

The introduction of the euro in the majority of the countries forming the European Union was unique – it was the first time in history that a single currency had been brought into force crossing national borders of independent states in advance of a political union. Single currencies were seen only to have succeeded where a single political structure was already in place but the European Commissioners deemed that this was a step that could be taken while they continued to debate what sort of political United States of Europe they wanted to impose on Europe.

When it was claimed that the introduction of the euro caused higher prices, the politicians were at pains to say it was not true. Now, as the euro completes its first year, the head of the European Central Bank has admitted that it should have been 'more honest' about the inflationary impact of the currency. ECB executives have conceded that Europe's consumers had seen prices of everyday items rise – some even might say rocket - as a result of the changeover*.

The EU had laid down very tight parameters within which all eurozone countries had to control their finances. This was to ensure that all had met the necessary economic criteria to join the euro, and to ensure that individual countries could not destabilise the currency by introducing unacceptable economic measures to solve internal political problems. To meet the January 1, 2002, deadline, it was claimed that some finance ministers juggled their internal accounts. Since then political 'elasticity' seems to have been introduced when deemed politically expedient.

Originally designed to protect the strongest currencies, such as the previous German mark, the European Commission's economic regulations are likely to be further breached by Germany in 2003. As Europe's leading economy, Germany accounts for 40% of the eurozone economy and is struggling to cope with low growth, soaring unemployment (4.22 million in December), a welfare system on the brink of collapse and a budget deficit not officially allowed by the European Commission.

To see how the euro has fared away from the political spotlight, this article by HSBC was specially commissioned for *WSA's* sister publication, *World Leather.*

The impact of the euro



On 1 January 2002 the euro became a reality for millions of consumers as euro notes and coin were introduced in the 12 eurozone countries. Their introduction marked the end of the three-year transition period for eleven of the EU countries which began on 1 January 1999, and a year's transition period for Greece. Arguably, the euro's launch was one of the most significant events to affect businesses and the financial markets in the European Union, since the development of the European common market. The rate of changeover of businesses from national currencies, eg DEM to euro, was not as swift as expected with many leaving their changeover to the last quarter of 2001. The public at large embraced the new currency only when notes and coin were issued. The cash changeover at the beginning of 2002 was, however, much faster than anyone had expected. According to the ECB, in less than a month, two thirds of eurozone cash transactions were in euro. The international scene was equally as fast off the mark and has welcomed the newcomer from 1999.

Although a relatively young currency, the euro is already the second most widely used currency internationally, though some way behind the dollar on most measures *(see Table 1)*.

The shares of the US dollar and the euro in international activity shown in *Table 1* broadly reflect the weight of their respective economies measured in terms of their GDP. If this is a true correlation, rather than a coincidental one, it would indicate that the euro will never challenge the dominant international role of the dollar until the eurozone's GDP equals that of the US.

Table 1: The international role of the euro and other international currencies: some key indicators (% of total)

	Euro	US dollar	Japanese yen	British pound	Swiss franc
Global debt accurities market (2002 Q1)	24.1	45.6	18.8	-	-
Broadly defined international debt securities stock (mid-2002)	38.9	44.5	6.1	-	1.9
Narrowly defined international debt securities stock (mid-2002)	29.0	43.8	12.6	-	4.0
Broadly defined money market instrument flows (2002 Q2)	36.3	38.1	5.1	-	2.8
International bank assets (2002 Q1)	24.0	52.0	10.6	-	-
Holdings in leading fund managers' bond portfolios (mid-2002, The Economist's quarterly polls)	28.0	50.0	14.0	5.0	-
Official reserves (all countries) (end-2001)	13.0	68.3	4.9	4.0	0.7
Official reserves (developing countries) (end-2001)	15.3	64.1	4.5	5.5	0.9

Source: BIS, IMF, ECB

The ECB recently concluded that whereas the dollar is used worldwide, the euro is an international currency with a strong regional focus. The dollar plays a role in exchange rate policies of countries on several continents, including Asia, whereas official use of the euro is concentrated in countries close to the eurozone – the EU accession countries, the western Balkans and the Mediterranean.

From its launch in electronic form on 1 January 1999, the euro quickly became established in the wholesale markets. In April 2001, the euro was used on one side of 43% of foreign exchange transactions by value while the dollar was used in 85%. In two markets - international bonds and credit derivatives – use of the euro has grown substantially since 1999. Wholesale markets aside, The Bank of England estimates that around half of the eurozone's external trade is now denominated in euro. Figures detailing the currency breakdown of international trade are difficult to find but figures for Japan act as an illustration of the euro's growing profile. The share of the euro in EU imports from Japan has increased from 40% to 52% between H2 2000, the second half of 2002, and H1 2002 and its share of EU exports to Japan increased from 18% to 29%.

