borne by the central bank. The fees may not be identical, as local conditions are not necessarily the same in all participating Member States. But the present differences in charges between banks and, even more so, between countries could, in some cases, be indicative of insufficient competitive pressures.

In conclusion, the basic argument is that the ESCB has a managing and cost-sharing responsibility in organising the conversion of "*its*" outstanding euro liabilities in the format of national currency banknotes. And the ESCB is certainly in a position to negotiate, in a

8 In the transitional period, the terms "purchase" and "sale" are strictly speaking no longer applicable to the exchange of national banknotes of the euro zone. Today, such transaction consist basically in exchanging a given amount, denominated in a national paper-based sub-unit of the euro, into an equal value amount in another national paper-based sub-unit. To be compared to the exchange of ten 2O BEF coins into a 2OO BEF banknote, which is obviously not a sale purchase.

restraining sense, the "fee" charged by private banks for the exchange of euro zone banknotes, especially, if it provides the banks with the facilities to reduce their costs and itself shoulders part of it.

1.2. The cost of making cross-border retail payments in the euro zone

Bank customers have started to complain about the considerable charges still levied on their cross-border transfers within the euro zone, whether they are made in euro or in any of the euro's national sub-units.

Early in March, the European Commission launched an investigation to verify suspicions of collusion on price fixing. The results of this investigation are not yet available.

Coming on top of the high fees charged for the exchange of euro zone banknotes, the high cost of cross-border retail payments left many disappointed and has reflected badly on the banks. The euro has come to be seen as a currency that mostly benefits operators in the financial markets.

It is true that the banks and other financial intermediaries have given priority to the changeover of their wholesale (i.e. large value) payment systems. The banks had no choice: the changeover of the money market to the euro was a necessary follow-up to the ECB's decision to manage its monetary policy - i.e. supplying or reducing liquidity in the money market - exclusively in euro. A similar decision applied to interventions in the exchange market.

The decisive push for the changeover of the bond markets came from the national authorities who, as required by the Maastricht Treaty itself, were to issue, as from the start of EMU, their new bond issues exclusively in euro. They even moved beyond this obligation by converting, on that date, their outstanding stock of bonds in euro as well.

Consequently, when by 1997 the likelihood of EMU starting on schedule made it too risky to "wait and see" any longer, banks and other financial intermediaries started in earnest to ready themselves for their participation, right from the start of EMU, in the euro money, exchange and bond markets.

Moreover, given the links between bond and stock markets - same "actors" (issuers, brokers, banks, institutional investors), same depositories (Cedel, Euroclear) - these markets prepared together for their simultaneous changeover.

All energies were spent on making the national wholesale payment systems euro-compatible and on linking them together in the TARGET system.

They also upgraded their national automated payment systems or ACH's (Automated Clearing Houses). Today, these systems process, *at the national level*, payment orders in a way that allows the payer to give his bank payment orders in his national currency unit or in euro; and the receiving bank to credit the payee according the currency denomination of his account: i.e. either in euro or in the national denomination.

Though the Commission, in its Green Paper of May 1995 on the single currency, alluded to the opportunity to ensure, in the context of preparations for EMU, the cross-border interoperability of the national payment systems, this suggestion was not taken up.

Consequently, today, most cross-border retail (i.e. low value) payments, whether in euro or in a national currency unit, continue to be processed by the existing, time-consuming and expensive, "correspondent banking" networks. Prices vary depending on whether or not payer and payee are both clients of the same banking group.

There are various reasons for the ongoing use of the existing system. First, there is the unattractive prospect of high investment costs for lower future returns, as the fees charged for cross-border payments would have to close in on those practised at the national level. There is also the difficulty of agreeing on the choice and the technical specifications of interlinking systems or of a new one. A pervasive protectionism was also present: with such a system in place, a number of today's "captive" bank customers might have been tempted to shift their banking business to a location beyond the national borders.

Whatever the merit of these arguments, as time goes by and cross-border shopping, commuting, trade in goods and services, including financial services, etc. take-off, one may expect the citizens and the public authorities increasingly to challenge the high costs and delays of retail cross-border payments as incompatible with the level playing field expected from the single market.

Banks are presently working – *inter alia* within the European Committee for Banking Standards (ECBS) – on various schemes to achieve the trans-border interoperability of their national retail payment systems. As all these systems are automated (electronic), agreeing on operating standards such as, for example, the format of the account numbers is essential. Progress is being made: in Belgium the IBAN (International Bank Account Number) in going to be progressively introduced from next year onward. But to be operational, it would need to be introduced in the other EMU participants as well.

Moreover, the national payment systems must be made euro-compatible. One option would be to link the national retail systems in a way similar to TARGET, which links the various national wholesale systems. Another, more favoured approach, would consist of creating a new trans-border clearing and settlement system for bank credit transfers operating along the lines of the international credit card systems.

These are matters for the banks to decide. But what should be their deadline? End 2001 would seem the obvious one. But this might be over-ambitious.

Indeed, at present the number of retail cross-border payments is rather insignificant compared to the banks' domestic retail transfers. There is hardly a business case to be made for a fundamental reform of the present correspondent banking system, especially if the fees charged would have to be aligned on those charged for domestic transfers, presently subsidised by the banks and which, consequently, they might have to raise.

This raises the sensitive question of the fees that the banks feel entitled to charge in order to recoup the cost of setting-up and running of their various payment systems.

In setting these fees, consideration should, of course, be given to the costs incurred, but also to the other side of the coin i.e. the revenue which the banks derive from the existence and use of these systems.

Indeed, encouraged by the banks, more and more people stop from paying their retail purchases with cash (i.e. banknotes, coins) and switch to paying with bank cards or electronic purses. These are indeed safer and more practical means of payment. Moreover, this switch increases both the number of bank accounts and the average amount of their outstanding balances. This benefits the banks whose revenues will increase as they routinely lend the positive account balances and charge debit interest rate on those in the red.

Data published by the ECB indicate that, from end-December 1997 to end-December 1998, cash in circulation in the euro zone rose merely from □318bn. to □323bn., while sight deposits with the banks increased from □1,297bn. to □1,378bn.

To conclude, the calculation of a correct "fee" to compensate the banks for the use of their payment systems is not a straightforward exercise. But since, as seen, it is in the interest of the banking sector to promote a reduction of cash - i.e. euro banknotes and coin from 2002 onwards - in favour of bank money, a business case can be made for the early availability, within the euro zone, of low cost retail payment systems, including cross-border credit transfers.

2. The Citizens' Use of the Euro in the Transitional Period

When mentioned in relation to the euro, the notion of "citizen" needs to be qualified. It refers to the citizen as a consumer or as a businessman, a worker, an investor, a student, a pensioner etc. in his relationship with money. As can be seen from this enumeration, such a relationship is multi-faceted: a wage earner is also a consumer. Consequently, a citizen may very well view the introduction of the euro with mixed feelings.

This said, it follows from the very basic principle of "no obligation, no prohibition" that a citizen of an EMU Member State cannot be obliged to use the euro during the transition.

But even if a citizen sticks to his national currency unit and abstains from using the euro, he will nonetheless be affected by the euro's broader economic and financial consequences. These will reveal themselves, with equal force, in the national sub-unit used by that citizen. The consequences are summarised hereafter.

2.1. Expected Economic Consequences of the Euro

2.1.1. Increased competition

With EMU, the markets of its participant counties have become a truly single market. The single currency - even under the guise of its national sub-units - has eliminated the exchange risk in a market of 290 million people. So far as business within this market is concerned, enterprises are free to invest, to set up subsidiaries, to conclude long term supply and delivery contracts without risking the loss-making consequences of an exchange rate movement. In fact, today their domestic market is the EMU market.

A first consequence of this opening of markets is increased competitive pressures. The ongoing movement towards concentration under way in the European industrial and financial sectors basically aims to acquire the size necessary to ensure a global presence on the enlarged new home market - and, by the same token, on international markets as well.

Concentration may be seen, in part, as a defensive reaction to competitive pressures: it is not necessarily synonymous with competition. But under the right conditions, competition between large units may be better for the citizen-consumer then competition between small units.

Concentration also means restructuring, and the latter often leads to workforce reductions. What are the likely short-term labour market implications of EMU and the euro? The answer is important for the citizen-worker.

2.1.2. Downward pressure on prices

Today, within the EU, significant price differences exist on consumer goods ranging from cars, computers, stereo systems, clothing, footwear, books and newspapers to table salt. To some extent they are due to different VAT rates or production costs. But many of them result from differentiated pricing policies by the manufacturer: the same car being priced higher in one country than in the other in order to take advantage of different demand conditions.

The introduction of the euro makes prices within the euro zone instantly comparable, provided they are denominated in euro. Thus, in the transitional period, price transparency will largely depend on the extent of the dual pricing policy adopted by the distribution sector. As an example, the annual subscription rates for the *Financial Times* are still quoted in a variety of national currencies. But, the rates quoted for the euro zone countries are derived from the single price of □399. Interestingly, this "equalisation" has - depending on the currency - significantly increased or decreased the subscription rates in some of these countries.

In border areas, on should expect an early generalisation of dual pricing, at least on one side of the border and a tendency to adjust to lower prices on the other side.

In the hinterland, consumer organisations should be relied upon to highlight the most glaring price discrepancies.

Moreover, the irrevocable fixing of the conversion rates will also help domestic producers - whether the price quotes received are in euro or not - to contract their supplies from the cheapest sources.

All in all, already in the transitional period, the citizen-consumer should benefit from lower prices on a range of widely traded products.

2.1.3. A stable, growth-promoting policy environment

Durable growth requires price stability. The ECB is in charge of delivering the latter. That means an inflation rate of less than 2%. The rate in February 1999 was 0.8% for the whole of the euro zone. The Stability and Growth Pact is designed to deliver a balanced mix between budgetary and monetary policies. As a result, both short and long term interest rates are at a much lower level than elsewhere (Japan and Switzerland excepted). Consequently, businesses are able to finance their investments at a relatively low interest rate cost.

Low inflation, low financing costs, an exchange risk-free market of 290 million people and less affected by the dollar rate: these are all factors that should favour the euro zone's long-term growth prospects. In short: EMU and the euro should deliver what motivated their creation. Any job losses should, hopefully, be temporary and ultimately offset by job creation due to faster growth overall.

2.2. Estimating the Citizen's Motivations to Use of the Euro in the Transitional Period.

Ideally, citizens should take advantage of the transitional period to operate a progressive changeover to the euro so that, on 1 January 2002, the only changeover to be completed would be the exchange of banknotes and coin.

Such scenario would imply that, by the end of 2001, dual pricing for goods and services would be generalised, payment in euro by non-cash means would be the rule and new contracts and other payment obligations would be drafted and executed in euro.

Even if it is unlikely to materialise, there are several reasons to press this case as much as possible.

One major reason is the time and effort it will take for everybody to assimilate a "euro" price memory and value scales.

In all participating Member States (except Ireland), the conversion of prices in the national currency unit into the euro unit results in both "lower" and "fractioned" prices. Paying in euro, a cup of coffee of 55 BEF will cost only □1.36. The fractioned conversion rates will have one positive effect: avoiding the French enduring habit of "francs nouveaux" and "francs anciens" prices. But their difficulty lies in the need to acquire a "euro" price memory and value scales which bears no resemblance to the one they are used to since childhood.

In other words, the citizen-consumer will not only need to memorise completely different euro prices for his habitual basket of goods and services but - which is even more difficult - relate these new prices to each other: i.e. assess their "value" differences. Indeed, the "lower" □1.36 price is not to be mistaken for a less expensive coffee. This is important for correctly relating "euro" expenditures to "euro" incomes. Otherwise, lower price tags combined with a defective awareness of the new value scales might result in overspending. Depending on how one looks at it, the sharply "reduced" salary figures could have the opposite effect.

Consequently, the three year timespan provided by the transitional period should be put to good use in changing, or at least start changing, the citizens' deep-rooted national price memory and value scales.

Dual pricing will help. According to the voluntary dual pricing agreement of 30 May 1998, between the consumer organisations and the professional associations from the distributive trade, tourism, craft and SME sectors, dual pricing is being progressively introduced on products on offer in shops, hotels and restaurants, on till receipts, on advertising leaflets, on price lists and catalogues, etc. Austria has followed a different track by legislating that dual prices will become obligatory from October 2001 onwards.

A publicly-displayed label will signal that dual pricing is being practised. The Euro Observatories, which are in the process of being installed, will exercise control (Germany excepted) over the correct application of the Agreement. In May 1999, the European Commission, together with the signatories of the Agreement, review its actual implementation.

However, one might question whether dual pricing alone will succeed in reconstructing the citizens' price memory and value scales. Indeed, if the citizen-consumer goes on to pay in his national currency unit, the euro price tag is not likely to retain his full attention. But it is certainly going to do so if he has the intention of paying in euro.

Whether he will actually pay in euro depends on:

2.2.1. The willingness of the sellers of goods, services and other assets to accept euro payments.

The signatories to the above-mentioned agreement of May 1998 who, beyond posting dual prices, also accept euro payments, will publicise their willingness to do so by displaying a separate label. The extent to which dual pricing and euro payments are practised is assessed in the May 1999 review arranged by the Commission.

The bond and stock markets of the EMU Member States operate in euro. Consequently, the financial intermediaries of the euro zone and beyond do, of course, accept euro payments when dealing in euro-denominated financial paper with their private customers.

With some exceptions, Public Authorities of EMU's Member States are willing to accept tax declarations and tax payments in euro by individuals. Public utilities invoice in both the national unit and the euro and accept euro payments. Cross-border transportation services - airlines, railways, etc. - also quote euro prices and are progressively accepting euro payments.

New long-term contracts - leases, real estate loans, life insurances, etc.- to which citizens are a party will, for obvious reasons, increasingly be denominated in euro.

2.2.2. The availability of euro means of payment.

Of course, the most commonly used means of payment for retail purchases i.e. banknotes and coin will not be available in a euro denomination until the beginning of 2002.
Provided the Point of Sale (POS) terminal of the retailer has been made euro compatible, bankcard holders (Visa or Mastercard) have the possibility to make euro payments. This is not yet the case in all Member States as the adaptation of POS terminals is still underway

Euro-zone holders of Diners, American Express, Visa or Master Card credit cards can make euro payments where card and euro are accepted. They are billed, without cost, for the euro's countervalue in their national currency, whether these euro payments are made domestically or in other countries of the euro zone.

