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EXTERNAL ASPECTS OF ECONOMIC AND MONETARY UNION

COMMISSION STAFF WORKING DOCUMENT

CONTENTS

SUMMARY

Economic and Monetary Union is a further step in the ongoing process of European economic integration. In this respect, it is also part of the wider integration in the global economy. EMU will enable the European Union to meet the challenges of globalisation.

While EMU implies an economic policy regime change primarily for the participating countries, it will also have important external implications. EMU will create an area whose economic potential will be comparable to that of the United States. Structural changes will occur primarily in financial markets. The present segmentation will be overcome in many respects and the European financial market will become truly integrated. The implied greater competition between banks and financial systems in general will lead to efficiency gains in terms of resource allocation and ultimately stimulate investment and job creation.

Given the size of the euro area, it is to be expected that the euro will play an important role as an international currency. As a trade invoicing currency, the euro will extend its role beyond direct trade relations. Given the stability oriented policy of the ECB and Member State fiscal policies aimed at sound public finances, the euro will play an important role in financial portfolio's world-wide, and as a major reserve currency.

The development of the euro into a major international currency will be gradual, but relatively important in those countries, which have close links with the EMU participating countries. Some effects will become observable even before EMU starts. Therefore, a careful preparation of the changeover is of paramount importance in order to reduce transitional uncertainties. The durability of convergence in the euro area will increase the confidence in the stability oriented policy of the ECB and should therefore reduce any risk premium initially attached to the euro. This will facilitate the ECB's task in pursuing a stability oriented policy. Speculation on possible effects arising from excess dollar reserves is not founded. Moreover, shifts in private portfolios are very difficult to ascertain as there are factors which work in opposite directions, thus largely balancing out net effects.

The long-term trend of the euro depends on both domestic and foreign economic developments and policies. However, the design of economic policy making in EMU will strengthen the European economy since it will encourage a balanced policy mix with low interest rates. The euro will be a strong and stable currency in the long term.While the exchange rate policy of the euro will be subordinated to the price stability objective, the ECB would respond to external developments taking the interests of the EMU as a whole into account.

EMU will have implications for the EU's relationship with international institutions with responsibility for improving the stability of the international monetary system. Although the most likely scenario is that the current managed floating system will be maintained, EMU should increase the symmetry in the international monetary system, thereby enhancing the benefits and allowing for a more efficient distribution of the benefits derived from international economic coordination. It will have also implications for the

operation of international institutions, e.g. for the economic surveillance carried out by the IMF. The euro will thus be the opportunity to strengthen the effectiveness of economic policy co-ordination, contributing to greater exchange rate stability

INTRODUCTION

1. The launching of the third stage of EMU and the introduction of the euro will represent a further step in the process of economic integration within the European Union. The effects will be felt primarily in the Member States participating in the euro area. The conduct of a single monetary policy will by itself imply a regime change for these Member States, but will also require enhanced co-ordination in other areas of economic policy.

   Given the economic importance of the euro area - whatever its initial size - the introduction of the euro will also have significant effects on Member States outside of the area as well as on countries outside of the European Union. These so-called external aspects of the euro are the subject of increasing discussion in international fora. The OECD, the IMF and the Monetary Committee have all devoted time to these external aspects. This document draws on discussions in these fora in attempting to provide some economic analysis of the likely impact of the euro on developments in the international economy and, more specifically, in the international monetary system. While the analysis will explore the main issues, it is not the intention to reach firm conclusions at this stage but rather to stimulate the debate.

2. From the debate so far, the relevant analytical framework for assessing the external effects of the euro is fairly straightforward. Nevertheless, exact quantification of these effects will not be possible. Firstly, many of the effects will be felt only gradually and will depend upon private sector expectations, while other effects will already be felt before the euro is introduced. Secondly, some of the effects will work in opposite directions. Thus, for example, the evolution of the euro exchange rate relative to other international currencies cannot be determined ex ante. Thirdly, by definition, the external effects of the euro will not only depend upon the economic policies and performance in the euro area but also on those of partner countries. Nevertheless, it is clear that a smoothly functioning EMU will be of paramount importance in assuring that the external effects of the euro are beneficial.

