INTRODUCTION

The Economic and Monetary Union in Europe, with a single currency for participating members, is now a definite reality. The single currency of the European Monetary Union, the ‘euro’ will be launched on January 1,1999. Effective this date, exchange rates of the currencies of the 11 participating countries will be irrevocably linked to each other and to euro. A common monetary and exchange rate policy will become effective, which will be managed by the European Central Bank. The euro will initially be used by central banks, commercial banks and some large market players. Smaller players and consumers in general are expected to shift to the euro latest by January 1, 2002, by which date euro notes and coins will be put in circulation along with notes and coins of participating countries. From January 1, 2002 to June 30, 2002, both euro notes and coins, and notes and coins of national currencies will co-exist as legal tender. By July 1, 2002, the switchover to euro will be complete, with the national currencies of the member nations losing their legal tender, and being replaced completely by euro, for all cash and currency transactions.

2. In order to study the implications of the launching of euro from 1.1.1999, the implications during the transition period from 1.1.1999 to 1.1.2002, the implications of the final switch-over to euro from 1.7.2002, and to study the measures required to be undertaken to ensure the preparedness of the Indian banking system for the transition to euro, the Reserve Bank of India constituted a Working Group under the Chairmanship of Shri V. Subrahmanyam, Executive Director. The Group comprised of officials of Reserve Bank of India, a few Indian and foreign banks and Government of India. (See Annexure X).

3. The Group examined various issues concerning euro, ranging from the broader economic impacts on trade and investment to micro and operational aspects relevant for commercial banks in India and also for trade and industry. The Group interfaced with the officials of the European Commission, Brussels, who imparted valuable information with regard to the launching of euro and the course that it is expected to follow subsequent to the launch and with the Foreign Exchange Dealers Association of India, who on the basis of the reports prepared by the working groups constituted under their aegis, gave detailed information regarding the operational changes that would be needed in the banking sector with the advent of euro.

4. This Report puts together the outcome of all the above initiatives and addresses the issue in two parts. Part I gives a detailed and consolidated narrative of the euro, its background, its general implications, its expected future course and the changes that will come about for central banks, commercial banks and their customers, as a consequence of the euro coming into existence. Part II examines the practical implications for banks operating in India, corporates and exporters.

5. The major focus of the report has been to provide an overview of the EMU and analyse the practical implications of euro for the Indian banks and corporates and an attempt has been made to prepare a comprehensive report covering all major aspects relating to introduction of euro. Important developments have been taking place in relation to euro as the Group was working on the report and every endeavour has been made to bring the report up to date. The Group trusts the Report would be useful for banks, their corporate customers, retail clients, as well as for general public who may want to be conversant with the euro and its implications, and be aware of the changes that will percolate to them and the options that will be available to them during the transition period to enable them to make informed decisions regarding their financial/banking transactions which are presently denominated in currencies of the EMU member states.

6. The Working Group also relied on the reports prepared by several banks as per the list furnished in the Acknowledgements at the end of the report.

RESERVE BANK OF INDIA
DATED : OCTOBER 31, 1998

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Economic and Monetary Union in Europe refers to the movement towards economic and monetary unification with the ultimate goal of introduction of a single currency. There are three stages for European Monetary Union (EMU). With stage III which is to commence from January 1, 1999, monetary union will be completed.

2. The Maastricht Treaty signed in February 1992 laid the foundation for the EMU in Europe. The treaty, inter-alia, laid down five convergence criteria for membership of EMU covering price stability, sustainable government financial position and convergence of interest rates and exchange rate stability.

3. The Council of Ministers meeting at Brussels over the weekend of May 2-3, 1998, decided that 11 of the 15 member states of the European Union were eligible and willing to join EMU. Greece was the only country to have failed to meet the economic convergence criteria laid down by the Maastricht Treaty. Denmark, Sweden and UK exercised their right under the treaty not to take part in the initial stages of the transition to the single European currency. The participating countries are Germany, France, Italy, Spain, The Netherlands, Belgium, Austria, Finland, Portugal, Ireland and Luxembourg. EMU comprising the eleven countries will be the second largest economic area with a single currency after the USA (It will be the largest economic area once the other members join). Nearly 30% of the GDP of the OECD is generated in EMU.

4. To ensure that EMU participants, once qualified, do not run an excessive deficit and endanger the price stability of EMU, the Stability and Growth Pact was formulated in December, 1996. Countries will face sanctions including fines if they exceed a deficit of 3% of GDP, unless the country takes immediate corrective action or faces exceptional circumstances such as recession.

5. When Stage III begins, the conversion rates of the national currencies to the euro will be fixed irrevocably and hence also the bilateral rates between the participating currencies. It has been decided that the current bilateral central rates of the EMU currencies in the ERM would be used for the irrevocable fixing of the conversion rates to the euro. This is to ensure a smooth transition from the national currencies to the euro and prevent speculative attacks on the currencies in the foreign exchange markets in the run up to the final fixing of exchange rates on December 31, 1998. The Central banks would take appropriate measures to bring these rates back to the parities announced in the unlikely event of differences arising.

6. The transition to the euro will be in three phases; during the first phase (Phase A) from May to December 1998, the European Central Bank and the European System of Central Banks were established. The legal framework and preparations by the banking sector will also be underway during this phase. In the second phase (January 1999- December 2001) (Phase B) the conversion rates between the euro and the national currencies will be fixed irrevocably. National currencies will thereafter be no more than different sub-divisions of the euro. However the euro will only exist as book money during this phase. Notes and coins will be introduced from January 1, 2002 (Phase C) and the exchange of notes and coins will be completed by July 1, 2002 at the latest. National notes and coins will cease to be legal tender from this date.

7. The switch to the euro is at varying speeds. The money, foreign exchange, securities markets and exchange and most clearing systems will switch to the euro on January 1,1999. Banking for individuals will probably be done largely in local currency upto the final changeover date. Corporate banking may well start using the euro earlier.

8. At the EU level, the legal framework for the changeover to the euro is based on two Council regulations. The first regulation took effect on June 20, 1997 and applies to all EU countries. A major component of the regulation is the confirmation of the legal principle of the continuity of contract. This means that existing contracts will remain in force with all rights and obligations – provided no other agreement has been made – after the advent of the new currency. The introduction of the euro will not result in "frustration of contract' and will not in principle, constitute grounds for unilaterally adjusting, not to mention terminating a contract.

9. The regulation also lays down, that ECU denominated receivables and payables will be converted to euro at a rate of 1:1. The conversion rates shall be adopted as one euro expressed in national currencies and shall be adopted with six significant digits. These rates which must not be rounded will be used to convert monetary amounts from national currency into euro and euro amounts into national currency. In the case of conversion from one participating currency to another, it must first be converted to a euro amount rounded to no less than three decimal places and then converted to other national currencies. This is called triangulation.

10. The regulation relating to legal status of the national currencies also called the legacy currencies, during the transitional phase January 1999 to December 2001 (Phase B), has also been passed. During the transitional phase B, anyone who wants to use the euro can, but no one can be forced to do so. New contracts and other legal instruments can be denominated in either national currency or euro. During this phase, non-cash transactions within one member country can be carried out in both euro and national currency. This principle is called "no compulsion, no prohibition". However all transactions in financial markets and those put through by ESCB will be in euro.

11. The irrevocable conversion rates for the euro must be identical to the value of the official ECU expressed in units of the legacy currencies on December 31, 1998. Since the bilateral rates at which the EMU legacy currencies will be 'locked in' are now known, the only uncertainty relates to the value of the legacy currencies against the euro. The exchange rates between the ECU and the participating currencies may fluctuate upto the last trading day of 1998 because currencies which are included in the ECU but will not participate in EMU can still influence these rates. Changes in the value of the ECU versus the participating currencies up to the end of 1998 and therefore the euro conversion rates – have no effect on the monetary value of the euro since all amounts expressed in national currency will be converted at the same rate. When the monetary union begins, the euro will become a currency in its own right and the official ECU basket will cease to exist. The external value of the euro will then develop on its own, no longer based on a currency basket of any type. One euro will be sub-divided into 100 cents and will be settled to 2 decimal places.

12. In theory, rounding errors can happen but they are expected to be minimal and on an average neither party should lose money.

13. The European Central Bank will be the central decision making body for monetary policy post January 1, 1999. Each ‘in’ country central bank will be responsible for (a) managing a portion of reserves on behalf of ECB (b) undertaking foreign exchange and reserves management operations in accordance with the instructions and investment parameters laid down by the ECB (c) monitoring collateral for TARGET (payments system) and (d) supplying the domestic markets with money.

14. The primary aim of the ECB and the ESCB is to maintain euro ‘price stability with growth’. From January 1, 1999 sole monetary competence will lie with the Governing Council of the ECB which replaces national decision making bodies such as the Bundesbank Council.

15. The day-to-day exchange rate policy is the responsibility of the ECB. The ECOFIN Council can only make general recommendations. The goal of price stability takes priority. Clear regulations exist for situations of conflict between the domestic stability (inflation rate) and external stability of the currency. ECB may not for instance pursue an exchange rate target versus the US dollar if this would threaten price stability.

16. There will be a single monetary policy and an integrated money market for countries participating in EMU. The regulation and supervision of banks and credit institutions continue to be the responsibility of the national supervisory authority.

17. The price stability expected of the euro both in terms of external value and interest rates, together with the low interest rate environment envisioned by adherence to monetary and fiscal discipline will provide for favourable trade finance terms in turn encouraging trade with the future eurozone marketplace.

18. ECB will be responsible for setting up the interest rate policy. The interest rates in euro areas will be influenced by the overnight reference interest rate to be sponsored by the ESCB (to be known as Euro Over Night Index Average, EONIA) and will be calculated as the weighted average of all overnight unsecured lending transactions in the inter-bank market. Amongst the various competitive sources for euro fixings in the inter bank market, the two main rivals will be EURO LIBOR (of the British Bankers' Association) and EURIBOR (of the European Banking Federation).

19. The ECB will not issue bonds. National EMU country governments will continue to issue debt in their own names. It is likely that EMU country governments will issue less debt in the future as they are bound by the Stability Pact to maintain relatively low levels of debt compared to current values. However, it is likely that corporate debt will close the gap.

20. The EMU has resulted in broadly positive ratings adjustment for sovereign debt issues in Europe due to removal of transfer risk and increased fiscal discipline and stable economic outlook. The EMU sovereign issues will now be assessed on the basis of stand-alone fiscal performance.

21. The real time gross settlement system being developed by ESCB (known as the TARGET) will link all RTGS systems in EU countries. It is set to be launched co-terminus with the onset of Stage III of EMU. TARGET is an inter-bank system for making payments in euro real time and on a 'payment by payment' basis. There will be standardised hours, standardised pricing and standardised intra day credit. NCBs will grant overdraft facilities only if they are fully collateralised.

22. The major positive implication of euro on business is the reduction in transaction costs and elimination of exchange rate uncertainty. However, the medium term sustainability of the financial discipline of the participating sovereigns will continue to remain as the critical factor for the success of euro.

23. For travellers to eurozone the costs will fall immediately since exchange rates will be irrevocably fixed and banks need no longer include a margin for foreign exchange risk but only a charge for administration costs.

24. For companies operating in India, the impact will be determined by the extent of contact they have with eurozone countries and the industry sector. They should assess strategic, operational and information technology issues as they progressively adopt the euro. Despite the principle of 'no compulsion no prohibition', many key European companies have already declared that they will adopt the euro as their preferred transaction currency. Therefore both importers and exporters may have to be prepared to make or receive payments in euro early in the transition period.

25. For importers, the prices of European goods and services are set for a shake up, as the euro will enable them to benefit from being able to compare more easily between eurozone countries and select on price. Exporters will have to harmonise selling prices in different markets. It may also be necessary to have the sales price in both euro and national currency.

26. Companies will be able to enter one coherent market free from impediments to internal trade with an impressive growth potential. Firms will be able to effect all their financial transactions in the entire EMU area only in one currency. This will offer ample scope for streamlining their treasury activities. At the same time competition between firms in eurozone will increase making it harder to operate in the area. All corporates will have to make sure that their business strategies live up to the demands of this environment.

27. Improved liquidity and lower transaction costs associated with euro will enhance its attraction “for issues of bonds from India”.

28. Indian companies dealing in EMU currencies in view of the “ no-compulsion no prohibition” principle are not required to invoice in or use euro till 2001. They can continue to invoice in the national currency if they desire. However as the rate between the national currency and the euro will be fixed, there is fungibility between euro and the national currencies.

29. For companies which have contracts denominated in EMU currencies there will be continuity of such contracts and they can receive in any national currency till 2001. If the contract continues beyond 2001, the payments/receipts will be in euro.

30. The money market in the Eurozone will be integrated and the overnight interest rate will be EONIA. Presently the loans/credits are linked to LIBOR or the prime rate. In future there will be two benchmarks, EURO LIBOR and EURIBOR. EURO LIBOR is like the offshore US dollar and will be based on rates quoted by 16 banks in London. The EURIBOR will be an onshore rate like PIBOR quotes. It will be collected from 57 banks from the eurozone. There is not likely to be much difference between EURIBOR & EURO LIBOR. In case of loans which are currently linked to LIBOR, they will in future be linked to EURO LIBOR which is the successor Index. The reference rate for new loans, could either be EUROLIBOR or EURIBOR.

31. As regards any existing contract where interest rate is fixed the rate will continue and there will be no change.

32. The launch of euro will provide an alternative to US dollar as a reserve currency. This is likely to have an impact on the portfolio allocation of investors.

33. The EU has been an important and growing trade partner for India. EU has emerged as India’s largest trading partner with 27 percent of India’s exports and over 30 percent share in imports. The economic reforms and liberalisation process introduced in India in early nineties has brought about significant improvement in bilateral initiatives for investment in India.

34. The advent of euro has significant consequences for the Indian Banking system. Some of the more important aspects are listed below :

i. Currently each bank has at least one nostro account for each European Currency. Over a period of time (during the transition period), banks have to take a decision on the number of nostro accounts required during Stage III and when they wish to dispense with legacy currency nostros. Banks will also have to decide on the number of euro accounts required to be maintained by them.
ii. Indian banks could avail of the pooling and sweeping services for more efficient cash management.
iii. RBI may permit banks to extend FCNR deposit facilities in euro and/or DM till 31 December 2001. Thereafter banks can offer only deposits denominated in euro.
iv. Even though there are at present several price sources, the ceiling rates of interest on FCNR deposits are linked to LIBOR. In the light of euro, new benchmarks are emerging. RBI may advise banks to adopt EURO LIBOR.
v. Banks may advise their borrowers (in foreign currency) regarding the change in respect of floating rate loans. The LIBOR linked loan will be linked to EURO LIBOR from 1 January 1999. Documentation may also be re-examined for impact and terms should be renegotiated where necessary. For new loans, banks may be allowed to use either EURO LIBOR or EURIBOR as reference rate for loans denominated in the eurozone currencies.
vi. In respect of overseas branches of Indian banks, they would be subject to host country regulations. The Chief Executive Officers at each centre should take a decision on opening of euro accounts taking into account a variety of factors affecting their business.
vii. Indian banks will have opportunities for diversifying their borrowing sources by tapping the vast liquid and diversified financial market. Indian Banks will have to gear themselves up to face more intense competition in the financial markets of EU. They will have to spruce up their systems / Information Technology to take care of the advent of euro.
viii. For investors, which includes foreign branches of Indian banks, currency performance considerations will cease to be a factor when investing within the EMU area. An array of financial instruments will become more accessible to investors via the single currency. In particular there will be a selection of bonds rated according to sovereign and corporate rather than currency risk. The single currency will have long run implications for industrial concentration, economic growth rates, tax regimes, labour costs and other factors affecting the profitability of companies in Europe.
ix. It is advisable for banks to incorporate a standard continuity clause in various agreements/documents to take care of transition to euro.
x. The emergence of euro will help create a bipolar or tripolar world. A question raised often is how strong will the euro be. This question refers to the future external value of the euro vis-a-vis the dollar and the yen. This is also related to the question of whether the euro will become an important international investment and reserve currency. The exchange rate of a currency depends on

various determinants such as real interest rates, economic growth and external position. Global financial markets are not predictable and perhaps as subject to sentiment as to strictly economic forces. It is, therefore, not possible to make a prediction on the future strength of the euro.

xi. Indian banks, IBA, FEDAI and several other organisations should take initiatives in the area of HRD, create awareness and understanding relating to euro and give wide publicity to the concept.

xii. The euro area has a long record of current account surpluses and this has the ability to finance foreign investment. For borrowers, the euro will become more attractive as a currency for international bond issues given the size and liquidity of the European bond markets. More companies can tap the enlarged euro market to raise funds in the form of debt and convertible issues for their growing investment in projects.