National cheques in euro are made available by the banks of most EMU Member States. These cheques have distinctive features (colour, euro logo, etc.) so as to distinguish them from those in the national denomination. They should not be used abroad (refusal, prohibitive costs).

The internationally-usable euro cheques allow to make payments both in the national unit and in the euro. If the euro is chosen, the euro's code EUR should appear in the appropriate case.

Travellers' cheques in euro are also available. As a rule, they are free of charge when used for payment at retailers. But banking charges apply when purchased and when used for cash withdrawal at a bank.

Finally, specific euro payment orders allow bank customers to make credit transfers in euro. Charges differ according to their domestic or foreign destination.

2.2.3. The citizens' motivation to pay in euro

Citizens are free to go on paying in the national currency unit till the end of the transitional period. In fact, sheer habit and the absence of a clearly perceived advantage in paying in euro may induce most of them to do just that. The fear of confusion is also an obstacle to dual use if it would imply, for example, carrying both a euro and a national currency cheque book.

Nonetheless, over time, a number of situations are likely to arise in which the euro might become the preferred payment unit.

To quote a few:

- About 34 million Europeans live within 30 kilometres of a border (maritime borders excluded). The highest percentage - over 10% of the population - is found in Belgium, Luxembourg, the Netherlands, Austria, Germany and France. In these border areas, dual display of prices is likely to be a must for the retail sectors on both sides of the border. In comparing prices, commuters will, of course, focus their attention on the euro price tags. Consequently, payment in euro will be preferred over payment in the "foreign" local currency.

- Each year, some 96 million Europeans, i.e. more or less 25% of the population of the EU, travel as tourists within the Union. Airlines, railroads, hotels, restaurants, shops, in short, all those that cater for the tourist trade - and not only in euro zone countries - have already started to take advantage of the possibility to reduce the number of currencies they need to handle by quoting prices and accepting payments in euro. This should suit tourists and business travellers alike whether they come from other euro zone countries or from third countries[9].

- Citizens will progressively become parties to long-term euro contracts. For example, real-estate loans are likely to be increasingly denominated in euro. This will mean monthly instalments in euro by the borrower. The same applies to many insurance contracts.

- The early switch-over to the euro by the European multinationals and export-oriented enterprises will have spill-over effects on their suppliers, subcontractors and clients alike. The fact that the market for airlines is dollar-based has had a ripple effect on the whole industry and its associated contractors, down to the price of airline tickets. A similar euro chain effect will be felt in growing number of SME's. As a result, an increasing number of professional people will become familiar with the euro, possibly even accepting to receive their salaries in euro.

- The agricultural sector could be a prime mover in this respect. Indeed, up to the start of EMU, prices were denominated in ECU but, in fact, paid out in the national currencies at the applicable "green" rate. Today, agricultural prices are not only set in euro but, in those countries that participate in the euro zone, support prices are paid out in euro has well. Of course, given the conversion facilities offered by the banks, producers could still choose to receive the countervalue on a national currency account. But still, Europe's euro-based agricultural market should have important spill-over effects on use of the euro by the European food processing- and distribution sectors.

Whatever the extent of the citizens' use of the euro in response to these developments, however, the larger part of EMU's population, by sheer habit and absence of a compelling motive, is likely to stick to its familiar currency as long as it can do so. This may be comfortable today. Unfortunately, it is bound to end in a distressing "big bang" for all those who, unprepared, wake up in the world of the euro on 1 January 2002.

This glum prospect has stimulated a wealth of information and communication activities by the Authorities, professional organisations, financial intermediaries, consumer organisations and others representing specific population groups.

The European Commission, for its part, is publishing euro brochures and newsletters of interest to the general public. It has a euro site on Internet and, according to the subject matter, the competent service can be contacted by telephone, fax or e-mail. It trains and regularly updates a group of professionals - the Euro Group - who are available as speakers at euro events, organised by the private sector. The Euro Info Centre (EIC) network has been entrusted with the organisation of a campaign to help firms with the changeover to the euro.

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[9] Europay's "Euro Tracker" which monitors euro payments by their card users reveals that, during January-February 1999, a total of 64 countries world-wide had settled cross-border euro transactions by their cardholders. Transportation (mainly road tolls) and Internet/mail/telephone order sectors account for most of them. Other sectors include general retail, airlines, hotels and restaurants.

This year the focus will be on those SME's which are geographically isolated or vulnerable because of their size or sector of activity.

Moreover, the Commission is running a euro information campaign in the international media e.g. on TV's EuroNews and co-finances the national euro information campaigns of the E.U. governments. The financial intermediaries, the business sector and their representative organisations are also actively providing information and advice on the euro to their clients, business partners or their members. Both public authorities and private sector organisations dispense information on euro-dedicated web sites and can be reached by telephone, fax or Email.

However, the Services of the Commission have estimated that for many reasons (illiteracy, exclusion from information channels and financial services, fear of the complexity of the issue, lack of interest, and so on), 30% or more of the European population might not be reached satisfactorily by the usual media (brochures, written material, T.V.).

The following groups are considered as being in need of specific modes of communication:

- people with sight- or hearing deficiencies;
- elderly people;
- population groups in economic difficulties.

In order to address their difficulties, the Commission has set up pilot projects called "The euro made easy" with the following objectives:

- set up working parties composed of members of these groups in order to identify their problems, questions and language;
- co-operate with them in developing tools for training trainers and mediators;
- mobilise the local and regional authorities to use these tools to train the field workers who are in contact with these groups.

A first pilot experiment has started in the region of Veneto. Others will follow.

The suggestion has also been made that sets of euro coins and notes should be made available before 2002 for testing by the blind. This seems reasonable enough; but there are both practical and legal obstacles to its practical implementation. The ECB has not lifted its reservations so far.

At this stage the conclusion is clear: the changeover to the euro by the citizen, has not taken off yet; and, regrettably, least of all in the "payment" area where it matters most in helping the citizens acquire a euro price memory and value scales.

It has been widely publicised that very few people have, so far, replaced their national currency account by a euro account. But the number of euro accounts should not, by itself, be seen as a measure of the citizen's interest in making euro payments. Indeed, the holder of a national currency account is perfectly able to make and receive euro payments as his bank will take care of the necessary conversions.

The main obstacle to the euro's use as a payment currency is to be found in the lack, so far, of a clear advantage in paying in euro rather than in the familiar national currency unit.

At the domestic level, this may be attributed to a number of factors.

- The absence of the most commonly used means of payment when shopping: banknotes and coin.

- The limited euro-compatibility of Points of Sale. Many POS till receipts already indicate the amount to be paid both in euro and in the national unit, but when it comes to actual payment, few (e.g. airline reservation systems) give the client the choice between the euro and the national currency unit. Many accept payment in the national currency unit only; others flash both amounts; finally, some automatically "impose" a euro payment when a foreign bankcard is used (e.g. highway tolls in France).

- National euro cheques allow the making of specific euro payments; but, as long as euro payments are not accepted nation-wide, carrying two cheque books will be necessary. This prospect might be unattractive to quite a few people.

- The international euro cheques avoid this handicap in those countries where they are also domestically used. There is nevertheless a danger of confusion, especially for the creditor, since in the absence of currency identification, the cheque is considered to have been written out in the national unit.

This mismatch, at the domestic level, between the comfort of a continued use of the familiar national payment instruments and the inconvenience of using, *in addition*, the limited range of payment means available in euro, does not augur well for the chances of a progressive changeover to the euro by the general public.

More information alone will not be sufficient to change this outlook. More communication might motivate many. But to bring the general public to choose the euro rather than his familiar national unit, incentives will be needed.

Otherwise, if a large part of the population were to remain insufficiently prepared, competitive pressures might ensure that *dual pricing* continues for quite a long time after the introduction of euro banknotes and coin.

VII. THE INTRODUCTION OF EURO NOTES AND COIN

1. Introduction

The conversion of fiduciary money is a daunting task of unprecedented logistical proportions. Although the key issues were identified very early on, it is obvious that banks and the NCBs (National Central Banks) were, first and foremost, focusing their efforts on successfully meeting the challenge of the target date of 1 January 1999. This has meant that, though impressive progress has been made in preparing for the physical conversion of notes and coin, an important number of issues and procedures still need to be dealt with. In all "in" countries, working groups are active where these issues are being discussed between the NCB and the banking and retail sectors.

In what follows, the key issues are highlighted and the importance of the matter stressed. Most of the information below is based upon survey data released by the European Banking Federation in December 1998.

2. Key issues

2.1 Banking charges for the conversion of notes and coins

In November 1997, DGXV published the "Report of the Expert Group on Banking Charges for the Conversion of the Euro". The recommendations made in this report were endorsed by the "Commission Recommendation of 23 April 1998 concerning banking charges for conversion to the euro" (98/286/EC). According to the standard of good practice defined in these texts, banks should convert "household amounts" of notes and coin free of charge during the final period. Banks which do intend to charge for conversion services should provide clear and transparent information concerning those charges to their customers, both before and after the transaction.

Although this is a very sensitive issue for the European Commission, consumer organisations and the general public, there are no indications that banks really do intend to charge the consumer. Annex B of the Expert Group report already showed that, in most countries, banks were unlikely or not intending to charge. In Spain, conversion charges are even prohibited by law. In Belgium, the Minister of Finance has indicated that if banks intended to charge, a law would be proposed to prohibit this.

Nevertheless, there is a strong feeling in the banking sector that - although they concur with the basic premise that conversion should be free of charge for the consumer - it would be unfair to let the banks incur the full cost of the changeover. Most banking federations are involved in negotiations with the NCBs and government to arrive at an equitable arrangement for sharing the burden and cost of this operation. In the Netherlands, banks have taken the firm stance that incremental costs caused by the cash changeover should not be borne by the banks at all. The Dutch Minister of Finance has already announced that a satisfactory solution is in the making. One of the main reasons why there should be room for such negotiations is that the NCBs stand to benefit substantially from the changeover, as important quantities of notes and coin have been lost or destroyed over the years and thus will not be presented for conversion.

The Commission Recommendation has left the definition of what constitutes a "household amount" up to the market. The information provided to DGXV by the European banking federations indicates that, where the question of "household amounts" has already been dealt with, the terms of the Recommendation have been exceeded, and decisions are being taken either at national level or at the level of groups of banks.

In Ireland, an overall total of at least 500 IEP has been agreed upon by banks and building societies. In the Principles of Good Practice drawn up by banks in Portugal, €500 is the figure cited. In the Netherlands, €250 has been proposed, but no definite decision has been reached. In Austria, the exchange of notes and coin will be covered by a Euro Pricing law. In the draft version of this law, "household amounts" are defined as being approximately 30,000 to 50,000 schilling. In Finland, Luxembourg and Spain, banknotes and coin will be exchanged free of charge in unlimited amounts. In other countries, a decision has yet to be taken or the issue is considered to be a commercial and competitive issue, which is to be decided by the individual banks. The European Savings Bank Group has stated that anything up to a cash value of €500 will, most likely, be considered reasonable.

It is important to note, however, that all the above applies to the conversion of *national* notes and coin into euro notes and coin. If consumers wish to convert banknotes or coin *of another euro-zone country* into euro notes and coin, banks will continue to charge a handling fee as they do now when consumers wish to exchange national notes against other foreign currency. One of the main reasons for this is that foreign banknotes always have to be repatriated, which makes the exchange of foreign currency an even more expensive service than the conversion of national fiduciary money into euro notes and coin. Most NCBs will not bear the cost of repatriating foreign banknotes that have not been exchanged at their counters and have delegated this task to the banks, which are allowed to charge for this service. Exceptions are France, Luxembourg and Portugal, where the NCBs have taken this task upon themselves or - in the case of France - have out-sourced this to a third party. In Belgium and Italy, the NCBs will only repatriate foreign banknotes presented at specifically designated branches. In Belgium, the NCB will share part of the cost of repatriation, provided that the banks respect maximum levels for the handling fee.

2.2. The Period of Dual circulation

As agreed at the Madrid European Council, the EU Regulation on dual circulation provides for a period of maximum six months after 1 January 2001, before the euro becomes the sole legal tender. This period may be shortened by national law. In the meantime, in most countries, a consensus has emerged between the banking community, the retailers and consumer associations that this period should indeed be substantially shortened, as this would both lower the cost of the operation and minimise consumer confusion.

The approach, however, differs rather widely from country to country. Three types of approach can be identified.

- There are countries where a consensus is emerging to limit the dual circulation period to 6 weeks/3 months. This is the case in Austria, Belgium, France, Germany, Ireland and Luxembourg. It should be noted that although Germany has decided that euro banknotes and coin will be the only legal tender from 1 January 2001, the end of Phase C is planned for 28 February 2001 and further allowances have been made for the vending-machine sector.

- The Netherlands is in a class of its own, as it aims to reduce the dual circulation period to just 4 weeks.

- Finally, Portugal and Spain are not considering shortening the original six-month period, while the other countries are still in the process of conducting feasibility studies on the issue.

In order to shorten the dual circulation period and facilitate the changeover, a series of measures need to be taken. The following logistical issues were discussed by the ECSAS and the ECB in Frankfurt on 15 December 1998.

2.2.1. Front-loading

Front-loading is the process whereby economic agents receive stocks of euro notes and coin before the start of Phase C. Three types of economic agent have been identified: banks, retailers and consumers. Frontloading has four aims.

- First, to cope with the very strong peak in demand for secure transport in January 2002 (cf. 2.2.2.).
- Second, to enable retailers to give change in euros from the very start of 2002.
- Third, to allow banks to offer their customers the option of withdrawing euro banknotes from ATMs as from the early hours of 1 January 2002 (cf. 2.2.3.).
- Finally, front-loading will speed up the process of cash substitution.

The ECB is of the opinion that front-loading the different target groups will have to be harmonised across Europe in order to avoid distorting competition between the various Member States. The ECB agrees with the idea of front-loading the banking industry and the retailers, given the role they will play in the distribution of euro currency in the overall economy. Legal arguments, however, may impede the front-loading of consumers, as this would, *de facto*, imply the introduction of the currency into circulation at an earlier date than officially adopted by the Council Regulation.

The estimation of how far in advance of “E-day” circulation of euro notes and coin to the banks ought to start, differs from country to country, but one to three months seems to be adequate. It has to be taken into account that the distribution of coins is the more cumbersome process and will probably take more time than the distribution of notes.