3. This document presents a first analysis of the external aspects of the euro. It is structured as follows. Section A sets out some economic indicators in order to evaluate the weight of the euro-area in the world economy, particularly relative to that of the United States and Japan. It will be shown that in many respects the euro-area would develop - over time - an economic weight similar to that of the United States. For simplicity, we will assume in the remainder of the analysis that the euro-area comprises the entire European Union so as to avoid any presumptions concerning the size of initial participation. This section also analyses the future

development of the euro as an international currency : as a means of payment, as a unit of account and as a reserve currency, compared to the present situation.

Sections B and C discuss the implications of the changed policy framework of the euro area. Section B analyses a number of transitional issues associated with the introduction of the single currency, in particular the likely currency movements. Section C examines long-term aspects, and attempts to draw some conclusions on the likely behaviour of the euro given the different environment in which monetary and fiscal policy will be operating. It also describes the institutional framework for the exchange rate policy of the area relative to non-EU currencies, as established in Article 109 of the Treaty. Finally, Section D analyses the consequences of EMU for international economic coordination. It sets out the institutional aspects which arise, particularly in the area of economic co-operation and surveillance and involving the IMF, the euro-area participants and the Community institutions.

A. THE EURO AREA IN THE WORLD ECONOMY. SOME STRUCTURAL INDICATORS

Principal characteristics of the euro area

4. An EMU of 15 Member States will have the following main characteristics (see Annex 1):

Its *economic and commercial weight* will be comparable to that of the United States and larger than that of Japan. In 1996 the European Union's share of the GDP in the OECD amounted to 38.3%, as against 32.5% for the United States and 20.5% for Japan. If intra-Community trade is excluded, the European Union accounts for 20.9% of world trade, as compared with 19.6% for the United States and 10.5% for Japan.

The *average degree of openness* of the Member States of the European Union (as measured by the share of exports in GDP) is currently 29.8%, compared with 8.2% for the United States and 9% for Japan. The degree of openness of some Member States is higher, rising to more than 60% in the case of Belgium and Ireland. If intra-Community trade is excluded, the degree of openness of the euro area is 10.2%, similar to that of the United States and Japan.

Due largely to a convergence of economic policy objectives, the economic cycles in the different Member States have over the last ten years become more synchronised. This trend will be reinforced in EMU owing to the implementation of a single monetary and exchange-rate policy, the increase in economic interdependence and the likely intensification of economic-policy coordination. This *greater cyclical synchronization*, combined with the size of EMU, will make economic developments in the euro area more important to the world.

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The economic performance of euro area will be *less sensitive to exchange-rate fluctuations*. This reduced vulnerability will result from the disappearance of strains between European currencies that can stem from fluctuations in the currencies of third countries or shocks outside the European Union. For example, the weakness of the dollar at the beginning of 1995 created strains in the EMS by reinforcing the German mark's role as a safe haven. The implied exchange-rate variability within the single market which reduced consumer and investor confidence, will disappear with the euro's arrival.

Euro financial market

5. EMU will create one of the largest government bond markets in the world. This market can be expected to develop rapidly. From the beginning of EMU, all new issues of government bonds will be in euro. However, European financial markets and therefore government bond markets can be expected to retain a number of country-specific characteristics for an interim period at least. This phenomenon will not be primarily due to transaction costs but to differences in tax treatments and a wide range of financial and monetary rules and instruments. EMU will diminish a number of these elements. The European financial market will become truly integrated as e.g.:

– the development of an efficient trans-border payment system will connect the existing financial centres (i.e. Target: Trans European Automated Real-Time Gross settlement Express Transfer system);

– the harmonization of financial instruments will imply convergence towards the most efficient means of financing;

– a single monetary policy - implying a unified money market - will intensify competition between banks and non-bank financial intermediaries;

– and finally, exchange rate risk between the participating countries will be eliminated.

6. There will be no single sovereign borrower on the euro markets as in the case of the Treasury in the United States. The yield on corresponding government bonds in Member States participating in the euro area may not converge completely. Yield differences which will reflect the market's assessment of default risk, are likely to be small given nominal convergence required on entry and the commitment to avoid excessive public sector deficits thereafter. Since the level of liquidity of the leading euro debt markets will be higher, a reduction in the liquidity premium incorporated in nominal interest rates could occur.

