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The Euro-Zone: Year One

The third Stage of Economic & Monetary Union [EMU], the creation of the euro-zone, began on 1 January 1999. This Paper looks at developments in its first year of operation. It looks at the performance of both the euro and of the economy of the euro-zone. It also looks at its impact on UK industry and the City of London. Lastly, it summarises public opinion evidence and attitudes towards the euro in both the euro-zone and the UK.

Timothy Edmonds

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Summary of main points

The dreams of many European politicians and civil servants of closer monetary integration were realised on January 1 1999 when eleven countries, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain, irrevocably tied their currencies to the euro (€) and the Third Stage of Economic & Monetary Union [EMU] began

The outstanding feature of the euro in its first year has been its decline in value. Apart from a brief period at the start the euro has generally traded well below its opening value of €1.1743 to the US dollar and €0.7058 to the pound.

Inflation for the whole euro-zone rose in 1999; however, the prospect of it rising above the ECB target of 2% is remote. The spread of inflation rates amongst member states converged slightly by the end of the period. Unemployment did not fall significantly. On its creation the euro-zone inherited an unemployment rate of 10.8%. Despite the improving economic conditions, by the end of the year the overall rate was still 9.8%. Amongst people aged less than 25 the rate was almost twice that at 18.4%.

Despite comments made by the ECB President that "it would take many years for the UK to be ready for membership" it is not obvious that the UK economy is any less converged with the euro-zone at the end of 1999 than it was in 1998. This fact, however, only serves to highlight the importance of the exchange rate and exchange rate stability as **the** issue to be settled before possible entry.

In terms of practical issues the start of Stage Three was something of a non-event. The experience of City firms was that the changeover had gone smoothly and all procedures worked properly.

A European Commission study into business preparations pre-entry concluded that, for many companies, the euro had provided the focus for a general review of activities. UK companies, because they are one stage removed from the euro, have, with the exception of larger companies with overseas branches or parents, had longer to adjust. For most UK companies, however, the evidence is that the euro has had very little impact. One regular survey of business responses found that 'the use of the European single currency is growing extremely slowly'.

Most evidence suggests that the City has not lost out due to the UK's non-participation in the euro-zone. The Bank of England concluded that since the euro's launch London has fully maintained its market share and found that the number of staff dedicated to wholesale financial activity in London had actually increased.

It is hard to gauge shifts in public opinion over the euro since both sides produced poll evidence to support their own viewpoints. Although the issue is uncertain, one long running poll found that support for the euro had declined over the year.

CONTENTS

I Introduction[1]

For more than twenty years many European politicians and civil servants harboured dreams of closer monetary integration between their respective national economies. Some were attracted by the idea of forming an alternative to the influence of the world's dominant currency, the US dollar. Some have been attracted by the advantages that a single currency would bestow. Others have argued for it on the grounds of political symbolism, while yet others have seen it as a way to import an economic model that has worked successfully in the major economy of Europe: Germany. Whatever the motivation this dream was partly realised when the Third Stage of Economic & Monetary Union [EMU] began on January 1 1999.

The purpose of this Paper is to look at the developments that have taken place during the first year of its existence. It will also look at the economic performance of both the euro-zone and of the currency itself. It also looks at the impact it has had on industry and on the City of London. Lastly, will look at public opinion towards the euro and EMU in both the euro-zone and in the UK.

II Economic Performance of the Euro-Zone

A. The Euro-Zone

The nearest economic comparator to the euro-zone in terms of size and economic development is the United States.

The euro-zone is slightly the larger of the two in terms of population, but rather smaller in terms of GDP. The euro-zone is a more open economic area than the US, with exports from the euro-zone about 50% more significant in GDP terms than in the United States. The two areas are also different in the sense that they are at different stages of their economic cycle. The US (assuming that it is on a cycle at all, rather than, as suggested by some commentators, on the ever-upward path of a new economic paradigm) is near the top of its cycle. By contrast, much of the euro-zone is recovering from a period of slow growth and continuing labour market difficulty.

The tables on the following page give some basic data on the performance of the economies of the United States the euro-zone and the UK.

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[1] References to EMU will refer to the political and constitutional process or event of monetary union. The area comprising the eleven participating member states will be referred to as the euro-zone. The official name of the new currency is the Euro, abbreviated to eur and the official symbol is €.

Comparative Economic Indicators

		Money Market Interest Rates [a]			Consumer Price Inflation [b] % change on previous year			Unemployment [c] % of labour force			Exchange Rates Monthly av'ge per ecu/eur	
		US	Euro-zone	UK	US	Euro-zone	UK	US	Euro-zone	UK	US	UK
1998	Dec	5.0%	3.2%	6.3%	1.6%	0.8%	1.5%	4.3%	10.5%	6.4%	1.172	0.702
1999	Jan	5.0%	3.1%	5.7%	1.7%	0.8%	1.6%	4.3%	10.4%	6.3%	1.161	0.703
	Feb	5.0%	3.1%	5.4%	1.6%	0.8%	1.5%	4.4%	10.3%	6.3%	1.121	0.689
	Mar	5.0%	3.1%	5.2%	1.7%	1.0%	1.7%	4.2%	10.2%	6.3%	1.088	0.671
	Apr	5.0%	2.7%	5.2%	2.3%	1.1%	1.5%	4.3%	10.2%	6.2%	1.070	0.665
	May	5.0%	2.6%	5.3%	2.1%	1.0%	1.3%	4.2%	10.1%	6.1%	1.063	0.658
	Jun	5.2%	2.6%	5.1%	2.0%	0.9%	1.4%	4.3%	10.1%	6.0%	1.038	0.650
	Jul	5.3%	2.7%	5.2%	2.1%	1.1%	1.3%	4.3%	10.0%	5.9%	1.035	0.658
	Aug	5.5%	2.7%	5.1%	2.3%	1.2%	1.3%	4.2%	10.0%	5.9%	1.060	0.660
	Sept	5.6%	2.7%	5.4%	2.6%	1.2%	1.2%	4.2%	9.9%	5.9%	1.050	0.647
	Oct	6.2%	3.4%	5.9%	2.6%	1.4%	1.2%	4.1%	9.8%	na	1.071	0.646
	Nov	6.1%	3.5%	5.8%	2.6%	1.5%	1.3%	4.1%	9.8%	na	1.034	0.637
	Dec	6.2%	3.4%	5.9%	na	1.7%	1.2%	na	na	na	1.011	0.627

Note: (a) interbank deposit 3 month bid rates
(b) harmonised indices, national index US
(c) standardised unemployment rates

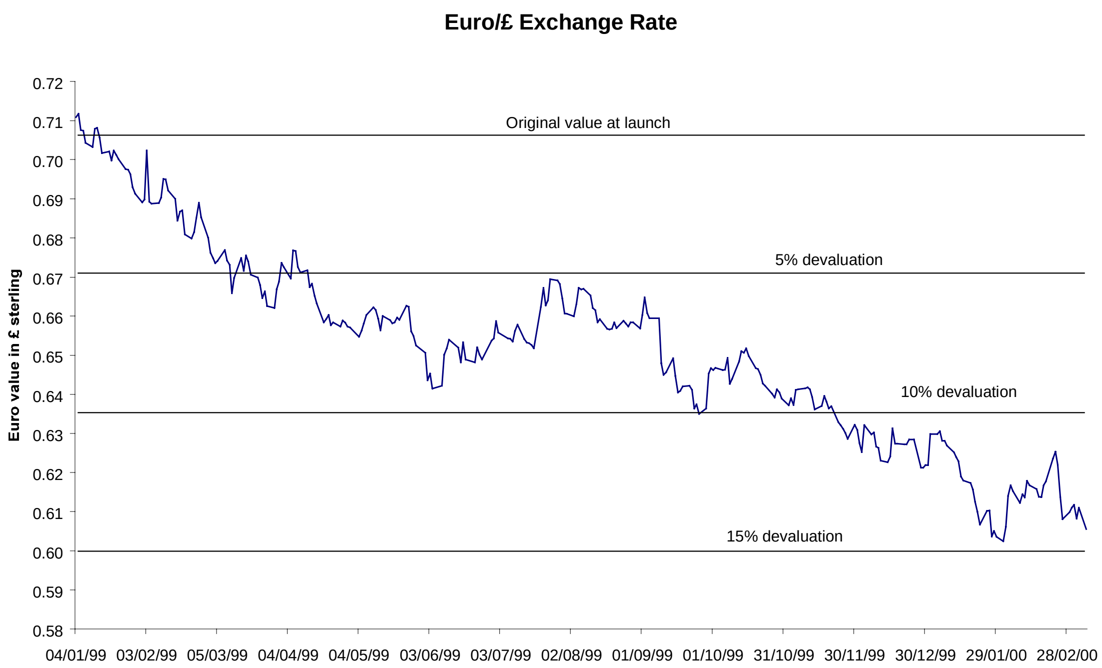
		Real GDP growth % change on previous year			Industrial Production % change on previous year			Unit Labour Costs % change on previous year		
		US	Euro-zone	UK	US	Euro-zone [d]	UK	US	Euro-zone	UK
1998	Q4	4.6%	1.9%	1.5%	3.7%	0.8%	-0.5%	-0.1%	2.5%	4.0%
1999	Q1	3.9%	1.7%	1.4%	3.5%	0.3%	-1.2%	-1.1%	2.5%	2.1%
	Q2	3.8%	1.8%	1.6%	4.1%	0.8%	-1.2%	-1.5%	2.2%	0.8%
	Q3	4.2%	2.3%	2.1%	4.4%	0.3%	0.3%	-1.3%	2.7%	-0.6%
	Q4	4.2%	na	2.9%	4.3%	na	1.9%	-1.3%	na	na