This immediately leads to the question of which value date the ECB is proposing for debiting the banks for the front-loaded amounts of euro notes and coin. The ECB has already agreed not to debit banks before 1 January 2002 for amounts delivered prior to that date, as it does not seem to be legally feasible to debit banks in respect of instruments which have not yet become legal tender. Moreover, the ECB considers that commercial banks should not be put at a financial disadvantage by the front-loading process. The European Banking Federation has proposed debiting the banks progressively in line with the collection of national currency units, so as not to penalise the banks for their active participation in the front-loading process. The ECB, however, seems to consider this procedure as too complex and is proposing to debit the banks either on 2 January 2002 or on different fixed dates during Phase C. It is obvious that the ECB’s first proposal would not be conducive to getting banks to accept sizeable stocks of preloaded euro notes and coin.

“Starter-kits” consisting of a predefined mix of rolls of coins and in some cases of banknotes are being considered in most countries in order to facilitate the front-loading of retailers. Only in Germany and Spain is this approach not being considered, and cash will continue to be distributed to retailers in the standard packages.

2.2.2. Transport and storage capacity

Security, transport and storage issues are essential in preparing for a smooth changeover. The sheer bulk of the notes and coin to be retired from and brought into circulation will cause important logistical problems that cannot be solved by simply relying on the existing capacity of the Cash in Transit (CIT) industry.

The ECB estimates that 12 billion banknotes and 50 billion coins will have to be produced. This represents respective weights of approximately 13,500 tons and 250,000 tons and a bulk of respectively 800,000 and 500,000 containers. The withdrawal of existing notes and coin will involve roughly similar figures - which may be somewhat lower due to lost and destroyed notes and coin. These figures illustrate the importance of front-loading.

The ECB has decided that security and transport responsibilities should be national prerogatives, since individual Member States’ positions vary with regard to several aspects concerning the currency in circulation and the logistical infrastructure of the cash supply.

In all countries, the changeover scenarios have shown that additional transport capacity is necessary. In most countries, alternatives such as transport by army, civil protection, railway or security escorts and “off-hour” transports at night and during the weekends are under consideration, but no firm decisions have been taken.

Another means of increasing the available transport capacity consists in relaxing the regulations governing the limits on value transported per vehicle, the weight and capacity levels per vehicle and overtime and work during week-ends, which impose restraints on the CIT industry. Changing the regulations concerning value limits will, however, create problems for the insurance industry, which means that insurance contracts will need to be renegotiated. In most countries, no firm decisions have yet been taken in these matters.

In most cases, banks expect their NCBs to shoulder the costs related to additional transportation and security. Again, however, this is more often than not still up for debate. Priority is now being given to the development of efficient and cost-effective scenarios, discussions about cost-sharing will no doubt arise in a later phase. The exception is Austria, where, apparently, the government does not intend to provide extra assistance to ensure the security of transport, and the current practice - banks bear the cost of picking up the notes and coin at the eight cash centres of the NCB - will not be changed.

In order to reduce the risk involved in transporting the national notes that have been withdrawn from circulation, banks have proposed having these notes invalidated on the premises of commercial banks. NCBs are, however, extremely reluctant to go along with this proposition.

Only in the Netherlands has a decision been reached whereby banks are allowed to invalidate old notes under specific conditions and using a special device. There may be a shift in this restrictive policy, as the ECB stated during a meeting on 15 December 1998 on the 2002 cash changeover that it was considering a proposal for having notes invalidated on the premises of commercial banks, as this would represent a significant saving in terms of storage and transport capacity. It was, however, stated that this is only conceivable if responsibility for security equipment and the costs were borne solely by the public authorities.

Coins are obviously a far greater logistical problem than notes. It is to be expected that banks will be confronted with a significant number of consumers wishing to convert their “piggy banks” to euro notes and coin. That is why, in most countries, banks are at least considering launching a campaign in the last quarter of 2001 to encourage their customers to hand in old coins before E-day.

2.2.3. Adaptation of Automatic Telling Machines (ATMs)

The general idea is that consumers with small stocks of cash in national denominations will spend their notes and coin in retail outlets, where they will obtain change in euro coins, and will withdraw new euro notes from bank counters and ATMs. According to the ECB, by the end of 1998, 140,000 ATMs were installed in the eleven participating Member States, and this number will be even larger by the end of 2001. ATMs are the primary source of banknotes for the general public. It is estimated that 70% of all euro banknotes will be distributed to the public *via* ATMs. A smooth conversion of the ATMs is a prerequisite for a successful and quick changeover.

The ECB is fairly optimistic about the picture that emerged after meetings with third parties, including ATM manufacturers. The pace of change in ATM technology has been so rapid over the last four years that a “Big Bang for ATMs” can now be planned. Nevertheless, the conversion of ATMs will involve extensive logistical planning and management to ensure that appropriate engineering, cash management and security are available within a short space of time.

Banks will either opt for a “Big Bang” overnight conversion from national banknotes to euro banknotes or for a more gradual approach. Overnight conversion will take place in Austria, Belgium, and Germany. The changeover is planned either during New Year’s Eve or the following night. The other countries have opted for a more gradual approach, as in the Netherlands where the last ATMs should be loaded with euro notes by 7 January 2002, or Portugal, where the last ATMs will only be loaded in June 2002. Portugal also seems to be the only country where the first euro note withdrawals at ATMs will only be possible as of February 2002. The consequence of a gradual approach is of course that national notes will continue to be circulated during the conversion period, which makes a quick changeover hard to achieve.

3. Conclusions

All banking federations have adhered to the standards of good practice set forth in the Commission Recommendation of 23/04/1998. This means that the cash changeover - at least for household amounts - will be free of charge for the consumer.

Most countries are in the process of establishing a minutely detailed scenario for the introduction of euro notes and coin, but an important number of large and small issues still need to be addressed. The money transport issue, in particular, is proving to be an exceedingly complex problem, which can only be solved through flexibility and creative thinking.

All parties are striving for a changeover period which is substantially shorter than the maximum period decided upon in Madrid, and in most countries this goal will be achieved.

In the cash changeover process, the banking community is to play a crucial role on behalf of the public authorities and is prepared to fulfil its duty. But the additional cost of the cash changeover will be considerable for the banking industry in all euro area countries. The issue of sharing the cost amongst governments, banks and retailers should be dealt with as the specific costs of the chosen scenarios become apparent. Compensation should be determined and allocated in a transparent manner, avoiding any distortion of competition.

VIII. A STRONG INTERNATIONAL ROLE FOR THE EURO

Summary

From the viewpoint of its *internal* value – that is, its purchasing power within the EMU area – the euro is very likely to be a strong currency. The budgetary discipline imposed by the Growth and Stability Pact, the independence of the ECB and its statutory objective of price stability are all sources of internal strength .

Whether the euro will also appreciate against the currencies outside the EMU in the coming years is more uncertain. Apart from economic fundamentals in the EMU and the US, there are structural and political forces which can influence the future value of the euro against the dollar (that is, the *external* value of the euro). The focus of monetary policy on price stability, the excess foreign exchange reserves of national central banks in the EMU, the international role of the euro as a transaction, investment and anchor currency, the lasting budgetary discipline in the EMU and, in the long run, a more efficient and flexible working of the EMU-economy are, at first sight, in favour of external strength for the euro.

Nonetheless, the impact of most of these forces is either ambiguous or not significant. It can therefore be expected that, on balance, they will not produce substantial exchange-rate movements of the euro against the dollar. If there is a net structural-political effect on the exchange rate of the euro, however, it will be upwards and in the long run.

1. Monetary policy in the EMU

The weakness or strength of the euro undoubtedly depends on monetary policy under EMU. The Maastricht Treaty has given the ECB a mandate to ensure price stability. In the event that the ECB's tough line on inflation creates a negative inflation differential with foreign economies, it will drive up the euro's external value. The reasoning goes that, if the euro's internal stability is commonly acknowledged, investors shift funds into it. Internal stability then translates into external power.

Nonetheless, it is not so likely that the euro's consolidation as a consequence of monetary policy will gain momentum. After all, the potential to create a strong currency through an orthodox policy depends on the international economic climate. As industrialised economies are expected to experience little inflationary pressure in the coming two years, the immediate impact on the euro of a policy aiming at price stability will be small.

Moreover, potential differences in the policy preferences of the members of the Governing Council, the decision making body of the ECB (which includes the Executive Board of the ECB plus the governors of the national central banks), may harm the ECB's credibility. On the other hand, it can also be expected that, in its first year of existence, the Bank will place overwhelming emphasis on establishing its credibility. The ECB might have been expected to be especially chary of a depreciation in the euro's exchange rate, and to view euro appreciation as an early sign of success. A strong euro is an instrument to ensure price stability: with a depreciation of the euro, import prices in the EMU would go up and inflation would be imported from outside the EMU.

The exchange rate policy that will govern the single currency, however, is still an uncertain aspect. Most probably, the ECB will pursue a policy of benign neglect towards the exchange rate. This means that the ECB will pay less attention to the exchange rate of the euro against the dollar than the *Bundesbank* did to the exchange rate of the mark before the start of the EMU. The reason is that the EMU area is much less open compared to the individual member states, as most of its trade takes the form of intra-EMU trade. In the EMU the share of export in GDP is approximately 12%, roughly the same as in the US, but clearly lower than the shares in the individual EMU-states (the weighted average amounts to 30%). As a result, monetary policy in the EMU will be less constrained by the exchange rate.

2. Decrease of EMU reserves

At the start of the EMU, €50 bn. of official reserves were pooled with the ECB, as required by the Maastricht Treaty. The transfer provides the ECB with a stock of assets in order to be able to intervene in the foreign exchange market. Official reserves not transferred to the ECB remain under the control of the national central banks. Changes in reserves by individual member banks are, however, not allowed to conflict with the ECB's monetary policy. The amount of the transfer is much lower than the reserves held by the central banks of the individual countries prior to the EMU-start. In 1997 these central banks held $300 bn of foreign currency reserves (of which 60 % were in $US and one third in the currencies of other EMU countries). As a consequence of the unification, reserves in the EMU-countries shrunk sharply as foreign exchange reserves held by one participating country in the currency of another became euros and were no longer available for foreign exchange interventions.

The EMU nevertheless still has an excess of reserves. There is a relationship between the level of a country's foreign currency reserves and the level of its imports. In 1997 the sum of imports of the EMU-countries originating from outside the EMU amounted to $US 750 bn. This is 12 % of GDP, almost the same percentage as the one in the US, but substantially lower than in the individual EMU countries (with an average of 33 %).

If the ratio of reserves to imports is kept equal to the average of the ones in the participating countries (i.e. 20 %), EMU will need reserves in the region of US$ 150 bn. The figure will probably even be lower because a country with an important reserve currency needs a relatively lower amount of reserves, as proves the relatively low ratio of reserves to imports in the US (3.3 %). Were the national central banks to reduce their excess levels of reserves instantly, this would boost the €/$ rate. Such a scenario, however, is unlikely as, in practice, any significant reduction of excess foreign exchange reserves must be co-ordinated under the supervision of the ECB. Moreover, the amount of excess reserves is only a small fraction of the daily volume of foreign exchange market transactions, worth US$ 1,000 to 1,500 bn.

3. The euro as an anchor currency

As the euro area is one of the world's largest economies, and the ECB pursues an orthodox monetary policy aiming at price stability, the euro will undoubtedly provide an anchor for a range of countries outside the euro area. Countries wanting to put an end to their bad inflation performance will want to fix their currency to the euro in order to lay the foundation of a credible anti-inflation policy. Private traders might then increasingly denominate transactions in euro, a practice that would lead them to hold working balances in euros, and would ultimately enforce the tendency for investments to shift into the euro. Nevertheless, it can be expected that the use of the euro as an anchor will remain constrained to a limited group of countries. After all, exchange rate policies most often not hinge on economic factors only, but also on inertia (continuation of habits), the historical conditions, international political ties among countries or even on military presence. These factors often favour the dollar.

EU Member States that do not yet, or are unable, to participate in the EMU may accede to EMR II. This means that, with a fluctuation margin of 15 % above and below the central rate, their currencies are pegged to the euro at an official parity, which can be adjusted if necessary. On 1 January 1999 the Danish crown and the Greek drachma entered the new system. The UK and Sweden continue to opt for a floating rate, for political reasons.