Internationalization of the euro

7. A currency develops at international level when its use extends beyond the frontiers of the issuing country and when it is used by private and official operators as a

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means of payment, a unit of account and a store of value. Various factors (e.g. the size of EMU, the stability oriented policy-mix and the wide financial market underpinning it) should facilitate the *development of the international use of the euro*. The behaviour of private operators, however, will be the most important factor.

The use of the euro in an area whose economic and commercial weight will be equivalent to that of the United States should reduce the information and transaction costs associated with its use. Companies which trade principally with the European Union will be prompted to invoice and pay in euros. With the euro being widely used in international trade transactions, European exporters and importers will no longer have to carry exchange-rate risks or cover themselves against such risks. The euro could also be used as a vehicular currency in commercial transactions not involving member countries of EMU. For example, if use of the euro were equivalent simply to that of the German mark today (see Annex 2, Table 2), 30% of world exports would be invoiced in euros following the changeover to EMU. Similarly, the simple conversion of assets currently held in European currencies into euros will mean that more than a third of the world portfolio will be denominated in euros, a percentage equivalent to that of the dollar.

8. Other characteristics of the euro area should also promote the international development of the euro beyond that currently applicable to the German mark. Stability oriented monetary and fiscal policies and the ECB's independence should make the euro a stable currency, protecting holders of euro-denominated assets from losses in purchasing power and promoting the euro's anchor-currency role. Similarly, the depth and liquidity of the European financial market will facilitate transactions on that market, thereby increasing the euro's attractiveness as an investment asset and a reserve currency for central banks.

9. The development of the euro's international role should first show itself in the countries which have close economic, trade and financial links with the European Union, such as the countries of Central and Eastern Europe and some Mediterranean and African countries. For example, the countries of Central and Eastern Europe which already tie their currencies to the mark will be linked to the euro *ipso facto*, and the private sector can be expected to use the euro in its trade and financial relations with the European Union. Similarly, the euro will automatically become the currency of reference for the franc CFA zone[1]. At the world level, these developments will be more gradual given the inertia effects that have prolonged the international role of the dollar since the end of the Bretton Woods system. The widespread use of this currency reduces the transaction and information costs linked to its use.

[1] The CFA zone is made up of two separate monetary unions having their own respective single currencies : the franc of the "Coopération Financière Africaine" in the Western part and the franc of the "Coopération Financière Africaine" in Central Africa. In this CFA zone, the currency has a fixed parity against the French franc.

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10. The development of the euro's international role and the deepening of European financial markets are likely to be accompanied by a greater international importance *of ECB action*. The monetary policy of the US Federal Reserve currently influences not only the conditions on US money and financial markets but also those on international financial markets as a result of the mobility of capital, arbitrage between markets, the depth and liquidity of the US financial market, and the dollar's international role. European monetary unification and financial integration, which will increase the attractiveness of euro-denominated assets, will also give the ECB's actionsan international dimension beyond that of the national central banks today. The internationalization of the euro might initially also complicate the conduct of domestic monetary policy as the evolution of monetary aggregates will become more dependent upon the decisions of foreign asset holders. Thus, a careful examination of the factors influencing monetary aggregates will be decisive in view of the execution of monetary policy.

11. The impact of the euro's introduction on the *allocation of private portfolios* is difficult to assess since it is hard to forecast the reaction of economic agents to a new currency. In the long term, the factors already identified will tend to increase the attractiveness of the euro. A diversification of international portfolios away from the dollar is already under way: between 1981 and 1995 European currencies' share of the world private portfolio increased from 13% to 37%, while the dollar's share fell from 67% to approximately 40% (see Annex 2, Table 4(b)). Similarly, the importance of European currencies is growing in international bond portfolios, with their share almost doubling to 37% between 1981 and 1995 (see Annex 2, Table 4(a)). The increased demand for euro assets is likely to be accompanied by an increased supply of such assets. At present, one of the reasons why issuers of international bonds prefer the dollar for large issues is that the cost of covering exchange-rate and interest-rate risks is lower with the dollar. However, the greater liquidity and depth of the euro market might reduce these costs to a level comparable to that of the dollar market, leading to an increase in the number of debt issues in euros. This is all the more likely given that the currency composition of the debt of developing countries (Asia, Latin America and eastern Europe) reveals a relatively low proportion of European currencies.