Note: (d) Q3 figures for August

Source: European Central Bank, Monthly Bulletin
OECD Main Economic Indicators

B. The Euro

The most commented-upon feature of year one was the euro's decline in value. Apart from a brief period at the start of its life the euro has generally traded well below its opening value of €1.1743 to the dollar and €0.7058 to the pound. A chart showing the value of the euro against sterling between January 1999 and March 2000 is shown below.



The euro declined steadily following its launch and reached a low point of 64.14 pence on 4 June 1999: a decline of 9.1% in just over six months. There followed a minor recovery throughout the summer however, from September onwards the decline resumed.

The European Central Bank (ECB) noted that the euro-zone currencies had, in 1998, appreciated by about 2% against both the dollar and sterling.[2] The implication being that a moderate weakening was to be expected. The ECB has suggested that developments since the start of the year owed more to the strength of the US dollar (which in turn has pulled up sterling) than any fundamental weakness of the euro. For example, in the December 1999 *Monthly Bulletin* the ECB put forward the buoyant state of the US economy, productivity improvements and 'relatively subdued employment cost increases' as reasons for investor's preference for the dollar over the euro. It also claimed that the half point increase in interest rates decided upon by the ECB in November 1999 only contributed to a lowering of long term rates, 'reflecting a reduction in future inflationary expectations in the euro area',[3] and did not support the currency. The issue of the euro's

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2 ECB, *Monthly Bulletin*, January 1999
3 Op cit p 50

weakness is seldom discussed directly in the ECB's economic reporting. It was not mentioned in the review of the year and when it is it is in the context of the inflationary impulse it may contribute to the euro-zone. The ECB merely reported the fact that:

> In nominal effective terms…During 1999 as a whole the euro declined by around 13.5%. The bulk of this decline is attributable to the euro's decline against the US dollar, the pound sterling and the Japanese yen. However, currencies with a smaller weight in the index, such as the Korean won, the Canadian dollar and the Australian dollar also contributed to the decline in the nominal effective exchange rate.[4]

Other commentators have also dismissed the fall in the euro's value. Prof. Buiter of the Bank of England's Monetary Policy Committee described it as "the non-story of the decade, of interest only to chartists."[5]

However, the impact of the devaluation has been anything other than a non-story. The low euro has been a boon for exporters in the euro-zone. In volume term's exports have been running about 5% up on the previous year and individual companies such as the German luxury carmakers have, reportedly, seen a boom in sales. The difficult decision facing the ECB is whether to raise interest rates to support the euro and limit the inflationary impact of higher import prices (e.g. of oil which is priced in $) but risk cutting short the export-led recovery currently taking place in the French and German economies.

Recently, however, there has been an indication that the policy of indifference towards the euro's value has changed. Following the decision in February 2000 to raise interest rates the ECB President stated that:

> Developments in the exchange rate of the euro are becoming a cause for concern with regard to future price stability. At the end of January the nominal effective exchange rate of the euro stood approximately 11 $^1/_2$% below its level in the first quarter of 1999. Given both the magnitude and the duration of this development, import prices can be expected to rise further, thereby increasing the risk that upward pressures on consumer price inflation might materialise in the medium term.[6]

C. Inflation

A low and stable level of inflation is the bedrock upon which most of the economic advantages of EMU are based. Consequently, the success of the ECB to deliver on its

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4 ECB, *Monthly Bulletin*, January 2000

5 Source: "A Problem of Perception", *Financial Times* 31/January 2000

6 Willem Duisenberg, Press conference Frankfurt am Main, 3 February 2000

constitutional imperative is crucial to the credibility of both the institution and the whole EMU project.

The Governing Council in the inaugural *Annual Report* declared that the monetary policy strategy consisted of three main elements:

- A quantitative definition of the primary objective of the single monetary policy, namely price stability;
- the "two pillars" of the strategy used to achieve this objective:
  - a prominent role for money, as signalled by the announcement of a reference value for the growth of a broad monetary aggregate; and
  - a broadly based assessment of the outlook for the future price developments and the risks to price stability in the euro area as a whole.[7]

The inflation target is defined thus:

> The primary objective of monetary policy, namely price stability, is defined as a year on year increase in the HICP[8] for the euro-area of below 2%.[9]

The prominent role for money is defined as an annual target of 4.5% growth in M3. The choice of a monetary target was somewhat surprising. Many national monetary authorities have abandoned monetary targeting as being too imprecise and difficult to control to be a reliable guide to policy. Of its importance the ECB state that

> The concept of a reference value does not entail a commitment on the part of the eurosystem to correct deviations of monetary growth from the reference value over the short term. Interest rates will not be changed "mechanistically" in response to such deviations in an attempt to return growth to the reference value.[10]

Annualised inflation, based on the harmonised index of consumer prices, and money supply figures, based upon the M3 measure, for the euro-zone are shown on the following page:

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7 ECB *Monthly Bulletin*, January 1999, page 45-6
8 Harmonised consumer price index
9 ECB *Annual Report* 1998, page 8
10 ECB *Monthly Bulletin*, January 1999, page 48

Inflation & Money Supply

% annual change

		HICP	M3
	Nov	0.8	4.7
1998	Dec	0.8	4.6
1999	Jan	0.8	5.7
	Feb	0.8	5.2
	Mar	1.0	5.5
	Apr	1.1	5.3
	May	1.0	5.4
	Jun	0.9	5.4
	Jul	1.1	5.9
	Aug	1.2	5.8
	Sept	1.2	6.1
	Oct	1.4	5.8
	Nov	1.6	6.2
	Dec	na	6.4

Source:Eurostat, ECB

Since inflation for the whole euro-zone is now double what it was in 1998 one might argue that the ECB has not been that successful in this key area, however, the prospect of the ECB missing its constitutional target of 2% remains remote.

