# What are the implications for the OCTs in floating issues in Euros

***Address delivered by Dr. Emsley D. Tromp on the occasion of the "Euro Awareness Seminar" organized by the Caribbean Association of Industry and Commerce, Port-of-Spain, Trinidad, October 8, 1999***

Dear ladies and gentlemen,

It is with a great deal of pleasure that I have accepted the invitation to share my thoughts with you on the impact of the Euro on financial-economic developments in our countries. The introduction of the Euro nine months ago marked a significant milestone in the process of European integration and will have a profound impact on the Euro area as well as on the world economy. The Euro has the potential to challenge the hegemony of the US dollar as an international currency and will, therefore, trigger structural changes in world financial markets, world trade and central banks' monetary policies. These changes will not come overnight and they depend heavily on the economic, monetary, and political developments in the Euro area. Nevertheless, everybody seems to be convinced that the introduction of the Euro will have a profound impact on the world economy, so we must be prepared. Seminars, like the one today, are excellent opportunities to discuss the likely impact of the Euro on our countries and to think about possible policy responses so that we can maximize the benefits from this new challenge.

In my address to you this morning, I will first discuss recent developments regarding the Euro, and I'll share my views on its potential as an international currency. Next, I will go into more detail on the use of the Euro as a financing and investment currency, with specific reference to the Caribbean OCT countries. As the title of my address suggests, I will shed some light on the opportunities and limitations for our countries of floating issues in Euros. Finally, I will offer some closing remarks.

On January 1, 1999, eleven member countries of the European Community joined the Economic and Monetary Union (EMU) and launched the new currency, the Euro. The participating countries are Germany, France, Italy, Spain, Portugal, Austria, Netherlands, Belgium, Luxembourg, Ireland and Finland. The introductory exchange rate of the Euro was set at US $ 1.17 per Euro.

The emergence of the EMU and its single currency, the Euro, goes back to the end of the Second World War. After the devastation caused by the war, a number of European countries agreed that it was in their best interest to work together in close cooperation on economic, financial, and monetary matters with the ultimate goal of achieving financial stability, a large and competitive European market, and the use of one currency. The first plan for the introduction of the EMU was born in the early 1970s and came to be known as the Werner Plan, named after its chairman. This plan resulted in the establishment of the European Monetary System (EMS) in 1979 and the creation of the European Currency Unit (ECU) from a basket of European currencies.

An economic and monetary union can be defined as a strong form of economic and monetary integration among a group of countries. Economic integration includes basically two steps. The first is to form one common market in which goods, services, labor, and capital can move freely. This step began with the completion of the Customs Union in 1969, continued with the full removal of exchange controls in 1990, and finally concluded with the suppression of internal border controls in 1993. The second step is close coordination and fine-tuning of economic policies among the participating countries of the union. This second step was concluded with adherence to the strict convergence criteria fixed in the 1992 Maastricht Treaty. Once the economic integration was in place, the process of monetary integration began on January 1, 1999, with the implementation of a common monetary policy conducted by an independent European Central Bank (ECB) and the formation of a single currency area.

The launching of the Euro heralded the first stage for the completion of the monetary union. This stage is characterized by the coexistence of national currencies besides the Euro for bank transfers. The stock exchanges of the Euro zone already list, trade and process stocks and securities entirely in Euros and banks of member countries effectuate their settlements in Euros. The first stage ends on December 31, 2001.

The second stage in the process of monetary integration covers the period January 1 to July 1, 2002, and entails the introduction of Euro coins and notes, while simultaneously removing the national currencies from circulation. On July 1, 2002, the third and final stage of the monetary union will be completed when the Euro becomes mandatory.