Table 3: Official exchange rate arrangements 1980-1999

Number of countries
(4th quarter; 1999 first quarter)

	1980	*1985*	*1990*	*1995*	*1997*	*1999*
Fixed exchange rates	97	95	85	66	66	66
currency pegged to						
- US dollar	43	35	25	22	20	19
- French franc	14	13	14	14	15	-
- other currency	5	5	5	8	11	7
- currency basket	35	42	41	22	20	19
- euro	-	-	-	-	-	21
Limited flexibility	10	20	20	16	16	6
- *vis-à-vis* single currency	0	7	8	4	4	4
- EMS (from 1999 onwards EMS-bis)	7	7	9	10	12	2
- adjusted according to set of indicators	3	6	3	2	0	0
Flexible exchange rates	32	33	48	98	99	99
- managed floating	-	22	23	44	46	45
- independently floating	-	11	25	54	53	54
Total	139	148	153	180	181	171

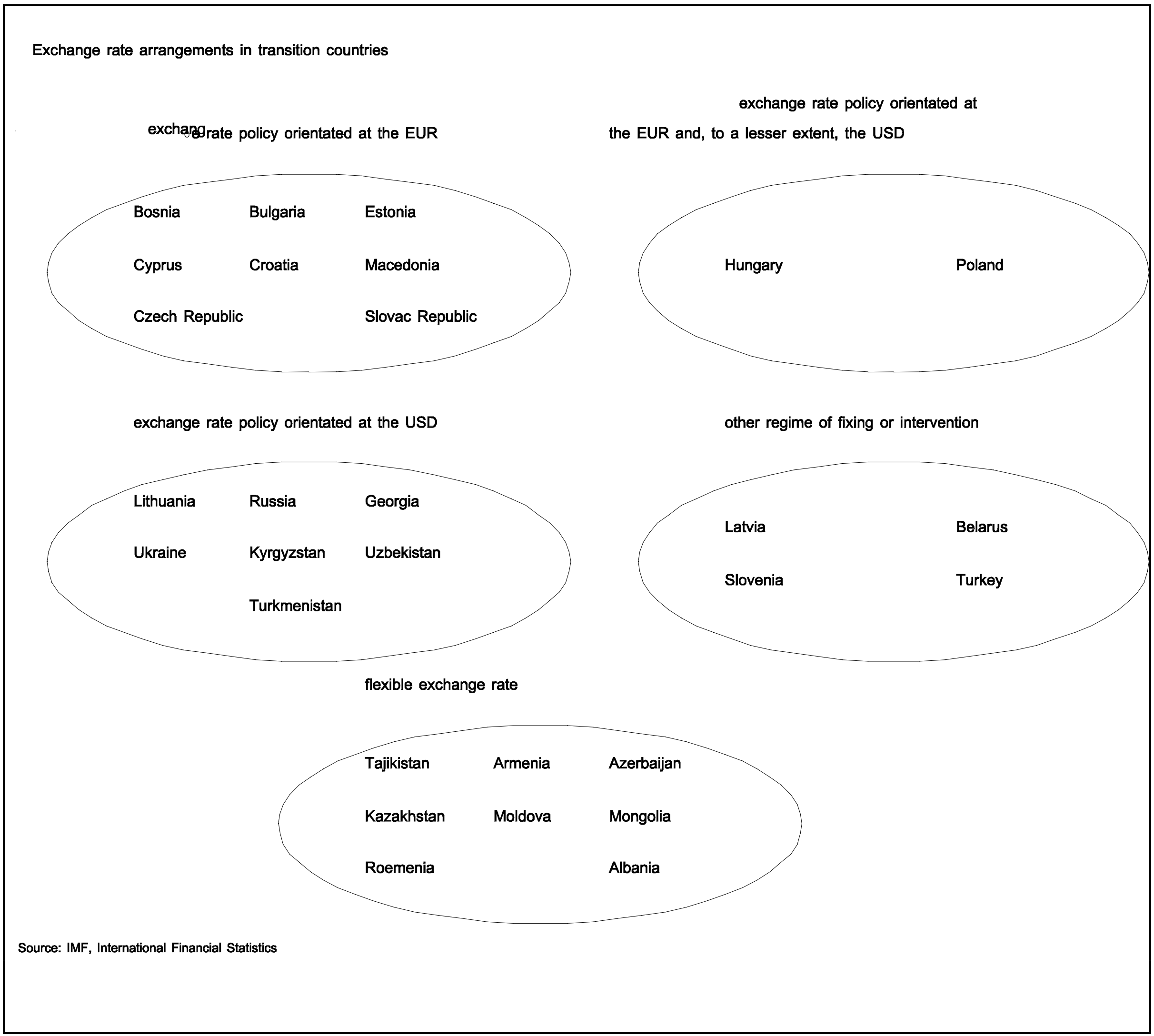
Source : IMF, International Financial Statistics; 1999: KBC

The Central and Eastern European countries and the successor states of the Soviet Union are nearest to the euro area and are therefore the most obvious candidates for linking their currencies to the euro in some way. It is likely that Central European countries will introduce a peg to the euro similar to that of the EMS II, even before their official accession to the EU. Hungary and Poland have already replaced the EMU currencies in their currency basket by the euro and plan to peg their currencies solely to the euro before the year 2000, if possible. The currency-board countries, Bulgaria and Estonia, will be adopting the euro to replace the German mark as anchor currency, and during 1999 Lithuania will be using the euro on a

50/50 basis with the US$ as anchor currency. None of the other accession candidates, finally, has yet announced any official changes to their exchange rate systems.

A euro orientation of currencies from the former Soviet Union (Georgia, Khirgistan, Turkmenistan) is unlikely. Most of these currencies are currently linked to the dollar, as a consequence of the importance of these countries' commodity exports (with prices likely remaining to be expressed in dollar), close trade relationships with Asia and the Americas, and a EU agricultural policy which proves inhospitable to imports from the east. Most developing countries in the rest of the world will probably continue to opt for the dollar as an anchor as it is the currency in which the largest amount of their debt is denominated. Only countries connected to Europe through their colonial past (as do the African counties in the CFA-zone of which the currency was linked to the French franc until the start of the EMU) managed their currency to the euro.

Figure 1: Official exchange rate arrangements 1980-1999



4. The euro as a transaction currency

Often, exporters and importers choose a currency for invoicing and settlement which can be bought or sold at low transaction costs in the foreign exchange market or has a high degree of acceptability for other transactions. At this moment, the dollar is the world's dominant transaction currency. The percentage of world trade invoiced in dollar is much larger than the US share of world trade: around 13% of world exports in 1997 originated from the US but almost half the world exports were invoiced in dollars. The EU accounted for about 19% of world trade, whereas the European national currencies' share of trade finance was only 31%. The euro will most likely increasingly be used as a vehicle currency in international trade, at the expense of the dollar. Any rise in the use of the euro will lead to a boost in demand for euros and consequently to an increase in its external value.

Table 4: Economic position of the EMU in the world

	US	Japan	EU-15	EMU-11
Relative size				
Population (in 10000000, 1997)	267,9	126,0	374,2	290,5
Share GDP in total (in % 1997)				
US, Japan, EU-15	38,9	20,9	40,2	
US, Japan, EMU-11	42,7	23,0		34,3
Share world export goods (in %, 1997)				
incl. intra-EU export	12,8	7,7	38,4	30,5
excl. intra-EU export	16,8	10,1	19,2	
excl. intra-EMU export	15,1	9,1		18,0
Degree of openness				
Sum of imports and exports goods as % of GDP (1997)				
excl. intra-EU resp. intra-EMU trade	21,3	18,1	19,3	24,0
weighted average member states			48,8	49,3
Relative performances				
GDP-growth (in % average 1993-1997)	3.0	1,5	1,9	1,7
Inflation (% increase cpl. average 1993-1997)	2,7	0,7	2,8	2,8
Decrease budget deficit (% GDP, 1997 against 1995)	2,0	0,3	2,6	2,3
Current account balance (% GDP, 1997)	- 1,9	2,2	1,2	1,7

Source : EC, Economic Forecasts en Eurostat, External and intra-European trade

Whether the euro will play the role of transaction currency depends on the size of the underlying economy and global trade. The larger the market, the lower the transaction costs and risks. In terms of the size of the domestic economy, the US are superior to the combined EMU-countries. In 1997 the US' GDP was ECU 6922 bn, compared with ECU 7125 bn for the EU as a whole and ECU 5552 for the 11 countries that entered the EMU. The EMU however has a larger volume of global trade.

Another criteria is a high degree of international acceptability and a deep and broad foreign exchange market. Liquidity of the euro can be provided by running deficits on the current account of the balance of payments in the EMU area or by tolerating loans in euro by foreign borrowers. Allowing foreigners to borrow in euro from banks in the EMU however increases the money stock in euro. This conflicts with the ECB's objective of price stability and the ECB will therefore probably (partly) sterilise the impact of international borrowing in euro on the money stock by open market operations. This means that international liquidity in euro has to be provided mainly by current account deficits. The consolidated external position of the EU has on average shown an equilibrium for the past two decennia. In 1997 the EMU area ran a surplus in its current account amounting to 1.5% of GDP. Were the euro to become a vehicle currency for trade, at the cost of the dollar, then a systematic deficit on the EMU current account would not necessarily push the euro down. Conversely, the US current account deficit (in 1997 at 2.2 % of GDP[10]) would put more downward pressure on the dollar.

Inertia favours the dollar. The more a currency is used for trade and invoicing the more it will continue to be used. Important in this respect is the dollar denomination of commodity prices, which will most probably tend to sustain. This is not only because of strong oil demand in the US and the relative large amount of imports of the oil producing countries from the US (which is five times larger as their imports from the EU), but also as a consequence of the (political) dependence of the oil producing countries on the US. An exception is Brent Oil from the North Sea, of which a large part goes to the EMU countries so that its price may perhaps be faster denominated in euro.

5. The euro and the financial sector

The euro's introduction creates money and capital markets in one currency of a size comparable to their US and Japanese counterparts. A growing market for euros will increase the external value of the euro. Since January 1 1999 money market transactions in the EMU can also be arranged between participating countries. In order to complete these transactions as fast and as efficient as was the case inside the individual countries before the EMU-start, a new payments system (the so-called "TARGET"-system) has been developed. That interlinking mechanism connects the real-time gross settlement systems of member countries. If outside the EMU (e.g. in London) an important EUR-market develops, this may place upward pressure on the external value of the euro.

Table 5: Capital markets: EMU, US, Japan and the UK (1997)
(% total)

	Bonds	Equities
US	46	61
EMU-11	30	15
Japan	20	12
UK	4	12
Total	100	100

Source: DB Research

[10] The US trade deficit has since continued to rise. In March 1999 it reached a record monthly total of $19.7 billion, and is likely to reach 3.6% of GDP in 1999 as a whole. The $ has nevertheless remained strong. [*ed*].

Early in 1999 the countries participating in the EMU converted their long-term government bonds in euros. It can be expected that after some time governments will manage their debt co-operatively, with a common emission of bonds having the same coupon and term structure, or that small countries will copy issues of large countries. Complete fungibility between bonds requires that the government finances in Member States are broadly similar. Only after the market considers different national bonds as sufficiently equal, will this lead to one single group of futures contracts and will the EMU market have an equal size and liquidity as the ones in the US and in Japan.

The introduction of the euro will probably also accelerate the processes of consolidation, competition and technological innovation that have characterised European equity markets in recent years. Moreover, there is optimism about the further development of a corporate bond market in the EMU. A sudden, massive breakthrough of the European equities and bond markets, however, is not expected, as there are still impediments, such as the absence of a harmonisation of rules and fiscal treatment in the EMU area.

All in all, it is not certain that the demand for euros originating in the financial sector will be sufficiently strong to push the euro's external value upwards. Yet, as a mere consequence of the euro's introduction, investors will change their asset allocation practices to determine their portfolio mix given structural changes in expected return and in how overall portfolio risk can be spread. Undoubtedly, much of past investment from non-Europeans in certain European currencies was dictated by the relatively high return. Since the launching of the euro, there is only one interest rate, and as a consequence investors will look for new investments with a higher return. Moreover, investors will no longer have the possibility to spread their risk among member countries. Although these effects will decrease investors' interest in the euro, they will probably be insignificant as nominal convergence among the participating countries had already resulted in a large stability of constituent currencies and lower, converged, interest rates before the beginning of the EMU.

In addition, the projected greater supply of euro-denominated assets will temper the upward pressure on the value of the euro. With broader, deeper and more liquid financial markets in Europe, issuers outside the EMU area potentially favour the euro. This applies, e.g., to multinational firms or to the governments of Central and Eastern European countries, who aim at joining the EU and the EMU in the future. For example, an emission in euro to buy in a dollar-debt will induce investors to hold a larger part of their wealth in euro and a smaller part in dollar. On portfolio-balance reasoning, investors will be ready to adjust their portfolio in such a way only if it provides a higher expected return. This requires a higher euro interest rate and/or an expected appreciation of the euro. To generate the expectation of an appreciating currency, first the euro has to depreciate below its equilibrium level.

6. Budgetary policy in the euro area

It is likely that the European Growth and Stability Pact, which governs budget conditions of EMU-countries, will lead to a further reorganisation of public finances in the next few years. Its effect on the euro's external value is judged not very large. From the economic literature we know that the impact of changes in public finances on the exchange rate is not unambiguous, certainly not in the short run, as a restrictive fiscal policy creates several opposite effects.

In the short run, a restrictive policy leads to a lower interest rate, which curtails the inflow of foreign capital, given increasing interest rate differentials. This will put downward pressure on the currency. On the other hand, the reduction of domestic demand improves the current account, strengthening the currency. In case of strong capital mobility, the deterioration of the capital account will offset the improvement of the current account and therefore the downward pressure on the currency will be dominant. In the longer run, a continued reduction in the public deficit will create a higher savings ratio and a lower ratio of debt to GDP. A country that saves more than its trading partners accumulates more foreign assets and will see its currency depreciate against others'.

From past experiences it is known that changes in public finances only have a significant impact on the exchange rate if the net lending or borrowing requirement of the government becomes very large (e.g. more than 10% of GDP). Therefore, the impact of the stability pact on the external value of the euro will remain very small.

7. Political influence on the euro

Although the European System of Central Banks (ESCB) is the only political body entitled to intervene on the foreign exchange market, the governments of the individual EMU countries can influence the development of the external rate of the euro in several ways. After all, almost all measures of macroeconomic policy exert an impact on the exchange rate.

The conduct of income policy (which, inter alia, determines whether and how governments correct for baleful wage developments), as well as that of structural policy (which is directed at increasing the efficiency, the flexibility and the dynamism of the economy) may be important determinants of the euro's external value. Structural policy measures fall under a number of headings: the labour market (e.g. an increase in labour flexibility in Europe), the public sector (e.g. a more efficient working of European governments, the harmonisation of national fiscal systems or political unification), financial markets (e.g. TARGET, co-operative debt management), agriculture and industry (e.g. a reduction of EU subsidies). The realisation of (some of) these measures will have a wholesome influence on the euro.

A direct political impact on the euro is possible, but is unlikely. Indeed, given the increasing level of international capital mobility an active political influence of the exchange rate is incompatible with pursuing an independent monetary policy (this is the so-called "monetary conflict triangle"). According to article 109 of the Maastricht Treaty the Council of Ministers can provide "general orientation" on the European exchange rate policy. Yet, on the European summit in Luxemburg end 1997 it was decided that such interventions can take place only in exceptional cases and may in any case not conflict with the objective of price stability.

8. Economic growth in the euro area

Some elements make us believe that the mere realisation of the EMU will have a positive impact on real GDP growth in the euro area. If this is the case, it will have a positive result on the currency. Yet, macroeconomic effects of the monetary unification are difficult to quantify and are not always unambiguous.

On the one hand, the creation of a more stable policy environment and the omission of uncertainties are likely to stimulate macroeconomic performances in the EMU countries. Also, savings on transaction costs by the introduction of the euro (estimated at roughly 0.5% of GDP by the Commission), should be seen as an efficiency gain, which allows increased production levels with a given amount of labour and capital. Nevertheless, it is not sure that this gain will be exploited immediately, as uncertainty surrounding the new currency may continue for some time. Acting in the opposite direction to the (permanent) efficiency gain there also exist (one-off) costs accompanying the introduction of the euro.