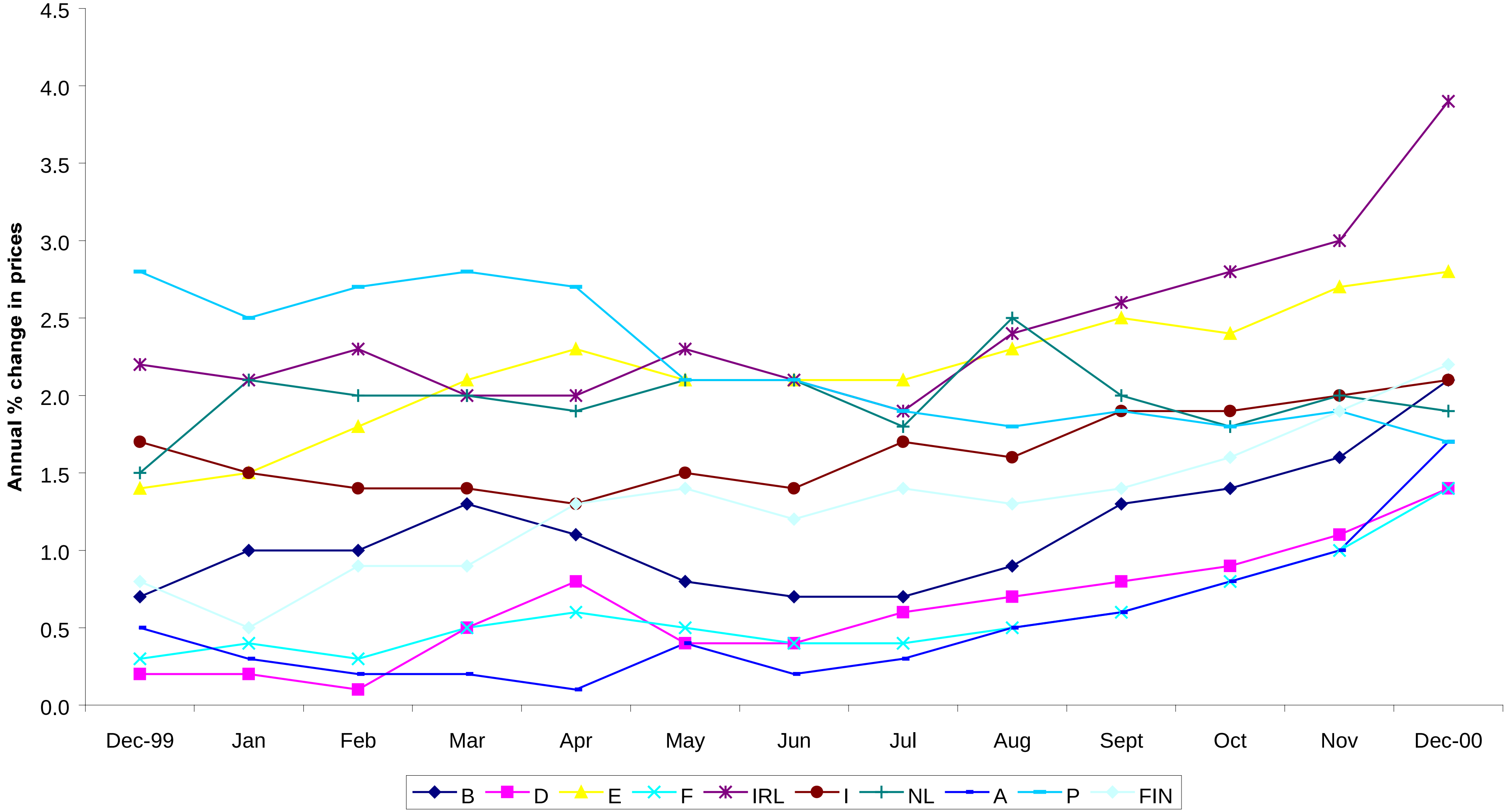
The M3 reference value was exceeded for the whole of the period. Despite promises at the start of 1999 that the impact of the money supply measure will "be made both clearer and more transparent"[11] it is still not clear what impact the excessive growth of M3 has had upon the Governing Council's decision.

Of rather greater interest are the domestic figures for the participating member states. Two questions were upper most in the minds of commentators at the start of the year. Would inflation rates converge, and, secondly, how would countries such as Ireland, with already high rates of inflation, fare when interest rates were further reduced?

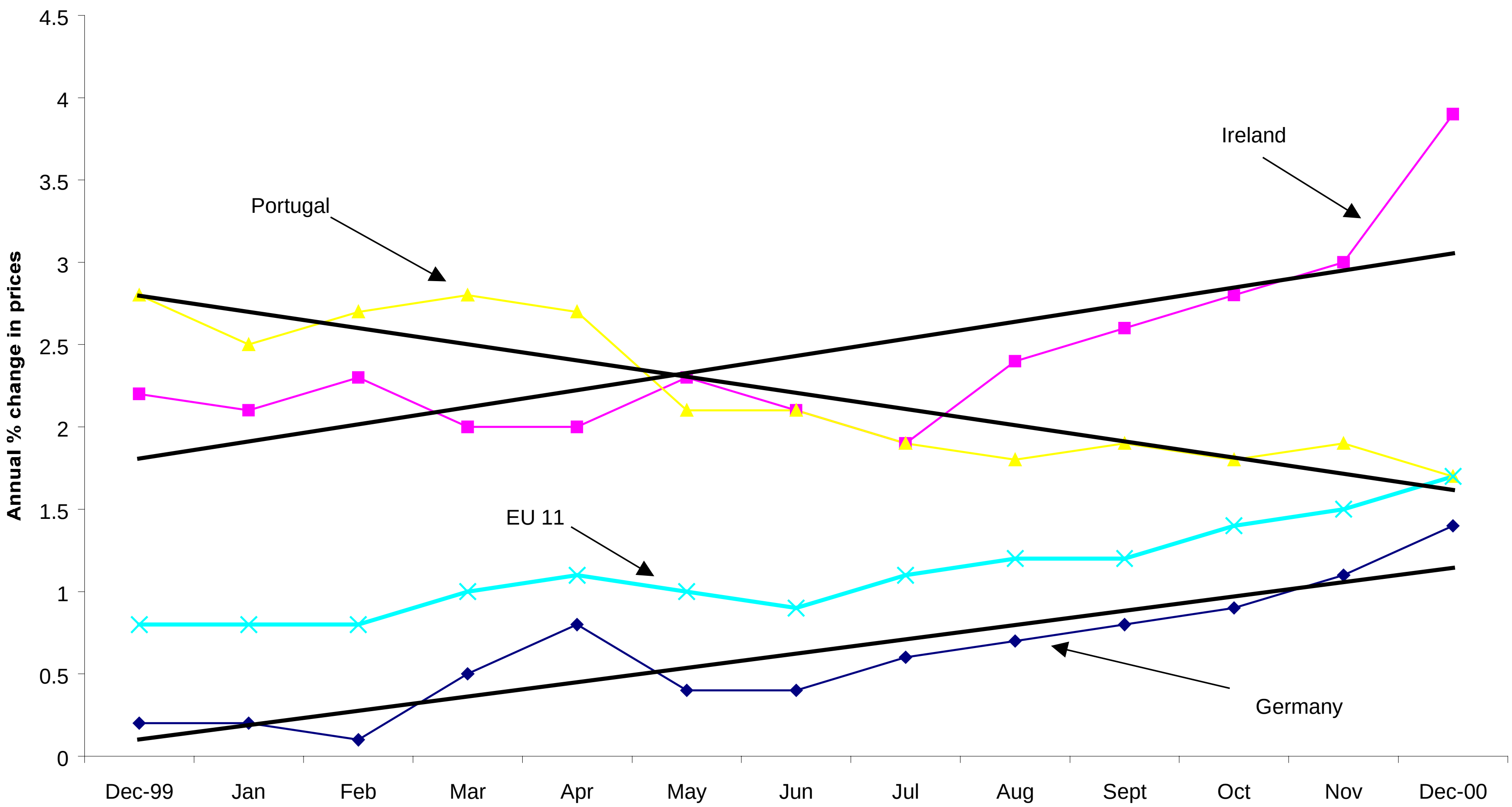
Graphs on the following two pages provide some clue. The first, 'Inflation in the euro-zone', simply plots the inflation rate of all the euro-zone member states (Luxembourg omitted). The second, 'Convergence in the euro-zone?', plots the inflation rates of the euro-zone average, the inflation rate of the state with the highest starting rate of inflation (Portugal), the rate of the state with the lowest starting rate of inflation (Germany), and, lastly, the inflation rate of Ireland. In the latter three cases a 'trend' line has been added to clarify progress.

[11] Op cit p 49

Inflation in the euro-zone



Inflation in the euro-zone



The results of the whole group show a fairly similar pattern of development. The spread of rates at the end of the period is slightly narrower than it was at the start, indicating some evidence of convergence.

The second graph, highlights some of the major differences within the group. The trend lines of the initial best and worst performers have converged strongly over the last year. This is a particularly encouraging result for Portugal as it has achieved this in combination with relatively strong economic growth and sharply falling levels of unemployment. The results for Ireland, however, are rather mixed.

Ireland has had the fastest rate of GDP growth of any of the EU 11 for several years. In three out of the last five years real GDP growth has been above 10%. The expectation in some quarters at the start of 1999 was that the effect of imposing euro-zone standard interest rates on the Irish economy (equivalent to an interest rate cut) would be to give an unsustainable boost to the economy and increase inflation. So far, the evidence of the impact is mixed. The Irish 'trend' line in the graph has roughly the same angle as that for Germany, implying that the rate of inflation increase is about the same in both countries: hence there is no problem. However, experience suggests that economies react rather slowly to interest rate stimuli and the rate of increase in prices since July is markedly sharper than that achieved in the first half of the year. Perhaps, therefore, Ireland's inflation problem may be more evident this year than last.

