€uro, Euro System and the European System of Central Banks

Vincent Mervyn Fernando *

On January 1, 1999, stage three of European Economic and Monetary Union was launched. That meant that eleven countries merged their monetary policies - on the basis of the Treaty of Maastricht signed in 1992 - and introduced a common currency, the **Euro.** The main purpose of this special paper is to present an overview of the "EURO", "EURO SYSTEM" and the "EUROPEAN SYSTEM OF CENTRAL BANKS" (ESCB). The paper is divided into three sections. Section 1 gives an introduction of a brief history of the European Community including the road to the EURO. Section 2, presents the Euro System and European System of Central Banks with their monetary objectives policy and policy instruments. Section 3, observes the implications for Sri Lanka and the world economy.

SECTION 1
A BRIEF HISTORY OF THE EUROPEAN COMMUNITY

The European Economic Community (EEC) was established in 1958 under the Treaty of Rome, with six members: **France, West Germany, Italy, Luxembourg, Belgium and Netherlands.** The membership has since been enlarged to include **Denmark, Ireland,** and the **UK,** (1973) **Greece** (1981), **Spain** and **Portugal** (1986), and the unification of Germany resulted in the incorporation of the East German economy into west Germany. **Austria, Finland** and **Sweden** Joined on 1 January, 1995.

The EEC is actually only one of three organizations created by the six original members. The Treaty of Paris (1951) created the European Coal and Steel Community (ECSC) to integrate the coal and steel industries of the six. The Treaty of Rome (1957) established the EEC, and a separate Treaty of Rome created Euroatom (an atomic energy community). These three organizations were amalgamated in 1967 and are all encompassed by the term **"European Community" (EC)** that will be used throughout this paper.

The original objectives of the EEC were set out in article two of the Treaty of Rome. There were: **"establishing a common market and progressively approximating the economic policies of the member states to promote through the community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its member states".**

The community has four principal institutions: The **Commission, Council of Ministers, European Parliament** and **Court of Justice.** The commission drafts directives, introduces policies and implements measures. The Council of Ministers consisting of representatives of the member states is the main decision making body of the Community. The European Parliament provides a forum for debate for elected representatives from member states. The **Court of Justice** deals with community policies and their application in member states.

a) The Common Agricultural Policy (CAP)
b) Regional Policy
c) Social Policy and Education Policy
d) Industrial and Commercial Policies
e) Monetary Policy
f) The Research and Investment Policy
g) Foreign Aid Policy
h) Environmental Policy
i) Economic Policy

The Road to the EURO

The concept of a common currency that is "EURO"** for Europe has its origins in the attempt towards economic integration of Europe suggested in the Treaty of Rome in 1957, that established the EEC, but the idea only crystallized during the Hague summit of European leaders in 1969. The final breakthrough came in 1992 when the Maastricht Treaty on European Union (EU) was signed and ratified by the member countries. Under the Maastricht Agreement, Member States of the European Community have committed themselves to an economic and monetary union that is to be achieved in three stages.

Stage 1 commenced on 1 July, 1990 and focused on the removal of disparities within the European Union (EU). **Stage 2,** which commenced on 1 January 1994, aimed at promoting the goal of achieving fiscal and monetary convergence among member states and the establishment of the European Monetary Institute (EMI) which was the forerunner to the European Central Bank (ECB). The EMI role is to: (a) strengthen co-operation between the National Central Banks and co-ordinate monetary policies; (b) facilitate the use of EU, and clearing system; (c) monitor the European Monetary System. By mid 1998 at the latest the European System of Central Banks (ESCB), including ECB, is to replace the EMI. During the period 1992-1997, member countries were required to fulfill the requirements which include **price stability** (defined as the rate of inflation within 1.5 percentage points of the three best performing EU countries), **Low long-term interest rates.** (Defined as within 2 percentage points of the three member states with lowest interest rates.), **exchange rate stability** (meaning that for at least two years a country has kept within the normal fluctuation margins as specialized under the European Monetary System (EMS) and a sustainable government financial position (defined as a budget deficit no longer than 3 % of GDP and a ratio of government debt no more than 60 % of GDP).