CHAPTER 1

EURO – AN OVERVIEW

Background to the EMU

Economic and Monetary Union (EMU) in Europe refers to the movement towards economic and monetary unification in the European Union, with the ultimate goal of introduction of a single currency. The process of economic integration in Europe began with the creation of European Economic Community (EEC), through the Treaty of Rome in 1957. The six founder members were Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Subsequent to the signing of the treaty, a common market was set up in Europe with common tariffs in member countries. Over the next few decades, the six-member EEC evolved into the present fifteen-member European Union (EU). The EU countries included Denmark, Greece, Ireland, Portugal, Spain, United Kingdom (which joined in 1992), Sweden, Austria and Finland (which joined in 1995), apart from the original six EEC member countries.

1.2 The objectives of the European Union include :

- creation of an area without internal frontiers
- strengthening of economic and social cohesion
- establishment of economic and monetary union, **including a single currency**

1.3 The genesis of monetary integration in Europe can be traced to 1981 when the proposal to create the European Monetary Fund was considered, but did not fructify. In 1986, the member States of the European Community ratified the Single European Act, which led to the establishment of the EMU Committee in 1988.

1.4 The EMU was launched in 1989 with the publication of the EMU Report. A year later, the study report 'One Market, One Money' argued for a single currency in Europe, which provided the broad contours of the present euro. This was also **Stage I** of the EMU. The idea of single currency acquired legal dimensions with the signing of the Treaty on European Union (Maastricht Treaty) in 1992. The Treaty was ratified by most EU members, a year later.

1.5 **Stage II** of the EMU started in 1994 with the establishment of the European Monetary Institute (EMI) in Frankfurt. The EMI, along with the European Commission has done most of the necessary groundwork chartered out by the provisions of the Maastricht Treaty. Stage II is manifested by a ban on central bank financing of public deficits and closer monitoring of the economic and fiscal policies of the members. The most important event of this phase has been the selection of the eleven founding members of EMU at the special summit in May 1998.

1.6 **Stage III** is to begin on 1.1.1999 with the formal launching of the euro. As ratified by the European Council meeting of May 2, 1998, with effect from 1.1.1999, the exchange rates of the currencies of the 11 member countries vis-à-vis euro will be fixed irrevocably and hence also the bilateral rates between the participating currencies. Responsibility for the single monetary policy will be transferred to the European System of Central Banks (ESCB) comprising of the European Central Bank (ECB) and the national central banks (NCBs) of the participating countries. On 1.1.2002, euro notes and coins will be introduced and the national notes and coins will be progressively withdrawn from circulation.

1.7 For the transition phase between 1.1.2002 and 30.6.2002, there will be a period of dual legal tender status for euro and national currencies. On 1.7.2002, the legal tender status of the currencies of the participating countries will be formally withdrawn. Euro will stand as the only legal currency in the euro zone.

1.8 Detailed events on the run-up to the launch of euro are given at Annexure I.

The Maastricht Treaty and the EMU:

1.9 The Treaty of the European Union (Maastricht Treaty) was signed on February 7, 1992 by the heads of states of what were then the 12 member states of the European Union. The treaty came into force on November 1, 1993. The treaty lays the foundation for the economic and monetary union in Europe. It includes seven titles, protocols and a final act. It covers provisions amending the Treaty, establishing the European Economic Commission, as also other provisions, such as those for common foreign and security policy and for co-operation in the fields of Justice & Home Affairs. The protocols provide for detailed statutory provisions, including those for the ECB and the ESCB.

The Convergence Criteria

1.10 The key to the monetary union is stipulated in the Article 109 j (1) of the Treaty, which lays down a convergence criteria that the member-states need to fulfil so as to qualify for joining the EMU at Stage III. The criteria are presented in the box given below. The Maastricht Treaty also makes it obligatory for the members-state to make necessary legal provisions to ensure independence of their central banks.

CONVERGENCE CRITERIA as laid down under the Maastricht Treaty	
PRICE STABILITY ***Average inflation rate during last 1-year should not have exceeded the inflation rate of the three member states with the lowest inflation rate by more than 1.5%.***	***LONG-TERM INTEREST RATES*** ***Average nominal interest rates on long term government bonds or comparable securities during last 1 year should not have exceeded 2 percentage points that of the average of the three best performing in terms of price stability.***
EXCHANGE RATES ***The currency must have fluctuated within the EMS bands for last 2 years without severe tensions and member must not have devalued its currency's rate on its own initiative.***	***GOVERNMENT DEFICITS*** ***GFD/GDP must be less than 3.0% or declining towards that level.*** ***Public Debt/GDP ratio must be less than 60% or approaching that level.***

Convergence among the EU members:

1.11 Adherence to the convergence criteria set by the Maastricht Treaty as a qualification for inclusion in the European Monetary Union was closely monitored through regular semi-annual reports prepared by the European Commission (EC), the executive organ of the EU, and the European Monetary Institute (EMI). The Convergence Reports prepared by the EC and the EMI in March 25, 1998 recommended the inclusion of 11 out of 15 member states in the EMU. These 11 states were considered to have achieved a high degree of sustainable economic convergence. These are Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal and Finland. These countries were accepted by the EU Council as first wave of entrants ('in' countries) or the founding members of the EMU to be launched on January 1, 1999. Out of the remaining four countries, Greece is considered not to have met the necessary conditions for joining the EMU, while three other members of the EU – Sweden, Denmark and United Kingdom (UK) have exercised their rights under the Treaty not to participate in EMU for the time being.

1.12 Eight countries - Belgium, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Finland, have met the legal provisions on national central bank independence in accordance with the Maastricht Treaty. Others, viz., France, Spain, Luxembourg and Austria have announced suitable legislation to bring about the required changes. Sweden is likely to consider these changes only at the end of this year due to legal compulsions. Denmark and U.K. are yet to ensure necessary legal changes for national central bank independence. Tables 1 to 3 appended to this report give the characteristics, economic and financial, of the euro area.

Stability and Growth Pact

1.13 In December 1996, the European Council Meeting held at Dublin agreed to the establishment of a stability and growth pact to support sound fiscal policy in the monetary union. The pact imposes on member states in Stage III of EMU, an obligation to avoid excessive deficits. Each member is expected to commit itself to aim for a medium term budgetary position of close to balance or in surplus, as well as outline an adjustment path to this target. The objective is to allow member states to deal with normal cyclical fluctuations while keeping government deficit within the reference value, which is 3%. To this end, two regulations have been agreed upon :

- strengthening of surveillance procedure and budgetary discipline
- excessive deficit procedure

1.14 By the surveillance procedure, EU member states will have to report their convergence programmes to the European Council. The EMU member states will, however, be obliged to submit stability programmes, which specify their budgetary objectives, together with adjustment path for the government surplus or deficit ratio and the government debt ratio. They will be subject to agreed sanctions for failure to act effectively on excessive deficits. The European Council will regularly examine both sets of programmes. If significant slippage from targets is identified, the Council can issue a recommendation to the concerned member-state of the EU or EMU. Such recommendations will constitute an early warning mechanism.

1.15 EMU member states that breach the 3% reference value will have to prove that downfall is due to an unusual event such as a natural disaster or a severe economic downturn. If the deficit cannot be justified, the member- state will be placed in an excessive deficit situation and the Council will issue a recommendation. Failure to take prompt corrective action - within ten months, at the most, from the date when data become available - would lead the Council to impose sanctions on a prescribed scale.

1.16 The sanctions will initially take the form of a non-interest bearing deposit at the European Central Bank, which will be converted into fines after two years, if the deficit of the government continues to be excessive. The maximum penalty in any one year will be 0.5% of the GDP.

1.17 The Stability and Growth Pact aims to follow a twin track approach : an early warning system for identifying and correcting budgetary slippages before they occur, and a dissuasive set of rules with a deterrent effect to encourage member states to avoid problems. By using a system of multilateral surveillance and sanctions, the Stability and Growth Pact is designed to guarantee budgetary discipline amongst members of the euro zone. These mechanisms are expected to encourage sustainable convergence of national economies, leading to lower interest rates and thus stronger economic growth.

The Exchange Rate Arrangement under the EMU:

1.18 Article 109 l (4) of the Maastricht Treaty provides for the irrevocably fixed conversion rates among participating EMU member countries, which forms the basis for the single currency. The European Council, will adopt the fixed conversion rates for the single currency on the first day of Stage III of the EMU, which is now fixed for January 1, 1999.[1] In a major move to reduce the speculative positions in currency markets, as well as to guard against a repeat of the ERM crisis of 1992, the European Council, exercised its powers under Article 109 l (4) on May 2, 1998 to adopt the then current bilateral central rates of the currencies of the EMU members for determining the irrevocable conversion rates for the euro. This decision is based on the recommendations of the Ministers of the EMU member states, the Governors of the central banks of the EMU and the EMI. The EMI believes that these rates are compatible with economic fundamentals of the countries, and is compatible with sustainable convergence among the member states participating in the euro area.

1.19 The 'in' NCBs will ensure through appropriate market techniques, that on December 31, 1998 market exchange rates between each pair of 'in' currencies – implied by the regular concertation procedure for calculating daily official European Currency Unit (ECU) rates – will equal their ERM bilateral central rates[2]. The Treaty requirement that the adoption of the irrevocable conversion rates for the euro must not modify the external value of the ECU (which will be replaced 1:1 by the euro), will thus be satisfied.

1.20 The bilateral central rates are given in the parity grid in the Table at Annexure II.

[1] The Maastricht Treaty provided for January 1, 1997 as the first possible date for beginning of Stage III and January 1, 1999 as the second such possible date. The Stage III is now set for the latter date.
[2] Concertation exchange rates are the rates communicated daily by the central banks of EU members as the representative exchange rate of their respective currency against the US dollar.

CHAPTER 2

STRUCTURE AND SYSTEMS FOR SWITCH-OVER TO EURO

The European Monetary Institute

The European Monetary Institute (EMI) was set up on January 1, 1994, under the Maastricht Treaty. The main task of the EMI was to prepare the regulatory, logistical and operational framework for the European System of Central Banks (ESCB) to perform its functions. According to the treaty, and the corresponding EMI protocol, the central tasks of the EMI were :

- improved co-ordination of the EU nations' monetary policies during the second stage of EMU, to support in particular the objective of price stability;
- Prepare the ground for the third stage of EMU, by integrated testing of various procedures between mid 1998 and end 1998;

The EMI was the forerunner of the European Central Bank. With the establishment of the ECB on June 1, 1998, the EMI ceased to exist.

European System of Central Banks (ESCB)

2.2 The monetary policy of the euro area will be conducted by the two tier ESCB, the European Central Bank (ECB) and the 15 National Central Banks (NCBs) of the European Union. The statutes of the ESCB and ECB are contained in a Protocol of the Maastricht Treaty, and thus have constitutional value; they can be changed only by a modification of the Treaty, unanimously agreed and ratified by all member states. The ECB will be responsible for framing the monetary policy for the euro area. The NCBs of the participating countries will be responsible for implementation of the monetary policy set by the ECB. The NCBs of 'out' countries also form part of the ESCB, but only through the General Council of the ECB.

Objectives of ESCB

2.3 The primary objective of the ESCB is to maintain price stability in the euro area. All other objectives are subordinate to this prime objective. Four other tasks in addition to ensuring EU – wide price stability as mentioned in Article 105 of the Treaty and in ESCB's statute include :

- taking monetary policy decisions for the euro zone;
- carrying out foreign exchange transactions;
- holding and managing the official foreign reserves of the member states in

accordance with the Treaty/Protocol;
- promoting smooth flow of payments in the EU.

Independence of ESCB

2.4 An essential feature of the ESCB is that it is independent from political authorities, both at the national and EU level. The independence is in the following four main forms :

- institutional independence : neither the ECB nor the national central banks may take instructions from national governments or European institutions;
- operational independence : with regard to choosing and implementing the monetary policy instruments by the ECB;
- independent personnel : members of Governing Council are appointed for long terms of office. The Executive Board members have a non-renewable eight-year term. NCB governors may have a five-year term with provisions for re-appointment;
- financial independence : independent national central banks are the sole subscribers to and holders of the capital of ECB.

European Central Bank (ECB)

2.5 The ECB came into existence on June 1, 1998. It is a legislative authority in its own right. An ECB regulation is binding in its entirety, and is directly applicable to participating member states. The ECB is expected to impose fines for breach of its regulations and decisions. However, such ECB instruments will not apply to 'out' countries. The two main decision making bodies of the ECB are the Governing Council and the Executive Board.

2.6 The Governing Council comprises the Executive Board members and the 11 Governors of the participating NCBs. It will formulate the monetary policy of the euro area, and will take decisions necessary to ensure the performance of all functions of the ESCB.

2.7 The Executive Board comprises the President, Vice president and four other full time members. The Board will have powers to implement monetary policy in accordance with the guidelines and decisions of the Governing Council.

2.8 There is also a General Council, which comprises President and Vice president of ECB, and Governors of all 15 EU NCBs. The General Council will take over the task of the European Monetary Institute in relation to 'out' NCBs, and will help prepare the decisions necessary for the 'outs' to join the single currency. The General Council will be kept informed of all the activities of the Governing Council, including the decisions on monetary policy.

Capital of ECB

2.9 The capital of ECB is 5 billion euros, to be subscribed by all the fifteen NCBs on the basis of population and economic strength (GNP) of the constituents. Each of the two factors for deciding the subscription amounts is given equal importance. The non-euro area NCBs will pay up 5 percentage of their subscriptions to the capital of ECB, and the euro area NCBs will pay up their full subscriptions. On this basis, the paid up capital of ECB will be just under 4 billion euros.

Reserve Assets

2.10 The foreign reserve assets of the ECB as stipulated by the Maastricht Treaty should be upto 50 billion euros to be held in non-EMU currencies or gold and transferable to the ECB by the NCBs upon joining the EMU. In accordance with this, the Governing Council has decided that the 11 national central banks will initially transfer foreign exchange and gold reserves equivalent of 39.50 billion euros to the ECB. This implies that with effect from January 1, 1999, an EMU participating nation's gold stock and foreign currency reserves will no longer serve the purpose of supporting the national currency, since the national currencies will only be sub-denominations of euro. The reserves of the ECB will serve to support the euro.

2.11 In addition, the Governing Council of the ECB has decided to hold gold at a proportion of 15% of the total reserves. Excess reserve assets will be held by individual national central banks, and above a certain amount, their use will require the approval of the governing council, as this could affect the efficacy of the ECB. The foreign reserve assets remaining with NCBs will be managed by the NCBs subject to the guidelines set by the ECB.

2.12 Interventions will be conducted on the basis of foreign reserve assets owned by the ECB. Interventions will be conducted either through NCBs, acting as agents of the ECB, or in exceptional circumstances by ECB itself.

2.13 Participating countries will require much lower foreign reserves in EMU than before, when they each had their own national currency to defend. One of the possible applications of the excess reserves is anticipated to be for the purpose of reduction of government debt.

Strategy for Monetary Policy

2.14 ECB will start setting the monetary policy for the 11 member states from January 1, 1999. The strategy for the conduct of the single monetary policy will include monetary targeting (where central bank controls the money supply) and direct inflation targeting (where central bank controls interest rates for a set forecast of future rate of inflation). The ECB meeting of September 1998 has announced a three pillared approach to monetary policy under the EMU, based on an explicit inflation target, a money reference value and a mix of other indicators. The monetary pillar will be the most significant. The inflation target would be a range of 2 percent or less.

Instruments of monetary policy of ECB

2.15 For the implementation of the monetary policy by ECB, three main instruments have been prepared, ***open market operations***, ***standing facilities*** and ***reserve requirements.*** These monetary instruments will enable the ECB to control short-term interest rates.

2.16 There will be four types of **open market operations** (OMO).

- Main refinancing operations conducted on a weekly basis with a maturity of two weeks. This is aimed at providing refinance to the banking system at regular intervals;
- longer term monthly tenders with maturity of 3 months in order to provide longer term finance to the banking system;
- Fine tuning operations;
- Structural operations.

2.17 The latter two will be conducted with the goal of influencing the structural position of the banking sector. The OMOs will be conducted in a decentralised manner, through the NCBs. The terms and conditions will be decided by the ECB and applied to the entire euro area banking system.

2.18 **Standing facilities** will be of two types.

- **marginal refinancing facility,** for counterparties in need of overnight credit, at an interest rate higher than the market rate and
- **deposit facility**, at a rate lower than the market rate, for counterparties with an excess of liquidity at the end of the day.