D. Unemployment

One of the most criticised features of the EU economy has been its failure to significantly reduce the level of unemployment in the member states. On its creation the euro-zone, which excludes the better than average performing UK labour market, inherited an unemployment rate of 10.8% compared to a rate of 4.4% for the United States.[12] Despite the apparent recovery in the euro-zone economies and the pick-up in demand for exports, unemployment has been slow to fall. At the end of the year the overall unemployment rate was 9.8%.[13] Amongst people aged less than 25 the rate was almost twice that at 18.4%. According to the ECB:

> The pace of net job creation, which was unchanged in the third quarter of 1999, is likely to have gained further momentum in the fourth quarter as a result of the economic upturn. The fact that the unemployment rate has been on a declining trend once again since September 1999 is consistent with the picture of a progressive strengthening of employment growth. [14]

[12] ECB *Monthly Bulletin*, January 1999
[13] ECB *Monthly Bulletin*, January 2000. ILO definition of unemployment, seasonally adjusted
[14] Op cit p 31

III UK Convergence

A. Introduction

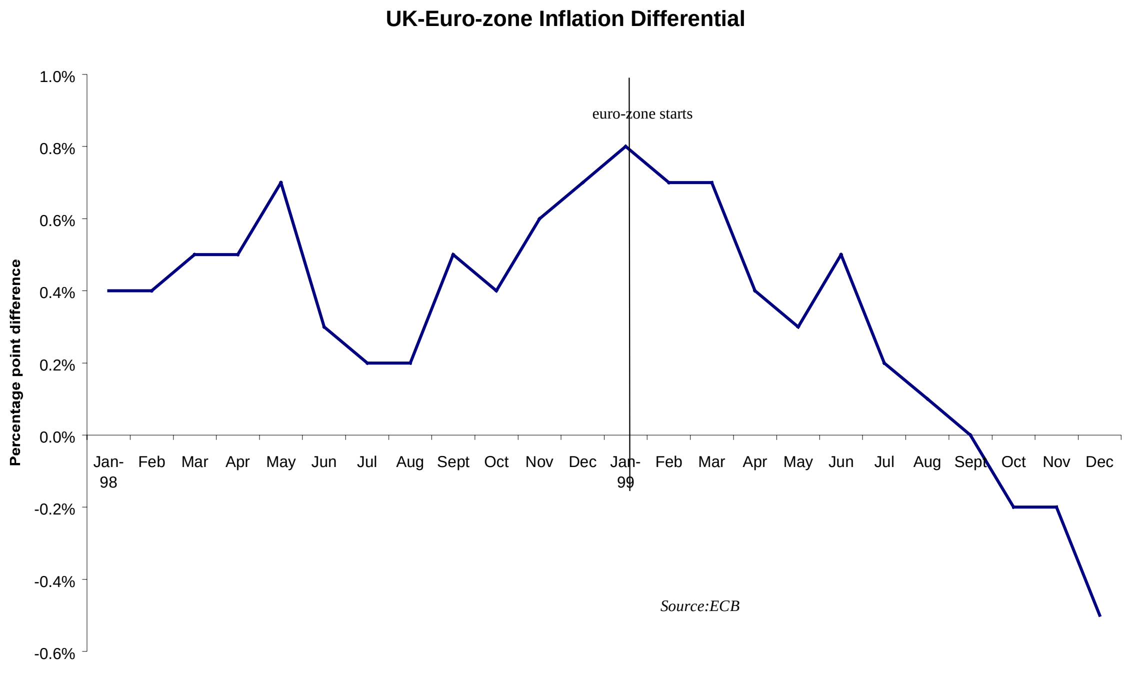
In January 2000 the ECB President declared that "it would take many years for the UK to be ready for membership".[15] In the light of the flexibility shown towards some applicants by the Commission during the convergence assessment in 1998, it is difficult to think that had the UK applied then for membership it would have been refused. Therefore, it might appear strange that within such a short period the UK has moved seriously out of line with its euro-zone neighbours. The following section looks at whether it is the case that the UK is moving further away from the euro-zone economy.

B. Economic convergence?

The graphs on the following pages show the percentage point difference between the euro-zone average performance and the UK for inflation, interest rates GDP growth and unemployment. The closer the line is to zero the closer aligned are the two economies.

15 See "Looking for exchange rate equilibrium" *Financial Times* 25 January 2000

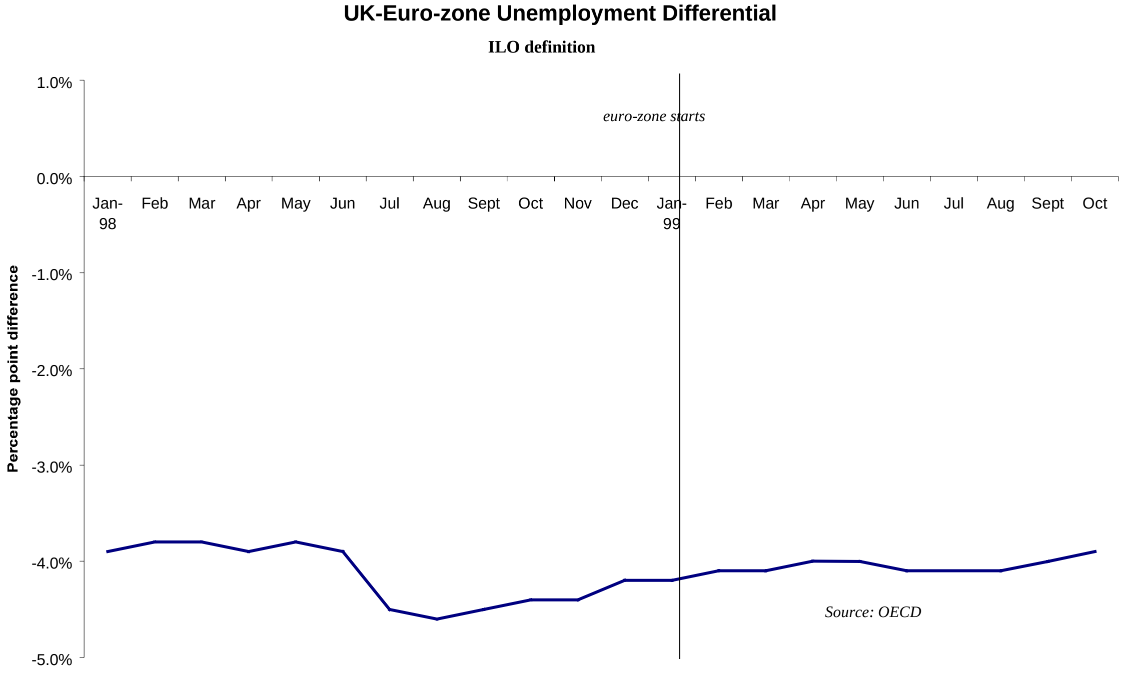
1. Inflation



Inflation in both areas is very low. Therefore the difference between them is tiny. For most of the period the difference has been substantially less than 1%: comfortably within the range permitted under the original convergence assessment. It is difficult to determine whether convergence has taken place. On the one hand inflation rates in the UK are now closer to the euro-zone average than they were (in fact the UK now has the lowest inflation rate, on a harmonised basis, in the EU), however, current trends resemble ships crossing in the night rather than long term convergence (denoted by a flattening of the difference curve around the axis).

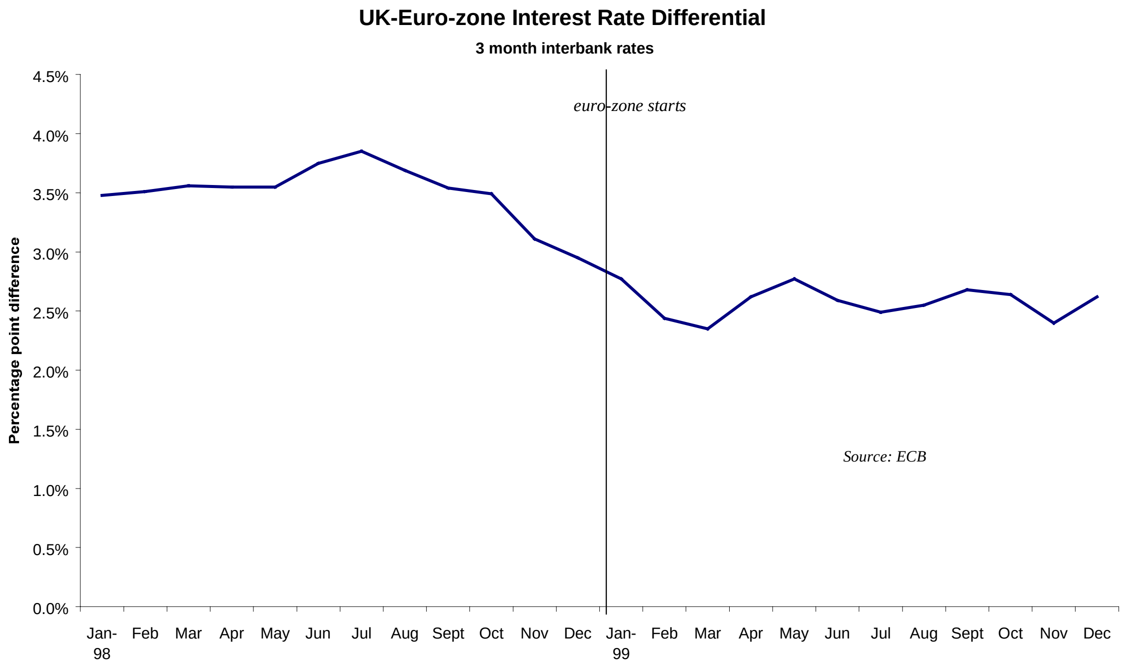
2. Unemployment

The situation is somewhat different with respect to unemployment. The graph on the following page shows that the UK's unemployment rate is well below that of the euro-zone as a whole, with very little variation over the last two years and no obvious sign of change in the near future.