9. Conclusion

At the world level, the economic weight of the EMU is roughly equal to that of the US. As a consequence of that, the euro is in a good starting position to become an international currency beside the dollar. This means that the euro will to an increasing extent function as a transaction, anchor and investment currency outside the EMU area. How fast the euro will play an international role and whether this will affect the □/$ exchange rate is uncertain. Most probably, the exchange rate will mainly be determined by the development of the macroeconomic fundamentals in the EMU and the US, and by the economic policies that determine these developments.

IX. SPECIFIC AREAS OF THE EURO'S FURTHER DEVELOPMENT

In terms of economic weight, market size and openness, the euro area comes close to the US. This is the euro's homeland; but its development is being furthered in other areas as well.

1. The use of the euro by the "pre-ins"

While waiting for their participation in EMU to enlarge the size and the weight of the euro zone proper, the "Pre-Ins" i.e. the UK, Sweden, Denmark and Greece, are likely to make a significant contribution to the development of the euro's international role.

Greece is determined to join EMU at the earliest opportunity: that is by the year 2001, when it expects to meet the convergence criteria.

For **Denmark**, which already meets these criteria, participation depends on the outcome of a referendum. No date has been fixed, pending a more favourable attitude to the euro by the citizens. Latest polls indicate a swing towards participation.

The **UK and Sweden** - though the latter has no formal "opt-out" - take a more guarded approach: EMU should first prove a success; and joining must be compatible with their national interests. In both countries, the apprehension that EMU is a stepping stone to political union is weighing down on public opinion. In both countries a referendum will decide on the issue. No firm dates have been fixed yet.

In the UK, the Government has recently outlined its policy stance on the issue. A detailed analysis is presented in part 2 hereafter.

For the "Pre-Ins", though they do not yet participate in EMU, the euro is not just another foreign currency.

Thus, Greece and Denmark have joined ERM II, and the euro has become their exchange rate anchor with a central rate of respectively 353.109 DRA and 7.46038 DKR. The normal fluctuation band of +/- 15% applies to the DRA ; for the DKR a smaller band of +/- 2.25% was agreed.

This decision obliges these countries to shadow more or less closely the monetary policy of the ECB. As occasional interventions on their exchange markets are likely to be predominantly in euro, their central banks will tend to increase the proportion of their total reserves denominated in euro.

In contrast, by not joining ERM II, Sweden and the UK preserve the possibility of pursuing an independent monetary policy, which might, however, result in some degree of exchange rate volatility *vis-à-vis* the euro. This could handicap prospects for joining EMU if these fluctuations were judged to be excessive, and if ERM membership continued to be considered a requirement for membership.

Whatever the timing of their EMU membership, in all four countries, the euro will increasingly be used as an **international currency** by a number of economic groups.

(i) Exporters and importers.

Exporters to the euro zone need to be prepared to list prices in euro, invoice in euro and accept to be paid in euro. Moreover, they will have to adjust to downward pressure on prices which is likely to result from the euro's contribution to price transparency all round.

Importers will benefit from this price transparency in the euro zone and from the lower transaction costs resulting from the use of the single currency.

Both exporters and importers will be less able to impose their own currency. On the contrary, euro-zone-based multinationals might pressure their suppliers in the "Pre-Ins" to price and invoice in euro. Consequently the exchange risk of the business sector in the "Pre-Ins" will increase.

(ii) Border towns and tourist areas.

In these areas, the retail sector is likely to see a commercial advantage in some forms of dual pricing and in accepting payments in euro. This is already the case, for example, with Marks and Spencer and Harrods in the UK.

In addition to a wide international use of the euro by the "Pre-Ins", its **domestic use** or "euro-isation" - i.e. the use of the euro ***between*** residents of the "Pre-Ins" - is also bound to develop, though mainly in the financial and business sectors

Indeed, multinationals and other large export-oriented enterprises, operating in the "Pre-Ins", may decide on an early switch-over to the euro. The ripple effects of such move are important as local suppliers and subcontractors would be asked to deal in euro as well.

The development of the euro is to some extent facilitated by the accommodative stance of the national authorities and financial sector of the "Pre-Ins", especially so in the UK, where the following euro facilities have been made available as of January 4, 1999 by:

a) the financial sector

Current, deposit and loan accounts in euro are available at most banks. Making and receiving euro payments both within the UK and with foreign operators can be done by cheque (special format) and credit transfers. Trans-border payment operations carry the usual foreign currency transfer costs.

Sterling credit cards can be used abroad to make euro payments in the same way as in the national currency units of the euro zone. Euro credit cards are also available.

b) the public sector

Business records and accounts may be kept in euro, but VAT accounts and customs duty accounts must be kept in sterling. Invoices by businesses may be made in euro, including tax invoices provided the latter also show the sterling equivalent.

This mixed approach, allowing for the euro's use "provided that...", is necessary because Sterling remains compulsory for tax returns and most customs declarations. However, if a delayed participation in EMU allows the "Pre-Ins" to learn from the experience of the others, it has also some drawbacks.

Indeed, the entry of the UK, Denmark and Sweden depends on the favourable outcome of referenda for which no firm dates have yet been fixed. This uncertainty about dates (and about outcome) is inhibiting preparations for the euro, particularly by the business sector. As a result, it might be necessary, when the decision to participate has been taken, to provide for a lengthy interval between that decision and actual membership. Moreover, if actual membership and the fixing of the conversion rates were to take place in or after 2002, the length of a "dual currency" transitional period in the newcomers would in all probability be rather short.

Indeed, from 2002 onwards, euro coins and notes will have been circulating within the first-wave participants. Under Art.109 L(5) of the Treaty, it would certainly be possible to suspend their "legal tender" status in the countries which joined in 2002 or thereafter. In practice, however, it would be difficult to stop their actual use from mushrooming in these countries. As a result, competitive pressures would impose, rather quickly, dual pricing and dual payment using both national and euro banknotes and coin.

As for the length of this period, a balance will have to be found between the demands of the retail sector for a short period and the demands of the citizens who will need time to familiarise themselves with euro prices, euro value-scales and euro banknotes and coin. Obviously, a longer period could be more readily envisaged for dual pricing than for dual circulation of banknotes and coin.

2. The UK: the new prospects

The euro's prospects in the United Kingdom over the next few years naturally depend above all on the issue of EMU membership. If there is little expectation of joining, the euro's role in the UK economy will be essentially that of a major foreign currency, comparable to the dollar. In that case, UK monetary policy will continue to focus on domestic price stability, and an unstable £/□ exchange rate is likely to be a recurrent problem. If expectations of EMU membership are dominant, the euro will increasingly function as a parallel currency alongside sterling, although used primarily by banks and large firms. If sterling then progressively locks onto the euro, currency instability will be less of a worry, although concerns might arise about the appropriateness of the single monetary policy for the UK economy.

2.1. Prospects of UK joining

The Prime Minister's statement in the House of Commons on 23rd February 1999[11] has been widely interpreted in the British press as a firm declaration of the Government's intention, in principle, to apply for EMU membership early in the next parliament. It considerably

[11] Reported in the *Financial Times*, Wednesday February 24, pp. 10-11.

reinforced the Chancellor of the Exchequer's statement in October 1997. The Chancellor's preconditions regarding further convergence between the UK and euro-area economies, and a successful start to EMU, still apply, but few see these as difficult obstacles.

However, the Government is also committed to a national referendum before joining, and this could be a tougher obstacle.

There is little doubt that such a referendum, held today, would be lost (see Figure 1). If a new Labour government were serious about joining, it would certainly mount a strong publicity campaign; and history shows that, on issues where the public feels uninformed, even if prejudices appear strong, such a campaign can be effective. The earlier referendum on staying in the EC was one such occasion (see Figure 2). Then, the new Labour government's campaign, mounted in late 1974, was effective in producing a large favourable swing in public opinion before the vote of June 1975. Nevertheless, the prospective vote on EMU might well be close.

A government decision to apply for EMU membership could be announced immediately after the next general election, possibly around May 2001. According to the timetable implied in the "national changeover plan" (see below), the recommendation would be followed by a referendum in the autumn.

If the outcome were favourable, intensive preparations for adopting the euro would commence immediately, with a view to introducing euro notes and coin within three years (perhaps even as early as September 2003). Sterling would be locked irrevocably to the euro at some point in that period; but the Government has not hinted when this might occur, pointing out that it would depend on decisions by the Commission, the ECB, and the European Council.[12]

These would relate principally to the Maastricht convergence criteria, which include exchange-rate stability. As no UK government would be likely to rejoin the ERM in the foreseeable future, the aim would be to achieve a sufficient period of *de facto* £/€ stability. Such stability could emerge if the markets were convinced of the imminence of UK membership and the £/€ market rate could be brought to a sustainable level. Credibility might require a government instruction to the Bank of England to target the euro exchange rate rather than domestic price stability, and would doubtless hang on a favourable referendum result.

Whether the UK would be allowed to join EMU without fulfilling the two-year qualifying period of formal ERM membership would be a matter ultimately for political decision by Heads of Government. There is evidently some latitude under the exchange stability criterion, as shown by the fact that neither Italy nor Finland had participated in the ERM for the full two years before admittance. The Treaty presents the criteria as guides to judgement rather than mechanical requirements, and this is illustrated by the fact that several countries were admitted despite failing to meet the precise terms of the fiscal criterion.

[12] Introduction of Euro notes and coin would of course have to await the irrevocable locking of sterling to the euro, which would signal UK membership of EMU. At that point, euro notes would become legal tender in the UK as elsewhere in the euro area (by virtue of Article 105a of the Maastricht Treaty).

2.2. Official preparations for the euro

The impact of the Prime Minister's February declaration was enhanced by the simultaneous publication of the *Outline national changeover plan* for the euro (HM Treasury 1999). This was presented as necessary to maintain a realistic option to join, although critics have said that its true purpose was to "bounce" public opinion into EMU membership. The plan supplements the programme of preparations introduced in 1997 by the Chancellor, who argued that the euro's arrival would be an important event for the UK economy, whether or not it joined EMU (HM Treasury 1997). However the new plan addresses adopting the euro as the domestic currency, whereas the previous emphasis was on preparations for the euro as a foreign currency.

Since autumn 1997 the Government has directed an intensive 'communications campaign' at business, designed principally to raise awareness of the euro's introduction in 1999 and guide practical preparations. An initial benchmark survey of small and medium-sized firms carried out for the Treasury in April/May 1998 indicated that awareness and preparatory activity were then very low among these business categories. This was in marked contrast with the state of awareness among large firms, which is known from industry surveys to be much higher - a pattern resembling that in the rest of the EU. The subsequent campaign has therefore been targeted at SMEs, featuring high profile business seminars, an information telephone line and website, regional focus group meetings, television and press advertising, technical fact-sheets (350,000 distributed), and direct mailing to 1.6 million firms (see House of Commons Treasury Committee 1998, Annex).

Government departments have also been pursuing a series of legislative and administrative changes to assist firms wishing to use the euro. Principal among these have been changes to simplify the redenomination of company share capital into euro; changes to accounting and asset-valuation regulations applying to insurance companies; and changes to the tax system to assist companies wishing to account and pay taxes in euro (House of Commons Treasury Committee, *ibid.*). New regulations in this field were introduced last year and companies now have the option to pay taxes, file accounts, issue and redenominate shares and receive certain grants in euro.

The Inland Revenue is considering the implications of exchange-rate variations for the tax take, should a significant number of firms choose the taxpaying option. However, decisions on whether to account or trade in euro are being left strictly to firms themselves.

2.3 The national changeover plan

The plan outlines the steps involved in joining the euro area and sets out, using case studies, the practical implications for the main economic sectors, while avoiding the question whether or not to join. The timetable (Figure 3) implies a total changeover period of up to 40 months from the initial governmental decision to the final withdrawal of sterling. This would be rather shorter than the corresponding period of the first-wave changeover (50 months), reflecting that preparations have already started in the UK and the euro already exists, and hopes that the UK would learn from its partners' experience.

FIGURE 2: THE UK'S CHANGEOVER TIMETABLE

I. Government decision to join single currency (May 2001?)

- Legislation for referendum introduced
- Banks start transition

II. Referendum 4 months later (October 2001?)

- Public sector begins final preparation of IT systems and staff training
- Shops begin changing tills and systems
- Royal Mint begins euro coin production

III. Sterling locked to euro within next 30 months

- Timing depends on progress by public sector and banks, and on EU convergence decisions

IV Euro notes and coin begin circulation 24-30 months after referendum (February 2004?)

- Euro notes circulate alongside sterling. Public encouraged to return sterling to banks.

V. Sterling ceases to be legal tender 2-6 months later

Source: Adapted from HM Treasury, *Outline National Changeover Plan,* 1999

The plan's principal implications for the main sectors involved are as follows:[13]

- *Banks and financial services*. The major task for the large retail banks will be conversion of their often elderly computer systems to handle high volumes of euro transactions and accounts. In the payments area, the capacity of 'CHAPS Euro' (the national automated high value payments system for euros) will have to be increased tenfold. Cheque-based payments systems will also require major enhancement.

- *Shops and supermarkets.* A smooth changeover in this sector will be crucial. As in the case of banks, the largest task for larger retailers will be the conversion of complex IT

[13] See also the Euro Preparations Unit's second report, *Getting Ready for the Euro,* (HM Treasury, Euro Preparations Unit 1999).

systems to handle the euro. There will be other massive tasks in the area of staff training and the replacement of large stocks of notes and coin over a short period. It would be preferable to avoid January as the date for introducing euro notes and coin (to avoid post-Christmas sales); most retailers would prefer the period of dual currency circulation to be much shorter than 6 months.

- *Non-financial businesses.* The chief tasks for businesses will be to adapt all systems (information technology, accounting, invoicing, etc.) to handle the euro, and to review pricing and marketing strategies to cope with stronger competition via the single currency. The relevant professional organisations (accountants, lawyers, etc.) should help firms to develop their conversion plans. Large corporate customers should play an active role in helping their suppliers through the changeover. Companies issuing and dealing in sterling securities will need to consider redenomination of face values. No indications are given of changeover costs, but independent commentators have put them at several billion pounds for the business sector.

- *Public authorities.* The main challenges will be the conversion of the massive and complex computer systems in the social security, revenue and excise departments, and staff training throughout the public services. The big departments are planning to spend ‘tens of millions of pounds’ on IT systems and are likely to need four years for the conversion, so they must start before the referendum.

- *Notes and coin.* An estimated 2 billion euro notes and 13 billion coins will be required. Coin production will take up to 30 months but notes can be produced more quickly.