12. The use of the euro as a *reserve currency* should also develop. The diversification of foreign-exchange reserves in favour of the euro will be linked to its increased use as an instrument of intervention on foreign-exchange markets and as an invoicing currency in world trade. It will mainly depend on the euro intrinsic qualities and its use in the denomination of international financial transactions. This diversification of reserves in favour of the euro would continue a trend that is already evident. Over the period from 1973 to 1995, the yen's share of official reserves grew from 0.1% to 7.4% and the mark's from 7% to 14.2%, whereas the dollar's share fell from 76% to 61.5% (see Annex 2, Table 1(a)).

B. TRANSITIONAL ISSUES

13. While the longer-term outlook for an international monetary scene with the euro is favourable, there are a number of transitional issues associated with the introduction of the single currency. They refer to a potential risk either of exchange-rate instability between the euro and other major currencies, or of a deviation of the level of the value of the euro away from what is considered appropriate. Although the discussions focus mainly on the early months of the existence of the euro, anticipation behaviour by economic agents could already have implications for the exchange rate in the period before introduction. Possible causes that have been cited for this unwanted exchange-rate behaviour include the perceived future monetary policy stance of the ECB, the dollar overhang in central banks and the reshuffling of private portfolios following the introduction of the euro.

14. The *monetary policy stance* in the early stages of the ECB has been a topic for discussion for some time now. An often heard argument is that the ECB would attempt to establish early counter inflation credibility by adopting a tight monetary policy stance. Interest rates would thus be higher than would otherwise be justified, and would result in an inflow of capital and associated upward pressure on the exchange rate. This could hamper Europe's export competitiveness and economic growth performance, which, according to this line of argument, could encourage European governments to compensate with expansionary fiscal policies, thereby reinforcing upward pressures on interest rates and the exchange rate.

    Although the ECB will be a new institution, it will be at the centre of a system of central banks of countries that have demonstrated their commitment to stable prices; there is thus no reason to assume that the Bank will not enjoy counter inflation credibility from the outset. Moreover, the statutory independence of the ECB and its legal obligation to pursue the goal of price stability mean that there will be no need for the ECB to demonstrate once more to markets what is already evident from the start. It also has to be recognised that the economic performance of each of the EMU members in terms of inflation fundamentals is better than in the past.

15. *Budgetary policies* on the other hand, although mainly decided at national level, will be set in the framework embedded in both the Maastricht Treaty and in the Stability and Growth Pact. As the Stability and Growth Pact will guarantee budgetary rigour in the euro area, there is no reason to expect the monetary policy stance, in the early stages of EMU, to be too restrictive.The European policy mix in the transition period is thus likely to be of the right kind, and not likely to provoke a mismatch on the exchange rate front.

16. A frequently mentioned cause for short-term currency instability is the perceived *excess stock of dollars* - often dubbed the dollar overhang - accumulated in central banks. Once the euro is introduced, the ESCB may hold surplus reserves even if

account is taken of the decline in reserves resulting from the conversion of holdings of currencies of countries participating in EMU into domestic assets.[2] The European Union as a whole currently holds more reserves than the United States or Japan; these holdings might be considered disproportionate to the Union's needs after the euro has been introduced, for two reasons: the disappearance of the need to stabilize exchange rates between European currencies (in an EMU of 15) for which also dollars were held as a possible intervention currency; and the fact that the proportion of trade denominated in foreign currencies will fall because intra-Community trade (more than 60% of current external trade) will take place in euros.

Several qualifications need to be made. First, although the absolute value of the amounts involved may indeed be substantial, they are not significant in view of the turnover in financial markets. Second, central banks are fully aware of the potential impact on exchange rates of their transactions; it can thus be expected that operations to reduce excessive dollar holdings, if any, will be done gradually, in close cooperation and with an eye on market effects.[3] The European Central Bank may also in the early stages of the euro's existence deem it appropriate to have a larger stock of foreign reserves at its disposal if it wanted to demonstrate its capacity to stabilize the euro exchange rate as part of its monetary policy strategy.