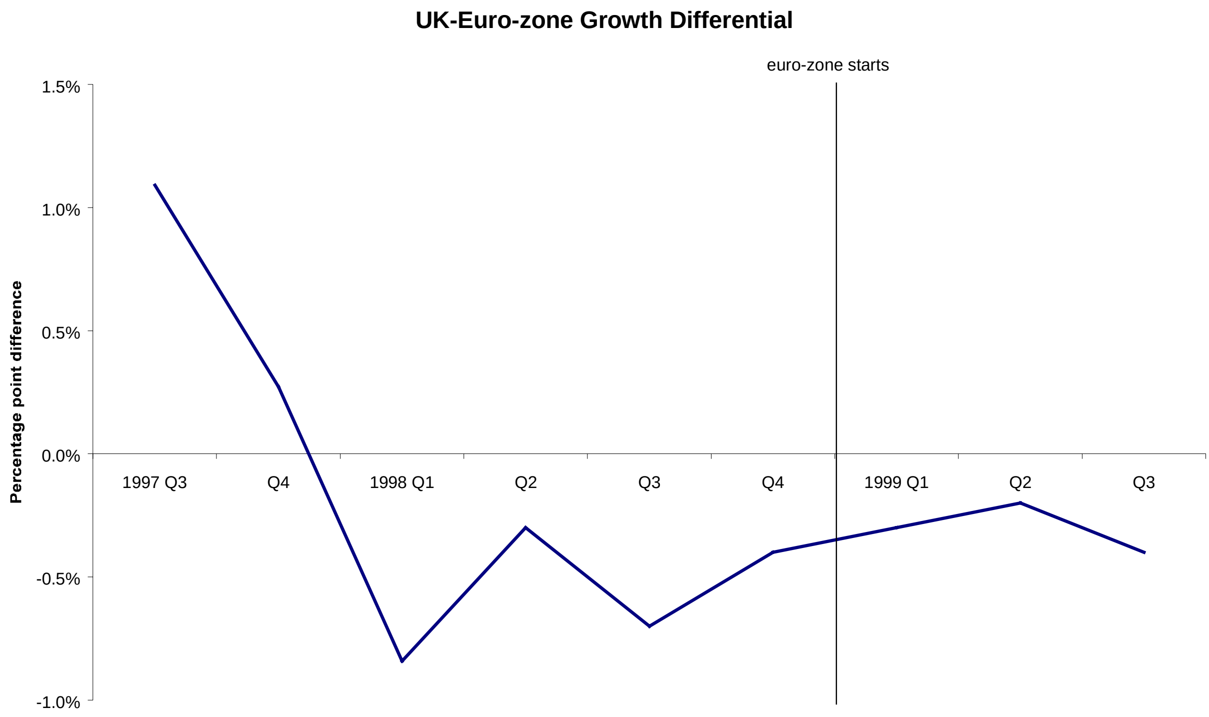
3. Interest rates

By contrast, interest rates do suggest a 'before and after' effect. The mathematical reason for the convergence is that whereas UK interest rates have fallen by about 1½-percentage points, euro-zone rates have declined by only ½ a percentage point. This reflects, amongst other things, the poorer growth performance of the UK over the period. UK market interest rates have been about 2.5 percentage points above the euro-zone average for most of 1999.



4. GDP growth

Lastly the growth rate differential is examined below. The difference in the annual change in real GDP quarterly growth for both areas is shown below:



Growth rates in the year from 1998 Q3 narrowed sharply. Before then the UK had been growing about 1% more or less than the euro-zone. Since then, however, UK growth has been within about half a percentage point of the euro-zone average.

5. Conclusion

Generally speaking, therefore, it is not obvious that the UK economy is any less converged with the euro-zone than it was in 1998. It is certainly not clear that it is less able to join on the basis of economic conditions than some existing members were in 1998, for example Ireland. Furthermore, the evidence does not suggest that the start of EMU and the work of the ECB has actually widened the gap between the UK and the euro-zone. This conclusion, however, only serves to highlight the importance of the exchange rate and exchange rate stability as **the** issue to be settled before possible entry and it is clearly this that is behind the comments (above) of the ECB's President.

If the UK government decided in the near future to recommend entry it would do so with a set of economic indicators that, with the exception of the exchange rate, would almost certainly pass any reasonable convergence assessment process as set out in the Treaty. The Treaty gives no guidance as to the exchange rate that the UK or other applicant countries, would have to join at. Furthermore, the disagreement between successive UK governments and the Commission as to whether or not the UK has to first join the new exchange rate mechanism for two years, has never been truly settled.

IV Practical Aspects of the start of the euro-zone

This section looks at the day to day impact of the first year of the euro. It starts with a brief summary of events in the first few days and weeks. A fuller version of this account first appeared in another Library Paper.[16]

A. The changeover

When the euro-zone began on 1 January 1999 eleven countries, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain, irrevocably tied their currencies to the new currency, the euro (€) at the exchange rates shown in the table below:

Euro currency rates

One euro equals:	
13.7603	Austrian schillings
40.3399	Belgian francs
1.95583	German d'marks
5.94573	Finnish markkas
6.55957	French francs
0.787564	Irish pounds
1936.27	Italian lire
40.3399	Luxembourg francs
2.20371	Netherlands guilders
200.482	Portuguese escudos
166.386	Spanish pesetas

Source: European Commission

In some respects the start of Stage Three was something of a non-event. The experience of City firms was that the changeover had gone more smoothly than had been expected. Private sector banks and the Bank of England were able to send their staff home early on the changeover weekend as all procedures worked properly. According to Reuters the massive redenomination exercise, covering more than one billion bonds, securities, contracts etc was completed seven hours ahead of schedule. One City commentator was quoted as saying that “we had a few glitches where we took a few minutes to think about what to do, but I can’t even think of anything I would describe as a problem”.[17]

[16] *Economic & Monetary Union the first six months*, Research Paper 99/75
[17] "Smooth conversion" *Financial Times*, 7 January 1999

Despite problems in the first two days the new banking payments system [TARGET] has worked as planned. In its first *Annual Report* the ECB commented that:

> The transition to the euro by the banking and financial sectors of the participating member states in only three and a half days after the irrevocable fixing of the euro conversion rates was deemed to be a remarkable success.[18]

The Bank of England echoed this view in its assessment of the conversion weekend. With particular reference to activity in London it noted:

> The conversion weekend was one of the biggest logistical operations that the London market has ever undertaken. An estimated 30,000 people were at work in London during the weekend. In addition to normal end of year processing, market firms had to activate changes in their systems to enable them to trade in euro, and to make and receive payments in euro, from 4 January. Many cash balances in participating national currencies had to be converted, and a large number of (mainly government) securities holdings had to be redenominated, using slightly different methods for different participating countries.
>
> Despite the scale of the exercise, the conversion weekend in London went well. Key market firms all completed their changeover operations in good time. There were no significant problems in London, nor within the euro area. Given the unprecedented nature of the undertaking, it was important that contingency planning arrangements were in place, both at the level of individual market firms, and among the authorities in case systemic issue arose. But in the event, they did not have to be used.[19]

B. The Impact on Industry

A study by the European Commission into business preparations before entry concluded that for many companies the euro provided the focus for a general review of their activities. Thus the euro acted as a catalyst, similar to the millennium. Many companies and institutions have undertaken reviews of "X in the 21st Century" simply because of the irresistible nature of something so special and unusual.