2.19 The rates for the marginal refinancing and the deposit facility will determine the ceiling and the floor for the overnight rate, which will be influenced by the rate on the regular repo tenders. It is thus intended that the money market rates move within a corridor delineated by the two standing facilities.

2.20 The ECB will have a minimum **reserve requirement system** for commercial banks, by which they are required to place funds at their central banks, in relation to their liabilities. The main features of the minimum reserve system, which will be specified by November 1998, are :

- The reserve base will comprise of bank deposits, debt securities issued and money market paper. Repos, deposits and debt securities with a maturity of more than two years will not be subject to minimum reserve requirements.

- The reserve ratios will be in the range of 1.5% to 2.5% .
- The Minimum reserve holdings will bear interest. The interest rate will correspond to the rate for the main refinancing instrument of ECB.
- A lump sum allowance of EUR 100,000 will be permitted to be deducted from an institution's reserve requirements so that institutions with a small reserve base will not have to hold minimum reserves.

2.21 The minimum reserve system will provide a level playing field to all the EMU countries. While some countries like Germany have already a minimum reserve system, compulsory reserves will be a new feature for some countries like Belgium and Luxembourg.

2.22 There will be no rediscount facility extended by the ECB. Currently, the rediscount facility is used only by a few countries within the EMU and is cost intensive, besides having other subsidisation effects. The ECB will however accept government and private assets, including private bills of exchange as long as they meet certain requirements, as collateral for lending to banks. All central bank credit, both intra-day and at longer maturity will have to be collateralised, as specified in the ESCB Statutes. The collateral shall constitute assets issued by financially sound institutions, denominated in euro, and located in euro area. This will permit greater flexibility in open market operations and allow banks, which do not have sufficient collateral in the form of government bonds to have direct access to the lending facilities of ECB.

2.23 Risk management measures to protect the ESCB against market and credit risk are also being developed.

2.24 The ECB will be required to draw up an annual report as per the Statute, and at least one report per quarter on the monetary policy.

Exchange Rate Mechanism - 2

2.25 On 1.1.1999, ERM-2 will replace the present ERM which was introduced in 1979 under the European Monetary System of the European Economic Community. The present ERM is based on the principle of parity grid linking of currencies and initially provided for a 2.25 percent fluctuation band (either way). This band was later increased to 15 percent (either way). It also in principle guarantees symmetrical and mandatory interventions from all ERM members to defend a currency which has reached the limits of its bands. The leading role under ERM is being played by ECOFIN and the Council of Ministers.

2.26 The ERM-2, will be the most important exchange rate policy 'bridge' between euro and the currencies of the member states with a derogation (those exempted from EMU participation). ERM-2 is designed to promote economic convergence in member states outside the euro area, through a currency peg to the euro, and thereby assist them in their preparation for joining the EMU. The euro will be the anchor of the ERM 2, while 'out' currencies or 'pre-in' may be linked directly and bilaterally to the anchor. Accordingly, central parities will be set for the 'pre-in' currencies against the euro, with a relatively wide standard fluctuation band of +/-15%. Narrower margins may be agreed in line with the progress on convergence. If the exchange rate of an ERM-2 currency threatens to move out of the defined band, the ECB and the national central bank of the respective country will intervene, in principle on an unlimited scale. However, interventions would be discontinued if it jeopardises the goal of monetary stability. Thus, intervention support by ECB will, in principle, be automatic and unlimited at the margin, subject to the overall objective of price stability. The burden of intervention will however be primarily borne by the central banks of the EU countries in the ERM-2. They will essentially use their foreign exchange reserves to defend their own currency. Central banks of 'pre-ins' will also have access to credit facilities.

2.27 All interventions will be in euros and not third currencies like US dollar. In order to preclude monetary policy disruptions due to large scale interventions, the sustainability of central parities will be reviewed on a continuous basis and realignments of central rates, if necessary, will be effected in a timely manner, in order to avoid speculation.

2.28 At the start of Stage III of EMU, when ERM-2 will become effective, it will have only two members apart from the euro zone countries viz. Denmark and Greece. Given the small initial membership of ERM-2, and the consequent small potential need for intervention to stabilise exchange rates, the new mechanism is expected to be less vulnerable to currency crisis than its predecessor.

2.29 Each member state is required to treat its exchange rate policy as a matter of common interest. This applies to both non-participating and participating countries from the beginning of Stage III. Even though the exchange rate will not be an immediate target for the conduct of the single monetary policy, the ESCB may decide to effect interventions in the foreign exchange market, in co-ordination with other major central banks.

Interest Rate Policy under the EMU

2.30 The interest rate policy under the EMU will be set by the European Central Bank (ECB). However, the open market operations in the ESCB will be conducted by the national central banks. Therefore, the interest rates in the monetary union will be influenced by actions of both ECB and the national central banks. ECB will however have an overriding position in the conduct of monetary policy in the single currency area.

2.31 The interest rates in euro areas will be influenced by the overnight reference interest rate to be sponsored by the ESCB and calculated by the ECB. This effective overnight reference rate in euro will be known as the Euro Over-Night Index

Average (EONIA) and will be calculated as a weighted average of all (without exception) overnight unsecured lending transactions in the inter-bank market, expressed in two decimals. The rate will be based on the transactions of the same panel of declaring banks as is accounted for in the calculation of EURIBOR. This would ensure that the most active banks located in euro area will be represented on the panel even while ensuring that the geographical dimensions of euro area are well covered.

2.32 It is possible that in due course banking associations, money and foreign exchange markets bring out alternative indicative rates representative of euro area. These could be calculated as mean rates or offered rates linked to an effective commitment to deal at these rates. However, the EONIA would retain its information value as calculations of alternative indicative rates could be problematic because of possible non-response in view of the sensitivity of the information required to calculate the indicative rates.

Payment and Settlement Systems – TARGET

2.33 TARGET (Trans European Automated Real Time Gross Settlement Express Transfer) is the real-time gross settlement (RTGS) system that has been developed to link the ESCB and the domestic clearing systems in the EU countries. All EU-central banks, will be linked through TARGET. Therefore, TARGET will also have an interface with the RTGS systems in the ‘out’ countries. TARGET has now been tested and is set to be launched co-terminus with the onset of Stage III of EMU. It is designed to facilitate trading in monetary instruments, particularly those related to open market operations. It is designed for large value payments, particularly those related to monetary policy but can be used for any cross-border euro payment. Substantial volume of commercial payments would however still go through netting system like ECU Banking Association (EBA). TARGET complies with the Lamfalussy standards.

2.34 The following will be the significant features of TARGET :

- Normal operating hours will be 7.00 a.m. to 6.00 p.m. Frankfurt time. Some facility for extended hours will be left to national central banks.
- In addition to Saturdays and Sundays, there will be two common holidays for TARGET, viz., Christmas Day, and New Years Day. On other business days TARGET will remain open, although some national RTGS systems may close on local public holidays.
- There will be a common cross-border price for TARGET transfers.
- Control procedures for TARGET have been provided by the ECB. ECB will also provide settlement services to cross-border large value net settlement systems including EBA. It will process payments for its own account, and will maintain accounts for certain international customers.
- NCBs will also provide TARGET level services to their RTGS members. It will cover the service level in a normal business day like operating time, availability

of the system, capacity, security, irrevocability and finality.

- There is provision for intra-day credit by non-euro area NCB to their own RTGS participants on the basis of a euro deposit with ESCB. Use of intra-day credit by a participant will be subject to a ceiling of 1 billion euro. After a liquidity deadline, 'out' banks can make payments only on the basis of positive cash balances. To avoid spill over risk, 'out' banks have to square their positions by close of business, or pay penalty of 5 percent over ESCB's marginal lending rate. 'Out' banks can keep overnight balances with their local NCBs, which will be remunerated at the deposit rate. 'Out' NCBs will take domestic collateral as security for their lending. 'In' NCBs can also accept this collateral for intra-day payment purposes, provided, the collateral is of the same quality as ESCB's eligible assets and the risk is borne by 'out' NCBs.
- There will be a wide variety of alternative arrangements available to make euro payments. Each EU country will have at least one national euro payment system and in some cases two (an RTGS system and a net end-of-day settlement system). All these mechanisms will be available for cross border euro payments. In addition, the 15 national RTGS systems will be linked through TARGET. In UK, the RTGS system, CHAPS EURO will be linked to TARGET.
- There are approximately 50 days on which there is a national holiday in at least one of the participating member states. Every national RTGS system will remain open on all TARGET business days.

2.35 A number of alternative payment arrangements will be competing for euro business. Some new routes will become available, in addition to the present mechanism for effecting cross border payments. While it is not yet clear which routes will be most heavily used, it is likely that there will be standard settlement methods for particular kinds of payments. A group of 31 major payment banks in Europe which has been meeting regularly, has recommended that the payment mechanism chosen should be at the discretion of the sender's bank, provided there is no specific agreement on the mechanism in the underlying contract. The sender's bank should use a route which delivers to the precise branch specified by the recipient's bank.

2.36 Individual banks will need to decide and specify the euro standard settlement instructions for each of their counterparties. This process of formulating, and distributing the instructions and their being agreed to by the recipient counterparties will require considerable efforts from all banks. An accurate database for this purpose will have to be created in view of the huge number of bank branches involved. In addition, banks with accounts in several systems may find themselves 'short' in some systems and 'long' in others. It will take some time for them to efficiently manage liquidity in all the systems simultaneously. These issues need to be addressed by the banks on a priority basis.

Options for cross-border payments within the EMU

2.37 Several clearing options will be available to banks for cross-border payments within EMU. These will include :

- TARGET, which will be operational from 1.1.1999, and which will clear euro transactions across banking industry. It will primarily be used for urgent high value payments.
- Correspondent banking, the traditional clearing method used for low value bulk payments, may continue to be the prevailing method for a majority of banks.
- EBA clearing, which is the ECU Banking Association processing centre for ECU between 49 major clearing banks. This will become the processing centre for euros, with the introduction of euro.
- Banks having pan-European network, which use their own network and access the local clearing directly.

Summary of options

	Payment type	End-to-end execution time	Geographic coverage	Service quality
TARGET	• Urgent • High value	Within minutes depending on banks involved	• All EU countries • All banks	• Real time execution • Finality of payments
Correspondent banking	• Urgent • Standard • Bulk	1-4 days depending on countries and banks involved	• All countries • Most banks	Quality differs country And bank-wise
EBA clearing	• Urgent • Standard • Bulk	Same day	• All countries • Member banks (49)	Quality differs bank-wise
European network banks	• Urgent • Standard • Bulk	• within minutes • Same day • 1-2 days	• All countries • All banks through local clearing houses	• Different services Available • Consistency across all countries.

2.38 Cost and efficiency will be the main determinants of the distribution of payment flows among the different systems. Prices for cross border payments will become more transparent, and the volume of payments will increase. Competition between payment systems will over a period of time ensure speed, reliability and economy in international payments in euro zone.

Settlement Systems in the EMU:

2.39 The standards for the use of EU Securities Settlement Systems (SSSs) have also been set out. The SSSs would be based on a set of nine standards, which would be used for settlement of credit operations of the ESCB during Stage III of EMU. These standards are expected to minimise the credit risks to which the ESCB will be exposed. The standards would ensure that adequate collateral is maintained and that a sound legal basis exists for timely payment and smooth transfer of securities.

These standards would address the settlement and custody risks as well, besides implementing a proper risk management procedure. Over the medium-term (by January 1, 2002), SSSs are expected to provide Delivery versus payment (DvP) facilities on an intra-day basis and not just on end-of-day basis. The ECB is expected to shortly publish the list of SSSs, which comply with these standards and can thus become part of the EU SSSs by January 1, 1999.

Euro and ECU

2.40 From 1.1.1999, the ECU will be replaced by euro on a 1:1 basis. All ECU payments for settlement beyond 1999 will automatically be made in euros. From the moment the conversion rates are announced, there will be no reason for a spot market in ECU distinct from the spot market in national currencies. This is because spot trades are for settlement two working days later. Any spot trade in ECU on December 31, 1998 will be settled on January 5, 1999 in euro, and will be convertible into national currencies at the fixed conversion rates. The quotation of the ECU in the foreign exchange markets as a basket will continue to be relevant only up until December 31, 1998, for same-day value. This same-day market might exist because any exceptional overnight ECU loans on that night and required to be settled through the EBA clearing system will attract interest at the usual overnight ‘basket‘ interest rate calculated by the EBA, before being converted to euro at the start of 1999. Any trades involving ECU on either December 30, 1998 or before 11.30 CET on December 31, 1998, for spot settlement will also be settled in 1999 in euros. Consequently, the spot value of ECU against the ‘in’ currencies on both these days will reflect the expectation of the irrevocable conversion rates to be set at 11.30 CET on December 31, 1998.

2.41 For the short period on December 31, 1998 from 11.30 CET until the early afternoon announcement, market rates for ECU against national currencies will presumably remain locked at the market’s own observation of the 11.30 rates. During this interval between 11.30 and the announcement, there may still theoretically be a bid-offer spread in cross rates between ECU and national currency reflecting minor market uncertainties over the exact rates observed by national central banks for purposes of fixation. In practice, however, cross-trades during this short interval are highly unlikely. Once the conversion rates have been announced, there should be no reason for any spot trades between ECU and national currencies, given the facility to convert amounts at fixed rates on the settlement day instead.

2.42 Institutions that adhere to daily valuation or end of the year valuation would require to value their ECU and national currency denominated assets and liabilities as at end-of-day on December 31, 1998. It will be left to the institutions themselves to determine whether to value these assets and liabilities at the irrevocable conversion rates announced, or to obtain market exchange rates for each currency separately. It is expected, however, that there will be very little difference between the two methods.

CHAPTER 3

PROCEDURES FOR TRANSITION TO EURO

Conversion Weekend

A good deal of work will be required to be completed by various market participants over the conversion weekend in January 1999. This chapter elaborates on some of the procedures that would assume importance during the conversion weekend and thereafter.

The Principle of 'No Compulsion - No Prohibition'

3.2 From January 1, 1999, the money, foreign exchange, bond and capital markets will switch over to euro. All new tradable debt will be issued in euro by the participating countries. All participating governments, banks and financial institutions in the EU will switch to euro almost immediately after its introduction on 1.1.1999. However, other economic agents viz., individuals, corporates and institutions will be free, but not forced to use the euro during the transition period upto 30.6.2002. The principle of 'no compulsion – no prohibition' will apply to such economic agents. They will be free to decide the optimum time for switch-over to euro, based on the costs involved in maintaining accounts in two currencies. Many European firms have formulated detailed change-over plans so that they can incorporate the changes they need to make into their investment programmes and strategic planning.

Legal Status of Euro

3.3 The legal status of euro and the national currencies (during the transition phase) is covered under Article 109 1 (4) Regulation adopted in May 1998. The Article states that with effect from January 1, 1999, the euro will be the currency of the participating member states, while the national currency units will become different denominations of the euro. The Article also covers the use of euro in private and public law. The rules give content to the principle of 'no compulsion – no prohibition' already established in Madrid in 1995. The Article provides for drawing legal instruments like contracts and laws either in euros or national currency units during the transition period. Legal instruments drawn up before January 1, 1999 will not change their denomination at this date, unless agreed or decided otherwise.

Calculation of irrevocable conversion rates

3.4 To calculate the irrevocable conversion rates on December 31, 1998, the regular daily concertation procedure for the official ECU will be used. This daily ECU procedure involves three steps.

- The first step involves each NCB of EU determining the exchange rate of its currency against the US dollar and communicating at 11.30 a.m. (CET) the mid points of the bid-ask spreads (rounded off to six significant digits), to the European Commission.
- The second step involves the European Commission calculating the exchange rates of the official ECU, using the rate recorded in the first step. The US$/ECU exchange rate (expressed as ECU 1: US$ X) is obtained by summing the US$ equivalents of national currency amounts that compose the ECU.
- In the third and final step, the official ECU exchange rates against the EU currencies are calculated (rounded to the sixth significant digit) by multiplying the US$/ECU exchange rate by their respective US$ exchange rates.

3.5 The same method of calculation, including the rounding convention will be used in determining the irrevocable conversion rates against the euro for the euro area currencies on December 31, 1998. However, in the first step, the bilateral rates between the euro area participating currencies obtained by crossing their respective US$ rates will be equal to the pre-announced ERM bilateral central rates, upto the sixth significant digit.

3.6 Hence, from January 1, 1999, the irrevocable conversion rate between the euro and each participating currency will be the only rate used for conversion either way, and also for conversions between the participating national currencies which are required to go through the euro. The rounding off may result in the implicit bilateral rates not always corresponding, to the last significant digit, to the pre-announced ERM bilateral central rates.

