Euro and its Implications for India[1]

Mr.Singh and friends,

It gives me great pleasure to deliver the keynote address at this seminar today. True, a lot has already been said and done on Euro and it is not easy to be original or innovative or even funny on a subject like this at this stage. But, Euro as a subject is of great contemporary relevance to all of us. So, we have to keep revisiting it. In any case, when my senior colleague and good friend Mr.R.V.Gupta asked me to deliver this address, I could not resist.

In the presentation today, after briefly reviewing the features and the current status of euro, I will highlight the current discussions on the benefits and the risks, arising out of euro for the European Monetary Union (EMU), and implications for the rest of the world. I am bound by duty to present an update on the actions taken by the RBI on euro. The implications of euro on India's macro variables such as trade, external commercial borrowings, etc. will have to be focussed. I will conclude with a quick assessment of the Indian experience with regard to euro after January 1, 1999. You would appreciate that the assessment has to be tentative and based on an informal assessment conducted in consultations with a few relevant banks in India.

Features and Current Status

Eleven of the fifteen countries in the European Monetary System have irrevocably linked their domestic currencies to the euro. The introduction of the euro marks the culmination of years of preparatory work. The preparatory work included, in particular, satisfying what is known as the Maastricht convergence criteria. The convergence criteria for membership of EMU covered price stability, Government financial position, interest rates and exchange rates.

The technical and logistical challenges during the changeover weekend were met most satisfactorily. Thus, a common monetary and exchange rate policy has now become totally functional.

The monetary policy of the euro area is conducted by the two tier European System of Central Banks (ESCB) – the European Central Bank (ECB) and the National Central Banks (NCBs).

The ECB is responsible for framing the monetary policy for the euro area.

The NCBs of the participating countries are responsible for implementing the monetary policy set by ECB.

The primary objective of monetary policy is to maintain price stability in the euro area.

The day to day exchange rate policy is the responsibility of the ECB.

The regulation and supervising of banks and credit institutions continue to be the responsibility of the national supervisory authority.

EMU country Governments are bound by the Stability Pact to maintain relatively low levels of debt as compared to current values.

On January 1, 2002, euro notes and coins will be put in circulation along with notes and coins of participating countries. Until June 30, 2002, both euro notes and coins and national currencies would co-exist. However, with effect from July 1, 2002, the national currencies would cease to be a legal tender and would be completely replaced by euro for all transactions.

Euro as a currency started trading in the international markets on January 4, 1999. After opening at 1.1742 US dollars per euro, it weakened marginally thereafter in January and February. The euro was quoted at 1.1180-85 US dollars as of February 19, 1999.

Benefits and Risks for European Monetary Union

There has been a lot of discussion about the possible benefits and risks arising out of euro for the EMU itself. There is even greater interest in the implications for the rest of the world. It may be useful to highlight the differing viewpoints in this regard.

Benefits

First, by eliminating different currencies, the euro eliminates foreign exchange risk, including to countries that are members of the EMU.

Second, an immediate implication of the introduction of the single currency is the reduction in transaction costs. The costs associated with converting one currency into another, cross-border transfers by companies and hedging of risks are reduced.

Third, the current nationally based bond markets are transformed into a single market with common conventions. The integration of financial markets is expected to boost the supply of new issues and instruments.

Fourth, the new funding and investment possibilities in the euro-region are expected to become more efficient and competitive. As a result of increased price transparency and competition, financing costs of firms will probably scale down.

Fifth, the higher yield corporate debt market will in all likelihood become much larger in the euro zone with the elimination of foreign exchange risk. This will enable corporate credit risks to be priced more accurately.

Sixth, elimination of exchange rate fluctuations between legacy currencies or in-currencies is expected to lead to a significant increase in trade and investment within the euro area.

Seventh, it is argued that giving other countries the ability to peg their currencies to a basket of hard currencies (say a mix of US dollar and euro) might stabilise fixed exchange rate regimes.

I have listed out some of the benefits, but there are also some concerns that have been voiced about the success of euro. I will list some of them for record and I am deliberately saying for record since, in my view, the risks do not appear to carry as much conviction as the benefits.

Risks for EMU

First, it is held that the different economies in the EMU are at different levels of economic cycle, and hence there may be occasions when a single monetary policy appears inadequate to tackle the problem of growth and employment in a comprehensive manner.