17. The impact of the introduction of the euro on private portfolio composition is difficult to assess. At the very liquid end, where cash or near cash is being held, private economic agents will be confronted with a changed portfolio, with the constituent parts of the euro being replaced by one single currency. This is an entirely new situation and reactions will differ according to the reasons for which money is being held. For example, traders within the euro area that previously kept different European currencies to diversify their risk may be faced with a surplus of euros for transaction purposes. On the other hand, investors that were previously not interested in European currencies because of the limited size of the money markets may now want to acquire euros. The impact of the adjustment on the supply of and demand for euros is thus not straightforward.

For financial assets with longer maturities the picture is even less clear. Investors will re-assess the risk-return ratio of assets currently in their portfolios that are to be converted into euros and are likely to shift their holdings accordingly. Also, the increased liquidity and depth of financial markets will itself make euro-denominated assets more attractive, thereby putting downward pressure on the interest rate. These changes can occur fairly quickly and even in anticipation of the creation of the euro; whether this will lead to changes in the exchange rate or to increased exchange-rate

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2 A number of studies, particularly those carried out by investment banks, have attempted to quantify this surplus but there is no consensus as to its scale: while some studies argue that there will be no surplus, others take the view that it could be as high as USD200 billion.

3 There is already close consultation between the European central banks on reserves transactions during the second stage in order to avoid any negative effect on the foreign-exchange markets.

volatility is hard to predict as the link between asset shifts, the demand for currency and its exchange rate is not straightforward.

18. The above considerations suggest that in the aftermath of the introduction of the euro, its exchange rate might be affected by adjustments by economic agents. Some will happen gradually and in an orderly manner, such as the adjustment of central bank reserve holdings; others, in particular those related to portfolio adjustments, could have a more direct impact in the short term. There will thus be a case for monitoring exchange-rate developments and, if needed, for close international cooperation to ensure that any unwarranted impact of transitional effects on exchange markets are minimized.

C. EXCHANGE-RATE POLICY AND EXCHANGE RATE OF THE EURO

19. The Maastricht Treaty sets out a policy framework that is designed to ensure that the Community is an area of economic growth and stability. As from 1 January 1999, a single monetary policy will be formulated by the European Central Bank. The Bank will be independent and its priority objective will be to safeguard price stability in the euro area. Fiscal policies will be the responsibility of Member States but budgetary discipline will be guaranteed by market pressures, by Treaty obligations to avoid excessive deficits and an obligation to submit stability and growth programmes designed to maintain a budgetary situation close to balance or in surplus in the medium term. The euro area will also pursue a single exchange-rate policy in relation to third currencies. This policy will be formulated through procedures involving the Council, the ECB and the Commission (Article 109 of the EC Treaty).

Impact of economic policies on the euro's exchange rate

20. Exchange rates can be affected by many factors, some of which are influential in the short term and others in the longer term. In the short term, exchange rates can be influenced by instruments employed for exchange-rate policy purposes. Such instruments include sterilized or non-sterilized intervention by central banks on foreign-exchange markets and variations in official interest rates.

In the longer term, exchange rates are determined principally by fundamental economic factors. These factors include such variables as growth, inflation performance, productivity, budget balances, current balances, and the relative supply of domestic and foreign assets. Expectations as to changes in these variables also play a key role in exchange-rate movements. These fundamental economic factors in turn depend on the economic policy pursued, the policy mix.

21. The economic policy factors which will influence the euro's exchange rate fall into two categories: internal and external. At the European level, the conditions for a stability-oriented monetary policy are set out in the Treaty. The independence of the

ECB and a fiscal policy avoiding excessive deficits are the basis upon which monetary policy will maintain stability and hence sustainable growth. In the beginning, however, short term considerations may impact on the euro. Such effects may become evident even before the third stage of EMU actually begins and may influence the currencies of likely euro area participants. Therefore, it is imperative that the preparatory work for the third stage ensures that the ECB can operate under the conditions provided for in the Treaty. A balanced policy mix should lead to sustainably low long-term interest rates enabling easy monetary conditions at an exchange rate which is appropriate in view of economic conditions.

22. Considering the economic prospects for the European economy compared to that of the United States, different cyclical positions will impact on the stance of relative economic policies and thus on the exchange rate. Given the Union's objectives to achieve both fiscal consolidation and full employment, this creates conditions for a relatively easy monetary stance in the euro area. Given that fiscal policy is committed to reducing the deficit towards close to balance or surplus, monetary policy would be able to conduct a fairly accommodative policy without jeopardising its primary objective of price stability.