3.7 The announcement that the current bilateral central rates will be used for permanently fixing the rates to determine the external value of the ECU, (which will be replaced by euro at the rate of 1:1) has reduced exchange rate uncertainty, but not eliminated it. There are a number of factors which still leave scope for movement in the exchange rates of the ECU vis-à-vis national currencies in the lead up to the monetary union. These are the following :

- The ECU currency basket includes Pound Sterling, Danish Kroner and Greek Drachma, the member states of which are not participating in the EMU. Before the exchange rates are fixed on December 31, 1998, the forward exchange rates for the euro against participating currencies for settlement dates in 1999, will be equal to the market's expectation of the conversion rates, and will therefore depend on the expected exchange rates for the three non-participating currencies at the moment of fixing.
- Though the participating central banks would be expected to ensure through "appropriate market techniques" that on December 31, 1998 the market exchange rates recorded according to the regular concertation procedure used for calculating the daily exchange rate of the official ECU, are equal to the ERM

bilateral central rates (as given in Annexure II), it is not necessary that this will be easily achieved. Unless the parities are perceived by the market to be credible, speculative pressures could emerge raising prospects for some realignment of parities. One or more central banks can become involved in an acrimonious debate over who bears the responsibility for divergence of the currency from its ERM central rate and who should bear the costs of adjustments in the form of intervention losses or interest rate changes.

- While the process of calculating exchange rates of the official ECU on December 31, 1998 has been well defined in terms of regular daily concertation procedure, problems could arise if the concertation exchange rates are not representative of market determined rates. Adverse shocks, economic or political or developments in financial markets, could severely test the arrangements as EU central banks seek to alter their daily concertation rates artificially, close to the date of the launch of euro.

3.8 From the early afternoon announcement on December 31, 1998, the forward value of the euro in relation to all the 11 currencies will be known. The ability to convert national currency amounts to euro at the conversion rates at any forward date means that there will be no forward markets in national currencies distinct from the forward market in euro.

Conversion, rounding and triangulation procedures

3.9 The euro will be the single currency for the EMU from 1.1.1999. Amounts in euro will be expressed with two digits following the decimal point and the small sub-division of the euro is the ‘cent’. National currencies of participating countries will continue to exist till 30.6.2002 as different denominations of euro. In addition, the principle of ‘no compulsion no prohibition’ will not necessitate conversions from euro to national currencies and *vice versa*, during the transition phase from 1.1.1999 to 30.6.2002.

3.10 The rules for conversion, rounding and triangulation between euro, 11 NCUs and the ECU are governed by regulation under Article 235 of the Maastricht Treaty. The geographical jurisdiction of this Regulation will extend to the entire EU zone. However, the rules on conversion and rounding will be applicable to conversions between the euro and its 11 national denominations. These include conversions from a national currency units (NCU) to euro or from euro to a NCU, or from one NCU to another.

3.11 Conversion

- The conversion rates will be adopted as one euro expressed in terms of each of the 11 NCUs to six significant digits. The number of decimal places will vary from one national currency unit to another.
- The conversion rates shall be used for conversions in either direction between the euro and the NCUs. Inverse rates derived from the conversion rates shall not be

used.[1]

- The bilateral central ERM rates of the participating countries' currencies will be used only for determining the irrevocable conversion rates for each of these currencies against the euro at the start of 1999. Article 235 prohibits usage of these bilateral rates for the purposes of conversion thereafter.

Conversion between euro and other currencies

3.12 Conversions between euro and other (EU or non-EU) currencies (such as pound sterling, dollar or yen) can arise after a foreign exchange transaction, or when accounts originally expressed in a number of other currencies need to be expressed in a single currency. Settlement of such transactions will take place in the same way that foreign exchange transactions are carried out, using rates quoted in the foreign exchange markets. Conversion and rounding rules of Article 235 Regulation do not apply to the calculations made after such operations. Currently there are no universally accepted rules on conversion and rounding after foreign exchange transaction, and the introduction of the euro will not change this position.

Conversion between NCUs and other currencies

3.13 As with conversions between the euro and other currencies dealt with in para 3.12, conversion between national denomination of the euro and other currencies like the pound sterling, dollar and yen could arise for a number of different reasons including foreign exchange transactions and conversion of accounts.

3.14 There are two methods for conversion between the national denominations of euro and other currencies, viz., via the euro or by using cross rates. Both are valid but do not necessarily produce the same result when applied to the initial amount. Counterparties to a transaction may therefore wish to check with each other on the type of method adopted.

3.15 Transactions settled via the euro involve a two step conversion from NCU to euro and then from euro to another world currency.[2] When converting from a NCU to another currency, the conversion rules (but not the rounding rules) apply to the initial step (from NCU to euro). When converting from another currency to a NCU, both conversion and rounding rules apply to the latter step (euro to NCU).

- Cross rates can be used to directly exchange from NCU to other currencies It will be possible to derive cross rates by using fixed conversion rates and the exchange rates between the euro and other currencies quoted in the foreign exchange market.[3] Besides, these rates could also be derived and published by

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[1] In practice this means that when converting from euro to national currency unit, it is necessary to ***multiply*** the euro amount by the conversion factor. When converting from a national currency unit to the euro, it is necessary to ***divide*** the national currency amount by the conversion factor.

[2] This process is similar to triangulation as discussed in para 3.19 below.

[3] Although it is not expected that there will be much trading in the foreign exchange market between the NCUs and other currencies, major banks in UK are expected to quote such cross rates involving sterling

information service providers, newspapers or individuals who may calculate these cross rates themselves. The conversion and rounding rules of Article 235 Regulation ***do not apply*** to this method – neither when converting from national denomination of a foreign currency, nor vice versa. There is no universally accepted convention on how many significant figures should be quoted in the cross rates, though they are often quoted up to four significant figures.

Rounding

3.16 The rounding rules contained in the Regulation are applicable solely in the context of conversions, and will not affect the existing rounding practices in other contexts.

- The conversion rates must not be rounded and truncated while making conversions. For example, if 1euro = DM 1.96045, the rounded rate of DM 2 or DM 1.96 will not be acceptable.
- After conversion into NCU, the results should be rounded up or down to the nearest sub-unit (or nearest unit in the absence of a sub-unit) or according to national law or practice to a multiple or fraction of the sub-unit or unit of the NCU. After conversion to the euro, the result must be rounded up or down to the nearest euro cent. If the result is exactly half way, then it must be rounded up.

3.17 The conversion and rounding rules of the Article 235 Regulation apply to currency and denominations only when converting between the euro and its 11 national denominations (NCU to euro, euro to NCU or NCU to NCU). They do not apply to any other type of conversion between the euro and other currencies like US$, Sterling or Yen. The rounding rules also do not affect existing rounding practices in other contexts like calculation of interest on a loan on a daily basis, where the amount of the loan and the interest amounts are expressed in the same denominations. Examples in conversion and rounding are given in Annexure III.

3.18 The Regulation, including its conversion and rounding rules will apply in all 15 EU member states. Some governments may, under their national law, introduce additional rules governing the introduction of the euro, which could have implications for the conversion and rounding requirements in those jurisdictions.

3.19 Triangulation

- Conversion between one national currency unit and another must be done via euro. This process is called 'triangulation'. For example, in order to convert French Francs into Deutsche mark, the French Francs will first need to be converted to euro, and then converted to Deutsche mark. In triangulation, it is permitted, but not compulsory to round the intermediate euro amount to no

for their customers' use.

fewer than three decimal places. The intermediate euro amount need not be recorded in any way. Different results may be derived from the triangulation process, depending on whether the intermediate euro amount is rounded, and if so to how many decimal places. If two different parties derive different results after triangulation, they may wish to check whether the intermediate euro amount has been rounded, and upto how many decimal places.

- No alternative method of calculations can be adopted, unless it produces the same results. In practice, it is difficult to prove that alternative methods of calculation do produce the same results as the triangulation algorithm. The onus of proof and the legal risks will rest with the person using the alternative method.

3.20 A table summarising the situations when the various methods of conversion should be used is given in Annexure IV.

Financial markets and exchanges

3.21 Money foreign exchange and bond market associations have proposed a harmonisation of market conventions in preparation for the euro. Some EU governments, on suggestion from market associations, have either already decided to use harmonised conventions for the new government debt in euro, or are currently examining the issue. The changes in the money, foreign exchange and bond markets expected after the introduction of euro. Table 5 appended to this report gives the changeover dates for the money, forex and bond markets. The proposed harmonised conventions in these markets are summarised below.

Money and foreign exchange markets

3.22 Immediately upon the introduction of the euro, during the first week of January 1999, interest reference rates would sought to be fixed.

Interest reference rates

3.23 There will be competitive sources for establishment of benchmarks for European short-term interest rates after the commencement of EMU, similar to the current LIBOR, PIBOR, FIBOR, SIBOR. The two active rivals will be British Bankers Association (BBA) with their benchmark EURO LIBOR, and the European Banking federation (EBF) with EURIBOR. Hence,

- fixed interest rates in legacy currencies will become fixed interest rates in euro
- BBA's ECU LIBOR will be replaced by EURO LIBOR
- Individual countries' LIBORs will be replaced by either EURO LIBOR or EURIBOR.

3.24 The main difference between the EURIBOR and the EURO LIBOR stems from the choice of participating banks. The EURO LIBOR will be, like the current LIBOR, the average of eight to sixteen lending rates of the most active and creditworthy banks in the London market. By contrast, EURIBOR index will be an average of rates quoted by a much larger panel of banks (initially 57), including atleast one from each member state within the euro area. The panel will be the same as that for the overnight reference rate for the euro, EONIA published by the ESCB. (See para 2.31).

3.25 With effect from January 1, 1999, EURIBOR will replace the national reference rates of all participating countries. Most EU countries have announced that they will replace national benchmark rates with EURIBOR for new and existing contracts.

3.26 International market participants may prefer to link new transactions to EURO LIBOR in order to avoid the basis risk, in relation to wholesale money market positions in London, and existing LIBOR based assets or liabilities. Domestic market participants in the euro area may prefer to use EURIBOR, which will replace the national inter-bank rates.

3.27 Market participants expect that there would be a spread between the two rates due to their different coverage. EURO LIBOR is likely to be lower than EURIBOR, if ECB reserve requirements impose a cost on deposit taking by banks established in the euro area. The ECB has decided to pay interest rate on the reserves. Since EURIBOR panel may contain some banks with low ratings, the reference rate could incorporate a risk premium which could set it higher than the EURO LIBOR benchmark. Hence, it is possible that EURO LIBOR : EURIBOR spread would be actively traded using basis swaps.

3.28 The table at Annexure V gives a comparison of the two benchmarks, EURO LIBOR and EURIBOR.

Market conventions

3.29 The market conventions for money, market foreign exchange markets and bond markets are given in Annexure VI.

3.30 The Bank of England has proposed that the euro should be quoted against the sterling on the basis of euro 1 = Pound sterling X. All market operators in London have been recommended to adopt this convention to avoid the risk of confusion and error.

Euro and the capital and bond markets

3.31 From the start of Stage III of EMU i.e. from 1.1.1999, all new government debt issued by participating member states will be in euro. Furthermore, the existing tradable public debt will be redenominated in euro. This would create sufficient liquidity in euro from the start of the Stage III itself. It will also help underline the credibility of member states' commitment to the EMU. The national authorities have also agreed to use the new harmonised market conventions for new debt as well as for redenominated debt .

3.32 All the exchanges in the euro area will convert to euro on January 4, 1999. This in effect means that all listed securities will be quoted and traded for settlement in euro. Bonds/equities denominated in national currencies will trade in these currencies, although cash consideration of each transaction will be calculated and expressed in euro. The final settlement in national currencies will be done by the intermediaries, viz., banks and brokers.

3.33 At the start of the transition period, local securities settlement, infrastructure and mechanisms are likely to remain unchanged. As the markets consolidate over time, it is anticipated that trading and settlement activity will concentrate, possibly in a regional cluster. National SSSs will need to align hours and agree on policies regarding local holidays. Over time, regulations would be harmonised as well. The move towards a pan – European exchange has already commenced, though it will take some time before it materialises.

3.34 Euro will eliminate currency risk within the euro area, which means that any remaining interest rate differentials or yield spreads in the euro bond markets will derive from differences in credit quality, liquidity, taxation and market infrastructure such as efficiency of distribution methods, and ease of settlement. The interest rate differentials will not be large in most cases, and the spreads are expected to fluctuate around 15-20 basis points. It is anticipated that while spreads stemming from market liquidity will probably be smaller than in the pre-EMU phase (due to the fact that bonds are denominated in the same currency) spreads stemming from credit risk could become somewhat larger.

3.35 As stated in the above para, spread differentiation on account of credit risk will remain important within EMU. This is because, there is no legal constraint on deviating from the fiscal deficit norm, and therefore from the level of outstanding debt, despite the stability pact, once a country has entered EMU.[3]

3.36 The euro bond market is expected to become bigger and deeper than the national currency markets on account of the following :

- A bigger investor base as compared to the national currency markets should encourage securitisation of debt. Bank borrowings comprise more than half of financial assets in the 11 EMU countries, but less than a quarter in USA.
- Investors will have a greater appetite for credit risk because of the removal of currency risk, bringing more demand for paper rated below AA.
- EU pension fund assets are expected to increase and funds are likely to have more freedom to invest in a wider range of euro assets.

[3] Moody's have stated in a special comment on Credit risk implications of EMU, that possible future increases in fiscal deficits, and therefore credit risk, must be taken into account when assigning the individual ratings of governments within EMU.

- Potential use of euro as a more important reserve / anchor currency than the national currencies that it replaces, will create demand for high quality debt and improve market liquidity.
- Euro area governments will continue to issue debts in their domestic markets, as well as in the international markets in some cases, though the Stability and Growth Pact ensures that market share of government debt will be reduced. To the extent regulatory restrictions are relaxed investors are likely to diversify across 'in' government issues to eliminate any excessive yield differences. The erosion of their captive domestic investor base will put governments under greater pressure to move their domestic markets in the direction of international best practices regarding transparency, issuance techniques, settlements, taxation, development of repo markets etc.
- The international euro market will remain the primary market for large international issuers that are well known to international investors. Some issuers may switch from the international market to domestic market, as in the case of 'in' governments who had previously issued in other EU national currencies. But the international distribution network of large investment banks will continue to attract bigger international issuers that want to use the international euro market in order to tap a wider investor base both inside and outside the euro area. The international euro market will benefit from the expected increase in euro issuance by EU corporates, if it is able successfully to market the lesser known issuers, perhaps rated below 'AA'.
- Domestic markets will also benefit from any additional non-government issuance. Some expectations are that the existing national markets will continue, as national investors will continue to have regulatory and tax incentives to invest in domestic assets, and local investors will be better able to assess the credit risk of local issuers. There is, however, another expectation that barriers between domestic markets will break down over time. Restrictions on issuers and intermediaries are likely to be removed quickly. For example, Bundesbank will remove the 'anchor principle', under which lead managers for DM bond issues in Germany must be incorporated locally. Similarly, the French authorities have announced that they are removing the distinction between international and domestic French Franc issues.

Market conventions in the Bond markets

3.37 The recommendations of the European Bond Commission on euro bond markets are given at Annexure VII.

Redenomination, Renominalisation and Reconventioning

3.38 In theory, all market participants will be free to choose either their local currency or euro for any securities transactions during the transition period. However, it is anticipated that the EMU securities market will move towards trading in euros from day one. All market quotes, local securities depositories and cash clearing houses will shift to euro. All 'on market' transactions will be in euro. For 'off market' transactions, participants will have the option to trade in euro or the local currency. However, given the situation, both issuers and subscribers will be comfortable if the national currency denominated securities are redenominated in euro.

3.39 Conversion of securities covers three distinct processes :

- Redenomination
- Renominalisation
- Reconventioning

3.40 **Redenomination** is a prerequisite to renominalisation and reconventioning. However, each of these processes can occur either at the same time or independently of each other at any time during the three year transition period. Much of the euro-zone Government debt will be redenominated over the conversion weekend.

3.41 Redenomination refers to the change of the unit in which the amount of outstanding debt is stated from a NCU to the euro. This can be achieved in two different ways:

- Bottom-Up method - where, each investor's holding is converted at fixed conversion factors and rounded;
- Top-down method - which assumes that the issue is divided into fixed number of units of the denomination increment size. Each unit is then converted, rounded and multiplied by the original fixed number of units. This process is unlikely to result in round euro amounts and as a result some issuers may choose to 'renominalise' as well.