Second, the stability and growth pact provides an excellent in-built mechanism to ensure fiscal discipline among the EMU countries. However, it is felt among some that the in-built mechanism may come under some stress during the early periods.

Third, some concern has been expressed by some regarding absence of clear rules on seignorage sharing and open market operations.

Fourth, since introduction of the euro, there has been some degree of volatility of euro against the US dollar. However, it is too early to formulate any medium-term view on the euro based movements in this short-term.
Fifth, it is conceded that there would be significant reduction in transaction costs, but there are doubts about the extent to which this will get translated into efficiency.

Implication for Rest of the World

It is too early to be able to assess accurately how important the euro will become in the international monetary system. It would take some time for borrowers, investors, traders, analysts and other financial market agents to become accustomed to a new currency and decide on the weight that they will assign to euro. However, in the medium to long run, there are expectations that the following benefits would emerge.

First, many feel that the euro may become a more attractive currency for bond issuers in future. In fact, the euro was the most popular currency for bonds issued in the international markets in the first month after its introduction. It accounted for approximately 55 per cent of the volume of new bond issues, compared with 40 per cent for the US dollar. This could well have been due to initial euphoria about euro denominated instruments. At this stage, we cannot state with authenticity how long and how far this trend in favour of euro will continue.

Second, there are some who are of the opinion that euro may also become an attractive currency for the investment of official reserves. Currently the US dollar is by far the most important official reserve currency worldwide. It is reported that well over half of official reserves are held in US dollar denominated assets while around one-fifth are currently held in EMU currencies. It is possible that some countries in Asia and Latin America, which traditionally have predominantly held US dollar reserves, may find it useful to consider divestment of part of their reserve holdings gradually by acquiring euro. The shift to euro assets by central banks around the world may among other factors, be motivated by its strength, its increasing use as a transaction currency and the more liquid and deeper bond market. However, it is reasonable to expect that such a shift will take place in a manner that will be non-disruptive of currency markets. In any case, it is perfectly rational to expect that there would be some coordination in ensuring non-disruptive currency movements between euro and US dollar in the same manner as G-7 currencies.

Third, some people expect that the euro could also emerge as an important anchor currency for other countries particularly among countries in central and Eastern Europe by virtue of their geographical closeness and possible economic linkages. Some of these countries, it is held, may find it useful to peg their currencies formally or informally to the euro or to a basket of currencies in which the euro is a large component.

Fourth, it is possible that international trade would find euro an alternate currency for invoicing. Roughly, 50 per cent of the world exports is invoiced in US dollars, almost four times the share of US in world trade. On the other hand, around 20 per cent of world exports are invoiced in EU currencies and 5 per cent in Japanese Yen. Almost all major internationally traded commodities are currently priced in US dollars. In the long run, it is expected that euro may become an important alternate currency for the invoicing of foreign trade.

Fifth, there is a feeling that euro may increasingly be recognised as a preferred currency for financial transactions. Trade finance could be more easily available to corporates in India and elsewhere as the European banks are expected to compete for business and are expected to extend credit at cheaper rates in order to stay ahead of each other. Also, in respect of long-term financing, those corporates that have natural hedge in euro may find it advantageous to borrow in euro and take advantage of lower costs.

It is expected by some that with elimination of currency risk and the formation of a single market, the scope for sector specific funds are attractive. Thus, raising funds for sectoral projects like financing of infrastructure projects could be easier with the introduction of single currency.

In sum, therefore, the implications to the rest of the world are not very clear but the general perception is very very positive. How important and popular would euro be, and how rapidly it would impact on the world depends on a variety of factors. In particular, it would depend on how the benefits and risks evolve.

Reserve Bank of India and Euro: An Update

The RBI had initiated, well in advance, preparatory work relating to the euro. I will quickly list the action taken by RBI before I move on to the implications of euro for India.

Steps taken by RBI

(i) The RBI commissioned a study on "EMU, Euro and India" under the aegis of Development Research Group (DRG) in the RBI. The study made an important contribution in terms of analysing the impact of euro on India.

(ii) In order to identify the measures required to be undertaken to ensure smooth transition to euro, a Working Group on Euro comprising officials from RBI, commercial banks and Government of India was set up in the RBI. The Group examined various issues concerning euro, ranging form the broader economic impact on trade and investment to micro and operational aspects relevant for commercial banks in India and also for trade and industry.