UK companies, because they are one stage removed from the euro, have, generally speaking, had longer to adjust to the new circumstances. However, some of the larger companies, particularly those with overseas branches have had to react more quickly. According to an FT survey of exporters the following companies have altered their systems to cope with the receipt of, and invoicing in, euros: BP, Rover Group, British Steel, Texaco, ICI (who expressed a definite preference for dealing in euros), Unilever,

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18 , European Central Bank, *1998 Annual Report*

19 *Practical Issues Arising from the euro*, Bank of England, June 1999

GKN, Vickers and Siemens.[20] For most companies, however, there is growing evidence that the impact of the euro has been something of an anti-climax.

An article from the Financial Times quotes the experience of a medium-sized (turnover £2 million) manufacturing company that had taken what the Commission in its study (see above) would have called a pro-active approach to the euro.

> In the days between Christmas and the New Year, Colin Scarsi, managing director of Green Tyre, an environmentally friendly tyre producer, slogged away in his office to produce a euro price list for all his continental markets.
>
> As the euro went live, he was ready for action, with a euro price list, a euro friendly computer system and a euro bank account, opened at the Newcastle branch of the Bank of Scotland. Four weeks later, he is still waiting for something to happen. Not one cent has passed into his euro account. “All I’ve got is probably more bank charges,” he says ruefully.[21]

A follow-up article that characterised matters under the heading – “The great euro yawn sets in” quoted various business organisations and trade bodies whose experience had been that there has been “a slowdown in interest in the euro”.[22] One study found that:

> UK organisations planned to spend 6% of the information technology budgets on euro related services last year, but actually spent only 1.4%. that is expected to grow to 3% this year. But the proportion of companies that say they will be making no changes has risen from 42% to 50%.[23]

As well as anecdotal evidence one regular survey of business responses has been published. Produced by KPMG consultants the latest quarterly survey noted that:

> The survey, designed to measure the speed at which the euro is being adopted in the UK, says that in the three months to the end of June just 0.23 per cent of the value of business between British companies was conducted in euros. This compares with 0.17 per cent in the March quarter, and 0.04 per cent in the first survey, carried out in January to establish a baseline for future calculations. KPMG calculates the value of second-quarter euro business at £1.1bn.
>
> In trade with the 11 euro-zone countries, the value of transactions rose from 5 per cent of total business to 7 per cent. Euro-denominated payments to UK companies rose from 4 per cent to 9 per cent, but euro payments from the UK to the euro-zone remained flat at 6 per cent. KPMG said UK companies appeared operationally unready to use the euro for payments, suggesting they are behind continental rivals in preparing for the replacement of legacy currencies.

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20 "Survey of Exporters", *Financial Times*, 30 October 1998
21 *Financial Times*, 28 January 1999
22 *Financial Times*, 24 May 1999
23 Ibid, Quoted from a report published by International Data Corporation

> The survey says the use of the euro and legacy currencies together rose from 21 per cent to 33 per cent of transactions with the euro-zone, possibly because the negotiating power of companies in the zone was rising. The value of euro-denominated transactions was highest among big companies, and in manufacturing and transport. The proportion processing at least one euro-denominated transaction rose from 12 per cent to 13 per cent.
>
> In trade with the rest of the world, the US dollar was used in 53 per cent of transactions, versus 42 per cent in the first quarter. The euro accounted for just one per cent of these transactions.[24]

The survey's authors are quoted in that article as saying that 'the use of the European single currency is growing extremely slowly'.

It was expected that the impact of the euro in the UK would be most pronounced with respect to financial services and the City of London. This is discussed in the next section.

C. Financial Markets & The City

At the launch of the single currency one of the most pressing questions was whether the City would be disadvantaged by the UK's non-participation in the euro-zone. This could happen in a number of ways. European exchanges and markets could merge; new debt and currency instruments could be the preferred medium of trade and hedging activity. In fact the experience of one year suggests that the City has not lost due to the UK's non-participation in the euro-zone

In the December 1999 edition of the Bank of England's *Practical Issues arising from the euro* publication, the Bank notes that:

> All the available evidence indicates that, since the launch of the euro, London has fully maintained its market share. Statistics for the change in London's market share are not yet available in every market. However, the latest figures serve to demonstrate the extent to which the City is not just a UK asset, but an asset for the EU as a whole.[25]

The article continues by describing developments in each financial sector.

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[24] 'Monetary Union Companies 'not ready' for replacement of legacy currencies', *Financial Times* 23 August 1999

[25] Op cit p 10

Bank representation

London has more foreign bank branches, subsidiaries and representative offices than any other financial centre (537 at April 1999).The latest equivalent figures for Frankfurt, Paris and New York are 242, 187 and 275 respectively.

Payments

Euro payments via the London CHAPS system account for around €62billion of cross-border payments per day (around 18% by value of all cross-border payments sent through TARGET in September). Of all the individual EU real-time, gross payments (RTGS) systems, only ELS in Germany has a higher proportion. CHAPS euro's share of business in TARGET is all the more striking since the euro is a foreign currency in the UK and banks in the UK are also heavy users of other euro payment systems (such as the EBA's EURO1 system). CHAPS euro has proved one of the most efficient and resilient RTGS systems in the EU since the beginning of the year.

Money market

The Wholesale Markets Brokers' Association (WMBA) estimates London 's market share of the overnight euro deposit market (broked and interbank combined) at around 20%.

Foreign exchange

The latest Bank of International Settlements (BIS) survey gives London's global market share of foreign exchange turnover as 32% ($637 billion per day), compared with 5% for Germany and 4% for France. The comparable figure for the US is 18%. Turnover is estimated to have declined globally since the introduction of the euro, owing to the disappearance of European currency pairs and risk aversion in the market since the events of autumn 1998. The overall decline in turnover between the euro and the other major currencies seems to have been around 15-30%. But overall turnover has declined less in London (by some 5-10%) than the euro area, and ticket sizes have increased. The market share of large firms, most of which are based in London, has increased at the expense of middle-sized firms.

Derivatives

London is heavily involved in both over-the-counter and exchange-traded derivatives. In the over-the-counter derivatives markets, which are growing faster, the same BIS survey gives London's global market share as 35% ($170 billion per day), compared with 10% for France and 7% for Germany (and 19% for the US). In the case of exchange-traded derivatives, over 90% of the euro short-term interest rate (STIR) contracts on the three major European derivatives exchanges are now traded on LIFFE. Eurex as been the largest derivatives exchange in Europe by volume since the repatriation of the Bund contract to Frankfurt last year, though Bund futures are extensively traded remotely from London. But the notional value of interest rate (STIR and bond) and equity index contracts is much higher on LIFFE than on both Eurex and Paris Bourse.

Bank lending

The BIS estimates that London originates nearly 19% of cross-border international bank lending, with $1,777 billion outstanding at the end of the second quarter of 1999, compared with 7% for France and 9% for Germany. (The comparable figures are 9% for the US, and 11% for Japan.)

Bonds

London 's market share of underwritten euro-denominated Eurobond issuance in the first nine months of 1999 is estimated at 54% (or the equivalent of $207 billion out of total issuance of $380 billion). London's market share has increased from 48% in the first quarter to 58% in the third quarter. These figures exclude domestic issuance and use the location of the bookrunner as a proxy for the centre from which bonds are issued. British Invisibles estimates that London had a global market share of secondary trading in the Eurobond market in 1998 of around 70%.

Equities

More foreign companies are currently listed on the London Stock Exchange (LSE) than on any other exchange (522 at the end of 1998). On the basis of 1998 data, around 90% of foreign equity turnover in Europe goes through member firms on the LSE. In the first nine months of 1999, equity turnover in euro has accounted for 38% of the total value of business reported to the LSE by its member firms.

Fund management

London is the largest global centre for institutional equity management, with $2,178 billion of institutional equities under management at the end of 1998: more than Zurich, Paris, Amsterdam and Frankfurt combined. British Invisibles estimates that around 20% of UK fund managers' portfolios are invested in non-UK securities.

Insurance

London is one of the largest centres for insurance business, with 22% of world marine insurance and 27% of aviation insurance business. It is the largest global centre for reinsurance.

The Bank also reviewed the geographical areas of activity of foreign financial institutions to determine which area they favoured to conduct their euro business. They found that the number of staff dedicated to wholesale financial activity in London had increased during the year and, in the case of a number of international market firms, around 80% of their European-based investment banking staff are located in London. Although some international market firms are established in Frankfurt to gain a presentational advantage in winning new payment business from clients, because the systems are so efficient the bulk of their processing work is actually done in London using the CHAPS euro and the EBA's EURO1 systems.