3.42 **Renominalisation** refers to a change in the minimum nominal amount in which the security issue is held and traded. It occurs either immediately after redenomination or at some other future time. The purpose of renominalisation is to create more convenient trading amounts. This can be achieved in two ways :

- a)Reducing the minimum nominal amount to one euro cent. This is the method chosen by Germany. b) The issuers will make cash repayments in respect of the odd lots resulting from repackaging to a round euro amount. This is the approach being adopted by France in respect to its government debt.
- a)Re-packaging an odd amount into a round euro amount, either the nearest euro amount or some larger euro amount b) a secondary market trading and repackaging the odd lots.

3.43 **Reconventioning** involves adjusting the euro related terms and conditions of the bond, as part of the conversion process. One of the main areas where reconventioning will occur is in the harmonisation of different market conventions. This in particular, affects the day count for calculation of accrued interest.

3.44 Redenomination, renominalisation and reconventioning is expected to lead to greater liquidity for the euro market from the very start. Higher liquidity may then lead to better prices. However, individuals/corporates will have to keep in mind the cost involved in redenomination, which may be prohibitive in the case of small issues. Furthermore, renominalisation-reconventioning may require the approval of bond holders in some countries, or suitable legislatory support.

3.45 Details of all the individual securities that will be redenominated/and or reconventioned over the conversion weekend, and afterwards need to be made available to the whole market, as soon as possible. These will be available on Euroclear website. All individual government issuers will confirm the necessary detailed information about the redenomination of individual securities for proper planning for the conversion weekend.

3.46 Non Government debt would not be redenominated immediately during the conversion weekend because such bonds will be traded in euro whether or not they are redenominated, due to cost factors and there are no presentational advantages, as in the case of Government bonds. Furthermore, the volume of systems work needed to convert cash positions and redenominate government bonds is already enormous. It is expected that national authorities would discourage this practice by putting in place financial disincentives. If non-government issuers wish to redenominate, they should do so at a later date during the transition period, either on a limited number of days set aside in advance by the national authorities or on a coupon date.

Taxation in EMU

3.47 Work relating to harmonisation of tax rates within the EMU countries is yet to be taken up. The greater price transparency that monetary union will bring about, will make governments more sensitive to unfair policies to gain advantage. The European Commission has launched a ‘Draft Code of Conduct for Business Taxation’. This is a non-binding code of conduct to tackle ‘unfair’ tax competition between member states. Despite this, member states are expected to inform each other of existing or proposed measures that may lead to unfair tax competition. The areas that might be affected by this code of conduct are :

- Luxembourg’s lack of withholding tax on foreign savings deposits;
- Ireland’s docks schemes to attract financial services;
- The Netherlands’ co-ordination centres which offer tax breaks for multinationals.

SWIFT

3.48 SWIFT has already issued guidelines on the impact of euro on its messages, during conversion to euro. These guidelines have been endorsed by the SWIFT EMU Standards Working Group, which included experts from major user countries, Euroclear, European Committee for European Standards (ECB) and European Monitory Institute (EMI). The changes in message standards are being kept to a minimum by SWIFT. No new messages or fields are needed but new code words have been introduced in order to support the communication of Euro Related Information (ERI). In particular, during the transition period, if information is necessary both in euro and in ‘in’ currencies in a message, the same may be provided as ERI, in a free text field. The euro code (EUR) is available for testing from April 1998, and is available for live use for settlement messages carrying a value date on or after January 1, 1999. The national currency codes of ‘in’ currencies and the ECU code will remain on the network, until the maintenance agency of ISO currency codes advises their deletion.

3.49 ERI will allow transport of euro related information, in particular the original currency and amount, in the free text fields of SWIFT messages. The basic principles of ERI are :

- Its use is optional; institutions will decide with their correspondents if they wish to use it.
- It may only be used when the settlement amount is expressed in euro and the original amount is in ‘in’ currency denomination.
- It may be used only in messages which do not have existing fields to specify the information.
- It is for information purposes only. In case of any discrepancy between the ERI and the settlement amount (or net proceeds) specified in the message, the settlement amount will prevail.

3.50 SWIFT has analysed different market scenarios and has published lists of messages likely to be used with or without ERI, during the conversion weekend. SWIFT has also prescribed ERI validation rules. The network will validate the structure of ERI but not its content.

ICC Decision

3.51 The International Chamber of Commerce, the world business organisation based in Paris[4] by its decision of April 6, 1998 does not amend the ICC rules in any way. Instead it has held that the introduction of the euro shall not have any effect of altering, discharging or excusing performance under any instrument subject to ICC rules. This decision emphasises the need to correctly interpret and apply ICC rules. All national committees of the ICC have been advised to interpret this decision widely. Continuity of contracts will not be affected by euro.

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[4] The ICC Commission on Banking Technique & Practice develops and maintains uniform rules for international trade, including Uniform Rules for Contract Guarantees, Uniform Rules for Demand Guarantees, Uniform Customs and Practices for Documentary credits, Uniform Rules for Collections, Uniform Rules for Contract Bonds and Uniform Rules for Bank to Bank reimbursements. All these rules are collectively called ICC Rules.

3.52 The above principles affecting national currency are legally binding in all EMU participating states and apply equally to payments to be made in a national currency unit by persons located outside EU. This is on account of the generally accepted legal principle that the definition of what constitutes legal tender is governed by the law of the country whose currency is involved. Banks in India should take care to subject all letters of credit and other documentary credits to the ICC rules of April 1998 along with the normal rules.

3.53 The consequences of the introduction of the euro in practice under the various ICC rules have been summarised in the table at Annexure IX.

CHAPTER 4

INTERNATIONAL IMPLICATIONS OF EURO

Advantages of euro

The euro is acknowledged to have strong advantages and disadvantages. The biggest advantage is the exchange rate certainty that the euro will bring about for the 11 participating countries. Euro presents an opportunity for the investor to invest in a broader market without the currency risk and to achieve portfolio diversification at the same time. On the down side, the biggest drawback is that member countries will have to live with the same monetary policy and the same short term interest rates, whether or not they are appropriate to the specific economic conditions of a particular country.

4.2 Some of the benefits of the euro are listed below :

- The immediate implication of the introduction of the single currency will be the reduction in transaction costs. Costs associated with converting one currency into another and costs associated with foreign exchange management and cross-border transfers by companies will be reduced.
- By sharing the same currency, the euro zone will develop into a single, wider, deeper and more resilient capital market. This will enhance liquidity, and spur the development of new financial instruments in euro.
- New funding and investment possibilities will open up, which will bring down financing costs of firms, and complete the integration of the financial markets. The higher yield corporate debt market will in all likelihood become much larger in the euro zone with the elimination of foreign exchange risk (on intra-zonal corporate debt investments) enabling corporate credit risks to be priced more accurately.
- Markets in the eurozone are expected to become more efficient and competitive. As a result of increased price transparency, and consequent competition, prices will probably scale down.
- Elimination of exchange rate variation between legacy currencies is expected to lead to an increase in trade and investment within the euro area.

4.3 There are, however, some concerns which run deeper than the benefits listed above. These relate to the medium-term sustainability of the convergence criteria, particularly on budget deficits and public debt, critical to the success of euro. All countries in Europe would be required to make sustained efforts to meet the convergence criteria, especially getting the deficit to 3% or less. The issue that is now being debated particularly by the ‘out’ countries is whether the fiscal rigour that is necessary to sustain a single monetary policy for disparate economies can be sustained with prevailing high levels of structural unemployment. Moreover, the ECB will have to exercise some flexibility, especially in relation to constraints on fiscal deficits imposed by the Stability and Growth Pact. With fixed conversion rates under the EMU, single short term interest rate, limited cross-border labour mobility and no scope for fiscal redistribution across Europe, the only avenue available to governments for adjustments will be to maintain tight fiscal discipline.

4.4 Another issue being raised is whether the current central rates are a reflection of the relative economic situations within the EMU. The other issue is whether the fixed parity rate enhances the competitive position of certain countries within eurozone. Lastly if exchange rates were previously used as adjustment variables in the event of economic disequilibrium, it is debatable whether there will be recourse to different kinds of variables now that the exchange rates are fixed. Further, it would be difficult to define an appropriate consumer price index (CPI) because of problems in measuring price trends in 11 different countries. The fixed parities of the eurozone may not be able to prevent the emergence of economic disparities within the EMU.

Bank mergers

4.5 Competition in the financial sector in EMU will be much more fierce across whole range of products. With the disappearance of frontiers in Europe, cross-border mergers may become useful and appealing. A market freed by a common currency may be exploited better with a strong partner. In the past few months several US banks announced plans to merge with other financial institutions in a bid to get a strong footing in Europe to provide a challenge for Europe's universal banks, by setting up universal banks themselves with a transatlantic reach. It is likely that within the European Union also, some merger activities will gain ground to counter bank mergers in non EU countries out to get a share in the European market.

4.6 There will be significant restructuring with increasing market concentration around large commercial banks with an international presence on the one hand, and smaller specialised providers of financial services on the other hand.

Euro as a reserve currency

4.7 The launch of euro could provide an alternative to US dollar as the most important reserve currency. As a dominant currency in one of the world's largest trading blocs, the euro's role as an international investment, reserve and trading currency is likely to grow. The present shares of the EMU currencies in reserves are generally much lower than their share in GDP or international trade and therefore there is an under representation of European currencies in international portfolios. Whether in each of these markets that share will increase and the dominance of US$ as an international currency will be challenged, would depend on the interplay of several factors and is difficult to predict just yet. The dollar accounts for nearly two thirds of official foreign currency reserves world-wide. (See Table 6 and 7 appended to this report). However, central banks may increase the amount of euro investments they hold in their portfolio. Some countries, especially the small ones on the EU's periphery may even decide to tie their currencies to the euro so that they will have to keep the bulk of their reserves in the new currency. However, the view from the US is that the dollar can successfully co-exist with the euro, even if euro does increase in popularity.

4.8 The introduction of the euro will make it easier for central banks to invest in triple-A government treasury bills, of which there will be ample supply, and which are typically subscribed to by risk averse central banks. However, even this diversification of reserves portfolio in euro will depend on several factors, including the role of the euro as an anchor and vehicle currency.

4.9 Larger shifts may take place in private portfolios. Nearly identical interest rates in the private market for interest rate swaps in different EMU currencies suggest that with the introduction of euro in these markets will transform into a single liquid and deep private capital market in euros. There will also develop a liquid and deep market in government bonds denominated in euros.

4.10 A table on the international uses of major currencies before and after the euro is given at Annexure VIII.

Nostro accounts and euro

4.11 At present banks generally maintain at least one nostro account in each country in order to make payments in the country's currency via the local payment system. With the euro it will be possible to make euro payments to any participating member state from any account held in any other participating member state.

4.12 Banks will have to look into consolidation of their existing nostro accounts in each foreign currency of the 'in' countries to one or more euro accounts. Banks of 'in' countries will be changing standard settlement instructions which will enable them to move from a position in which payments in the various national currencies are made and received via one or more correspondents in each country across the national currency payments system, to a position in which all payments (euro and any national currency) are made and received by a participant itself or via a single correspondent which is a member of the national RTGS system connected to TARGET, or a member of other euro payments system such as the EBA clearing.

4.13 Transactions in ECU entered into before the onset of Stage III but maturing subsequently will automatically convert to euro, and must be settled in euro.

4.14 Outstanding transactions in any national currency will remain in that currency during the transition period, unless and until the parties agree bilaterally to convert to euro. Any such conversions should be irrevocable.

4.15 In cases of forward foreign exchange transactions involving two EMU currencies, the parties implementing the bilateral agreement to convert the underlying transactions should decide whether to leave the transaction in any national currency, convert it to euro or close it out immediately.

4.16 In case of payment netting, most market participants will not net amounts in underlying transactions that are in different national currencies, even if both parties use a euro nostro, because few have the systems capability to perform such netting. If market participants wish to net payments, they should convert their transactions in national currencies to euro with the bilateral agreement of the counterparty.

4.17 From the conversion weekend in January 1999 onwards, market participants will need to be able to look at their positions in participating national currencies as positions in euro at the conversion rates. Until all transactions are converted to euro, banks will need to have the capacity to create combined positions.

4.18 Consumers who opt for denominating all their transactions in euro during the transition period 1999-2002, can draw legacy currency notes and coins from just one euro account or a set of euro accounts in each country. Likewise cash – notes and coins – of legacy currency can be deposited into a euro account.

Financial Markets

4.19 At the end of 1997, the market value of bonds, equities and bank assets issued in EU countries was more than USD 27 trillion, roughly the same magnitude as World GDP. Euroland has the potential of becoming the largest financial market in the world.

4.20 EMU will create the second largest bond market in the world. With the total volume of outstanding bonds in EMU currencies, and the ECU of USD 7 trillion, the euro denominated bond market will be equivalent to 50 percent of the dollar bond market and 130 percent of the Yen bond market. The EMU bond market will be characterised by higher volumes of bond issues under broader range of instruments. This will also enhance the liquidity of the products. Yield differentials between euro denominated assets, e.g. government bonds will no longer entail exchange rate risk premia. Interest rate spreads will be determined only by the differences in the credit risk rating of the issuer and by market liquidity and will be much lower than have been so far.

4.21 Growing competition will also intensify the trend of disintermediation of corporate borrowing. There will be a shift from bank financing to debt security financing. The new asset classes such as asset backed securities are gaining in importance for the same reasons.

4.22 The euro equity market will be second only to that of USA in terms of market capitalisation and turnover. However, the ratio of market capitalisation to GDP at 44 percent in the euro areas is still significantly lower than that of USA (139 percent) or even Japan (50 percent). What is more important is that the EMU equity markets are highly segmented along national lines today. The elimination of the exchange risk in eurozone will increase transparency and competition. This will accelerate the integration of markets. There will be a shift in emphasis from currency to various sectors such as institutional investors and Pension Funds as currency matching rules between assets and liabilities will become irrelevant for euro denominations. A key factor in the potential for growth of the eurozone equity market is the expectation of stable and low yields on euro bonds which beyond a stage will inhibit private investor interest in eurozone bonds and turn it towards equity investment instead.

UK and EURO

4.23 UK has decided not to participate in the EMU for the present. It is therefore one of the 4 ‘out’ or ‘pre-in’ countries. For the present it may also not join ERM 2. It has however given its intention to join the EMU if the single currency works and is successful. Remaining out would not mean that UK will not be concerned with the development of the single currency and its market. It is being ensured that UK's infrastructure is developed to allow any one who uses euro in wholesale payments, and across financial markets to do so from the first day of EMU. The financial community is being prepared in particular for the introduction of euro by explaining as widely as possible the relevant issues, identifying areas of co-ordinated activity and identifying and filling gaps where required. The UK’s commitment to euro reflects London’s commitment to maintain its pre-eminence as a financial centre for Europe.

4.24 CHAPS Euro will be available to make euro wholesale payments within UK, and cross-border to and from UK from the start of 1999. CHAPS Euro will be priced competitively, as EMI had indicated that the prices of cross border and domestic transfers in euro should be broadly similar, even though pricing of payment transfers within national RTGS would be a national decision. The capacity of CHAPS Euro will be flexible so that it can adjust to any increase in demand. Furthermore, CHAPS Euro will remain open on every day that TARGET is open, i.e. every week day except Christmas day and New Year day, even when it is a public holiday in UK. The system will allow wider direct membership. Applications for direct memberships from overseas banks on a remote basis will also be allowed, although, given the number of banks already operating in London, this option is unlikely to be exercised by a significant number of banks.

4.25 The CHAPS Euro will be a robust and efficient Real Time Gross settlement System (RTGS), like the sterling RTGS. TARGET would also be made efficient and as attractive to users as possible. UK has also decided that commercial banks operating within UK will be able to make and receive TARGET payments, which may involve scheduling payments or obtaining their own credit where needed. In addition Bank of England is also exploring the possibility of providing its own credit if necessary. Irrespective of the rules governing payments systems there will be active euro markets in major international finance centres outside the euro area. Payments and settlements will take place in the most efficient, reliable, and competitive routes.

4.26 Finally, the emergence of euro will mean that London's status as a premier financial centre will be under strong challenge from Frankfurt (which enjoys the advantage of home base of ECB) and Paris (which is a strong base for derivatives trading).