(iii) RBI continuously reviewed commercial banks' preparedness for euro, which included operational and computer system changes.

(iv) Follow up action on the recommendations of the Working Group was initiated by RBI. The follow up actions related to changes in market practices and changes in the rules of Foreign Exchange Dealers Association. A notification was issued under Foreign Exchange Regulation Act facilitating use of euro as a new currency.

(v) The RBI also convened a meeting of banks on December 29, 1999 to review and confirm their preparedness for switching to euro. Participating banks reconfirmed that the various issues relating to the transition such as setting up correspondent arrangements, opening of euro deposit accounts, training of staff, settlement instructions and changes in swift messaging standards had been addressed and action taken.

(vi) Necessary changes in software etc. were effected in the RBI systems. Training was imparted to staff dealing in euro related issues. Seminars were organised by RBI on euro and RBI officials participated in seminars organised by outside agencies.

(vii) High-level discussions were held with heads of institutions of Euro countries on emerging issues.

(viii) RBI commenced publication of Rupee-euro rate in its Weekly Statistical Supplement and RBI Bulletin.

(ix) In addition, FEDAI issued operational instructions to banks and conducted seminars/workshop for banks.

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Implications of Euro

The implications of euro on India can be analysed in terms of its probable impact on trade, external aid, external commercial borrowings, foreign direct and portfolio flows, banking related issues, technology, etc.

External Trade

The eleven countries comprising the EMU region have 25 per cent share in India’s exports and 30 per cent share in imports. There may not be any direct immediate impact of introduction of euro currency on India's exports and imports to and from these countries. But, it is expected that European corporates will become more competitive as they would rationalise, streamline and become cost efficient competitors. At the same time, the evolution of a market of a huge size in terms of euro is expected to open up many new commercial activities for businesses. This would mean Indian corporates have larger opportunities to be proactive and competitive. Sectorally, there could be scope for software exports as a result of switchover to euro.

Trade Invoicing

Indian exporters and importers are currently invoicing approximately 85 per cent of its total trade in US dollars. Shift into invoicing in euro by Indian business will depend on a number of circumstances. Oil and fertilisers, which are major items of import for us, are denominated in US dollar as per international practice. Similarly, the buyers and sellers in other countries may still continue with US dollar denomination. However, it is likely that European companies, which were earlier invoicing in US dollars, may prefer to shift to euro. Indian business will no doubt keep observing international practices, preferences of trading partners, and their own convenience in such a shift in invoicing from US dollars to euro.

Foreign Currency Accounts/Deposits

These can be classified into nostro accounts of banks, foreign currency accounts maintained in India by banks such as EEFC/RFC accounts and Foreign currency deposits accounts (FCNR-B) in DM. During the period of transition, banks can maintain nostro accounts in "in currencies" or/and euro. Banks in India have already opened nostro accounts in euro. In the case of foreign currency accounts, banks have been allowed to open accounts in euro also. Similarly, in the case of FCNR(B) deposits, banks have been permitted to offer "Euro accounts" in addition to DM during the transition period. In respect of existing fixed rate FCNR(B) deposits, the interest rates will continue till maturity. For existing floating rate deposits, as these are linked to Libor, banks have been advised to use Eurolibor, which is the successor index. For new deposits, banks have been allowed to link their interest rates either to Euribor or Eurolibor.

Foreign Direct Investment

Of the total foreign direct investment in India, EMU countries accounted for around 12 per cent. Euro is unlikely to have an impact on the existing investments in India, which are denominated in rupees. The investor can remit the funds in any convertible currency of his choice including euro. Only in the case of GDRs, if they are denominated in any of the national currencies, the issuer can redenominate to euro during the transition period. It is expected that a broader and deeper euro market would make euro more attractive.

External Commercial Borrowings

The introduction of euro could open financing opportunities for Indian corporates who have been so far largely tapping the markets abroad in US dollars in the form of bonds and syndicated loans. With euro becoming important, competition between US dollar and euro could be intense resulting in a possible marginal reduction in spreads for us. In any case, in terms of borrowed funds, India can have more options and possibly a marginal reduction in cost - both in terms of euro and US dollar market. It is expected that Indian borrowers can now have greater access to European markets in view of the larger investor base and a common financial market. In terms of long term financing, those corporates that have natural hedge in euro may find it advantageous to borrow in euro and take advantage of lower costs. There is scope for raising dollar denominated and euroloans in EMU region.