After the introduction of the Euro at US $ 1.17 per Euro, the exchange rate of the Euro has dropped steadily to its current US$1.06. This drop can be attributed to two main factors. The first is the diverging growth trends between the United States and the Euro area. Economic activity in the United States is still robust, while the Euro area has incurred a slowdown. The resultant trends in interest rates have not failed to impact on the relationship between the Euro and the dollar. The second explanation for the drop in the exchange rate is the Kosovo crisis, which weakened the Euro as the dollar established itself as a safe haven.

These developments in the Euro/dollar exchange rate do not undermine its potential to become an important international currency. The US dollar has dominated the international financial system for nearly a century. Because of its extensive use by third world countries in the settlement of international trade and financial transactions, the importance of the US dollar far exceeds the United States' share of world output. Furthermore, the value of world exports settled in US dollar is nearly four times as high as that of US exports. This is attributable to the combined and reinforcing effects of network externalities and economies of scale in the use of a predominant international currency.

International use of the Euro

The Euro is already the second most widely use currency. Its development as an international currency will mainly be a market-driven process. The economic factors likely to affect the international role of the Euro are the size factors (e.g. the volume of cross-border transactions) and the risk factors (e.g. inflation). Its implications for the OCT countries can be reviewed by looking at the various functions of the Euro in the international trade and financial transactions as store of value, unit of account and medium of exchange both for private and public use.

The international role of Euro depends on several factors. First is the matter of size. The larger the foreign exchange market in a given currency, the lower the transaction costs in that market. This will engender a trend towards centralisation. The 11 EMU members have a combined gross domestic product (GDP) of US$ 6,300 billion against $8,100 billion for the United States. Furthermore, the Euro area will become the world's largest importer and exporter, excluding the intra-EMU trade. Therefore, the Euro is likely to be used more by traders and to become more important as a unit of account and a medium of exchange. Second, the issuing country should possess broad and deep financial markets that are substantially free of controls—that is, financial markets with an efficient technical infrastructure. This characteristic will contribute to the international demand for the country's currency, reflecting central banks' and other investors' preferences for safe, liquid financial instruments. As I will discuss later, the Euro area's financial market is developing rapidly to meet these criteria. Third, the risk characteristics will continue to be a major factor in determining its international role. The currency should have a stable value, which is linked closely to the issuing country's ability to maintain price stability. The independent European Central Bank with price stability as its main objective and the Growth and Stability Pact agreed among the Euro countries provide a solid foundation for stable prices. Fourth, there needs to be confidence in the political stability of the issuing country. The political unity among the Euro members is an area that still needs improvement. This is particularly true with respect to the efforts directed at the further convergence of the economies and the reduction of the persistent high unemployment. Finally, to become an international currency, it should play a significant role as an international store of value. Given the increasing significance of the Euro in international trade and finance, many of the world's central banks are likely to diversify their currency portfolios in favor of the Euro.

The factors that determine the Euro's role as an international currency indicate that several criteria have already been met, while the remainder are expected to be met in the near future. Therefore, the use of the Euro as a vehicle currency in the international markets is likely to expand rapidly and to challenge the hegemony of the US dollar.

The establishment of a single, non-segmented European capital market is developing rapidly. The monetary union has created one of the three largest financial markets in the world, offering a considerably broader range of investment and financing instruments than is currently available in Europe's still fragmented financial marketplace. The greater depth and breadth of markets in financial assets denominated in Euros will lower transaction costs, narrow interest spreads, and, as a result, attract an increasing number of borrowers to tap into the expanded European financial system. These borrowers also are located outside the Euro area. For instance, the first Hong Kong corporate issue in Euros generated good demand, primarily from European investors, but also with significant interest from local buyers. Furthermore, Brazil, Argentina, South Africa, Canada and the Philippines rescheduled their international debts in favor of the Euro. These transactions served to illustrate that the Euro is gaining ground in the international financial markets as an investment and financing currency.