Euro and SDR

4.27 SDR has a weight of 40% dollar, 43% for European currency and 17% for Yen. The European currency therefore has the largest weight in SDR. The IMF has decided that after launch of the EMU in Europe, on January 1, 1999, the euro will replace the current currency amounts of the DM and the FRF in SDR valuation basket, which includes the currencies of Japan, U.K. and the US. The specific amounts of euro and the valuation basket which will replace the DM and the FRF respectively will be announced by IMF promptly following the announcement of the conversion rates between the euro, DM and FRF of the European Council. The financial instruments in the SDR interest rate basket, the market yield of three month treasury bill for France, the U.K. and the US, the three month inter-bank deposit rate for Germany and the three month rate on Certificate of Deposits in Japan, will remain unchanged although the French and the German instruments will be expressed in euro. In line with the currently effective decision on the SDR valuation and interest rates basket, the next revision of the SDR will take place not later than the year 2000 with any changes to take effect on January 1, 2001.

Europe and Asia

4.28 Europe and Asia are important trading partners for each other. USD 146 billion worth of goods and services, i.e. 14 percent of Asian countries' aggregate exports were exported to the EU in 1996, more than three quarters of which went to the member states of the EMU. In the opposite direction, about the same quantum, namely, USD 146 billion was imported by the Asian economies from EU. This amounted to 16 percent of the region's total imports.

4.29 The weight of the Asian region in determining the future international currency structure is indicated by its important role in international banking and bond markets, its share of global currency reserves and rising presence in world trade.

4.30 A decisive factor in the eventual importance of the euro in the global markets is its acceptance as a reserve medium by other countries especially those with large currency reserves. Asia's financial weight is particularly apparent in this regard. With regard to the level of international reserves, the top five in the world are located in Asia viz. Japan, China, Taiwan, Hong Kong and Singapore. Japan alone holds 14% of the world's reserves. Asia's share will rise further, as part of the reserves held by central banks in Europe will become obsolete.

4.31 The current strong dollar orientation of the global trade has been particularly evident with respect to Asian trade. The invoicing in Asia has taken place mostly in US dollar for a variety of reasons. A large proportion of trade is in raw materials, which is typically denominated in US dollars. US is also the most important market. The dollar's sway in Asia at the expense of Europe has been enhanced by the fact that given the many different European currencies, capital markets were relatively illiquid in each individual currency and change in currency reserves and invoicing structures were saddled by high transaction costs. The move to euro, will in the long run lead to a levelling of international currency structures and reveal the economic significance of each underlying currency area. The dynamics of globalisation can also be expected to favour euro since EMU firms with production bases in Asia will tend to invoice in euro particularly if they source their components from Europe or export to Europe. The attractiveness of euro as a trading and payment currency for Asians will definitely increase.

4.32 The likely reorientation of Asian countries towards bond markets and away from bank credit could lead to a broader international use of euro.

4.33 It can be expected that EMU will attract new Asian business ventures into Europe. A number of reasons which upto now might have discouraged companies from European investment will disappear, such as comparatively small and highly fragmented product and financial markets, wide interest rate differentials or heavy currency fluctuations. The next few years will be required for Asian companies to reassess their European market presence and business structure.

4.34 While there will be benefits from the use of a single currency and a single internal market, competition between firms within eurozone will increase, making it harder to operate in the area. A side-effect of this competition will be that it will be easier to identify weaker companies whose survival in the market has been the result of protection or advantage offered by home currency. These companies run the risk of being taken over or being forced into liquidation. All corporates, including importers from Asia will have to make sure that their business strategies live up to the demands of this environment. There may be competition from European companies in the Asian market or in other markets in which Asian and European firms operate as rivals.

Euro and gold

4.35 The Monetary Union is going to have a significant impact of various aspects of international investment not least gold**.** Generally it has been assumed that the euro would put further downward pressure on gold prices. As the ECB will need less reserves than the combined total of EMU members the need for large holdings may be reduced. There has recently been gold selling by national central banks including those of Australia and Netherlands. Switzerland is considering reducing its gold stock. Although there was some fear that there could be EMU related gold sales the position is uncertain. Banque de France and Bundesbank have both indicated that they have no intention themselves of selling gold. The EMU-11 have gold holdings which are more than the USA and more than 10 times that of Japan. These countries may not want to reduce further gold's position. There could be better management of gold holdings through gold lending and options. The decision by ECB to hold 15% of the total reserves in gold is significant. However there is no clear view on the impact of EMU on gold price. However, the views of the European Central Bank on the use of gold in the world financial system will be the key to the future price of the metal.

CHAPTER 5

INDIAN BANKS AND EURO

The introduction of euro will have a direct impact on the operations of banks in India and on the overseas branches of Indian banks. The areas of operations which will be affected by introduction of euro are discussed in this chapter.

General

5.2 With effect from 1 January 1999, all ECU components of transactions will be converted to euro at the rate of 1:1. This implies that ECU will cease to exist. Except for the currency code and possibly interest indices, all transaction variables will remain unaltered. There will be perfect continuity. The correspondent banks will send new confirmations of the outstanding transactions after ECU conversion. During the transition period from 1 January 1999 to 31 December 2001, the currencies of the eleven countries of EMU will only be expressions of euro and therefore more appropriately referred to as legacy currencies.

5.3 A number of interest indices in the EMU area will cease to exist and be replaced due to changed market conventions. There will be no more ECU indices as a result. The major indices relevant for banks in India and the successor interest index are given below :

Country	Current Indices	Successor Indices
France	**PIBOR (FRF & EU)** **TMP**	**EURIBOR** **EONIA**
Germany	**FIBOR**	**EURIBOR**
United Kingdom	**LIBOR ECU**	**EURO LIBOR**
United Kingdom	**LIBOR legacy currencies**	**EURO LIBOR**

The successor interest index will apply from 1-1-99; FIBOR and PIBOR will cease to exist from January 1, 1999.

5.4 The conventions under which the market operates at present link the currency of payment to a particular country. By default the payment is made and settled using a payment system in the country concerned. With the introduction of euro this linkage is removed. A group of 31 major global clearing banks called Heathrow Group has recommended best practices for clearing banks when routing euro payments for same day value to other clearing banks with access to more than one euro payment system.

5.5 All the market associations have issued or are in the process of preparing suggested amendments or addition to their standard documentation to take account of the introduction of euro. Although the precise context varies, there is a broad similarity as to the areas, which may be covered by counterparties e.g.

- Confirmation on continuity of contracts
- Confirmation of applicable successor price sources
- Clarification of payment and netting transactions
- New and amended definitions for such terms as the euro, ECU settlement days and business days
- Clarification of calculation methodology or necessary adjustments taking into account the nature of the underlying asset and other factors such as redenomination.

5.6 The full conversion rates (quoted to six significant figures) must be used for conversions in either direction between euro and its national denominations or between legacy currencies. Inverse rates derived from conversion must not be used. When converting from the euro to a NCU it is necessary to multiply the euro amount by the conversion factor. When converting from a NCU to the euro it is necessary to divide the NCU amount by the conversion factor. Following a conversion, any monetary amount to be paid or accounted for should be rounded up or down generally to the nearest sub-unit with results that are exactly halfway rounded up. Conversion between one NCU and another must be done via euro (triangulation). When converting legacy (NCU) to legacy (NCU) via the euro, the euro equivalent calculated must not be rounded to less than 3 decimal places. “Synthetic cross rates” between legacy currencies are not acceptable.

5.7 Payments in NCU can be made till 31 December 2001. However, the wholesale markets will deal exclusively in euro from 1-1-99. Customers will retain the ability to make payments in NCUs for the duration of the transition period and during this period, payments can be made from a bank’s euro account in any one of the NCUs as well as in euro. In practice banks will rely on the customer specific accurate payment information. A request from a customer to make a FRF payment will be converted to euro at the fixed conversion rate on delivery by the paying bank. The paying bank might however include “ERI” or Euro Related Information which the bank receiving the resulting SWIFT payment message should recognize as a NCU funds transfer. The receiving bank is obliged to credit the account in the currency of the account (EUR or FRF). These account transfers between banks will be in euro.

5.8 With the introduction of the single currency, a global euro bond market will develop. From 1 January 1999 the governments participating in EMU will issue new debt in euro and redenominate all or part of their outstanding tradable debt into euro. Private issues will follow this stance ahead of January 2002, when redenomination will automatically occur. ECU denominated bonds will automatically redenominate into euro at the start of stage 3 at a rate of 1:1. From a legal point, the decision of a borrower not to redenominate outstanding debt during the transition period does not have any implications. According to Article 8(3) of the regulation based on Article

1091 (4) of the Treaty any amount payable within the member state can be paid by the debtor either in euro or in NCU and the same amount must be credited to the account of the creditor in the denomination of his account. Only at the end of the transition period, where in legal instruments a reference is made to the NCUs, these references shall be read as references to the euro unit according to the respective conversion rates.

5.9 Simple redenomination does not affect the bondholder as it does not represent a change in the economic value of the bond. However renominalisation (which is a step beyond simple denomination changing the minimum tradable amount) can induce a change in the economic terms of the contract, in so far as it implies a rounding different from the nearest euro cent. As a general rule and independently of the redenomination method applied, investors are guaranteed from the loss of the economic value of the contract.

5.10 The Association of Banking & Financial Industry has proposed a list of conventions for the euro market. Both EMI and the European Commission have endorsed these conventions. These conventions are given in the Annexure VII.

5.11 From 1 January 1999, there will be only one currency euro for the eleven members of EMU and the NCUs will only be expressions of the euro. The euro and the NCUs are fungible between each other during the transition period in view of the fixed conversion rates. The principle of “no compulsion no prohibition” will allow account holders to continue to hold NCUs accounts upto the end of 2001.

5.12 Correspondent banking will remain an important payment channel in the eurozone for several reasons :

- The introduction of euro highlights the current segmentation of clearing houses. For the time being there are no Automated Clearing House (ACH) to ACH links.
- Book transfers will offer a cost-effective alternative.
- Not every bank has direct access to European cross border banking systems.
- In most cases cheques will still have to be presented for payment in the city in which they are drawn.
- Efforts are needed to promote truncation and the smooth transfer of cheques throughout Europe.
- Account relations in other currencies will remain

5.13 Currently each bank has at least one nostro account for each European currency and sometimes more than one. Although this will probably not change at the outset, the need for banks to hold a cash account in each member state will gradually diminish once their principal correspondents are able to offer a clearing service throughout the monetary union. Indian banks technically would need only one euro account anywhere in the European Monetary Union for payments in all EMU countries. Most correspondent banks are offering the possibility of converting existing accounts to euro while keeping the same account number. The bank will automatically convert every settlement from a NCU to euro using fixed conversion rates. The advantages of a single euro account are :

- Only one contract of EMU.
- Uniform price and service level for entire EMU
- Reduced need for cash management activities
- Streamlined back office and nostro related functions

5.14 However, the consolidation of all nostro accounts to one euro account cannot occur overnight. One important factor in this context is that no one bank can offer an unlimited intra day credit or other credits and hence there may be need for more than one euro account. Banks have to take a decision on the number of nostro accounts including accounts, which need to be continued in national currencies. During the dual currency period of EMU it will not be necessary to hold an euro account to make all euro payments. The fixed exchange rate between euro and the NCUs allows for consistent and easy translation into either currency. An euro account can be held in any EU country regardless of whether that country participates in EMU. Any decision regarding the location of the account should consider the varied regulations or restrictions regarding pooling arrangement across the European Union if more than one euro account remains. During the transition period correspondent banks would be prepared to offer dual reporting of balances and individual entries regardless of whether the account is in euro or remains in NCUs. Therefore banks may decide on the number of accounts required depending on the invoicing pattern of their clients, need for direct access to the local market their internal computer systems, the quantum and nature of credit facilities required and tax and other strategic considerations.

Payment system

5.15 At the moment payment system in the European union are extremely compartmentalised. Each country has its own domestic clearing system in its local currency, which only deals with its national central bank. Non residents do not participate directly in national clearing systems and in general do not hold accounts with the central bank of other countries. To make their payments abroad they call upon the services of local banks (their correspondent banks). After the introduction of euro, domestic payments will continue to be channelled through national clearing systems (either a net Automated Clearing House or the RTGS). Whether this will involve the domestic net settlement or gross settlement system will depend on the amount and the urgency of the transaction.

5.16 Intra European Union payment will be able use of one of the following four channels :

- Correspondent banking i.e. cross border payment arrangement through direct account relationship between banks.

- Domestic clearing systems via direct or remote access e.g. French TBF or German EAF system.
- The Euro Banking Association (former ECU Banking Association) clearing system which is being adapted to operate euro in future.
- The payment transaction system of the ESCB, “TARGET”.

5.17 The choice of channel for the transmission of a payment order from one bank to another will be within the clearing bank. Thereby, these clearing banks will make the decision about which payment channel has to be used on factors such as costs involved, cut off time, speed of processing etc. However, they have to route a payment order through RTGS, whenever instructed. It will be mandatory for credit institutions to use TARGET for payments directly connected with monetary policy operations. As far as banks in India are concerned correspondent banking will be the major channel for payments.

5.18 Overseas bank branches operating in euro area need to familiarise themselves with several key features of TARGET relevant to banking operations. These include timing of operations, provision of intra day liquidity and pricing of services.

Cash management

5.19 The ability to sweep surplus cash balances or fund short balances in euro across borders is a feature of the single currency that has received much attention as corporates and banks seek to evaluate the real value of the euro in terms of cash management.

5.20 Indian banks could avail of the pooling and sweeping services, which will be subject to legal, tax, and regulatory constraints, which still exist, in individual countries. Pooling enables the account holder’s credit and debit balances in euro and NCU to be notionally offset for the purposes of calculating interest to maximize liquidity without transferring funds. Sweeping involves transferring funds between different accounts denominated in euro and NCU into a single euro account so as to give the account holder more flexibility in handling cash flows. Sweeps can be carried out domestically or cross border. If they are carried out cross border and for same day value, sweep time may have to be aligned with the cut off time in the markets concerned. While deciding number of accounts to be maintained and the number of correspondents, banks should keep in view the potential for more efficient cash management with the single currency.

Money and foreign exchange

5.21 Treasury services in the euro money and foreign exchange markets are expected to continue to take much the same form in euro as they do in participating currencies at present. The difference will be the depth and liquidity of the euro cash markets and associated derivatives with foreign exchange trading focussed, in particular, on euro against the dollar and to some extent against sterling and yen.

There will be a liquid inter bank market with bank loans, FRNs, swap and other derivatives priced on the basis of EURO LIBOR or EURIBOR.

5.22 Regarding quotation of euro in the Indian foreign exchange market, it will be based on ‘Certain for uncertain’ that is 1 euro = Rs….. The symbol for euro is…

5.23 FEDAI may have to formally adopt the method of quotation of merchant and interbank rates for euro in line with the conventions given in Article 235 Regulation and advise its members accordingly.

Documentary credits and euro

5.24 The International Chamber of Commerce has issued a Decision Paper unanimously adopted by the ICC Commission on Banking Technique and Practice on 6 April 1998 which ensures the future smooth running of the instruments issued under ICC Rules. The Decision Paper does not amend any articles of ICC Rules in any way but merely indicates the correct interpretation of these rules after the introduction of euro. With effect from 1 January 1999, as per ICC decision, the documents can be denominated in euro, in the original currency of the documentary credit or in the NCU of the beneficiary. Payment can be made in euro or in the original currency of the documentary credit. Documents will give the appearance of conformity (no divergence) if they are expressed in different currencies in accordance with what is stated above. These guidelines apply to transferable credits also during the transaction period. The principles set forth in the Decision Paper also apply to guarantees and bonds. The Decision Paper is given in Annexure IX.

5.25 All letters of credit (L/Cs) issued by banks which are in legacy currencies could as a matter of abundant caution and transparency contain the following clause “subject to UCPDC (1993 Revision) ICC Form No.500 read alongwith ICC Publication No.470822 Rev of 6 April 1998”.

5.26 Although Letters of Credit can be issued in euro from 1 January 1999, it is possible to draw up the offers or contracts in euro and provide for a clause for the substitution on 31 December 98 of the euro for the NCU at the fixed conversion rate if the dispatching of documents or payments are to be made after 1 January 1999. From 1 January 2002 LCs/guarantees/bonds can be issued only in euro.

FCNR/RFC deposits

5.27 FCNR deposits can be accepted in four currencies currently i.e. USD,GBP, Yen and DM. DM deposits can continue to be accepted till 31 December 2001. Euro provides opportunity for raising larger FCNR deposits as there will be no currency risk between EMU currencies.

5.28 In this context the following may be taken note of :

- From 1 January 1999, DM will continue only as a legacy currency.
- Price sources for DM will be replaced by that of euro and the interest rate on euro and DM will be identical.
- During the transition period the “no compulsion no prohibition” principle applies which gives a choice to the investors to use euro or DM.