Among the long-term considerations, the euro exchange rate will reflect the functioning of EMU. In particular, the challenge of greater competition must be met by appropriate structural policies. Greater labour market flexibility, tax and social security reform in the direction of the most efficient systems will help the European economy to adapt to global challenges. If these reforms were to continue, EMU would contribute to a structural reform which would ultimately have a positive effect on employment.

23. In summary, the euro could evolve into an international currency in an environment of stability both internally and externally. In addition to these factors, which are influenced primarily by domestic economic policies, the euro exchange rate would also be influenced by external economic developments.

Exchange-rate policy in the euro area

24. The reduced degree of openness of the euro area, its lesser sensitivity to exchange-rate fluctuations and the increased impact of its economic policy at world level have occasionally been cited in support of the suggestion that the euro area could adopt an attitude of "benign neglect" towards the euro's exchange rate. But such an attitude would be at odds with Europe's experience of coordination. It would expose it to the danger of excessive fluctuations, or even prolonged misalignments, in the euro's exchange rate which could undermine the viability of the global trading system. Periods of misalignments are frequently accompanied by protectionist temptations. As the euro is likely to become an international currency, it may also be vulnerable to mood swings which could affect its stability. Furthermore, pressure would probably be brought to bear to include exchange-rate considerations in the conduct of economic policy. This pressure could stem from

sectors or regions which are more dependent on the extra-Community market for their sales. The ECB, national governments and Community bodies will continue to take account of the euro's exchange rate, the former primarily because it may affect the price-stability objective and the latter because it will influence cost-competitiveness and the growth outlook for the European economy.

25. The implementation of EMU is unlikely to create greater exchange-rate instability in the international monetary system. EMU should create an area of stability at world level, and there is not necessarily any conflict between internal and external objectives: the implementation of strict internal policies will promote international financial stability. The adoption of the euro should therefore be seen as an opportunity to put an end to the erratic fluctuations and prolonged misalignments of the type that occurred between 1980 and 1985 and to contribute to achieving more stable international monetary relations. The EU's increased influence on the international monetary scene will also provide an opportunity for a more intense economic dialogue with its partners.

26. Many types of exchange rate policy regimes are possible, ranging from the adoption of a fixed exchange-rate system like at Bretton Woods to managed or free floating. In practice, however, there is no reason to expect that the euro area would require any change from the current system which seeks to correct marked misalignments and excessive exchange-rate fluctuations through a combination of economic policy dialogue, occasional use of intervention and verbal exchange-rate management. However, such a system is not optimal and has to be improved. The instruments and means of doing so exist and should be studied more closely.

The institutional framework

27. The Treaty implicitly acknowledges that exchange-rate policy is an important element of both monetary and economic policy and it provides the structure for organizing the dialogue necessary for resolving potential conflicts. Exchange-rate policy will be defined in a framework of close cooperation, respecting the objective of price stability, between the monetary authority and the other Community bodies.

The Treaty organises the exchange-rate policy in three levels:

- the conclusion of formal agreements on an exchange-rate system which will be the responsibility of the Council; however, this requires a recommendation from either the ECB or the Commission, the ECB having to be consulted in an endeavour to reach a consensus consistent with the objective of price stability,

- general orientations for exchange-rate policy which may, in the absence of an exchange-rate system, be formulated by the Council but have to be without prejudice to the primary objective of the ESCB to maintain price stability, and

– conduct of foreign exchange operations (interventions, daily management of exchange reserves), for which the ECB will have sole responsibility.

The framework for close cooperation between the monetary authority and the other Community bodies is established by Article 109.

28. *Article 109(1)* sets out the procedure for concluding formal agreements. This paragraph makes it clear that the decision to conclude a formal exchange-rate agreement is the responsibility of the Council. The Council has to decide unanimously, on a recommendation from the ECB or from the Commission, after having consulted the ECB and the European Parliament. Consultation between the Council and the ECB is aimed, in this case, at achieving a consensus consistent with the objective of price stability. There is however no requirement for the Council and the ECB to agree: the obligation is only one of effort. From a purely formal viewpoint, should the views of the Council and the ECB diverge, those of the former would prevail. However, a significant disagreement seems unlikely since the Council is always bound to respect the objective of price stability for exchange-rate policy.[4]

The practical arrangements for negotiation and conclusion are to be decided under the conditions defined in paragraph 3: the ECB, or the Commission, could, for instance, be mandated by the Council to fulfil a specific role in the negotiation of (or to negotiate) the agreement.