The purpose of the EMS is to maintain the stability of currencies, control inflation and promote economic growth through co-operation. The cost for the member States is the consequence of compliance with the requirements imposed by the Exchange Rate Mechanism (ERM). ERM has been defined as a semi-fixed system of rates of exchange which allows currencies to go up and down between agreed limits. All countries within the system are entitled to join the ERM but entry into the ERM is not a pre-requisite for membership of the EMS. Thus, although the UK has participated in its arrangements from the beginning, sterling did not go into the ERM until October, 1990 and subsequently left in September 1992 to become eligible for adoption of "Euro". The 11 countries which were eligible to join "Euro" were selected.

Stage 3, commenced on 1 January, 1999 with the formal introduction of the Euro and the irrevocable fixing of the exchange rates between the participating countries. The exchange rates between the Euro (EUR) and the National Currencies of Members of the EMU were fixed

* Senior Assistant Director, Central Bank of Sri Lanka.

** The Euro is the common currency of the newly formed "Euroland", a single economic zone formed by the integration of 11 of the 15 member countries of the European Union on 1 January,1999 as given in **Table 1**. Banks and stock exchanges begin to trade in Euro. Euro used for cheque and credit card transactions in 1 January, 1999*. Euro notes and coins will be made available in physical form alongside national currencies only on 1 January, 2002. The national currencies of participating countries will be completely replaced on 1 July 2002 after a six-month transition period. These 11 national currencies will no longer be accepted as legal tender thereafter. The summary note on the road to the Euro is given in ***Chart 1.***

Chart 1

Irrevocable Euro Conversion rates **

Country	Currency	1 Euro =
Belgium	Franc	40.3399
Germany	Mark	1.95583
Spain	Peseta	166.386
France	Franc	6.55957
Ireland	Pounds	0.787564
Italy	Lira	1936.27
Luxembourg	Francs	40.3399
Netherlands	Gulider	2.20371
Austria	Schilling	13.7603
Portugal	Escudos	200.482
Finland	Markkaa	5.94573

Source: Monthly Bulletin – European Central Bank : January,1999

There will no longer be bid-offer rates between the Euro and these currencies. No cross rates will be allowed, for example, between DEM and ERF. No inverse rates will be permitted. Rates between the Euro and these currencies will be quoted up to six significant figures; Rates between these currencies and other currencies may also be quoted through the Euro.

THE ROAD TO THE EURO

1946 - Winston Churchil calls for a "United state of Europe"

1952 - The European Coal and Steel Community is established

1957 - The European Economic Community is setup

1963 - France and West Germany sign a treaty of cooperation

1972 - European lenders agree to economic and monetary union by 1980

1979 - The European Monetary System (EMS) and European Currency Unit are created

1986 - An agreement is reached on a tariff free internal market to be set up for European Community Members by the end of 1992.

1989 - The Berlin Wall falls

1990 - Germany is reunified

1992 February 7-Signing of the Maastricht Treaty introducing plan for single EU currency by January 1999

1992, June-In referendum on a single currency Denmark rejects the plan and Ireland votes in favour

1992, December-France votes in favour of single currency in referendum

1993, May-Denmark rejects EMU in second referendum

1993, November-German court rules in favor of Maastricht Treaty

1994, January-European Monetary Institute founded in Frankfurt

1995, December-European leaders confirm date for single currency

1998, May-11 initial participant nations choose to launch the Euro, Central Bank chief chosen

1998, December 31-Participant nations fixed exchange rates

1999, January 1-Banks and stock exchanges began to trade in Euro. Euro used for cheque and credit card transactions

1999, January 4-Financial Markets opened to a brave new world

1999 January 7-The ECB Governing Council met for the first time with responsibility for the single currency.

2002, January 1-Euro coins and notes released for circulation and become legal tender

2002, July 1-Old currencies cease to be legal tender

The Euro

The Euro is the common currency of the newly formed euroland a single economic zone formed by the integration of 11 of the 15 member countries of the European Union. (EU)*** It was named in December 1995 and came into existence on January 1, 1999. The introduction of the **Euro**, which is considered to be the most significant event in institutional developments in the global financial area, after the Bretton woods Institutions, would have far reaching implications on the global economy.