The implications of the international use of the Euro for the Caribbean OCT countries

As mentioned, the implications of the increasing international role of the Euro for the Caribbean can best be analysed in light of the various functions of the Euro in the international financial and trade transactions. In terms of the private use of the Euro as an investment and financing currency, the following can be noted. The Caribbean OCT countries share some common characteristics, which have implications for borrowing in Euros. First, most of our countries are very small with an extremely open economies and are therefore very vulnerable to external shocks. Second, most of our economies have a low degree of diversification with tourism as the main economic activity. Third, being located in the backyard of the United States, economic and social ties with the U.S. are much stronger than with Europe. Due to the close financial and trade links with the United States, the majority of our foreign exchange transactions are denominated in US dollars. Consequently, many of us have pegged our currencies to the US dollar. In the area of social ties, the United States also dominates. We watch American television, spend our vacations there, send our children to study at American universities, and probably all of us have family or friends in the United States who went there in hope of a better future. The fourth common characteristic of the Caribbean OCT countries is that we share our colonial past with Europe, and this is still reflected in relatively large aid flows and preferential trade relations.

Although the dominance of the United States in our international economic and social relations is evident, the introduction of the Euro may mark significant changes. Since the Euro is a very young phenomenon, discussing its significance for our countries is still speculative. Nevertheless, I dare to give some insight in its likely impact on trade, aid, and borrowing.

As far as the Caribbean OCT countries are concerned, the Euro will probably affect our trade with Europe only slightly; it will have a greater impact on our financial markets and debt management policies over the short and medium terms. The impact of the Euro on trade with Europe will be mainly indirect. If European economic growth picks up as a consequence of increased efficiency and competition in Europe, demand in the Euro area for imports from our countries will increase. On the other hand, an improvement in Euro area competitiveness through the elimination of exchange rate risk and lowering of transaction costs could result in trade diversion and a reduction of imports from the Caribbean OCT countries. This accounts, however, for only a small number of goods that compete directly with goods produced in the Euro area. Therefore, the Euro is likely to have only a slight, albeit positive, impact on trade with our countries.

With respect to aid flows from Europe to the Caribbean OCT countries, not much change is expected. Traditionally, our countries receive significant amounts of aid from the European Union. These aid flows were denominated in the main European currencies and the ECU and are now denominated in Euros. The main question is whether the Euro will increase or reduce exchange rate volatility between the main international currencies, which in our case is the US dollar. There is, however, no reason to expect that the Euro will be either too strong or too weak against any other currency.

When we consider capital flows, we have experienced a considerable increase in European foreign direct investment in our countries over the past decade. It is believed that the introduction of the Euro will enhance these investment flows further. Institutional investors in the Euro area may shift a larger share of their portfolios into developing countries once investments within the Euro area are no longer classified as foreign investments for exchange risk management purposes and currency exposure limits cease to apply to them.

In addition to an increase in European foreign direct investment, debt issues denominated in Euros may gain importance in the medium term. The currency composition of foreign debt should be related to the composition of earnings from foreign trade. As trade between the Euro area and the Caribbean OCT countries grows, Euro-denominated debt may well account for a larger share of our total foreign debt. In light of this, we need to reassess our hedging strategies. In the longer term, a shift in Euro interest rates will have an effect on the foreign debt service of our countries, because part of our debt will be denominated in Euros. In the near term, however, the impact will be minor because only a small part of our external debt is currently denominated in the national currencies of the Euro area countries or in the Euro. Whether the emergence of the Euro and major European capital markets will greatly change our access to capital, depends on several factors which are partly determined domestically. I will discuss these factors in relation to the opportunities and limitations for the Caribbean OCT countries concerning floating issues in Euros.

Floating issues belong to the more sophisticated debt instruments in the financial markets. The main immediate advantage of floating issues in Euros is the low Euro interest rate. Yesterday, the average 3-month money market rate in the Euro area amounted to 3.29%, compared to 6.16% in the United States. Two-year government bonds rated at 3.68%, compared to 5.77% in the United States. Thus, interest rates in the Euro area are currently roughly 50% lower than in the United States. Current developments, like the rising oil prices and the stronger growth in the Euro area, could eventually lead to higher interest rates. However, the favorable differential vis-a-vis interest rates in the United States is expected to remain large enough to make it worthwhile for the Caribbean OCT countries to explore the possibilities of issuing debt denominated in Euros.