29. *Article 109(2)* enables the Council to issue general orientations for exchange-rate policy in the absence of a formal agreement of the type referred to in Article 109(1). These general orientations can be decided by the Council acting by qualified majority on a recommendation from the Commission and after consulting the ECB, or on a recommendation from the ECB.

As to the ECB, it would have to organize its operations in a way consistent with these orientations, which however must not contravene the primary objective of price stability, the ECB being entrusted with the task of conducting monetary and exchange-rate policies with the view to respecting this objective.

30. *Article 109(3)* describes the procedure needed to define the arrangements for negotiating and concluding agreements concerning "monetary or foreign-exchange regime matters". The inclusion of monetary regime matters takes account of the fact that the Community (euro area) will have exclusive competence for the negotiation of such matters, as it has for foreign exchange regime matters according to Article 109(1).

Arrangements defined according to Article 109(3) will have to ensure that (i) the

4 In addition, article 3 a, paragraph 3 states that activities of the Member States and the Community "shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments".

Community expresses a single position; and that (ii) the Commission is fully associated with the negotiations. The arrangements are to be decided by the Council, acting by a qualified majority on a recommendation from the Commission and after consulting the ECB. Agreements concluded according to Article 109(3) are binding on the institutions of the Community, on the ECB and on Member States.

31. *Article 109(4)* lays down arrangements for deciding the common position and representation of the Community at the international level when matters of particular relevance to EMU are at issue. Article 109(4) thus covers issues of particular relevance for EMU other than agreements concerning monetary or exchange-rate regime matters. According to Article 109(4), the representation of the Community at the international level has to reflect the division of responsibilities between the Member States and the Community in economic and monetry matters. However, according to *Article 109(5),* without prejudice to Community competence and Community agreements as regards economic and monetary union, Member states may negociate in international bodies and conclude international agreements.

32. In accordance with *Article 30 of the ESCB Statute*, the national central banks will provide the ECB with *foreign reserve assets*. The ECB will have full powers to hold and manage the foreign reserves that are transferred to it. In accordance with Article 31.2 of the ESCB Statute, all other operations in foreign reserve assets remaining with the national central banks after the transfers referred to in Article 30, and Member States' transactions with their foreign exchange working balances shall, above a certain limit, be subject to approval by the ECB in order to ensure consistency with the exchange rate and monetary policies of the Community.

D. EUROPE AS A PARTNER AT INTERNATIONAL LEVEL

33. The completion of EMU has the potential to lead to an important evolution in the international monetary system. The single currency is being introduced at a time when the international monetary system is already in a period of transition, with the dominant position of the dollar giving way to a more multi-polar system. Such a system is not inherently less stable than a unipolar system but, by definition, appropriate arrangements for co-operation between poles will be crucial to the stability of the system.

    The implementation of EMU will also tend to make the international monetary system more symmetrical with the potential gains to be obtained from coordination tending to be more uniformly distributed among the various partners. European economic policies are likely to have bigger spill-over effects on the economies of Europe's partners, while the removal of the possibility of intra-EU tensions triggered by international exchange-rate movements removes one source of EU vulnerability towards the outside world.

34. The direct implication of EMU is that the EU will have a single exchange rate and a single monetary policy, and that it will be the policy mix at European level that is

relevant for the rest of the world and for any international macro-economic policy coordination. Although part of this policy mix is the result of policies set at the national level, the obligation of the member States to closely coordinate their economic policies (Article 3a) and the different procedures set out in the Treaty to accomplish this should enable the euro area to pursue consistent policies and provide a valid reference point for international economic affairs, both bilaterally and in international bodies.

This reality is reflected in the Maastricht Treaty, and in particular in Article 109 of the EC Treaty. This Article not only sets out internal procedures for the Community to establish an exchange-rate policy, as discussed earlier, but also offers a framework which will allow the EU to be an effective actor on the international stage on macro-economic and monetary issues. Although the Article is complex, there are several principal points:

- it is clear that the EU, or the euro area, must establish, where relevant, a common position for international discussion of "agreements concerning monetary or foreign-exchange regime matters" and on "issues of particular relevance to economic and monetary union";
- responsibility for these matters lies with the Council, although both the ECB and the Commission have roles to play. The underlying intention of these provisions is to make clear that the Council and the ECB cooperate in this area in a way that recognizes ECB responsibility for monetary policy and the primary objective of price stability;
- the representation of the Community at international level is for decision by unanimity, although it must respect the allocation of competences in the economic and monetary union.