The main **objectives** of introducing a common currency - Euro - are ;

a) To facilitate travel in EC countries by removing the losses involved in conversion of one currency into another.

b) To encourage cross - border investments in EC countries by European companies by removing exchange risks.

c) To implement most effectively a common and uniform exchange rate policy and monetary policy in all the EC countries.

d) To achieve the final objective of establishing a single European economy and through it a United State of Europe.

e) To effectively counter the US dollar as the main reserve currency and replace it by Euro thereby regaining Europe's lost glory.

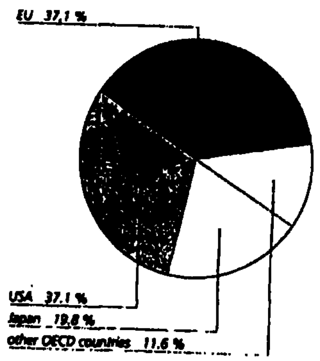
The Change over to Euro Bank Notes and Coins

The EU regulation on the practical aspects of the introduction of the Euro States that bank notes and coins denominated in national currency shall remain legal tender within the territorial limits of their country until six months after the 1 January 2002 at the latest. As long ago as the Madrid European Council in 1995, it had been agreed that this period of dual circulation may be shortened by national law. Since then, a broad consensus has emerged that a short period would facilitate the change over, help to reduce the burden on retailers and financial institutions and avoid confusion for customers. This burden will consist in managing two currencies simultaneously, which will create practical difficulties and involve extra costs. Taking these drawbacks into account, most national central banks have now adopted the working assumption that the period of dual circulation could last between two weeks and two months, the logistics of a rapid change over scenario are being modeled with the involvement of different interest groups at the national & European levels.

At the end of 1997, there were approximately 13 billion bank notes in circulation in the member states, shared among 79 denominations. The 1997 production of national bank notes of the EU member states amounted to approximately 6.5 billion. Whereas the European System of the Central Banks (ESCB) has mainly focused up to now on the completion of the "bank note" as a product and preparations for its production, utmost priority will now be given to detailed planning of the change over process.

Under the terms of the Maastricht Treaty, only the Governing Council of the ECB will have the right to authorise the issue of bank notes

Europe - a market with 373 million consumers



* With the beginning of stage three of EMU, the former EMS ceased to have effect. It was replaced by the new European exchange rate mechanism ERM II.

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*** At present 11 of the 15 EU members have joined the EU. They are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The UK, Denmark, Sweden have volunterily opted out for their own reasons, while Greece is an involuntary exclusion due to non-compliance with the convergence criteria.

within the future Monetary Union. Given the long lead-times in the banknote area, the printing of the first bank notes started in the first half of 1999, to be put into circulation on 1 January,2002. The withdrawal of national currency is scheduled to commence immediately after that date and the old bank notes will lose their status as legal tender within 6 months of the Euro Launch.

A future German Law will prescribe that Deutsche Mark notes and coins will cease to be legal tender as soon as the Euro cash is introduced, namely on 1 January 2002 (What is known as the legal "Big Bank".) particularly with regard to coin operated machines, certain change over regulations will however, permit the further use of Deutsche Mark cash for a limited period. According to estimates by the Association of Slot Machine Operators, the conversion of Germany's roughly 1.7 million coin operated machines will take around 100 working days. The most crucial adjustments for the introductions of Euro coins cannot be carried out until after the launch date, as the slot machines cannot simultaneously only accept national currency coins and Euro coins. Conversions before January 1, 2002 would therefore result in losses of turnover.

The bank note and coin volumes will also partly be absorbed by credit institutions and retailers, such as super markets, to which Euro bank notes and coins will already be distributed before the date of issue. This "Front Loading" Serves the following main purposes.

First, to cope with the very strong peak in demand for secure transactions by 1 January 2002. **Second**, to permit retailers to give change in Euro from the very start of 2002. **Third**, to allow banks to offer their customers the possibility of withdrawing Euro notes at the ATMS as from the first few hours of 1 January, 2002.

SECTION 2
The Euro System and the European System of Central Banks

The Euro System - Comprising the European Central Bank (ECB) and the National Central Banks (NCB)* of the Member States which adopted the Euro on 1 January 1999- has assumed the task of conducting the single monetary policy for the Euro area (Euroland). These are currently 11 NCBs in the Euro System. If and when, all 15 member states participate in the Euro area, the term "Euro System" will become a synonym for the European System of Central Bank (ESCB) (see the chart 2).