5.29 In view of the foregoing RBI may allow existing DM deposits to run to maturity till 31 December 2001 after which they get automatically converted to euro. Banks may accept new / renewed deposits in DM and euro. The DM depositors may be advised that the deposits will get automatically converted to euro on 1 January 2002. Deposits already accepted in DM may be allowed to be converted into euro at the option of the investor. This will be consistent with the “no compulsion no prohibition” principle.

Interest rates on euro deposits

5.30 From 1 January 1999, the money market reference rate could be EURO LIBOR or EURIBOR. Both EURO LIBOR and EURIBOR are daily average rates at which banks lend to each other but the make up of the two rates is different. Some bankers criticize EURIBOR for basing its calculation on a wide pool of 50 + banks compared to 16 for LIBOR which may result in EURIBOR being quoted at a higher rate as some of the member banks of EURIBOR may have lower credit ratings and liquidity. However Banque de France and Bundesbank are understood to be strong proponents of EURIBOR which they hope would lure money market business away from London after EMU. ISDA has confirmed that the replacement of all existing national price sources with EURIBOR is certain. (Italy is expected to make an announcement shortly).

5.31 At present even though there are several price sources as per RBI regulations the ceiling interest rate on FCNR deposits is linked to LIBOR. We may therefore advise banks to fix interest rates based on LIBOR as hitherto. The British Bankers Association proposals for EURO LIBOR are as follows :

- From 1 January 1999, BBA will cease to fix LIBOR for ECU and replace it immediately on the same screen page with a LIBOR fixing for euro.
- EURO LIBOR will be fixed spot. A cash euro fixing will also be provided if there is sufficient demand.
- The fixings on the last two London business days of 1998 (i.e. on 30 and 31 December) will be euro fixings for value of 4 and 5 January 1999 respectively. They will be fixed by the new panel of 16 banks.
- The days count basis for calculating interest accrual for EURO LIBOR will be the actual number of days elapsed, divided by 360.
- Settlement rates for NCUs for which LIBOR is currently calculated and which participate in the euro will continue to be published during the transition period. The rates for NCUs will be identical to those for euro units from 30 December

1998. There will not be separate panels for rates in NCUs.

5.32 The RBI may therefore issue instructions to banks on the following lines.

- In the case of existing fixed rate FCNR deposits, banks will continue to pay the rate contracted till maturity.
- In the case of existing floating rate FCNR deposits, banks may at the next interest fixing date calculate the spread over the relevant EURO LIBOR rate.
- For new deposits/renewed deposits, interest rates both fixed and floating should be linked to EURO LIBOR.

EEFC/RFC deposit accounts

5.33 Banks are currently allowed to accept these deposits in any currency. The deposits are mostly in US dollars. However, the instructions applicable to FCNR deposits in regard to currency in which these deposits may be accepted i.e. euro or DM may be made applicable mutatis mutandis to these deposits also. As regards interest rates, there are no regulations from RBI in this regard and RBI may leave it to each bank to determine the interest rate as hitherto.

Overnight and Money market investments

5.34 Banks in India are allowed to invest 15 per cent of their Tier I capital in specified money market instruments. Since these are short-term investments, they will run till maturity without the need for redenomination. New deals will most likely be denominated in euro. Banks are also permitted to invest surplus funds on overnight basis. The Wholesale Market Bankers Association (WMBA) is creating a new index called Euro Overnight Index Average (EONIA) in conjunction with BBA to support the Euro Overnight Index swap market. It will be a weighted average rate of all unsecured overnight euro deposit trades arranged by bankers in London only. The ESCB will compute the EONIA as a weighted average of all overnight unsecured lending transactions undertaken in the euro area inter bank market by banks on the reporting panel. However, banks may be advised to make investments after 1 January 1999 only in instruments denominated in euro. As all money market transactions are expected to mature in the original currency, all day count conventions and conditions will remain the same.

Other investments

5.35 Banks in India do not have long-term investments and the need for redenomination of securities may not arise. Even otherwise the redenomination will be decided by the issuer of the bond.

Foreign currency loans

5.36 Foreign currency loans in DM can continue in that currency till 31 December 2001. After 1 January 2002 it will get automatically converted to euro. While there will not be any change in interest on fixed rate loans till maturity unless the agreement provides otherwise, in respect of floating rate loans, it will have to be linked to EURO LIBOR if it is LIBOR based loan. In this context banks may advise their borrowers of this implication well in advance after consulting their legal department. Documentation may also be reexamined for impact and terms should be renegotiated where necessary. New documents should incorporate a clause ensuring continuity of contracts. Banks could also refer to the international practice in this regard. In the case of new loans, the reference rate could be either EURO LIBOR or EURIBOR. (See para 5.45)

Indian banks' overseas branches

5.37 The overseas branches of Indian banks will be subject to local regulatory requirements in regard to the introduction of euro. The Indian banks presence in euro zone is as follows :

Germany	State Bank of India – one branch in Frankfurt
France	State Bank of India and Bank of India - one branch each in Paris
Belgium	State Bank of India – one branch in Antwerp Bank of Baroda – one branch in Brussels

5.38 The regulatory authorities in the countries where our banks operate in the euro zone as well as other countries would have issued instructions or may be in the process of doing so. The Chief Executive Officers at each centre would have to take a decision on the opening of euro accounts in consultation with the Head Office. The quantum of business and credits and the opportunity for efficient cash management would be some of the considerations. In respect of investments held by the branches, in NCUs, they will have to be redenominated. The national stock exchanges and Central Securities Depositories of the 11 participating countries have chosen to quote trade and settle securities exclusively in euro from 4 January 1999. Broker dealer will therefore be prepared to quote trade and settle securities in euro from 4 January 1999 following their migration to euro over the conversion weekend. Institutional investors, however, do not face such an aggressive timetable as the accounts and reports will continue to be available in national currency denominations. The principle of "no compulsion no prohibition" means that these will continue to be provided by custodian banks until NCU denominations are phased out on 31 December 2001.

5.39 Over the conversion weekend, bonds issued by all 11 of the governments whose currencies are participating in the EMU will be redenominated in euro. All new bonds issued by governments will be denominated solely in euro. Banks investments in bonds will also get redenominated.

5.40 The most significant impact for the branches operating abroad is the elimination of exchange rate risk across the euro zone, which will encourage branches to buy and sell securities across national borders on a larger scale. Indian banks will also face more competitive pressures as banks previously protected by currency barriers will face increased competition for domestic business.

5.41 Indian banks abroad will have greater opportunities for asset allocation as exchange risk is eliminated. The structure of the bond market will gradually change within eurozone. As a consequence the eurozone will gradually move towards a credit culture as the emphasis shifts from inflation and currency risk to credit risks.

5.42 Indian banks will also have opportunities for diversifying their borrowing sources by tapping the vast liquid and diversified financial market.

Information Technology

5.43 Major European banks have invested substantial sums for setting up technology appropriate for the euro. As far as Indian banks are concerned certain modifications would be required to the existing systems to take care of the advent of euro. Some of the areas are listed below :

- Account books will be required to be maintained in dual currencies
- A new currency 'euro' will have to be put into the Master Table of the computers.
- Arrangements will have to be made to take care of conversion rates set between the legacy currencies and the triangulation approach used to calculate from legacy to legacy currency.
- Systems would have to be modified to provide for linkage between the legacy currency and the euro as all the legacy currencies will be connected through the euro.
- In order to avoid confusion all outputs should show both euro and the legacy currency till 2002 and the system should be capable of dual reporting.

5.44 Each bank may set up a small group of 2 or 3 members to examine each and every form/book, which is required to be modified following introduction of euro.

Continuity of Contracts

5.45 The basic principles underpinning continuity of contracts are :

- Any country is entitled to define its currency – 'the sovereign right' or the ***lex monetae principle***. Any change in a country's monetary law is therefore binding on any third party. So continuity of contracts should be ensured.
- Within the member states of the EU, the concept of continuity of contract under EMU means that the introduction of the euro will not affect or alter any terms of a legal instrument unless the parties to it agree to the contrary. Regulations regarding continuity – which will apply to all EU members whether they are EMU members or not state that the introduction of the euro will not justify contract amendments, adjustments, termination, changes in reference rate and other currency or interest rate related parameters of the contract. However, the regulation allows parties to agree otherwise.
- An EU regulation does not have any force outside the EU. Recognition of the contract in jurisdictions outside the EU depends on the local legal position.
- The 'problem contracts', which need to be identified are those where the following criteria apply

i. The term of the contract extends beyond 31 December 2001.
ii. There is a payment obligation in one of the NCUs which will cease to exist.
iii. The law of non-EU country is applicable.
iv. The contract is in ECU which will cease to exist.

5.46 If the law of the non-EU country is applicable, problems with respect of continuity of contracts will arise. Two aspects of continuity will be as under :

i. Will the single currency be recognised by a third country law as replacing the existing national currency of the relevant member state?
ii. Will there be any grounds on which it might be claimed under that law that the contract is to be cancelled, rescinded or terminated or varied in whole or part, consequent to the introduction of euro?

5.47 As regards **i.** above, with a few exceptions, in most countries, the 'nominalistic' principle applies. This principle connotes that a debt denominated in a national currency should be satisfied in the currency which is a valid currency according to the laws of that country. As regards (ii), " no Indian law would appear to prohibit an Indian debtor from discharging his obligations" merely because of the introduction of euro. It has been the view held by the courts in India that commercial impossibility or hardship caused by larger financial liability does not entitle the debtor to claim discharge from his contractual obligations. Impossibility must be physical or legal impossibility and not impossibility in reference to ability or circumstances. Whether the Indian party is entitled as creditor to receive payment in the currency of the member state or in euro when substituted, there appears no legal provision governing the situation, except perhaps Foreign Exchange Regulation Act. While no amendment to the Act appears necessary, RBI (Exchange Control Department) may consider if the prescription of permitted currencies and permitted methods of receipts/payments requires amendment.

5.48 It is, however, advisable for individual contracting parties to incorporate a standard continuity clause in various agreements/documents on the lines of ISDA EMU continuity provision, with suitable modifications. However, prior to inserting the clause, the documentation should be checked with regard to provisions conflicting with the continuity clause.[1]

5.49 Principle of hardship is expressly recognised by some European countries. However, replacement of national currencies by euro is not an unforeseeable event, whose application would add to or detract from the wealth of any one party to a contract. As such, there should not be any ground for applying hardships. Similarly, adjustment clauses concerning events that substantially alter the balance of provision of services should not apply to the transition to euro.

Financial supervision

5.50 The Maastricht treaty envisaged a separation of responsibility between the ECB which would handle monetary policy, and the national authorities which would continue to conduct financial supervision.

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[1] The State of Illinois in USA has enacted a new legislation in this regard, known as the "Euro Conversion Act". Section 10 of the Act deals with continuity of contracts. Section 10, Clause (a) provides that if the subject or medium of payment of contracts, security or instrument is a currency that has been substituted or replaced by the euro, the euro shall be a commercially reasonably substitute, and calculated in accordance with the regulations adopted by the Council of European Union. Clause (c) of the same section provides that performance of the obligation described therein may be made in the currency of the contract or in the euro, but not in any other currency. Section 15 of the Act provides that the substituted currency does not change the contract requirement, in the event of introduction of euro, so as to affect the performance of obligations in foreign currency. Section 20 makes the Act subject to anything that parties to the contract agree.
As of now the only overseas jurisdiction where specific legislation has been passed to deal with continuity are certain states in the United States. In New York and Illinois, legislation was adopted in July 1997 while corresponding legislation in California came into force in June 1998. The financial law panel has published a report on continuity of contracts under the law of Singapore. Even though the regulation under article 235 of the Treaty does not apply as part of the domestic law in Singapore, the report concludes that this seem to be of little consequence in respect of monetary obligations, given the natural inclination of Singapore law towards continuity. Hongkong Monetary Authority is aiming to introduce specific legislation to remove any doubt about continuity of contracts denominating in NCUs or ECU subject to anything that parties may have otherwise agreed. Other countries known to have considered their position, but which have no current plans to introduce specific legislation to deal with euro include Canada, Malaysia, South Africa and Switzerland.

CHAPTER 6

EURO AND INDIA – IMPLICATIONS FOR TRADE AND INVESTMENTS

The European Union (EU) has been an important and growing partner for India. Indo-EU trade had received a major boost with the introduction of Generalised System of Preferences (GSP) in 1971 and signing of Commercial Co-operation Programme in 1974. These two developments had a major impact on the composition of trade that underwent a shift in favour of manufactured items. There has been a rapid growth of Indo-EU trade since then, and EU has emerged as India's largest trading partner, with 27 percent share in India's exports and over 30 percent share in imports. However, despite India's large share of trade with EU, invoicing in EU currencies accounts for only 7.2 per cent of the trade. (See Table 10 for world invoicing in major currencies) To the extent trade is with the euro countries or countries whose currencies move closely in alignment with euro, invoicing in euro is likely to minimise risk, given the expectations of a strong euro. From the European perspective, India still remains a marginal player in EU trade as India's share in EU's imports from the world ranged from 0.32 percent in 1980 to about 0.41 in 1995. On the export side, EU's share of exports to India in EU exports to the world was around 0.46 percent in 1995.

6.2 The major exports of India to EU consist of textiles, leather and leather products, pearls, chemicals, machinery, animal and vegetable products and miscellaneous manufactured goods. The price elasticities of major exports to EU have been relatively large implying that any cost reduction and quality improvement in the products that are exported to EU, could lead to significant increase in quantum of exports. However, income elasticities for most of the commodities are quite low. The key to boost our exports to EU destinations will crucially depend on the movement on income elasticities of major exports to EU. The commercial policy constraints from the EU side in the form of tariffs, quantitative restrictions, technical barriers including product standards and anti-dumping investigations will have a bearing on India's exports.

6.3 A study conducted by the Research Department, Confederation of Indian Industry, published in March 1998 has listed certain specific action plans to enable India to benefit from the developments within EU and particularly the single market and EMU. As far as India EU trade is concerned, the study recommends need for a fresh approach to EU as India's trade structure does not reflect the changes taking place in the EU market. The other comments made in the study are :

- India's export basket consists largely of low value items catering to lower segments of the EU market.
- There is an urgent need for restructuring of India's Textiles and Clothing industry with a view to increase competitiveness for which textile mills have to be modernised and large scale units need to be encouraged to be export oriented.
- India needs a different textile policy for survival in a non-MFA regime.
- Large trading houses of the country could think of the possibility of forming joint ventures with large trading companies in the EU having EU wise business network.
- Meeting the EU standards would be a major challenge for Indian exporters. Following implementation of a single market, rules and EU policies relating to product standards have been raised substantially. Health and safety standards have been made stringent. Indian products have to meet not only system standards (ISO 9000 etc.) but also standards relating to product processes (such as CE Mark Certification). EU has notified bodies for giving CE Mark Certification. Certain Indian bodies may be trained and authorised to give such certification in India.

6.4 Economic reforms in India with liberalisation in trade and investment policies have now paved the way for broader industrial and technological co-operation between India and the EU. There has also been a remarkable improvement in bilateral initiatives for investment in India. Liberalisation of foreign investments through India's capital market has opened a new vista of opportunities for the EU investors. Also, significant investment opportunities have emerged for foreign direct investment (FDI) in a vast number of areas including manufacturing and infrastructure. The momentum of private investment inflows from the EU countries is set to be sustained.

6.5 Of the total foreign direct investment in India (as at the end of March 1993), EU countries accounted for around 65 percent. Share of EU countries in the total portfolio investment in India as at the end of March 1995 was around 50 percent. On the Indian side, many enterprises have been found to be establishing strategic business linkages within the EU. Many Indian corporates have raised substantial capital by way of listing their stocks in the European capital market, creating in the process a linkage between the EU investors and the Indian companies.

6.6 In the past, India received almost half of what South Asia received by way of official capital inflows from the EU countries. The 1990s, saw a significant improvement in the flow of official loans and grants from the EU countries. However, it is likely that official loans from the EU countries may suffer a reversal in view of their own long-term adjustment needs like moving over to zero-budget deficits, reducing labour-market rigidities and increasing demand for public spending in social sectors within the EU. In 1994-1995, EU countries accounted for 35 percent of bilateral assistance to India under external assistance programme.

6.7 **T**he effect of euro on the external debt hinges on the possibility of a strong/weak euro vis-à-vis the US dollar. Around 13 per cent of our external debt is denominated in the EU currencies.