35. A substantial amount of work will still be required in order to establish suitable arrangements within this framework. These issues will need serious discussion both within the Community, and with the Community's partners in the relevant international organizations, since the advent of EMU will also have implications for how some of these institutions operate.

36. A straightforward case concerns the IMF, where the introduction of the single currency will trigger a substantial number of fundamental and operational questions. One example concerns the concept of a national balance of payments, and of a balance-of-payments need, which is of particular relevance given that the IMF Member States' right to draw on Fund resources is intimately related to this. Here, the question for the Fund will be how this is going to be dealt with in the single currency area, where the concept of a BoP need at Member State level in particular becomes hard to define. Another example refers to the representation on the Board of Governors and the Executive Board, where, depending on the subject, the Union's need to respect the Treaty's requirements on position taking and representation will have to be reconciled with the requirements embedded in the Fund's Articles of Agreement. Identification and discussion of all these issues is needed well in

advance of Stage III to ensure no transitional problems. Similar questions will have to be raised with respect to other institutions or fora, such as the G-7, where issues that fall within Community competence are also discussed and where existing practice will have to be checked against consistency with the Treaty.

ANNEX 1

ECONOMIC INDICATORS

US - JAPAN - EUROPEAN UNION

	Population (Mio) 1995	Share of OECD GDP (%) 1996	Share of world trade (%) 1996	Export GDP ratio (%) 1996	Foreign exchange reserves in Bn $ end 1995**
USA	263	32.5	19.6	8.2	49.1
Japan	125	20.5	10.5	9	172.4
EU15	370	38.3	20.9*	10.2	349.8

* Excluding intra-EU trade

** Source : IMF

ANNEX 2

INTERNATIONAL ROLE OF THE MAIN CURRENCIES

1. Official role

A. Share of total official currency holdings (%)			
	end 1973	end 1983	end 1995
US dollar	76.1	71.1	61.5
European currencies[1]	14.3	15.8	20.1
of which: German mark	7.1	11.7	14.2
Yen	0.1	4.9	7.4

1 Pound sterling, German mark, French franc, Dutch guilder

Source: IMF annual reports.

B. Number of currencies linked to:	1983	1994	1994 (% of world GNP)
the dollar	34	25	1.53
European currencies (including the ecu)	18	19	0.25

Source: IMF annual reports.

2. Currency use in international trade

Share of the main currencies as regards use in international trade				
	1980		1992	
	% of world exports i	Internationalization ratio[1]	% of world exports i	Internationalization ratio
US dollar	56.4	4.5	47.6	3.6
German mark	13.6	1.4	15.5	1.4
Yen	2.1	0.3	4.8	0.6

Source: European Commission

1 For the definition, see footnote 1of text.

3. Transactions on foreign-exchange markets

Breakdown of transactions by currency[1]			
	April 1989	April 1992	April 1995
US dollar	90	82	83
German mark	27	40	37
Yen	27	23	24
Other	56	55	56
Total as %[2]	200	200	200

Source: BIS, surveys of activities on foreign-exchange markets

1 Gross turnover. Daily averages.

2 Since any transaction on the foreign-exchange market involves two currencies, the total of the proportions of transactions involving a given currency is 200%.

4. Currency in which financial assets and liabilities are denominated

A. Share of outstanding international bonds			
	end 1981	end 1992	end 1995
Dollar	52.6	40.3	34.2
European currencies	20.2	33.0	37.1
of which: German mark	n.a.	10.0	12.3
Yen	6.9	12.4	15.7

Source: BIS, international banking and financial activity

B. Share of world private portfolio			
	end 1981	end 1992	end 1995
Dollar	67.3	46.0	39.8
European currencies	13.2	35.2	36.9
of which: German mark	n.a.	14.7	15.6
Yen	2.2	6.9	11.5

Source: BIS, international banking and financial activity, and own calculations.