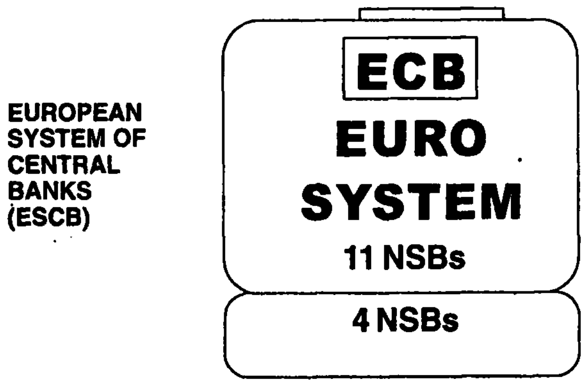
As decided by the ECB Governing Council on 9 June,1998 the 15 countries in the EU and their NCBs percentage shares in the key for the capital of the ECB is given **Table 2**.

The Euro System is governed by the **Governing Council** and the **Executive Board** of the ECB. **The Governing Council** comprises all the members of the Executive Board and the governors of the NCBs of the member states which have adopted the Euro. The **Executive Board** comprises the President, the vice-president and four other members appointed by the Heads of State or Government of the member states which have adopted the Euro.

The **ESCB** is governed by the decision making bodies of the ECB. In this respect, the **Governing Council** of the ECB is responsible for the formulation of monetary policy while the **Executive Board** is empowered to implement monetary policy according to the decisions and guidelines laid down by the Governing Council. **The General Council** is composed by the President, The Vice-president of the ECB and the Governors of the National Central Banks of all EU countries, the other members of the Executive Board of the ECB may participate, without having the right to vote.

CHART 2

EUROLAND AND ESCB



* It should be noted that NCB of Member States which have not adopted the single currency in accordance with the Treaty establishing the European Community (Treaty) retain their powers in the field of monetary policy according to national law and are not involved in the conduct of the single monetary policy.

Key Features of the Euro Area

Many of the key features of the Euro area as a whole, such as the size and openness of the economy and the financial structure, are quite different from those of the individual member states and should rather be compared with those of the United States and Japan (Table 3).

In 1997, the Euroland accounted for 15 per cent of the **world GDP** at constant prices. In contrast, the United States and Japan contributed to about 20 per cent and 8 per cent of world GDP respectively. The share of the Euro area in total **world exports** (of goods) amounts to almost 16 per cent which substantially exceeds the shares of both the United States (13 per cent) and Japan (9 per cent). In terms of size and structure, the **government sectors** in the Euro area differs significantly from those of the United States and Japan. As represented by the share of government expenditure in GDP, the government sector is significantly larger in the Euro area (49%) than in either Japan (39%) or the United States (35%).

Turning to a member of key **monetary and financial indicators**, several structural differences between the Euro area's financial system and the financial system of the US and Japan may be noted. The key difference in particular from the United States lies in the relative roles played by banks and securities markets, whereas the Euro area's financial system is predominantly based on banking products and equity financing plays only a limited role, in the US equity and debt securities markets provide the principal means of financing and saving. This general picture of the financial structure of the Euro area can be illustrated by reference to various indicators. Bank deposit, if measured relative to GDP, are more significant in the Euro area (84%) than in US (55%), but can important than in Japan (99%). Similarly, the outstanding amount of domestic bank credit, both in absolute terms and relative to GDP is far higher in the Euro area than in the US, although it is comparable, as a share of GDP, to that in Japan.

Labour market characteristics also defer substantially between the Euro area and the two other economies. The labour of overall **unemployment rate** in the Euro area (10.8%) is far higher than in US (4.4%) and differences are accounted for by a host of factors, including structure features of the two labour markets such as wage and non-wage labour costs, employment protection legislation and the scale and duration of unemployment benefits. The official unemployment rate of Japan is also only 4.4 per cent.

Overall, the Euro area, as one of the largest economies in the world will play a significant role in shaping global macroeconomic conditions. Equally, it will be open vis-à-vis its trading partners, although developments in the domestic economy will by far outweigh external factors. Residents of the Euroland will undoubtedly benefit from the enhanced growth employment opportunities which are afforded by a large internal market.

