BACK TO BASICS

Euro Turns Five:

Hamid Faruqee

THIS JANUARY marked the five-year anniversary of the European single currency—the euro. A historic milestone in the process of European integration, the euro has created a new monetary reality for 300 million Europeans that few would have believed possible a generation ago. While the future course of this "grand monetary experiment" remains unknown, the euro has already seen significant changes in its brief existence. Like most five-year-olds, the euro has had its share of ups and downs, and its role—both within Europe and overseas—continues to evolve and expand.

History in the making

The birth of the euro marked a watershed in the postwar history of European integration. Fifty years of endeavor to create a closer union and a cooperative future for the people of Europe in the aftermath of the Second World War, in many ways, culminated in the advent of the single currency. The process that led to Economic and Monetary Union (EMU) with the euro as its currency was accomplished in three distinct stages.

The initial stage was the removal of all restrictions on capital movements between member states by July 1990. With the full liberalization of capital, the European "single market" had a deeper financial dimension. Greater fluidity of financial markets, however, also raised the stakes on possible tensions within an exchange rate regime of currency bands. The second and third stages provided for a compact enshrined in the Treaty of European Union (Maastricht Treaty), setting the groundwork for the euro. Maastricht specified nominal criteria for the adequate convergence of the economies of future participants in the euro in four areas: inflation, interest rates, exchange rates, and government finances. The second stage also laid out the blueprint for a new institutional architecture to form and operate the currency area, including the establishment of the European Monetary Institute as the precursor to a European central bank. The third stage commenced on January 1, 1999, when 11 countries fixed their exchange rates to the euro.

New monetary and fiscal architecture

Adopting the single currency also meant adopting a single monetary policy. Under the Maastricht Treaty, the independent European Central Bank (ECB) safeguards the euro's value by pursuing its primary objective—maintaining price stability. What became of the national central banks? They now comprise, together with the ECB, what is known as the "euro system": a network responsible for defining and implementing monetary policy, ensuring the smooth operation of payment systems, conducting foreign exchange operations, and managing official foreign reserves.

Governors of the national central banks within the euro system, together with the ECB's executive board, constitute the ECB's Governing Council—the main decision-making body responsible for formulating monetary policy for the area. Making this unprecedented transfer of monetary sovereignty a success depended critically on the credibility of this new supranational institution. Lacking a track record, the ECB has drawn on the experience and credibility of the national central banks in building its reputation. The ECB has come of age in a very short time, owing to its substantial institutional independence and a clear monetary policy strategy aimed at price stability, the meaning of which has more recently been clarified as consumer price inflation "below but close to 2 percent."

Monetary union also has implications for members' public finances. While the ECB conducts a single monetary policy, fiscal—and structural—policies remain the responsibility of each member, albeit with the stipulation that national policies be regarded "as a matter of common concern." One implication is that the monetary integrity of the euro area needs to be supported by sound fiscal budgets. To ensure areawide fiscal discipline, the Maastricht Treaty obligates members to avoid "excessive fiscal deficits," as defined more fully in the Stability and Growth Pact (see article, page 22). The pact's principal aim is to maintain sound government finances as a permanent feature of EMU through its monitoring and (if necessary) penalty components. The pact aims to promote budgetary policies that would support a stability-oriented monetary policy without resorting to excessive fiscal deficits during the course of normal cyclical fluctuations.

Queuing up for the euro

Along with new institutions, the euro area's geography has changed since the single currency's creation. Since Greece's entry as the twelfth member in 2001, the euro area covers all but three members of the European Union prior to its enlargement this past May: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. When ratifying the Maastricht Treaty, the United Kingdom and Denmark were granted "opt outs" from replacing their national currencies with the euro while leaving the option open for the future.

Europe's Grand Experiment

Sweden was granted a derogation but not permanent exemption and so is required to adopt the euro, but not by a fixed date. Of these three countries, only Denmark currently maintains the Danish krone's rate of exchange against the euro well within narrow (±2¼ percent) fluctuation bands of EMU's transitional exchange rate mechanism, ERM2.

All 10 countries that joined the European Union in May are expected to adopt the euro, though no deadline has been set (see the article on page 29). In addition to the other convergence criteria specified in the Maastricht Treaty, a country intending to adopt the euro must undergo at least two years of exchange rate stability in ERM2. With the current diversity of exchange rate arrangements in these countries, the prospect of wider euro adoption will thus entail a shift toward greater use of the euro, first as a reference and intervention currency and, eventually, as domestic money. Nevertheless, deciding whether it is preferable to adopt the euro sooner or later—or at all, as in the case of the United Kingdom and Denmark—is a complex issue. Fundamentally, each country must determine for itself at what point the benefits of conformity—such as the promise of greater trade and financial integration with the euro area—outweigh the costs—notably, accepting a "one size fits all" monetary policy.

Currency without borders

On the global stage, the euro has played a role second only to the U.S. dollar. For its part, the ECB neither promotes nor hinders the internationalization of its currency. Nevertheless, given the euro area's economic size and the legacy of its national currencies, the euro's role as an "international currency" was both immediate and far-reaching from its inception. The uses of an international currency can be categorized in terms of the same functions associated with domestic money—as a unit of account, a medium of exchange, and a store of value.

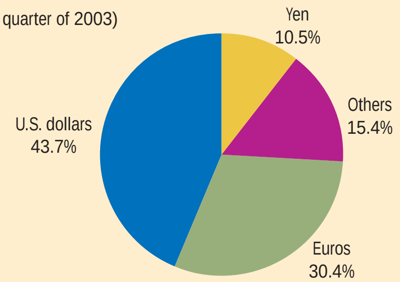
The euro is used as a settlement currency for about half of the euro area's external trade flows. As a parallel currency for cash-based transactions, the euro's use is more difficult to assess because these trades usually go unrecorded and sometimes involve activities in the informal, or underground, economy. Bank data on net currency shipments—euro banknotes sent abroad minus those received—indicate that more than €30 billion, or nearly 10 percent of all euros in circulation, was provided to nonarea residents during the euro changeover from January 2002 through June 2003.

The euro's most important international role in the private sector has been as a currency of denomination for financial assets. For example, the share of euro-denominated debt (issued by nonresidents) has risen steadily since 1999 and now accounts for nearly one-third of the outstanding stock of international debt securities, behind only U.S. dollar–denominated debt (see chart). In international loan markets, the respective shares of euro and dollar loans to nonresidents are similarly distributed (37 percent and 46 percent).

Euro as a leading financial currency

A breakdown of international debt securities by currency of denomination shows that euro-denominated debt accounts for nearly one-third of the total.

(Second quarter of 2003)



Source: European Central Bank.

In terms of the euro's official uses, reference and intervention currency functions tend to be closely intertwined. In 2003, 51 countries and territories outside the euro area relied on the euro as their reference or anchor currency or as part of a currency basket peg. A number of EU accession countries and countries in the western Balkans and Africa use the euro as the sole anchor currency. Moreover, Russia maintains in its currency basket peg a 60–40 split between the U.S. dollar and the European single currency. As a reserve asset, the dominant currency in official holdings of foreign reserves remains the U.S. dollar although the euro has seen its relative share rise steadily from 12.7 percent at end-1999 to 18.7 percent at end-2002. As the currency area's map continues to be redrawn, and backed by the ECB's credibility, the euro's reach in global trade and finance will likely continue to expand. ■

Hamid Faruqee is a Senior Economist in the IMF's European Department.