As expected the introduction of the euro brought a substantial increase in merger and acquisition (M&A) activity in the EU, indeed for a time M&A activity in the EU was at higher levels in 1999 than in the US. So far, European M&A activity has been mainly within national borders, although an increase is also expected across borders following the recent example of the take-over of Mannesmann by Vodafone. Although the top US-owned investment banks in Europe are generally recognised to have a leading position in the market, most institutions have been building up their core M&A staff both in London and across the euro area.

The Bank concluded its review of London's first year experience by saying that:

> It is early days, and market practitioners in London are not complacent. But all the evidence available to date indicates that, since the launch of the euro, London has fully maintained its market share. International market firms believe that the City's global competitiveness depends on: its critical mass of skills, financial services and professional support services; the pool of financial talent available; an efficient financial infrastructure; and a regulatory framework which is fair, appropriately light and quick to adapt. The City of London is determined to remain competitive in future.[26]

Not all commentators shared the view that the launch of EMU actually mattered that much to the City. One survey began:

> There have been more pages, column inches and broadcast hours about the launch of EMU and the single currency than almost any other event in the financial history of this century.
>
> It is tempting to believe that in terms of urgency and importance, there could be few issues more important in the thinking of the banking industry during the autumn of 1998. The survey results show otherwise, however, at least for the London markets. Only the foreign branches and subsidiaries, together with global/universal banks, rate this as more than seven out of ten in terms of importance. If you look at the respondents as a whole, the launch of EMU manages a mean score of 6.5. Seven out of ten other issues score higher.[27]

This air of detachment is mirrored in another way in comments made by the outgoing Lord Mayor of the City of London, Lord Levene, who is reported as saying that although EMU has been a 'positive' experience for the City, the government would have to look to other parts of the economy to support the case for joining. "The City's relationship to the UK was almost offshore".[28] However Levene is also quoted as saying that :

> 'A significant number of responsible and acute observers in Europe believe that London's business would, in time, be eroded if the UK's entry into EMU is long delayed. '[29]

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[26] Op cit p 16
[27] British Bankers Association, *The Banking Year Ahead 1999/2000*, p 78
[28] Levene's remarks on euro please the sceptics, *Financial Times* 9 November 1999
[29] EMU is not the real threat, *The Times*, 11 May 1999

This has been seized upon by some as an argument for British entry, however, one respected writer on the City, David Lascelles, writing for the pro-Europe, anti-euro, group- New Europe commented that:

> Certainly, London's position outside EMU does not seem to be making much difference. There are no regulatory or monetary barriers between the City and Euroland. A large proportion of euro business is settled in London as quickly and safely as if it was in Euroland. And institutionally, the merger of European stock exchanges will be based on the proposed alliance between London and Frankfurt - and not, as the French once hoped - an alliance between Paris and Frankfurt. But while much of the dynamics of EMU favours London, there is anxiety in the City that London could be a loser. Lord Levene, the Lord Mayor, said recently: 'A significant number of responsible and acute observers in Europe believe that London's business would, in time, be eroded if the UK's entry into EMU is long delayed.' This is prompting moves to strengthen governance of the City and give it a clearer sense of where its future lies though City opinion is deeply divided over whether it would do best in or out of EMU. Ironically, though, top Continental bankers do not see it that way. Rolf Breuer, chairman of Deutsche Bank, said: 'London will no doubt remain the leading centre in Europe thanks to its advantages of size, excellently qualified personnel and the attractive tax, legal and cultural environment.'
>
> This difference of view may arise because London and Frankfurt are very different sorts of centres. London is truly international: the great bulk of its business has little to do with the UK economy, or even Europe, which accounts for only one third of assets traded. Indeed, the City actually benefits from the weakness of the UK economy because this forces it to go out and find new business elsewhere, speeding up the internationalisation of its markets. Frankfurt is at an earlier stage of development where its growth is being fuelled by the needs of the local economy: listing new companies, developing an institutional investor base, and building new markets.
>
> The almost complete absence of international business opportunities in Frankfurt means it is unlikely to threaten London's dominance of that end of the business. The same goes for Paris, and also Europe's smaller centres, which should not be left out of the picture: Amsterdam, Milan, Madrid, Stockholm, and so on. London will undoubtedly lose business to all these centres as they grow. This is a process that will occur whether or not the UK joins EMU. The bigger question is whether any of them will achieve sufficient mass to attack London's wider position. It cannot be ruled out, but it seems unlikely in the foreseeable future.[30]

[30] 'A Survey of Britain: Europe's incoming tide: And the quarrelling Canutes': *The Economist* 6 Nov 1999

V The European Central Bank

A. Introduction

Since the ECB is the key institution at the heart of EMU its constitution and procedures were described in detail in the previous Library Paper on EMU.[31] Consequently this section largely concentrates upon its monetary policy actions and statements.

The governing legislation of the ESCB is set out in the Amsterdam Treaty (previously the Maastricht Treaty) as amended or supplemented by subsequent regulations. The primary objective of the ESCB is set out in Article 105 of the Treaty.

> The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 [promotion of harmonious, balanced and sustainable development of economic activities][32]

Price stability is defined by the Governing Council to mean:

> Price stability shall be defined as a year on year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability according to this definition is to be maintained over the medium term.[33]

There has been some concern that this target embodies a deflationary bias to policy as the definition excludes the possibility of too low an inflation rate. However, this is refuted by the ECB. They comment that:

> The phrase below 2% clearly delineates the upper bound for the rate of measured inflation in the HICP which is consistent with price stability. At the same time, the use of the word “increase” in the definition clearly signals that deflation, i.e. Prolonged declines in the level of the HICP index, would not be deemed consistent with price stability.[34]

Monetary policy within the euro area is described as having ‘two pillars’.

The first is the ‘prominent role that is assigned to money’.[35] By this the ECB mean the explicit inflation target of 2% that they have set. It could be contrasted with alternative inflation strategies that might have targeted intermediate indicators of inflation such as

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31 *Economic & Monetary Union: the first six months*, Library Paper 99/75
32 Treaty of Amsterdam, Cm 3780, Article 105
33 ECB, *Monthly Bulletin*, January 1999, p 46
34 Op cit p 46
35 Op cit p 47

the money supply. In fact monetary targeting is not excluded from policy formation entirely.

The second pillar of monetary policy is a reference rate for the growth of M3 of 4½%. The influence of this rate is described thus:

> The reference value will help to inform and present interest rate decisions aimed at maintaining price stability over the medium term. Therefore, in the first instance, a deviation of monetary growth from the reference value will prompt further analysis to identify and interpret the economic disturbance…The relationship between actual monetary growth and the reference value will therefore be regularly and thoroughly analysed by the Governing Council.[36]

The January 2000 edition of the *Monthly Bulletin* indicated that after the first such review the 4½% annual growth rate target for M3 would be retained for the forthcoming future.[37]

Other indicators that will be assessed by the Council as they affect price developments include wages, the exchange rate, bond prices and the yield curve.

The ECB has three main interest rates that affect the euro-zone economy. The first is the repo rate, which is equivalent to what is colloquially termed the 'base rate' in the UK. Below this central rate is the deposit facility rate (the rate at which banks can deposit money with the ECB) and above it, the marginal lending facility rate (the rate at which banks can borrow money from the ECB- in its lender of last resort function). For much of the period the deposit rate has been 1% below the repo rate and the lending rate 1% above.

The ECB changed interest rates three times between January 1999 and the following February. In April 1999 rates were reduced by a half percentage point; then raised by the same amount in November before rising again, this time by one quarter of one per cent in February 2000. Over the same period the Monetary Policy Committee of the Bank of England made eight changes of interest rates.