The Stability Oriented Monetary Policy Strategy of the Euro System

The main elements of the stability-oriented Monetary Policy strategy of the Euro System were presented to the public on 13 October,1998, and have subsequently been elaborated in speeches and statements by the President of the ECB and other members of the Governing Council.

The strategy consists of three main elements:

a. A quantitative definition of the primary objective of the single monetary policy, namely price stability; and

b. the "two pillars" of the strategy used to achieve this objective:
   - a prominent role for money, as signaled by the announcement of a **reference value** for the growth of a broad monetary aggregate; and
   - a broadly based assessment of the outlook for future price developments and the risks to price stability in Euro area as a whole

Price Stability and Its Importance

The Governing Council of the ECB has defined the price stability as **"a year on-year increase in the Hamonised Index of Consumer Prices (HICP) for the Euro area of below 2 per cent."** Price stability according to this definition "is to be maintained over the medium term."

The HICP for the Euro area is a relatively new concept. The chosen definition identifies the HICP as price index that should be used in the assessment of whether price stability has been achieved and maintained. This index was initially created for the assessment of price convergence in stage Two and is largely harmonised across the various countries in the Euro area.

The Benefits of Price Stability

Price stability improves the transparency of the relative price mechanism, thereby avoiding distortions and helping to ensure that the market will allocate real resources efficiently both across uses and across time. A more efficient allocation will raise the productive potential of the economy. Moreover, stable prices minimize the inflation risk premium in long-term interest

Table 2

COUNTRY SHARES IN THE ECB

COUNTRY	NAME OF THE CENTRAL BANK	PERCENTAGE SHARE (%)
Austria	Oesterreichische National Bank	2.3663
Spain	Banco de Espana	8.8300
Greece	Bank of Greece	2.0585
Denmark	Denmarks National Bank	1.6573
Germany	Deutsche Bundes Bank	24.4096
Finland	Suomen Pankki	1.3991
The Netherlands	De nederlandsche Bank	4.2796
Belgium	Banque National de Belgique	0.1469
Sweden	Sverīges Risk Bank	2.6580
Luxembourg	Banque Centrale du Luxembourg	0.1469
Italy	Banca d' Italia	14.9616
France	Banque de France	16.8703
Portugal	Banco de Portugal	1.9250
Ireland	Central Bank of Ireland	0.8884
United Kingdom (UK)	Bank of England	14.7109
Total		100.0000

Source: European Central Bank

Table 3

KEY CHARACTERISTICS OF THE EURO AREA, JAPAN AND UNITED STATES

	Reporting Period	Unit	Euro	United States	Japan
Population	1998	mn	292.0	270	127
GDP (share of world GDP)	1997	%	15.0	20.2	7.7
Agriculture, Fishing, Forestry	1993	% of GDP	2.4	1.7	2.1
Industry, (Including construction)	1993	% of GDP	30.9	26	39.2
Services	1993	% of GDP	66.7	72.3	58.7
General Government Receipts	1998	% of GDP	46.7	35.9	33
Social Security Contributions	1998	% of GDP	17.0	9.4	11.1
Expenditure	1998	% of GDP	49.1	34.5	38.6
Current transfers to Households	1998	% of GDP	20.2	13.7	15.7
Exports of goods	1997	% of GDP	13.6	8.5	10
Imports of goods	1997	% of GDP	12.0	11.1	8.1
Exports (% of world exports)	1997	%	15.7	12.6	7.7
Bank deposits	End-1997	ECU bn	4657.9	3953.4	3663.4
	End-1997	% of GDP	83.9	55.3	98.8
Domestic Credit	End-1997	ECU bn	7128.5	5881.5	4710.8
	End-1997	% of GDP	128.5	82.2	127.1
Claims on the Private Sector	End-1997	ECU bn	5125.9	4931.1	4033.6
Claims on the General Government	End-1997	ECU bn	2002.6	950.4	677.1
Domestic Debt Securities	End-1997	ECU bn	5002.4	11364	4052.2
	End-1997	% of GDP	90.2	164.7	108.5
Issued by the Private Sector	End-1997	ECU bn	1897.9	4729	1192.4
Issued by the Public Sector	End-1997	ECU bn	3104.4	6634.7	2822.9
Stock Market Capitalization	Oct. 1998	ECU bn	3190.9	9679.7	3300.9
Real GDP Growth	1998	%	3.0	3.3	-2.5
CPI Inflation	Nov. 1998	%	0.9	1.5	0.8
Unemployment Rate (% of labour force)	Nov. 1999	%	10.8	4.4	4.4
Broad Money Growth	Q 3 1998	%	4.4	7.4	3.3
Three-month Interest Rate	End-1998	%	3.3	5	0.18
10 year Government Bond Yield	End-1998	%	3.9	4.7	2.02
General Government Surplus (+) or deficit (-)	1998	% GDP	-2.3	1.4	-5.5
Gross debt	1998	% GDP	73.8	59.3	115.6
Current Account Balance	1997	% GDP	1.1	1.7	2.3