There has been some downside, however. There is a perception that the euro has caused prices to rise in the eurozone. In Greece this resulted in a four-day boycott of shops and markets. Official Eurostat figures show, however, that inflation increased by only 2.4% from 2001 and the European Commission has been trying to stress that the euro changeover has had little effect on prices.

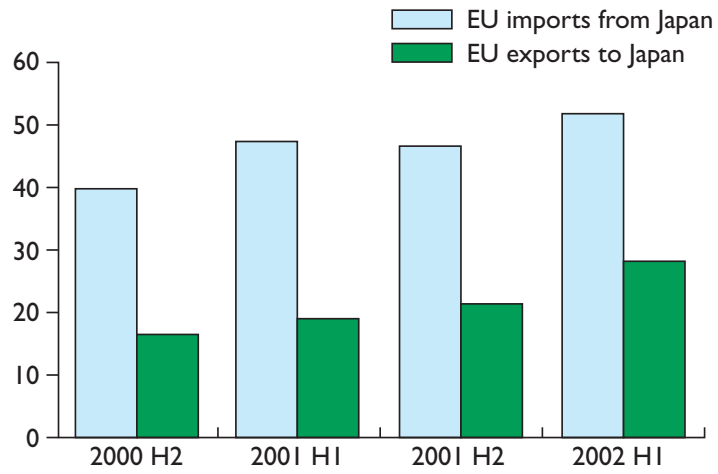
Apart from the 12 countries which formally adopted the euro, around 40 other countries or territories either use it or have their exchange rates pegged to it. The euro is in over 300 million pockets and the number is growing. As recently as December, North Korea announced that it will stop using US dollars, widely used for both international and domestic transactions, and start using euro instead.

Accepted both domestically and internationally, it is, of course, too early to say how economic crises within the eurozone or in other parts of the world will affect the stability of the euro. But its prognosis looks good. It has proved flexible enough to date to accommodate changes to its operating sub structures. The stresses and strains of these adjustments have made front page reading in many parts of the world with much of the adjustment being fought out under the public gaze. A Growth and Stability pact was conceived prior to the launch of the new currency to guarantee its soundness. It has two main tenets:

1) Members of the euro must move their public finances into surplus or close to balance in the medium term.
2) Members should not breach a budget deficit ceiling of 3% of gross domestic product. If they do, they may be fined.

Portugal has already breached the 3% deficit ceiling. In December there were demonstrations in Portugal as a result of the government trying to meet the requirements of the Pact by cutting public sector spending. Germany is close behind Portugal and France has refused to be governed

Share of the euro in the trade of the European Union with Japan (%)



by the Pact causing the European Commission to give them, Italy and Germany two years to get their finances in order. A lively debate has ensued on whether the Growth and Stability Pact should be changed but the core objective of sound and sustainable public finances remains a condition for the stability of the euro. The controversy is being viewed very much as part of the evolution of a young currency.

In December, agreement was reached that ten new countries would join the EU in 2004: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. The expansion adds nearly 75 million people to the 378 million already living in the EU, but the increase of population by nearly 20% adds less than 5% to the Union's wealth, according to Eurostat figures. This brings countries with a different profile into the EU.

It is expected that some of the Eastern European countries will enter the exchange rate mechanism ERM2 as soon as possible after joining the EU. This would put the earliest possible EMU entry date at 2006 but many within the eurozone think a longer transition period would be appropriate, with 2008 being a more realistic date.

But what about the three countries currently in the EU which have not adopted the euro? The Danes held a referendum in 2000 on the subject and received a "no" vote from its people whilst Sweden has set a date of 14 September 2003 for its euro referendum. The UK government has committed to carrying out by June 2003 an assessment of the five economic tests set by the chancellor. The UK government's policy is that if these tests, set in October 1997, are passed they will recommend entry to the UK electorate.

Whatever the outcome, the euro looks set to run and run. Even the 'out' countries are experiencing the euro effect. Used in all three, research in the UK indicates that more UK businesses now hold euro accounts than dollar accounts. Countries are queuing up to join the EU with their governments keen to adopt the euro when they are economically able to do so. The euro phenomenon will spread but there remain very substantial numbers of citizens who do not share such enthusiasm. An EU survey in mid-December taken in Germany showed that two-thirds were in favour of a return to the mark.

Surveys published at the end of December continue to highlight the difference between the political and economic dimensions of the euro. Unemployment has increased in all eurozone countries in the past twelve months, except in Italy (-0.2%), Greece (-0.8%) and Finland (-0.1%). The three member states which have not joined the eurozone – Britain, Sweden and Denmark, have all seen unemployment fall. The ordinary people in the street are finding difficulty in using the currency in daily life, varying from 28% in Ireland to 64% in France.