2.4. Current progress on adapting to the euro

(i) Businesses

By October 1998, after six months of the business information campaign, awareness of the euro’s start date among SMEs had doubled, and action levels had trebled, compared with the rather low April/May benchmarks (see Table 1). As in the first survey, euro awareness and activity were found to be higher among the 45% of firms having a trading or business connection with other EU countries, and among SMEs with more than 50 employees. The minority that had started preparations before the euro’s introduction had focused on practical changes like new IT systems, but had paid little attention to more strategic issues.

Table 6: Euro-awareness and readiness among SMEs

Proportion of SMEs (%)	April/May 1998	October 1998
Aware of single currency	90	94
Aware of start date, 1 January 1999	11	23
Believe it important to make preparations	31	34
Have already started specific preparations	5	13

Source: HM Treasury, Euro Preparations Unit (1998)

Other survey information suggests that firms making specific preparations for the new currency were also intending to use it directly. Enquiries were made by APACS (the Association of Payment Clearing Systems) between May and October 1998. These showed that 13% of businesses were planning to open euro bank accounts before the UK joins EMU, principally in order to accept payments from EU customers and/or to pay suppliers in euro, mainly in the UK. APACS estimated that after 1 January 1999 there would be €1.5 million payments in euro per month from UK companies to EU recipients and €2.4 million payments per month to recipients in the UK, the latter figure representing 3% of business payments within the UK currently made in sterling. Experience so far is in line with these estimates.

It seems clear that large firms will be in the lead in promoting corporate use of the euro in the UK. This will apply particularly to multinationals with extensive production interests in the euro area, as these firms will have a strong incentive to transact in euro in order to reduce currency risk, and to borrow euro in order to take advantage of low financing costs.

In contrast, the incentives for smaller firms, and for those with lesser business links to the euro area, are very mixed. On the one hand, firms whose incomes and costs are largely fixed in sterling will be wary of absorbing the exchange risks implied by trading in euro, so long as the £/€ exchange rate continues to float. On the other hand, those who supply or purchase from large firms with EU links may well find themselves under strong pressure to invoice in and accept euros, and to pay in euros. A recent *Financial Times* survey of the 50 biggest UK exporters found that a number will be encouraging their UK suppliers to use the euro. These include British Petroleum, Imperial Chemical Industries, Guest, Keen and Nettlefold, Rover Group and Siemens. Many big exporters will be able to handle euro transactions, but most will review their policy towards suppliers in the light of commercial developments. They will have to take account of the potential consequences of passing large exchange risks to their more vulnerable suppliers and customers. Clearly, UK prospects for the euro in this sphere will depend heavily on whether political support for joining EMU gains ground.

(iii) Retailers

Overall, few UK high street retailers, large or small, have been directly affected by the launch of the euro, apart from those that import substantially from the euro area, who have been preparing to pay their suppliers in euro where there are clear benefits from doing so. However shops that accept foreign currency cheques or traveller's cheques recognise that they now need to be capable of handling a range of euro instruments.

Awareness that euro non-cash methods have been available to customers since 1 January 1999 is much higher among large than small retailers (86% as compared with 28% - see HM Treasury, Euro Preparations Unit 1999). Retailers who accept foreign currency payments, most of whom are in the larger category, recognise that the situation could change markedly when euro notes and coin begin to circulate in 2002.

(iii) The financial sector - the City [14]

The UK financial sector has grown much more rapidly than the rest of the economy in recent decades and now accounts for some 15-20% of GDP, depending on whether associated activities like property-selling and accountancy services are included. Although regional centres like Edinburgh and Manchester are significant, the bulk of activity is concentrated in the City of London, where much of it consists of ‘wholesale’ activity - large-scale business conducted by major financial institutions and corporate treasuries. The great majority (approximately 500) of banks in London are internationally-owned and generate profits for shareholders worldwide, while also being responsible for substantial employment and income in the UK. Thanks to its attractiveness as a financial centre, London hosts the world’s largest foreign exchange market by a considerable margin, accounting for around 30% of global trading, nearly twice New York’s and three times Tokyo’s (Bank for International Settlements, 1995). The City is also a leading player in many other financial markets - the Eurobond market, of which it is essentially the home; the asset management industry, in which it dominates in Europe; and the stock market, which is Europe’s largest. Even major German and French banks have based their market operations in London, Deutsche Morgan Grenfell being a notable example.

Because of the size and importance of London’s international financial markets, firms in the City have been much more affected by the advent of the euro that other parts of the economy. Banks and securities houses have been preparing for it for some time, under Bank of England guidance. In the final months of 1998, city firms repeatedly tested the euro-readiness of their payment and settlement systems, individually and in groups, in an effort to ensure that conversion would go smoothly. These preparations paid off: the ‘Conversion Weekend’ of 31 December to 4 January proceeded without significant hitches or disruptions to London’s financial business. Few, if any, trades failed in the first two weeks of the euro’s launch.

Some settlement delays were however encountered in TARGET (the official system for continuous settlement of cross-border payments in euros at the wholesale level, linking all EU national automated real time gross settlement systems); but these originated in other centres and mainly reflected inputting errors by banks not sufficiently familiar with TARGET technology. They were essentially teething troubles arising mainly from operational errors rather than fundamental faults in the new system. Even so, settlement logjams were still being encountered from time to time in March, causing the system to remain open beyond its normal daily hours and creating liquidity problems for some users. Urgent steps are being taken to resolve these problems but it may be a while yet before banks across the euro area become familiar with all system’s properties and gain full confidence in it.

Since 4 January 1999, financial institutions in London have been trading and settling in the full range of euro instruments and routinely making wholesale euro payments, despite TARGET’s teething troubles. ‘CHAPS euro’, the UK leg of TARGET, now routinely processes same-day high-value payments between banks in the UK, and between the UK and other EU centres. With some 35,000 payments per week sent through CHAPS euro in

[14] Information for this section was drawn from the monthly Bank of England reports, *Practical Issues Arising from the Introduction of the Euro,* especially Chapter 6 of the September edition (Bank of England 1998); from the Euro Preparations Unit’s second six-monthly report (HM Treasury, Euro Preparations Unit 1999); and from discussions with representatives of banks, the British Banker’s Association, and the Association of Payment Clearing Systems.

February, mostly high-value city payments, the system is operating at around the expected level. An average day's clearing, including EU payments into the UK via TARGET, has been running at □150 billion. CHAPS euro has been designed to handle any conceivable increase in payment volumes over the next few years.

Most city firms have been reconciled for some time to the more obvious costs associated with the euro: loss of income from dealing *between* EU national currencies (which has been only a small share of total forex trading in London); the merging of futures contracts; and reduction of scope for traditional corporate banking (as 'house' banks lose their ability to offer cheap local funding). But many firms see the euro opening up new opportunities. In money and foreign exchange markets, the greater depth and liquidity of the euro cash markets will offer advantages for larger or more skilled players, implying some pressure for rationalisation. With some 30 different euro payment systems now available to choose from, there will be a premium for efficient management of intra-day liquidity by settlement banks offering euro services, and for the flexible routing of payments to suit individual customer needs. A liquid euro interbank market is already operating in London, with all the usual services - loans, FRNs, swaps and other derivatives priced using euro LIBOR. Although national repo markets are likely to remain separate for some time, a pan-European repo market in euro securities may develop in London in due course, as regulations and practices are harmonised.

Benefits are also confidently expected from the consolidation of the euro area's major debt and equity markets. The euro government bond market is one of the world's largest, with market capitalisation of around $2,000 billion equivalent to around 80% of the US Treasury market. The facts that Euroland's governments can no longer control issuance of their own currencies, that bailouts are prohibited under EMU rules, and that *national currency* risk no longer exists in the euro area, imply that there will be much more emphasis on *sovereign risk* in rating euro-area governments' creditworthiness. London institutions' comparative strengths in securities research and portfolio management should stand them in good stead in this respect. London traders could also benefit from the expected growth of investor demand for euro-denominated corporate and municipal bonds, caused by the fact that corporate credit ratings in euro will no longer be constrained by the ratings of their national governments, and the scale of government debt issuance will be limited by the Stability and Growth Pact. In the longer term there is likely to be some shift in the pattern of euro-area corporate borrowing away from banks, which is relatively high in euro-area economies, to bond and equity finance, which is more common in 'Anglo-Saxon' markets (see Table 2).

Table 7: Capitalisation of national equity markets *(% of GDP, 1997)*

Italy	23
Germany	32
Spain	36
France	41
Netherlands	130
Switzerland	163
UK	165

Source: Bank of England (1998), p. 92.

Although the boost to Euroland's bond and equity markets given by the single currency is expected to benefit London on the whole, given its expertise in these fields, some significant loss of share in the Eurobond market, hitherto one the City's most successful markets, is perhaps to be expected as competition develops from euro-area centres. These centres seem bound to benefit from scale economies given by the consolidated weight of EU government debt issuance in euro, and may exploit this advantage to attract corporate bond issuers and issuers outside the EU who might previously have chosen London. Clearly, any such loss of share would be minimised if the UK joins EMU in the foreseeable future. However, a more important factor than the euro in this connection is likely to be the fate of recent moves to harmonise the tax treatment of income from savings across the EU.[15]

Along with the shift to disintermediation in the euro area portrayed above may come a trend towards greater asset-backed securitisation of bank loan and mortgage portfolios, as banks seek to free capital for more profitable investment. These are all areas of business in which city firms look to have a comparative advantage, although its full exploitation may have to await removal of remaining prudential restrictions on cross-border equity investment in some EU states, and greater harmonisation of EU regulatory requirements and market practices.

(iv) The financial sector - Retail banking

For the time being UK banks are concentrating on providing euro services to their corporate customers, including SMEs. Accounts are also available to personal customers but demand for these is expected to remain relatively limited, although it might expand significantly when euro and notes circulate in the euro area. Domestic clearing for euro-denominated cheques has been available since 4 January 1999 - the first occasion on which clearing for foreign-currency cheques has been provided in the UK. (Clearing of cheques in euro drawn on banks outside the UK will continue to be substantially slower and more costly than domestic clearing, as no high-volume cross-border cheque clearing is contemplated in the euro area.)

Since the euro's launch, the number of euro-denominated cheques cleared within the UK has been, predictably, small - in the low hundreds per month - although growing steadily. Euro payments can also be made electronically into euro or sterling bank and building society accounts, and a euro paper credit clearing facility could be introduced within six months if warranted. A large UK retail bank reports that it opened 30,000 euro accounts in January, although most were for firms rather than individuals. Its account charges are the same as for sterling accounts. Nevertheless UK banks are not anxious at this stage to provide massive numbers of euro personal accounts, and are not promoting them.

Use of the euro by private individuals in the UK is likely to remain relatively small in scale, at least until euro notes and coin are available, whether or not there is a decision to join the single currency. Without notes and coin, and given the non-availability of cross-border

[15] At present London's bond markets, together with those of Luxembourg, gain competitively by being able to avoid charging witholding tax on cross-border interest payments. If the Commission's proposals for a Directive to oblige EU governments either to levy a minimum withholding tax of 20%, or to provide information that would enable other governments to tax cross-border interest recipients in their own jurisdictions, are adopted (see Commission 1998), London and Luxembourg would stand to lose a substantial amount of Eurobond business. Much of this business might then migrate to low-tax centres outside the EU, e.g., Zürich, rather than to other EU centres.

cheque clearing, the incentives for individuals to use the euro as a transactions currency are small. So long as sterling floats against the euro, the risks for personal savers and mortgage borrowers, who might in principle be more interested, are also likely to remain high, except for the very few with euro-denominated incomes. The position could of course change radically if and when the UK opts to join EMU, when personal interest in the euro would depend heavily on the willingness of large employers, particularly public authorities, to give a lead by paying their staffs and suppliers in euro. Banks might then compete strongly to offer euro personal accounts, and encourage customers to convert sterling notes and coin in advance of the deadline.

2.5. Conclusions

The City of London has been planning for the introduction of the euro for some time and regards it as more of an opportunity than a threat. The immediate loss of business associated with the merging of EU national currencies into the euro is seen as relatively minor, whereas the potential longer-term gains from the expansion of cross-border business in euro-oriented financial services are perceived as large. Surveys suggest that city firms have cost advantages in the provision of many such services, and these are unlikely to be entirely negated by having to operate outside the euro area, given the increased access offered by the Single Market. They are therefore confident of benefiting from the euro's introduction provided they can remain competitive and do not suffer from adverse discrimination in euro markets, a possibility that continues to worry some.

Because of what is seen as a more flexible supervisory regime in previous years, and the markedly greater development of private market-based provision in the UK, British pensions and insurance institutions have more expertise in cross-border portfolio management, and in the management of exchange risk, than most EU counterparts. There is therefore considerable optimism that the longer-term institutions, as well as London's international banks and securities houses, will thrive under the new currency, whether or not the UK joins the eruo area. Even so, particularly for the longer-term institutions, their market shares of euro business will certainly depend significantly on whether the euro becomes the UK's domestic currency in due course, although EU moves to harmonise cross-border withholding tax are seen in London as a greater potential threat than non-participation in EMU.

The UK financial sector, although important, is not typical of the whole economy, for which the euro will remain a major foreign currency unless and until the country decides to join EMU. So long as sterling remains unlocked to the euro, small and medium-sized firms will be wary of the euro because of aversion to the associated exchange risks. Even after a decision to join EMU, supposing it happens, the euro will probably have little impact on the lives of ordinary people until notes and coin begin to circulate and large employers take the lead in paying their staffs and suppliers in euro.