In the press the most talked about issue has been the apparent benign neglect with which the ECB has viewed the decline in the value of the euro. The euro's decline is documented in other parts of this Paper. However, the following comments reported from the Council Summit in Cologne in June 1999 reflect some of the feelings and worries about the euro:

> 'I worry about growth but not the level of the euro which is only a consequence of the economic situation.' - Romano Prodi, Commission presidential nominee

36 Op cit p 49
37 ECB *Monthly Bulletin*, January 2000 p 56

> 'We are not in favour of neglect of the euro. Clearly the decline in the euro's external value over the last few days has not been good news.' - Hans Tietmeyer, President of the Bundesbank and ECB council member
>
> 'I not going to express myself as concerned or not concerned. I am inclined to play it down.' - Wim Duisenberg, President of the ECB
>
> 'The German Government is eminently interested in a stable euro. We are doing all we can politically and fiscally for it to stay that way.' - Gerhard Schroder, German Chancellor
>
> 'The current weakness of the euro can be explained and to a certain extent was desirable in view of the economic situation in Europe.' - Guy Quaden, Governor of Belgian central bank and ECB council member
>
> 'We are working to avoid too many people speaking about the euro. We have all agreed that the less we talk about the euro, the better it is.' - Giuliano Amato, Italian Finance Minister[38]

In public the ECB does not have an official view on an appropriate level for the euro and it's concerned only if the euro's weakness contributes to internal price pressure. The comments of the ECB President at the February 2000 press statement, coinciding with the increase in ECB interest rates, suggests that that time may have finally arrived. Mr Duisenberg said:

> Developments in the *exchange rate of the euro* are becoming a cause for concern with regard to future price stability. At the end of January the nominal effective exchange rate of the euro stood approximately 11½% below its level in the first quarter of 1999. Given both the magnitude and the duration of this development, import prices can be expected to rise further, thereby increasing the risk that upward pressures on consumer price inflation might materialise in the medium term.[39]

There have been no obvious constitutional changes to the ECB or changes to the manner in which it operates. Questions about its accountability and the 'democratic deficit' remain, but there has been no move to meet some of these concerns by, for example, publishing more information on the ECB's proceedings or the voting record of the Governing Council. These issues were discussed in great detail in the previous Library Paper.[40]

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38 Quoted in *The Times*, 5 June 1999

39 ECB Press statement 3 February 2000

40 Library Paper *Economic & Monetary Union: the first six months*, 99/75

VI Public Opinion towards the Euro

There has been a hard fought battle for the hearts and minds of both the public and the business community over the euro. Both pro and sceptic camps have commissioned opinion polls that, unsurprisingly, support their own viewpoints. Although the issue is far from clear cut the general impression from press reports is that support for the euro may have declined over the summer.

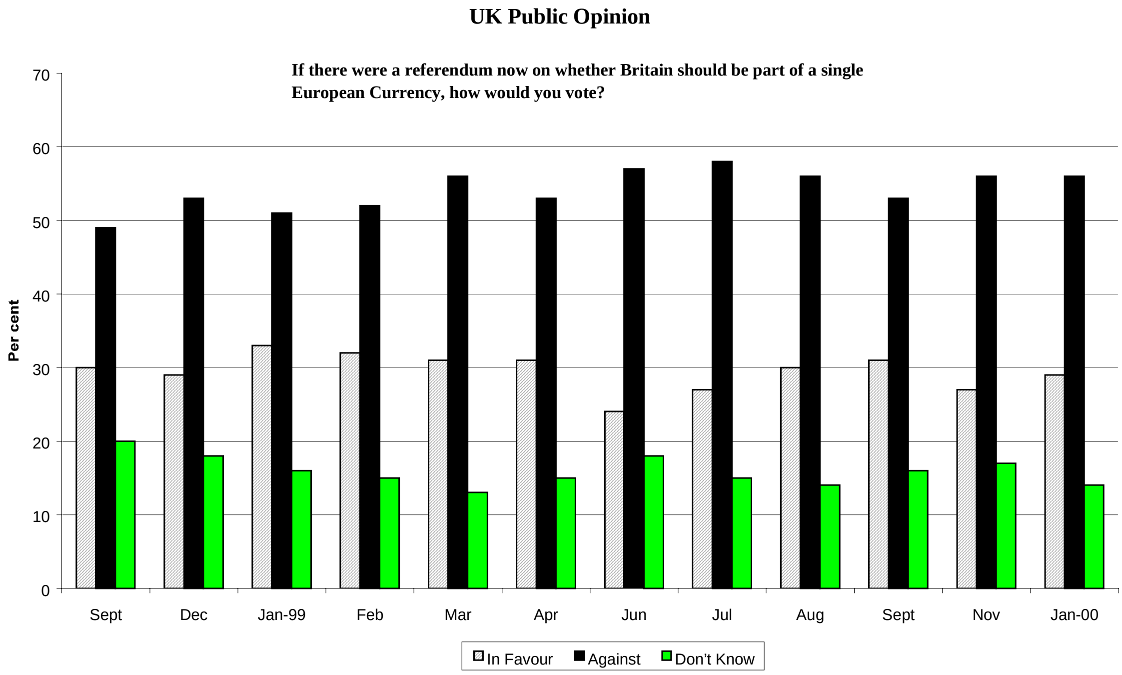
A poll commissioned by the CBI in the summer found that 52% of its membership were in favour of entry eventually, i.e. after the next general election and a period of 'wait and see'. This finding was challenged by the Business for Sterling Group, which complained that the CBI's membership was dominated by large firms and did not represent the views of the real business community. One of its polls, published in March 1999, found that only 41% of businesses favoured entry on any terms. An Institute of Directors poll commissioned in June 1999 found that 42% of its members favoured entry within the next five years and a further 24% did, but after a longer period of delay.

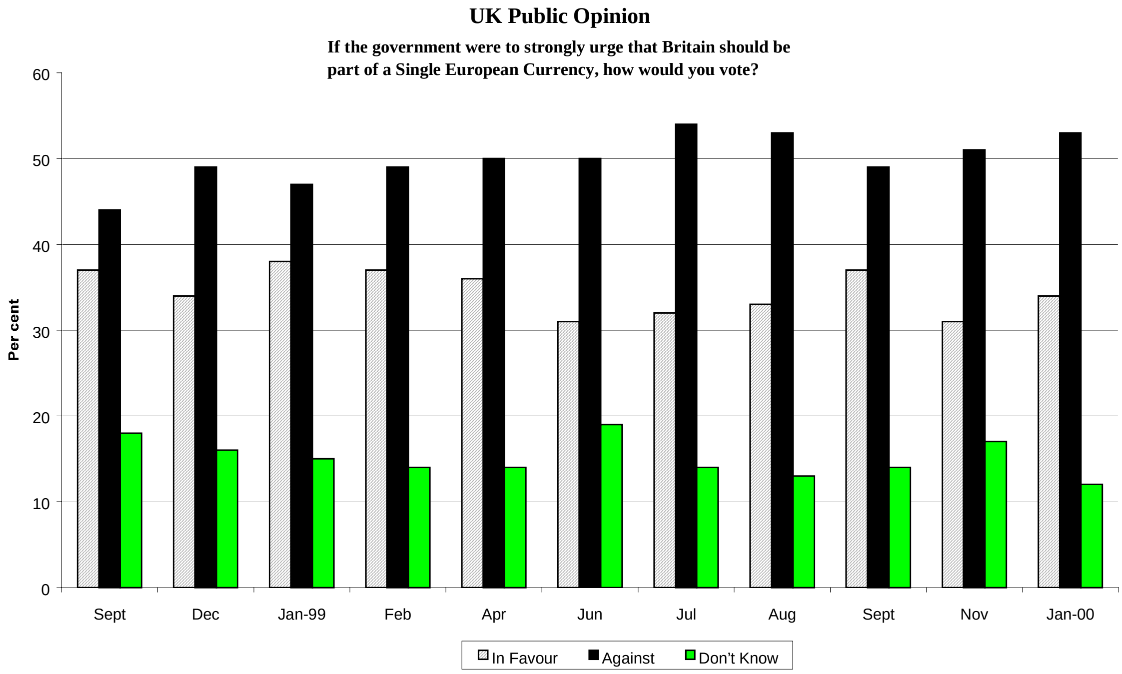
These and other polls confirmed the view that as of July 1999 most large companies were leaning towards acceptance of entry within the next five years but, a considerable number of small firms were more fearful.

A major survey commissioned by the *Financial Times* in November 1999, however, presented a picture of almost complete balance between the two camps. Although the same big/small split remained, weighting the responses by economic activity, employment and number (un-weighted) the proportions in favour of euro entry were 52%, 49% and 37% respectively.[41] Even amongst the pro-euro big business group support has declined. The group that is now 52% in favour were, in 1998, 63% in favour.

With respect to UK public opinion on the euro again the signs appear to indicate growing scepticism for the euro. A regular monthly poll conducted by Mori appears to indicate a small decline in support for the single currency over the past year. The results are shown in the graphs on the following page:

[41] Reported *Financial Times*, Business divided over euro 1 December 1999





An ICM poll of 1,000 individuals found a marked decline in support in its February 2000 survey as compared to its October 1999 survey. In October 49% of individuals were in favour of entry. This had declined to 46% in December and to 37% in February.

Across the EU public opinion is regularly recorded in the Eurobarometer series of opinion polls. The survey asked the question: what is your opinion of the following statement- 'there has to be one single currency, the euro, replacing the national currency? Unfortunately it is too soon for the survey to pick up the full impact of the first year of the euro. The latest survey includes opinions no later than spring 1999. A comparison of the results for spring and autumn 1998 are shown in the graphs below. They reveal a small overall decline in support for the euro compared with the situation pre-entry.