Banking Issues

Among the Indian bank branches in EMU countries, State Bank of India has branches in Frankfurt, Paris and Antwerp, while Bank of India and Bank of Baroda have a branch each in Paris and Brussels, respectively. The most significant impact for the branches operating abroad is the elimination of exchange rate risk across the EMU region, which will encourage branches to buy/sell securities across borders on a larger scale. Indian banks will no doubt face more competition than before.

Issues Related to Business/Industry

The euro will pose some challenging questions to Indian companies possibly requiring assessment of corporate strategies. I trust most corporates are already doing this. For my part, I will list a few, may be self evident, observations.

First, the euro will greatly enhance sales and procurement possibilities as currency related obstacles to the mobility of goods, services and factors within EMU region will cease.

Second, the euro region will also be attractive investment locations as they may serve as access points to the entire EMU region and the newly emerging markets of Central and Eastern Europe.

Third, selecting a business location in Europe will be easier for Indian companies as exchange rate considerations no longer matter for the choice of right business location.

Fourth, enterprises could concentrate on other critical parameters directly related to the demands of the company such as production cost, proximity to market centres and infrastructure.

Fifth, Indian companies with already established sales and production networks in Europe will face more strategic challenges. They will come under pressure from newly emerging competition within the EMU area. Innovation and cost cutting will be crucial for competitiveness and the future market position in Europe.

Sixth, managements must see the timetable for the changeover for a number of business activities including offers and price lists, new contracts, invoices, accounting and controlling, payrolls, balance sheet and profit and loss accounts.

Information and Technological Issues

Modifications may be required in the existing computer systems to include euro as a currency. The modified systems must be able to provide a linkage between the legacy currencies and the euro as all the legacy currencies are connected through euro.

Legal Issues

There should be no difficulty in Indian law regarding continuity of contracts *per se*. Under FERA, RBI has notified euro as a permissible currency and hence it will not be contrary to law to make or receive payments in euro. However, a clause on continuity of contracts has been recommended for existing contracts, which spill over to 2002 and beyond.

Review of Indian Experience after Euro

The RBI has started publishing data on rupee/euro exchange rate since its inception. The rates are also available in the RBI page of Reuters. All the banks are also quoting rupee/euro rate. Since January 4, 1999, when the first quote on euro/dollar rate was available, the rupee has appreciated against the euro during the period.

A few banks were informally contacted to ascertain their experience with regard to euro.

Some banks are also quoting euro-rupee forward premia. It is seen that generally, the six-month forward premia of euro is around 9.0 per cent annualised, implying a six-month forward rate of Rs.49.90 against the euro. Spot and forward deals are being undertaken in euro by both Indian public sector banks and foreign banks.

The recent trend indicates that most corporates continue to undertake transactions in in-currencies and no significant change to euro has been observed. However, major corporates, who manage their foreign exchange actively, have started using euro to hedge existing in-currencies exposure. As a result, the market has witnessed a few forward and swap deals in euro. A few option deals in euro have also been reported.

Some banks are still maintaining nostro accounts in in-currencies alongwith nostro accounts in euro. However, the number of nostro accounts in in-currencies has considerably reduced and the balances in in-currencies are showing a declining trend. Banks are reportedly waiting for euro transactions to pick up in order to further rationalise their nostro accounts.

With regard to trade invoicing, external commercial borrowings and FCNR-B deposits in euro, it is too early to expect any perceptible shift to euro. However, minimal as it might be, FCNR-B deposits in euro have been opened.

Banks are continuing to organise seminars in order to make them familiar about euro. Some corporates with outstanding loans in the in-currencies have received notification from lending agencies of change in benchmarks to Euribor/Eurolibor. Most of the larger corporates seem to be aware of these benchmarks. However, among the smaller companies, awareness is limited.

Finally, I expect this seminar by ASSOCHAM will also help us make an assessment of the situation and identify areas needing the attention of corporates, banks, RBI and Government.

We are eagerly looking forward to the result of deliberations today.

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[1] Keynote address by Dr.Y.V.Reddy, Deputy Governor, RBI, at Seminar on Eurocurrency and its Implications for India, at ASSOCHAM, New Delhi, on February 20, 1999. I am grateful to Dr.A.Prasad and Shri.Rajiv Ranjan for their valuable assistance.