Source: Monthly Bulletin- European Central Bank-January 1999 rates, thereby lowering long-term rates and helping to stimulate investment and growth Maintaining price stability avoids the large and arbitrary redistribution of wealth and incomes that arises in inflationary as well as deflationary environments, and therefore helps to maintain social cohesion and stability. These arguments collectively suggest that maintaining price stability in itself contribute to the achievement of output or employment goals. The logic underlying both the Treaty and Euro System's stability oriented monetary policy strategy is therefore that output and employment goals are best served by a monetary policy that focus on price stability.

The reference value – a prominent role for money

Inflation is ultimately a monetary phenomenon. The Governing Council therefore recognized that giving money a prominent role in the Euro System's strategy was important. To signal the prominent role it has assigned to money, the Governing Council has announced a quantitative reference value for monetary growth as one pillar of the overall stability-oriented strategy. The reference value is intended to help the Governing Council analysis and present the information contained in the monetary aggregates in a manner that offers a coherent and credible guide for monetary policy aimed at price stability.

The reference value for monetary growth has been derived using the well-known relationship between money, on the one hand, and prices real gross domestic product (GDP) and the velocity of circulation, on the other. For prices, the derivation of the reference value has to be based on the Euro System's published definition of price stability. On 1 December 1998 the Governing Council announced its reference value for M_3 growth. The derivation of the reference value was based on the following medium-term assumptions.

I. Price stability must be maintained according to the Euro System's published definition, so that year-on year increases in the HICP for the Euro area are below 2 %.
II. The trend of real GDP growth lies in the range 2 -2½ % per annum.
III. Over the medium term, the decline in the velocity of circulation of M_3 is in the approximate range ½ -1 % each year.

Without prejudice to the primary objective of price stability, the ESCB has to support the general economic policies in the European community. In pursuing its objectives, the ESCB has to act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

The basic tasks to be carried out through the ESCB are :

- to define and implement the monetary policy of the community;
- to conduct foreign exchange operations;
- to hold and manage the official foreign reserves of the member states;
- to promote the smooth operation of payment systems.

In order to achieve its objectives, the ESCB has at its disposal a set of monetary policy instruments, the ESCB -

(a) Conducts Open Market Operations (OMO);
(b) Offers standing facilities; and
(c) Requires credit institutions to hold minimum reserves on accounts with the ESCB.

Open Market Operations

Open market operations play an important role in the monetary policy of the Euro system for the purposes of steering short-term interest rates, managing the liquidity situation in the market and signalling the stance of monetary policy.

Among the open market operations, the **"main refinancing operation"**, i.e. a weekly tender with a two-week maturity, plays a pivotal role in the eurosystem's monetary policy framework. Indeed, it is mainly through this operation that the Euro System steers movements in short-term market interest rates and refinances the banking system. In addition, the Euro System also regularly conducts **"longer-term refinancing operations"**. These are monthly tender operations which have a three-month maturity. By contrast with the weekly tender, in the monthly tender the Euro System does not, as a rule, intend to send signals to the market. Other types of open market operations which the Euro system could conduct, when deemed necessary, include **fine-tuning operations**, which are aimed, in particular, at smoothing the effects of unexpected liquidity fluctuations in the market. Furthermore, the Euro system has the possibility of using open market operations (such as the issuance of ECB debt certificates) to adjust **the structural positions** of the Euro system vis-à-vis the financial sector. Since the start of Stage Three the ECB has not, however, seen any need to carry out such "structural" operations.

