The euro: a done deal on Jan. 1, 1999

Peter J. Widmer

Board member Peter J. Widmer, Chairman of Julius Baer Investment Management, Inc., and a Member of the Group Management Committee of Julius Baer Holding, offered an update on the European Union and the euro.

The deadline for the introduction of the euro is approaching; however, "the euro is not the first step of European integration; it is the last," said Peter J. Widmer, addressing the Global Executive Forum.

The next important date in the process is May 1998, when, on the basis of 1997 figures and projected 1998 figures, the circle of countries participating in the European Monetary Union will be fixed. "The circle will be a large one (*13 countries), with pretty much everybody joining, except for the UK and Greece."

With an economy that is outperforming countries in the rest of Europe, the UK has decided not to join in the first round. Said Widmer, "The UK's economy has expanded and grown very much like the United States' economy. Unemployment is down; interest rates are higher because of consumer spending." In contrast, "the rest of Europe is just coming out of a recession and is experiencing low inflation and high unemployment."

Greece is working toward qualifying, but isn't there yet.

*Ed. Note: As we go to press, we are advised by Mr. Widmer that Sweden and Denmark will not join in round one, reducing the number of countries participating in the EMU from 13 to 11.

Exchange rates

The Treaty of Rome in 1958 called for stable exchange rates in Europe. The rates will be fixed in May 1998, and become effective Jan.1, 1999. Between May and December, the national currencies will continue, but at the fixed rates.

At this time it is not known what the exchange rate for the euro will be in May, "but we believe it will be close to what it is now. We don't look at the currency versus the dollar, but rather at the currencies among themselves," said Widmer.

"Don't expect any big surprises," Widmer told the board. "Rates are basically where they're going to be because everything is in line. So in May we will know who is in it and at what price."

Strong or weak

Whether the euro will be a strong or weak currency is another issue. "The danger is that it will be a super strong currency, for several reasons:

- The 13 nations combined (France, Germany, Spain, Belgium, Italy, Netherlands, Portugal, Austria, Sweden, Denmark, Finland, Ireland, Luxembourg), represent a huge trade surplus, said Widmer. "You wind up with the largest share of world trade and a huge foreign exchange reserve position, about five or six times that of the United States. Seventy percent of these reserves is held in U.S. currency, creating a potentially large overhang of U.S. dollars in the markets."

This doesn't mean that the dollar has to weaken to accommodate this situation; the fundamentals don't call for that. However, the euro will be a serious competitor to the dollar as a reserve
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medium. This is good news for the United States, said Widmer, because "in the history of economics, reserve currencies have all fallen by the wayside, starting with gold and silver."

• The second reason why the euro is in danger of becoming too strong is that on Jan. 1 the European Central Bank will be chaired by Mr. Deusenberg, currently chair of the Dutch National Bank. "Mr. Deusenberg is very conservative and will not tolerate inflation or do anything that might weaken the currency."

• The euro needs to be stronger than the Deutschmark to head off any challenges that might pop up in the Constitutional Court in Germany; Germans won't want to accept a currency that is weaker than the Deutschmark.

After Jan.1, 1999, transactions between members of the EMU become domestic transactions. It's all the same market, the same currency.

Economic roles

The global economic roles of the European Union and the United States are nearly identical. The EU accounts for about 31 percent of world output and 20 percent of world trade. The United States provides about 27 percent of global production and 18 percent of world trade.

The dollar's percentage of world finance far exceeds the economic weight of the United States. The dollar's market share is three to five times that of the Deutschmark, the only European currency now used globally.

The dollar will probably remain the leading currency indefinitely, but the creation of the euro will narrow and perhaps eventually close the present monetary gap between the United States and Europe. The dollar and the euro each are likely to wind up with about 40 percent of world finance, with about 20 percent remaining for the yen, the Swiss franc, and minor currencies.

Last step

After the euro becomes a fact, a large issue will be tax harmonization and this challenge will be considerably more difficult than creating the euro. "We still don't know whether a euro-dominated Italian government bond will carry a withholding tax or if countries will have a tax on income," said Widmer.

Another issue will be incorporating all of Central Europe, from Estonia to Bulgaria, into the EMU. Right now, these countries don't have anywhere else to go, but they don't qualify for membership.

Widmer projects that eventually 25 countries will seek membership.

Quick Facts
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- The new European currency, the euro, will come into existence when Stage Three of Economic and Monetary Union (EMU) begins on Jan. 1, 1999. Then, exchange rates of the currencies of the member states participating in EMU will be locked with each other and with the euro.
- The euro and the currencies in EMU will all be, in effect, the same currency.
- From the beginning of Stage Three, the European System of Central Banks (ESCB) will announce and execute all monetary policy operations in euros.
- It is expected that financial markets will largely change over to the euro at an early stage.
- The euro will not become legal tender in general circulation until the ESCB issues euro banknotes and coins.
- Shortly after the euro becomes legal tender, probably in 2002, the national currencies of states participating in EMU will be withdrawn from circulation.