Figure 3: UK attitudes to staying in the EC (%)
Source: Gallup

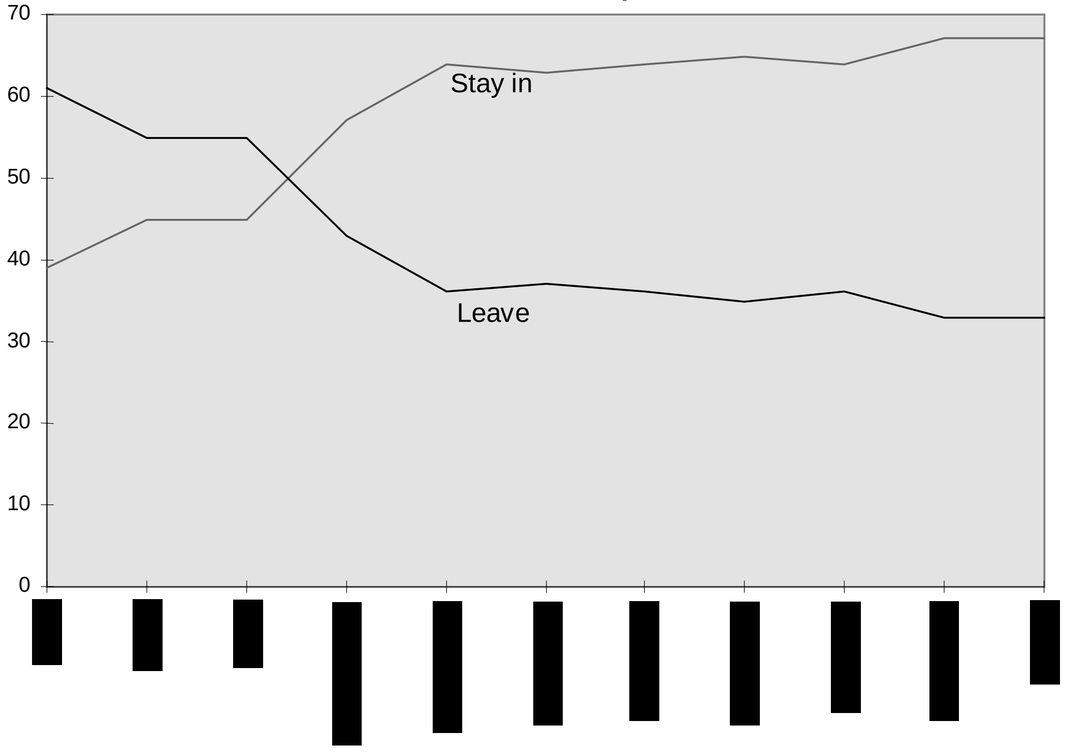
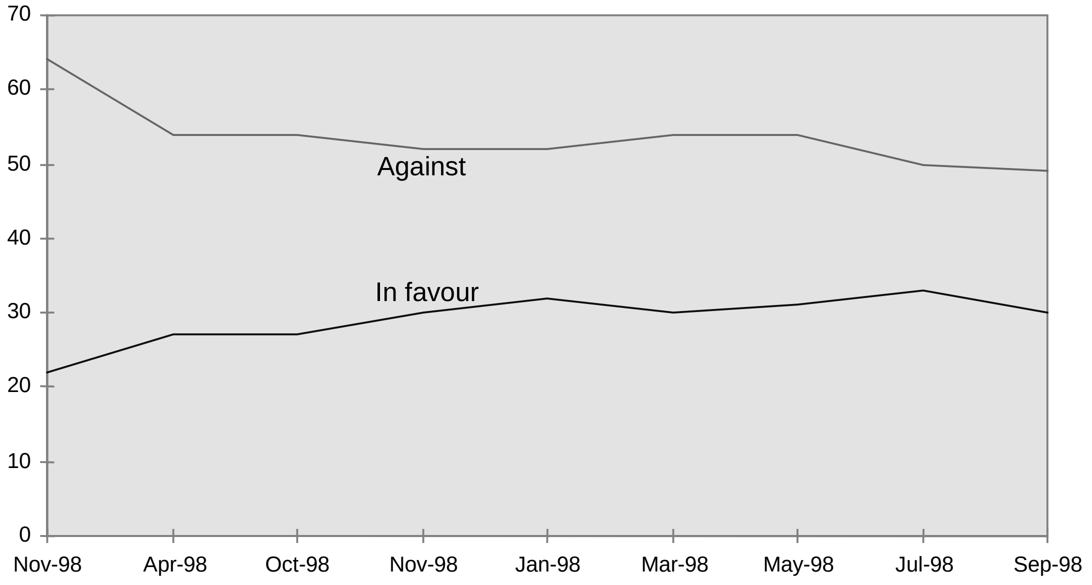


Figure 4: UK attitudes to membership of EMU (%)
Source: MORI/Salomon Smith Barney



4. Developments in International Financial Markets

The euro's entry on the international bond market has been a resounding success. In January 1999, its first month of trading, on a total of $140 bn worth of bonds, about 50% were issued in euro, against 40% in dollars.

This is a remarkable result since, in the past, the combined issuance in the currencies of the EMU participants never reached more than 36% of total issues, with the dollar hovering around 47%. Not only the dollar was affected, but pound sterling as well: its share fell to 4% from its average level of about 9%. Obviously, the euro has more appeal to issuers and investors alike than used to have all its "legacy" currencies taken together.

The euro's successful start in the bond market was helped both by fundamental and transient factors.

Among the first, the euro's low level of long term interest rate, as compared to those on the US dollar and the pound, attracted a large range of issuers. The expectation of capital gains, by way of rising bond prices, attracted the lenders which included a number of Japanese investors.

The main transient factor was the urge of some issuers to be among the first to be seen to tap the international euro bond market.

The data for February and March point to a more balanced position as both the euro and the dollar obtained around 44% of market share, the Kosovo conflict having a negative impact both on the euro issuing activity and on the □/$ rate[16].

But, beyond its performance in terms of global issue volume and market share, the entry of the euro on the international bond market presents also the following positive developments:

- *An increase in the issue size*. The number of issues with a size of □1bn or more increased significantly compared to the past performance of the "legacy" currencies. This responds to investor demand for more liquid issues, more particularly by sovereign issuers, still the largest segment of the market. Indeed, the crises in emerging markets has increased the interest in safe and liquid fall-back possibilities;

- *An increase in the number and size of corporate issues.* Among the reasons have been the absence of exchange risk; low interest rates; and an ongoing trend towards disintermediation i.e. obtaining finance on capital markets rather than borrowing from banks. This suits investors as the variety of corporate issuers and their different ratings increase the range of the yields available.

- *A trend towards diversification of issuers and investors.* Issuers from the EU dominate the euro bond market, but it looks set to attract foreign issuers. So far, Argentina, the Philippines and Canada have come to the euro market.

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[16] The Kosovo and other factors continued to affect the •/$ rate, with the • declining to only just above parity with the $ by the early Summer of 1999. However, it recovered to stand at $1.06 by September. [*ed.*]

Investors also come mainly from within the EU, but demand from Japan has been increasing and is picking up from low levels in the US.

All in all , the euro is off to a promising future on the international bond markets. Contrary to what many expected, foreign investors' demand has not fuelled any undesirable appreciation of the euro on the exchange markets. It may have slowed down its depreciation.

As to the equity markets, a striking difference has been existing between the European equity markets and the US: the size of the EMU equity market is less than 1/3 that of the US, while EMU15 would be about 1/2 that size. However, change is underway. Disintermediation, mergers and acquisitions are drawing the big and even smaller enterprises, not only into the euro bond market, but also into the euro equity markets as the prime suppliers of their financing and capital needs.

As international financial transactions represent the bulk of the exchange market transactions ($1.25O bn a day), the euro has started to establish itself has a "vehicle" currency for trading other currencies. This role has so far been a quasi exclusivity of the dollar. It consists in using the dollar as the intermediary in the exchange of other currencies.

Thus trading any two currencies other than the dollar involves a sequence of two forex operations. For example, a trader wanting to buy Greek Drachma with Norwegian Krone will do so by buying US$ against NOK and buying GDR against US$. The reason: the size of most bilateral forex markets such as e.g. the NOK/GRD forex market being too small too accommodate even moderate orders efficiently, i.e. at a reasonable cost and without significant exchange rate movements.

Already in the period of ECU's existence (1979-1998), a similar though limited "vehicle" role developed for that currency. In reality, however, the DEM had acquired that function much more so than the ECU.

The latter's and the DEM's replacement on 1.1.1999 by the euro, which encompasses the former forex markets in all 11 "in" currencies, already increased that "vehicle" function (formerly exercised by the DEM and to a limited extent by the ECU) substantially. In particular, the "Pre-In" currencies, but also the Swiss Franc and the currencies of central and eastern European countries and of several African or near-eastern countries are increasingly being traded against the euro.

Reuters and EDS (Electronic Data System) are even operating euro centred electronic forex systems not restricted to distributing information but effectively facilitating forex deals against euro between participating banks, which thus must be "running books" of currencies against euro, next to "running books" of currencies against US$.

More and more traders are thus simultaneously "running books" of currencies they specialise in, both against US$ and (increasingly) against □. As a consequence of that rapidly increasing practice, however, they must accept to do so at dwindling profit margins, in particular compared to the generous margins available in "the old days" when a restricted number of banks specialised in ECU trading.

Though not strictly related, a brief comment should be made on a question that keeps coming up: "Is the EMU zone not vulnerable to speculation from within during the transitional period i.e. as long as the national currencies exist?"

In other words, speculation being based on anticipation, could a Member State in difficulty (inflation, recession, etc.) not be forced to quit EMU because of the generalised flight out of its currency into another currency of the euro zone?

This question overlooks the fact that there is no longer any national euro zone currency to sell or to buy. On 1 January 1 1999 the euro has become the *currency* of each participant and, what used to be national currencies have become *sub-units* of the euro. Switching from one sub-unit into another is, or course, perfectly feasible. But it would be without any of the effects that are usually associated with speculation: currency depreciation, loss of reserves, rising interest rates, etc. The only consequence would be the exchange, without limit, by the ESCB of all amounts tendered in a given sub-unit for the other sub-unit in demand. This zero sum operation would leave the euro zone's money supply unchanged as well as the prevailing monetary conditions.

Speculation cannot force a Member State to quit EMU. This is not to say - though the Treaty does not provide for it - that a Government may not choose to quit. But it is difficult to imagine which circumstances might trigger such far-reaching decision.

X. THE EURO AND THE INTERNATIONAL MONETARY SYSTEM

Given its underlying economic weight, internal currency stability and financial market size and openness, the euro undoubtedly will become an international currency.

However, the real challenge for the euro is more ambitious: will it develop its international role enough to change the present dollar-monopoly into a euro/dollar duopoly? Such an outcome would be tantamount to dividing the world in two currency blocks of matching weight, with the yen possibly gaining a secondary status.

The sheer magnitude of the challenge, and the inertia to change which benefits the "vested" dollar, do not point to a speedy realisation of this prospect. However, the advances in information and communication technologies, the ongoing globalisation of the financial markets and the internationalisation of the national economies allow a challenging of entrenched positions much more rapidly and efficiently than before.

Whatever the timing of the outcome, the euro is already today the currency of an area which, in terms of population, economic weight, share in world trade and financial market size, is a close match for the US. Consequently, the □/$ rate is the exchange rate which will matter in the international monetary system.

Upholding the euro's key position at the international level challenges EMU's Member States and the ECB on two accounts:

- *First*, developing a common view on the euro zone's external monetary policy stance, including the ways and means to avoid misalignments and excessive volatility of the □/$ rate; and

- *Secondly*, agreeing on how and by whom EMU will be represented in the international monetary institutions i.e. the Group of Seven (G7), the International Monetary Fund (IMF) and other international monetary bodies or ad hoc meetings.

1. The euro zone's external monetary policy stance

The □/$ rate should not be a matter for the European side alone. The remark by a previous US Secretary of the Treasury that "the dollar is our currency, but your problem" is on its way to becoming obsolete.

Up to now, US monetary policy has been basically determined by domestic monetary policy requirements. This resulted in a policy of "benign neglect" of the dollar's exchange rate.

This approach is based on the following facts.

- Foreign trade (sum of exports and imports) represents only 21% of US GDP. Thus domestic conditions quite naturally prevail in the setting of monetary policy as the US will not accept "letting the tail wag the dog".

- The dominant international role of the dollar as the anchor currency for an important number of foreign currencies, its unique role as an invoicing and payment currency between third countries, and its use for the pricing of a wide range of primary products, are all *additional* factors which allow the US, given the size of the international dollar area, to be relatively indifferent *vis-à-vis* the exchange rate movements of other currencies against the dollar.

The euro is bound to alter to an increasing extent the basics of this rather comfortable situation.

In the first place, being the currency of a single market of about the US size and with a similar export exposure, the present position of EMU's Member States *vis-à-vis* the dollar is radically different from their past EMS situation.

In those times, a dollar outflow from the US knew only one destination: the DEM, thus pushing it up against the dollar and against the currencies of the other EMS participants. In order to preserve their DEM link, the latter were left with no other choice but to pull up their currencies against the dollar by exchange-market interventions and interest rate hikes. In the end, all of them rose against the dollar: the DEM as a direct result of the dollar inflow, the others as a result of their countries' monetary policy reactions which were not always consistent with their domestic policy requirements. (see the EMS crises of 1992-93 and 1995).

Today, an identical dollar inflow into the euro differs in three respects from the previous situation:

- the incoming flow pushes the euro up against the dollar, but it does so to a lesser extent than it did to the former DEM/dollar rate;

- sharing the same currency, all EMU participants appreciate in unison *vis-à-vis* the dollar;

- contrary to the EMS situation, the monetary policy balance between the EMU participants is not affected.

In other words, because of its size (a multiple of the German exchange market) and a much decreased external exposure (EMU exports represent about 13% of its GDP), the euro zone has acquired a resilience *vis-à-vis* exchange rate movements that used to be the privilege of the dollar alone. The euro's development as an international currency i.e. a currency used *between* third countries, should increase this resilience.

But such development cannot but happen at the expense of the dollar's dominant role. Indeed, one's gain is another's loss in certain areas: for example, use as an anchor currency; reserve assets held by central banks; role as international invoicing and payment currency; vehicle currency in the exchange markets: and a pricing currency for primary products or for whole industrial sectors (e.g. aircraft).

Over time, a situation might thus arise in which the euro and the dollar, besides being the currencies of comparable continental-size markets, would also have international roles of equivalent importance.

The policy consequences of the coexistence of the euro and the dollar as international currency twins are hard to fathom.

A mutual degree of benign neglect might be a likely outcome - but only up to a point.

The financial intermediaries of the euro zone, through mergers and acquisitions, are not just adapting to the euro market but also positioning themselves as global players at the broader international level. Consequently, capital movements, which already represent the bulk of the exchange market transactions, will even more so determine the level and, more particularly, the volatility of the exchange rates, including the □/$ rate.

This prospect highlights the need for some sort of monetary co-operation between two comparable currency zones in the making so as to avoid mutually detrimental misalignments and excessive exchange rate volatility.

