The EURO cometh, and so do the challenges

Peter J. Widmer

Peter J. Widmer is a member of the Group Management Committee at Julius Baer Holding Ltd., Switzerland, responsible for all institutional investment activities outside of Switzerland. He is also chairman of the board of directors of Julius Baer Investment Management, Inc. The United States is Julius Baer's most important market with over $5 billion dollars under current management.

There will be no surprises," said Peter J. Widmer, as the countdown continues for the euro to become the currency of choice for participating Member States of the European Monetary Union.

If you are a resident of these countries, or a traveler left with pockets full of assorted European currencies, you still have plenty of time to convert them before the final countdown is completed.

Talking about the chronology of events in the introduction of the EURO, Widmer said, "It's important to remember this is not the first step; this is the last step." Target dates:

May 1-3, 1998
The European heads of state will meet to decide on which Member States will participate in the EURO. "In all likelihood, it will be eleven (France, Germany, Spain, Belgium, Italy, Netherlands, Portugal, Austria, Finland, Ireland, Luxembourg) out of the 15 existing Union members."

Also during this meeting, the bilateral exchange rates will be fixed between participating currencies; external exchange rates will be fixed by the end of the year.

July 1, 1998
The European Central Bank becomes operational, charged with setting monetary policy for all members of the EMU.

Dec 31, 1998
Exchange rates will be irrevocably fixed. "The value of the EURO is going to be identical to the value of 1 ECU (European Currency Union), and that is traded daily in the market; the price is about $1.08."

Suddenly, with the introduction of the EURO, there is price transparency. Just as a single currency in the U.S. makes it easy to determine the competitiveness of products from state to state, it will be easy to see if you're getting a fair deal on products as you travel in Europe. So, if the price of caviar is 80 EUROs in Germany and 120 EUROs in Portugal, you know immediately that something is wrong. The result is a market force that will put pressure on producers to line up their prices.

Jan. 1, 1999
The banking and finance industry will switch to the EURO, but individuals will continue to use their country's national currency.

All new government debt will be issued in EUROs. "The entire stock of outstanding government debt of, so far, four member countries, but probably by then all of them, will be converted into EUROs. This assures that there is liquidity in the capital markets."

"So if you hold Deutschmark bonds in your portfolio, 100,000 DM will be about 50,124 EURO. There will be lots of fractions in these portfolios at first because the exchange rate is structured that way. This assures that there is liquidity in the capital markets."
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Jan. 1, 2002
EURO coins and notes will be put into general circulation, eliminating the national currencies of Member States by July 1, 2002. For the following several years, it will still be possible to exchange national currencies for EUROs at the national central banks.

Will it work?

The EURO will have a positive impact on the economies of Member States, said Widmer, pointing to the convergence criteria (see sidebar below) that must be met by participating countries.

"Italy, for instance, brought their deficit down to three percent. They are still way over the 60 percent ceiling on government debt allowed for participation in the EURO. But that's the one criterion where the direction is more important than the actual figure."

Under the Amsterdam Agreement, a penalty will be levied on a country that goes on a spending spree after changing over to the EURO. If, for example, the country has a budget deficit of 5 percent for the year, instead of the allowable three percent cap, the country must pay the difference into a stability fund at the European Central Bank. "This is money lost, and will not be released," said Widmer.

The EURO agreement has no legal escape clause. If for some reason the markets don't accept the EURO, a different currency would have to be substituted. The Deutschmark would be a reasonable alternative, but that would send the printing presses into overdrive.

Strong or weak?

There is no fear that the EURO will be a weak currency, but there is a danger that it will be too strong, based on the combined trade surplus of the 11 countries and their extremely strong reserve position versus the rest of the world.

"Seventy percent of the reserves are held in U.S. dollars, so there is a potential overhang of dollars," said Widmer. "This doesn't mean that the dollar has to weaken, but there is too much gold around and too many dollars. If the fundamentals in the U.S. weaken, then you could see downward pressure on the dollar."

Widmer expects that the European Central Bank will be "an anti-inflation, very tough central bank," with leadership making sometimes unpopular calls, much the same as the U.S. Federal Reserve Bank under Chairman Alan Greenspan.
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**EMU convergence criteria**

Member States must meet the following convergence criteria:

**Deficits:**  
The ratio of government deficit to gross domestic product must not exceed 3% annually.

**Debt:**  
The ratio of government debt to gross domestic product must not exceed 60%.

**Price stability:**  
Average inflation rate must not exceed by more than 1.5% that of the three best performing Member States in terms of price stability.

**Interest rates:**  
There must be a long-term nominal interest rate which does not exceed by more than 2% that of the three best performing Member States in terms of price stability.

The object of the convergence criteria is to ensure that economic development within EMU is balanced and will not cause tensions among the Member States.

*Source: European Union*