In the medium term, two other advantages of floating issues in Euros can be mentioned. First, the creation of a large, liquid, and integrated capital market as a result of the introduction of the Euro will improve market efficiency and, therefore, lower transaction costs. Second, the funds available for non-Euro countries on the Euro capital market are expected to increase because of the reduced borrowing of the public sector, given the Euro area governments commitment to reduce their public debt to more sustainable levels as agreed in the Stability and Growth Pact. This also creates prospects for interest rates to remain low in the long run.

There are, however, also limitations for the Caribbean OCT countries to entering the Euro capital market. One limitation is the interest rate risk, which is paramount in floating rate debt instruments. Short-term interest rates tend to have a higher volatility than longer-term interest rates. This risk can be controlled however, by various hedging strategies and by building in special features.

Another limitation is the country risk rating of the region. International lenders analyze the financial standing and capacity to pay of countries before providing finance. The result of such an analysis is translated into a mark-up, i.e. a risk premium, on top of the basic interest rate. For instance, the long-term Moody's rating of the OCT countries indicates a non-investment grading for a majority of these countries. This rating causes the risk element in the final interest rate offering to become prohibitively high. To improve our access to the Euro capital market will require a comprehensive medium-term-oriented path of structural reforms and fiscal consolidation. Building a good reputation requires time and perseverance of our policymakers, but a good reputation will eventually contribute to better country risk ratings and, consequently, lower risk premiums and hence interest rates at which we can borrow.

A third limitation of floating issues in Euros is currency risk, since most of our countries have pegged our currencies to the US dollar. We can minimize this risk, however, by gearing the Euro share of our total foreign debt with the Euro earnings from our exports to the Euro area. This should be reflected in the currency composition of our foreign exchange holdings. Such an approach could be supported by appropriate hedging strategies in the foreign exchange markets.

A final limitation I would like to mention is the soundness of our financial sectors. The banking industry and the non-bank financial sector in our countries should be subject to adequate supervision by an independent supervisory authority to assess continuously the solvency and liquidity positions of the institutions operating in our jurisdictions. Since these institutions are intermediaries in foreign debt issues, they must have a good reputation to be taken seriously in international consortia that structure these issues. Such a reputation is not only related to financial soundness, but also to the adherence to the internationally accepted guidelines on money-laundering practices. Countries that do not show sufficient efforts to combat money laundering, run the risk of being excluded from the main international financial markets.

Closing remarks

In conclusion, it can be noted that the introduction of the Euro will have a profound impact on the world economy and on the Caribbean OCT countries, especially in the beginning of the new millinium. In this seminar, we focus particularly on the Euro's impact on our countries. This impact consists of challenges as well as threats. The Euro is expected to have a small positive effect on our trade with the Euro zone, but little impact for the flows of aid. In contrast, capital inflows, including foreign direct investment, portfolio investment, and foreign borrowing are likely to grow significantly.

With respect to the latter, I discussed the opportunities and limitations associated with floating issues in Euros. The availability of funds in the Euro capital market is expected to increase substantially in light of, among other things, the decreasing role of the public sector in the Euro area. Together with lower interest rates compared to the United States, our countries should continue to explore the possibilities to tap the Euro capital market. The funds raised should be used to finance productive investments aimed at enhancing our foreign exchange generating capacity. However, floating issues in Euros have various risk elements, which translate into mark-ups on the basic interest rate. We can minimize these risk premiums and, therefore, reduce our financing costs through appropriate risk-control strategies, the implementation of sound financial-economic policies, and maintenance of a strong and healthy financial sector.

Thank you for your attention.