At first sight, the creation of the euro might simplify the monetary co-operation between the two currency zones as the competence previously held by the monetary authorities of EMU's Member States have been pooled within a single Institution, the ECB. But this prospect is hampered, on the European side, by two institutional characteristics of EMU.

i) The role of the ECB

The ECB's constitutional obligation to pursue price stability as its primary objective constitutes an initial constraint. This is because it does so by managing money market liquidity according to, on the one hand, a reference growth rate of (presently) 4% for the broad monetary aggregate (M3) and, on the other hand, a set of "price sensitive" indicators which include the euro's exchange rate.

The euro's exchange rate is only one indicator, among others, which the ECB takes into account in determining its monetary stance.

A further institutional constraint results from EMU's built-in dichotomy, with the ECB as the single monetary authority, while eleven national authorities remain responsible for their economic and budgetary policies. This might hamper the presentation of a common stand in international fora.

ii) The determination of the euro's external value

Moreover, on *exchange rate policy* proper, the Maastricht Treaty (Article 109) involves - depending on the subject matter - not merely the ECB, but all EU governing bodies: i.e. the Commission, the ECB, the Ecofin Council and the European Parliament.

Thus, on *formal exchange rate agreements with third parties* - e.g. a new Bretton Woods System of fixed exchange rates or a binding target-zone regime - the rules are clear (Art.109.1). The initiative must come from the Commission or the ECB. The Council consults the European Parliament, seeks the ECB's consensus on a regime consistent with price stability and, finally, decides by unanimity.

On the ECB's *exchange rate management* the rules on the sharing of competence between the ECB and other EU bodies are less precise (Art.109.2).

Thus, the Ecofin Council, on a Recommendation by the Commission or the ECB, may, by qualified majority "formulate general orientations for exchange rate policy"; but they "shall be without prejudice to the primary objective of the ECB to maintain price stability".

These provisions were somewhat held in check by the following Conclusions of the European Council of 12-13 December 1997:

> *"...While in general exchange rates should be seen as the outcome of all other economic policies, the Council (i.e. Ecofin) may, in exceptional circumstances, for example in the case of a clear misalignment, formulate general orientations for exchange rate policy".*

The rest of Art.109.2 continues to apply.

In a subsequent informal meeting, finance ministers and central bank governors agreed that such general orientations would be issued only rarely.

It is important to note that in the "Council" to which Art.109 refers, only EMU participants have voting rights (see Art.109 k 5).

All in all, the ECB's obligation to maintain price stability and the Council's "general orientation" capability, circumscribed both in frequency (exceptional circumstances) and in content (compatible with price stability), point to a rather flexible euro exchange rate policy. The dollar's appreciation against the euro by about 10% since the start of EMU and the *lowering* of the ECB's interest rates on April the 8th seem to confirm this view.

iii) Who adjusts?

Overcoming these difficulties is important as monetary policy co-ordination between two major currency zones basically centres on one issue: who does the "adjusting"?

Generally speaking, in the EMS - the DEM being the anchor currency - it was left to the other participating countries to adjust. At the international level, with the dollar as the dominant international currency, it is up to the rest of the world to adjust.

Today, the US and the euro zone represent two blocs of similar weight (GDP) and export dependence (12-13% of GDP). However, their respective economic development in terms of growth and/or inflation cannot be expected to be similar or synchronised. Thus, at times, the domestic demands on the stance of their monetary and exchange rate policies are likely to differ.

Being relatively closed economies, the effects on the €/$ exchange rate of the ensuing policy differences will most likely be treated with some "benign neglect" by both sides, unless overshooting or misalignment threatens to become a serious domestic problem for one of them. If this were to happen, the growing interdependence and volatility of the global financial markets would most likely make it a "shared problem". Such outcome would be rather novel for the US But it would increase the chances of a burden-sharing approach to address it.

2. The representation of the Euro zone in international monetary institutions

On December 11-12, 1998, the European Council, meeting in Vienna, agreed on the modalities of the euro zone's representation to be proposed to a number of international institutions.

a) the Group of Seven (G7)

The members are: the US, Japan, Canada, U.K. France, Germany and Italy. At the level of "Finance" meetings, they are attended by the Finance Minister and the Central Bank governor of each G7 member.

It was proposed to open these meetings to the President of the Ecofin Council (or, if his country does not participate in EMU, the President of the Euro11 Group) and the ECB President. The Commission was also to attend, assisting the Ecofin Presidency.

On a transitional basis, one of the three permanent European G7 members whose countries (Germany, France, Italy) participate in EMU would, on a rotating basis and starting with Germany, provide support to the president of the Euro 11 Group, e.g. in assuring continuity.

Before each G7 meeting, a common position on EMU related issues would be prepared in a consultation meeting. To facilitate these proceedings, a teleconference network would link the Finance Ministers, the ECB and the Commission.

However, G7 withheld its agreement on the EMU representation as proposed. In this group, the EU is already represented by the finance ministers and central bank governors of four member States. The US, in particular, had been expecting a lesser rather than a greater number of European participants. This demand could have been met if, given the participation of the ECB President, the Central Bank Governors of France, Germany and Italy had withdrawn.

Further representations are being made by the EU to obtain the G7's agreement on a modified arrangement.

b) The International Monetary Fund (IMF)

The ECB has been granted an observer status at the IMF Board meetings. The views of the Euro 11 Group are to be voiced by the Executive Director of the Member State holding the presidency of the Ecofin Council. A Commission official will act as an assistant to the delegation of the president of the Euro 11 Group at IMF meetings.

c) External missions in third countries

The president of the Euro11 Group will lead the delegation, assisted by a Commission official and by representatives of Member States with a particular interest or expertise in the region or countries visited.

*

These proposals are to be seen as a first step. Their complexity in some areas (G7) and the "hands-off" approach in others (IMF) highlight the reluctance of the EMU Member States to face-up to uncomfortable facts - essentially that representation in international organisations, such as the G7 and the IMF, must be adapted to the pooling of monetary competences within EMU.

Thus, it seems reasonable and accepted that issues related to EMU's single monetary policy stance be handled by the ECB: in the G7 by its President; in the IMF Board meetings by its representative.

In non-monetary matters, EMU's national authorities retain ultimate responsibility. In order to have an "EMU representative" present in these organisations they should:

- come to a common view among themselves;
- share, with ECB, a common stand on exchange rate issues;
- where necessary, come to common view with other EU members; and
- give their representatives some negotiating leeway.

This is a tall order, but an essential one if the stand taken by the EMU representation, speaking for 11 countries, is to weigh more than the - at times diverging - opinions of the present four European members.

APPENDIX: MANDATE AND METHODOLOGY

On 27 October 1998 the Directorate General for Research of the European Parliament awarded the Trans European Policy Studies Association (TEPSA) the execution of the study on "The Euro As 'Parallel Currency' 1999-2002".

Content of the Study

The three questions raised in the study specifications and the fields of research suggested by TEPSA are presented hereafter :

A. *" How far can the euro develop within the euro area in the period 1st. January 1999 to 1 January 2002 when it will be used on a " no compulsion, no prohibition " basis, but when no euro notes or coins will be in circulation ?"*

The euro's development potential during this period depends on:

1. The use made by the national authorities of the flexibility provided by the Regulations on the legal status of the euro.

   As a general rule, these Regulations provide that all legal instruments (laws, acts of administration, contracts, etc.) which, on 1 January 1999, impose the use of the national currency, must be executed in that currency.

   This could severely limit the euro's use by private sector operators as they would - under the existing national laws and regulations - be largely prevented from doing so. However, the euro Regulations also allow the national authorities,

   - to redenominate their public debt in euro,

   - to impose the use of the euro as the "currency" of organised markets and payment systems, and

   - to modify statutory provisions imposing the use of the national currency in e.g. tax declarations and payments, publication of company accounts so as to allow a choice between the euro and the national unit.

   The study should asses the extent of the Authorities' own use of the euro and of their euro friendly amendments to national laws and regulations which, on 1 January 1999, impose the exclusive use of the national unit.

2. The number and variety of euro services offered by the financial intermediaries of the participating Member States.

   As a result of the decision by the European Central Bank to manage, from 1 January 1999 onwards, its monetary policy exclusively in euro, on the one hand and the change-over to the euro by the participants' government bond market on the other, the financial wholesale markets (interbank market, exchange market and capital markets) have also decided to adopt the euro as their pricing and trading unit.

It will be up to the financial intermediaries to take care of the conversions euro/national currency to suit those of their customers who wish to continue to deal in the national unit.

Banks, in particular, will have to adapt their payment systems so as to reconcile the wishes of clients wanting to pay in euro with those of beneficiaries wanting to receive the national unit, and vice versa. The same holds true for debit and credit card payment systems.

More generally, banks and other financial institutions such as insurance companies and other providers of long term services will also need to be able to provide such services in euro alongside the national currency.

The Study will present an overview of the various euro services which the financial market operators are planning to provide in the 1999-2002 period

3. The euro’s appeal to private market operators.

The extent of the euro’s use by private market operators of the euro zone will be determined by two main factors:

i) the possibility to do so. This will depend on a positive euro approach by the authorities (see 1 above) and on the availability of euro instruments supplied by the financial sector (see 2 above).

ii) the advantage of using the euro rather than the the national currency unit. As of the beginning of 1999, an important number of European multinationals will replace their national base currency by the euro for the whole of their operations: accounting, pricing, invoicing, payments, reporting...

Their interest in doing so : the efficiency gains resulting from the substitution of several currencies by one only.

At the retail end of the market a different situation might prevail. Indeed, in the absence of euro notes and coins, the general public might continue to favor the use of the national currency unit. But the situation is likely to be different i.a. in border towns, international travel, tourist areas and increasingly in other market sectors as well as retailers might see a promotional advantage in accepting the euro.

A survey of the attitudes and plans of a representative sample of the various private market operators should help in gaining a more precise insight in the motives and volume of an early retail use of the euro. The plans (dual pricing) and attitudes of SME’s operating mainly on the domestic market should also be taken into account.

B. *" What particular problems will exist in the period 1st. January 2002 to (at the latest) 1 July 2002, when euro notes and coins will be in parallel circulation with national notes and coins within the euro area? "*

As of 1.1.2002, euro notes and coins will be introduced in all participating Member States in replacement of the national units. But the subsidiarity principle applies to the way of proceeding with the change-over as well as to the decision on the length of the period. A much shorter period is generally preferred (a few weeks or less) Motive: limit confusion by the general public e.g. paying in national currency notes and, in return, receiving change in euro coins.

Issues to be examined include the following: How to assist elderly and visually impaired persons? How will the phasing in/out be implemented (its precise method and sequence? Ensuring the security of transportation and storage, the adaptation of ATM's and other note or coin operated machines, etc). Will banks be allowed to charge their customers for the exchange at their counters? Will questions be asked about the origin of the money (proceeds of the underground economy, money laundering)?

Information on these and other issues should be gathered at the national level (authorities, banks). A definitive approach may still be in the making on some of them.

C. *"How far is the euro likely to be used in those Member States not participating in EMU Stage 3 on 1 January 1999 (e.g. the UK), and also in non-EMU countries (e.g. the associated states in Central and Eastern Europe), both before and after the introduction of euro notes and coins?"*

The international role of a currency depends in the first instance on its underlying economic, financial and commercial weight. With the creation of EMU, the respective weights of euro-land and of the US become broadly equal. Thus, in principle, the euro has the potential to rival the dollar as an international currency.

The E.U. Member States which do not (yet) participate in EMU constitute a natural area of development for the euro. Even if, for these countries, the euro still qualifies as a foreign currency, it will have a special status: their own currencies will be pegged to the euro (at least those of the Member States aspiring to an early entry); their trade with euro-land will essentially be priced, invoiced and paid in euro; the euro is likely to become the major currency traded on their exchange markets (possibly displacing the dollar as the intermediary in currency dealings); their financial markets will not only price and trade in the national currency but increasingly in euro as well; local multinationals may even decide to be quoted and traded in euro.

The UK for its part is keen to complement its euro-dollar market by an equally important euro-euro market.

The development of the euro as a financial instrument should further be fostered by the adoption of harmonised market rules and conventions for the euro bond markets, money markets and foreign exchange markets as proposed by the European banking and financial sector.

At the larger international level, the euro will certainly encroach on the dominant role of the US dollar as "the" international trade and financial currency . Indeed, according to the relatively greater weight of their trade and financial relationship with the euro-zone, a certain number of third countries might favour the euro over the dollar: exchange rate policy focused on the euro; central bank reserve holdings in euro; export/import pricing and payment in euro; investing on the euro's financial markets; bond issues in euro both by the authorities and the private sector (some have already done so), etc.

The main questions to be tackled by the Study on the international role of the euro are the following: How fast (or slow) is this development going to be? In which countries and domains is it most likely to take place? What are the necessary terms and conditions to make it happen? And, finally, would such development increase the prospect of more effective international economic and monetary co-ordination?

Methodology and elaboration of the project

A group of expert was created who regularly met to discuss the development of the project. The co-ordination of the study was assured by the Belgian TEPSA member institute, the Groupe d'Etudes Politiques Européennes (GEPE). The project leader was André Louw, Member of the Groupe d'Etudes Politiques Européennes and former advisor at the European Commission. The meetings were chaired by Prof. Jacques Vandamme, Honorary President of TEPSA

This core group decided about the division of labour among the authors. Draft versions of the contributions were sent to the authors and discussants before every meeting. Authors were invited to take account of possible divergent opinions in their final contributions.

As requested by the contract a mid-term interim report was sent to the DG for Research of the European Parliament for comments.

Authors

Danny De Raymaeker	General Director, Directorate Payments, KBC Bank, Brussels *Chapters IV and VII*
André Louw	Groupe d'Etudes Politiques Européennes and former advisor at the European Commission *Summary, Chapters I, II, III, VI, IXA, IXC (with André Swings) and X*
Luc Moulin	Advisor, Association for the Monetary Union of Europe, Paris *Chapter V*
Chris Taylor	National Institute of Economic and Social Research, London *Chapter IX.B*

The KBC Bank Studies Department wrote *chapter VIII.*

Discussants

Jean-Claude Koeune	Chief Economist, Banque Bruxelles Lambert
Sylvain Plasschaert	Professor emeritus of the Catholic Universities of Leuven and Antwerp
Jean-Jacques Rey	Director at the National Bank of Belgium
André Swings	Former general manager, KB
Jef Van Ginderachter	Professor at the Catholic University of Namur

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