6.8 Thus, EU has a much more important role to play in India's economy; a role that should facilitate effective and gainful participation of India in the global economy. Similarly, India too is significant for EU as a high potential and growing market outside the EU. The future relationship should be built on this principle of equal and mutually beneficial partnership along with growing inter-dependence and sustainable linkages. Such a relationship has to be built on the dynamics of co-operation in trade and investment. Focus has to be on marketing of investment opportunities in India to EU countries. Areas such as agriculture, infrastructure, energy etc. could be the prime focus of Indo-EU co-operation.

6.9 It must however be recognised that introduction of euro cannot be a sufficiently strong stimulus to alter the fundamental forces driving European – India trade. Factors such as the development of exchange rates, the cyclical performance in the two regions as well as the remaining barriers to trade and trade relations with the rest of the world certainly play a more significant role overall than EMU could conceivably do. In the long run, however, the euro will leave its mark on European Indian economic relations by paving the way for more stable relations and facilitating financing of trade and investment activities. But this will also require a response from Indian traders and investors to reconsider their business strategies in Europe in order to compete in a more dynamic environment.

Practical implications for Indian firms having trade relationship with EU

6.10 Indian trade and industry should note that when measured by most key economic parameters the 11-eurozone countries create in aggregate the second largest currency after the United States. The euro is also anticipated to become the second largest currency block after the US dollar and a global reserve currency. The market will be highly competitive. It is predicted that the creation of a single market will result in the rationalisation of a number of European industries with larger companies being able to grow through mergers and take-overs. Exporters, where competitors are euro land companies may face increased competition from a more streamlined and cost efficient group of competitors. At the same time a market of this size is expected to open up many new commercial opportunities for businesses which can be proactive and competitive. It is, therefore, important for Indian trade and industry to know and understand euro and its implications.

6.11 The important impulse for closer trade links between Europe and India will result from positive economic forces set free by the euro. Indian firms will be able to enter one unified market free from impediments to internal trade with an impressive growth potential. The firms will be able to effect all their financial transactions in the entire EMU area in only one currency. This will offer scope for streamlining treasury activities.

6.12 With effect from 1 January 1999 euro will become the book currency of 11 countries in the eurozone, comprising Germany, France, Austria, Netherlands, Belgium, Luxembourg, Spain, Finland, Italy, Portugal and Ireland. The currencies of these eleven countries will exist for three more years. Euro notes and coins will appear in the market on 1 January 2002 and will replace the legacy notes and coins by 30 June 2002.

6.13 Eurozone will resemble USA in certain respects. Its GDP will be 80 per cent that of USA and 50 per cent larger than that of Japan. A significant part of the external trade of the 11 countries will become internal trade in euroland, which will contribute to about 20 per cent of GNP. Former national financial markets in the 11 countries will be replaced by an unified financial market which will be the second biggest in the world after USA.

6.14 There will be significant capital market efficiencies resulting from the elimination of currency transaction costs. The establishment of monetary union is expected to result in tremendous efficiency gains in the real and financial sectors.

6.15 The share of US $ in international transactions decreased from about 50 per cent in 1980 to about 47 per cent in 1992. The combined share of DM, FRF, NLG, ITL and GBP has risen from 31 per cent to 33 per cent during this period and the trend is likely to continue. Trends in trade invoicing are given in Table 8.

6.16 From 1 January 1999 the euro will be introduced in cashless form via payments travellers cheques, credit cards and trading systems throughout the eurozone. From this date, conversion factors/rates between the national currency and the euro will be irrevocably fixed. The ECU will be replaced by euro on a one-for-one basis. From 1 January 2002, euro notes and coins will be introduced and national currency notes and coins will be withdrawn from circulation within a maximum period of six months i.e. by 30 June 2002. From this date, euro will be the only legal currency in eurozone.

6.17 From January 1999 to 31 December 2001, companies can use either national currency or the euro for all international transactions credit facilities or deals. Under the EMU principle of “no compulsion no prohibition” a company is under no obligation or pressure to use either national currency or euro for any business transaction during the transition period. Invoicing and payment can be done either in euro or in national currency.

6.18 As the conversion rate between the euro and the national currency will be irrevocably fixed, there will be no exchange gain or loss and the currencies will be fungible. Conversion between one national currency and the other will also be via euro.

6.19 Although there is no compulsion to use euro during the transition period, Indian companies must be prepared to invoice or pay in euro because they may encounter customers and suppliers in Europe who deal only in euro. Euro will increasingly be recognised as a preferred currency for trade and related financial transactions. Countries which are not part of EMU but within EU and other countries which have shown interest in joining EU may also start adopting the euro as an invoicing and payment currency. However, some end customers in EMU may continue using national currencies throughout the transition period particularly retail businesses and other companies dealing mostly in cash. As per indications, the largest corporations in the chemical, electrical and automotive industry will change their accounting over to euro in 1999. As a result, initially all will request invoicing sales and purchases in the euro. The same is true for price quotations, new contracts etc. Other chemical companies, large retailers and service companies will follow in 2000. In 2001, most other companies will make the changeover, probably with the exception of those, which conduct most of their business with private households or in cash. Payroll systems will probably be the last area to change from their national currency.

6.20 The greatest advantage of euro will be price transparency as the euro will enable consumers and importers of European goods to benefit from being able to compare more easily between eurozone countries and select on price. Indian companies, which have economic relationship with countries in EU, should make arrangements to switch to the euro without waiting for the end of the transition period.

6.21 The progressive use of euro by Indian businesses will require assessment of the strategic, operational and information technology issues. Switching to the euro represents an investment in time and resources but it will provide a simple and convenient way of conducting business in Europe. Companies will have to review promotions, new business and sales strategies and contracts and decide what changes will be needed in the market communications plan.

6.22 There are currently a wide range of differing sales and value-added taxes, duties and imports across eurozone countries and there are no agreed plans to harmonise these. These tax disparities will be highlighted with increased product price transparency. Therefore importers from EU could seek the best value in EMU countries.

6.23 During the transition period, companies may have to maintain dual currency systems. The systems must be capable of processing euro transactions and adopting the new conversion process between euro and NCU or between legacy currencies (the triangulation method).

6.24 The International Chamber of Commerce has issued guidelines to cover handling of documents claims and payments. Briefly, during the transition period creditors can present documents in national currency or the euro. Debtors can settle in national currency or euro. From 1 January 2002 all payment and claims will be in euro. As already pointed out, as the national currency and euro are fungible, banks will be in a position to make and receive payments in euro or the national currency.

6.25 In the case of contracts where the payments are indexed to a basket containing national currencies, the composition of the basket will undergo a change. The weights of the national currencies will have to be substituted by their euro equivalents. Information relating to contracts indexed to SDR is given in paragraph 4.27. In view of what is stated therein, the specific amounts of euro and the valuation basket will be announced by IMF after the conversion rates are announced. In terms of the Indo Soviet Protocols dated 25 November 1978 and 30 April 1981, payments to certain Russian organisations who had supplied machinery etc. on deferred payment terms are indexed to the value of the rupee determined in terms of a basket of 16 currencies. Of the sixteen currencies named in the Protocols, seven currencies viz. Austrian Schilling, Belgium franc, French franc, Deutsche mark, Italian lira, Dutch guilder and Spanish peseta will be only denominations of euro. As in the case of SDR, the specific amounts of euro in the basket will have to be factored in.

6.26 There will be no change in the manner of calculating import duty on goods invoiced in euro or in national currencies from January 1, 1999 except that there will be only one exchange rate viz. The euro rupee rate. In the case of imports invoiced in national currencies during the transition periods, the currencies will be converted to euro at the fixed conversion rate and euro rupee rate will be applied.

6.27 On continuity of contracts, specific legislation has been established inside the EU and some other jurisdictions to ensure the introduction of the euro does not impair the continuity of ECU and national currency loan contracts. A reference may be made in this connection to paragraph 5.45 of the Report. In view of what is stated therein and in para 5.47, Indian companies are unlikely to face problems on continuity of contracts. However, in specific cases companies may take legal advice in the matter.

6.28 Travellers to eurozone will save exchange on costs associated with conversion and reconversion of the national currencies.

6.39 Banks in India will be able to offer spot and forward exchange contracts in euro as in the case of the national currencies**.**

6.30 There will be no serious impact on issues of debt paper denominated in EMU currencies maturing prior to 31 December 2001. However, Government bond markets will quote on actual/actual next year and most new paper is likely to be in euro. After that date the payment will have to be made in euro. Companies, which have foreign currency liabilities in EMU currencies, can pay either in euro or the national currencies till 31 December 2001. After that date the payment will have to be made in euro. In the case of fixed interest rate liabilities denominated in EMU currencies, the interest rate will continue till maturity. For floating rate loans, as some price indices would no longer exist, the appropriate benchmark will have to be used. For example the benchmark for DM LIBOR will be the new EURO LIBOR; for FIBOR it will be EURIBOR. Borrowers may seek advice of their banks/legal department to take appropriate action. The new indices are given in Annexure V.

6.31 As per current exchange control regulation the interest rate on short-term trade finance cannot exceed the Prime Lending Rate. FEDAI may continue to provide this information as hitherto by obtaining rates from banks in eurozone. RBI may also consider if changes are required in this regulation.

6.32 The euro will pose some challenging questions to Indian companies possibly requiring fundamental amendments to corporate strategies. Regardless of whether an Indian firm has established a presence in the EU or whether it is planning to enter, the euro will greatly enhance sales and procurement possibilities as currency related obstacles to the mobility of goods services and factors within EMU will vanish. The EMU countries will also be attractive investment locations as they may serve as access points to the entire EU and the newly emerging markets of Central and Eastern Europe.

6.33 Indian companies already established in the EU 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. Management must see the timetable for the changeover for a number of business activities including offers and price lists, new contracts, invoices, accounting and controlling, pay rolls, balance sheet and profit and loss accounts. However there is no need to change everything at one stroke due to the transition period. A number of factors will determine the right timing, the EDP software configuration, the structure of customers and suppliers as well as the legal and public administrative framework of the respective country. Once the decision on timing is made, it must be communicated both internally and to customers, suppliers and shareholders. For companies having strong economic relationship with EMU, the euro project requires the attention and full support of top management.

6.34 Selecting a business location in Europe will be easier for Indian companies as exchange rate considerations no longer matter for the choice of the right business location. Enterprises can concentrate on other critical parameters directly related to the demands of the company such as production costs, proximity to market centres and infrastructure. It will also not be necessary to maintain more than one business location only for protecting the company against exchange rate movements and high currency related transaction costs.

6.35 One effect on investment into India could be that the absence of exchange rate uncertainty may provide a stimulus for intra EMU investment. This could happen when the investment destination in India is competing with an investment destination in EMU. The effects are, however, ambiguous. In general, balance of investment capital flows depends more on market volume and trade flows and is less influenced by the development of exchange rates. A strong domestic demand and a conducive FDI policy would continue to make investments attractive rather than the monetary innovation of EMU. Conversely since the investment guidelines of some Pension Funds in certain European countries have specified allocations for "foreign currency" investments and these allocations were in part being used for intra-European investment, there could be a higher appetite for Indian/Asian portfolio investment from such funds post January 1999 or euro.

CHAPTER 7

MEDIA, PUBLICITY AND HRD INITIATIVES FOR EURO

General Media and Publicity initiatives

In order to help create awareness and understanding on the euro, media and publicity initiatives need to be necessarily taken at all levels.

7.2 At the national level, important information relating to the introduction of euro should be released to the press and television in the form of advertisements, by the Indian Bankers Association (IBA) or Foreign Exchange Dealers Association of India (FEDAI).

7.3 Seminars may also be conducted by IBA and FEDAI on specific issues relating to banks and banking products for member banks. For example, seminars on Uniform Customs and Practices (UCP) conventions affecting trade finance may be held by FEDAI, and Frequently Asked Questions (FAQs) may be addressed by IBA and individual banks. Banks will also need to hold customer service seminars with major chambers of commerce and major export bodies.

7.4 The FEDAI may also conduct a flagship workshop in association with Federation of Indian Exporters Organisation (FIEO) for the Chief Executive officers of all Export Promotion Councils (EPCs) and other apex trade bodies, to familiarise them with the euro and its impact on the exports/imports from/to India. Subsequently, more workshops may be conducted by these EPCs and other apex trade bodies in various centres in the country to give a wider publicity to euro related issues affecting the public.

7.5 At the regional level, initiatives may be taken by banks to organise and lead forums on euro, bringing together for discussions key economic agents like the traders, customers, governments agencies like EPCs and the like.

Specific initiatives – customer education

7.6 One of the most important areas that banks will have to look into is preparing their customers for the changes that will come about in their banking transactions as a result of the introduction of euro. Banks will have to undertake customer education programmes in order make their customers conversant with the switch-over to euro, the transition phase, the final coming of euro and the phasing out of national currency units of EMU participating countries. Customers will have to be made aware of the choices available to them during the transition phase, of making or receiving payments in euro or a national currency, as well as the costs involved in the conversions from euro to national currencies, and vice versa.

7.7 Customer education will involve clarifications on conversions, rounding and triangulation procedures under the euro and that small rounding differences could arise during the transition period when euro or national currencies are both being used simultaneously for transactions. Such customer education should be provided not only at the individual bank level, but also at the levels of industry and government.

7.8 Three major groups need to be addressed separately for customer education programmes. These are, i. wholesale markets ii. the trade finance customers and iii. retail customers.

7.9 Wholesale Markets would involve the Indian banks, institutions and a few very large corporates who need to understand specific issues like the impact of euro on payment systems, nostro arrangements, TARGET, EURIBOR vs EURO LIBOR, market conventions, redenomination of bonds/instruments etc. in the capital and securities markets. In addition, impact of IT issues will need to be discussed with a few select large corporates (top corporates in the public and private sector), Indian banks and financial institutions, who may be involved in euro capital and money markets directly as borrowers and investors. Short duration seminars may be arranged at the National Institute of Bank Management (NIBM)/Bankers Training College (BTC) for the benefit of bankers and financial institutions.

7.10 Trade Finance customers involve exporters, importers and large/medium/small scale operators. This is the most vulnerable segment, and needs urgent and widespread education to benefit from opportunities thrown up by euro as well as understand the new rules governing this market, both in the pre-conversion and post conversion period. Contents of the communication to these economic agents should be based on the following :

- brief economic background, benefits and time table to the euro.
- list of FAQs on euro which have been prepared by many international banks, and modified specially to suit Indian companies.
- specific issues impacting exporters/importers, including, legal position on continuity of contracts, payments, SWIFT, reimbursement/settlement issues, redenomination, insurance cover, accounting, need to modify IT software and the impact of double taxation treaties on withholding tax.

7.11 In the case of retail customers using foreign currency demand drafts, telegraphic transfers and traveller's cheques, it is a low value but high volume issue for the banks. For this reason, bank counter staff training would be very necessary. A communication kit for bank counter staff via IBA/RBI/IIB could be produced. It is essential that such training is imparted to the branch level officials.

7.12 As mentioned earlier, press advertisements placed in major dailies/magazines would greatly increase public awareness to the euro. Banks may also issue booklets to their customers on the practical issues that may arise and hold area-wise seminars and conferences, to enlighten them on the effects of euro on their businesses.

HRD and Training initiatives in banks

7.13 Banks would need to undertake speedy action to strengthen the expertise of their manpower in all fields, viz. Information Technology (IT), treasury operations, economics, finance and marketing in relation to euro. Banks must work out their strategies for the switch-over to euro, and their personnel must be kept informed of the same. For instance, the finance personnel need to be fully conversant with, and trained on loan accounting and bond valuation market practices which will come into effect with the launch of Stage III of the EMU.

7.14 A comprehensive module for training for banks may be worked out by FEDAI. Euro workshops and seminars may be conducted by FEDAI with a focus on the micro operational aspects of the banks. Seminars conducted by RBI and NIBM could focus on the macro aspects useful to banks and other participants.

7.15 The training programmes of the banks will have to pay specific attention to the following :

- in the key areas where the introduction of the euro is of critical significance e.g. finance, accounting and IT, the staff could benefit from familiarisation programs for statistical systems being developed under the EMU, including monetary and balance of payment accounting with special treatment therein of cross-border flows;
- Officials and other staff members who have frequent contact with customers, should be given a priority with respect to the training programmes. Training should prepare the employees sufficiently to handle queries as well as be familiar with any calculations relating to currency conversions, pricing of currency contracts and other operational eventualities. The training should also have a multiplier effect as the trained staff could serve as euro agents in their own banks.

7.16 The Group feels that an early conversion to and usage of euro will reduce conversion problems for banks. It will be in the interest of the Indian exporters/importers to also switch early, and start thinking in euro terms immediately. This needs to be emphasised in all customer communications.