The ESCB has available five types of instrument for the conduct of open market operations. The most important instrument is **reverse transactions** (applicable on the basis of repurchase agreements or colateralised loans). The ESCB may also use outright transactions, the issuance of debt certificates, foreign exchange swaps and the collection of fixed-term deposits. Open market operations are initiated by the ECB, which also decides on the instrument to be used and the terms and conditions for their execution. They can be executed on the basis of standard tenders, quick tenders or bilateral procedures.

Standing Facilities

Standing Facilities aim to provide and absorb overnight liquidity, signal the general stance of monetary policy and bound overnight market interest rates. **Two standing facilities are available** to eligible counterparties on their own initiative subject to their fulfillment of certain operational access conditions.

Counterparties can use the **marginal lending facility to obtain overnight liquidity** from the national central banks against eligible assets. Under normal circumstances, there are no credit limits or other restrictions on counterparties' access to the facility apart from the requirement to present sufficient underlying assets. The interest rate on the marginal lending facility normally provides a ceiling for the overnight market interest rate.

Counterparties can use the **deposit facility to make overnight deposits** with the national central banks. Under normal circumstances, there are no deposit limits or other restrictions to counterparties' access to the facility. The interest rate on the deposit facility normally provides a floor for the overnight market interest rate.

The standing facilities are administered in a decentralised manner by the national central banks.

Minimum Reserves

The ESCB's **minimum reserve system applies to credit institutions in the Euro area and primarily pursues the aims of stabilising money market interest rates** and creating (or enlarging) a structural liquidity shortage. The reserve requirement of each institution is determined in relation to elements of its balance sheet. In order to pursue the aim of stabilising interest rates, the ESCB's minimum reserve system enables institutions to make use of averaging provisions. Compliance with the reserve requirement is determined on the basis of the institutions' **average daily reserve holdings over a one-month maintenance period**. Institutions' holding of required reserves are remunerated at the rate of the ESCB's main refinancing operations.

Payment-System-TARGET

The efficient implementation of monetary policy measures and the allocation of central bank money throughout the European money market require a **sound and efficient large-value payment system for the Euro.** Such a system is available in the form of the real-time gross settlement TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer System).

Its operational design as a real-time gross settlement system means that **payments are executed one by one as soon as adequate cover is available, and are therefore settled with immediate finality.** This enables the ECB, the national central banks and credit institutions to transfer cross-border payments through this system as quickly and securely from one participant to another, as participants are accustomed to doing in their national systems. Following the decentralised approach, **TARGET is a network of the individual national real-time gross settlement systems which are connected with each other by means of an "Interlining Component"** (communication network and joint facilities and procedures). This ensures that the participants can also make gross-border transfer by using the existing access to their national system. (Chart 3)

The **objectives** of TARGET are: (a) to provide a safe and reliable mechanism for the settlement of cross-border payments on a RTGS basis; (b) to increase the efficiency of intra-EU cross-border payments; and (c) to serve the needs of the ESCB's monetary policy.

The salient features of TARGET can be summarized as follows:

- Target is the real-time gross settlement system for the Euro,
- It consist of fifteen national real-time gross settlement (RTGS) systems and the ECB payment mechanism (EPM), which are inter linked so as to provide a uniform platform for the processing of cross-border payments,
- It is a real –time system: under normal circumstances payments will reach their destination within a couple of minutes, if not only a few seconds, of being debited from the sending participant's account: all payments will receive the same treatment, regardless of their value,
- Target is a gross settlement system in which each payment will be handled individually.
- Acknowledgement of the successful execution of each individual payment order will be sent to the sending national central bank in real time.
- It is available for all credit transfers in Euro between EU countries, including those countries not participating in EMU. It will process both inter-bank and customer payments. There will be no upper or lower value limit for its payments. It is mainly intended for large-value payments. However, participant's with only a limited number of smaller cross-border corporate and retail payments to be processed could also consider using it for their entire cross-border Euro payments business.
- It Provides intraday finality: settlement will be final once the funds have been credited. The money received will be central bank money. It is accessible to a large number of participants. Hence, most credit institutions will be able to use it to make payments on their own behalf, independently of other participants.
- Target is very easy to use. To initiate a cross-border payment, participants will simply send their payment orders to the Euro RTGS system in which they participate using the domestic message format with which they are familiar. TARGET will take care of the rest. The beneficiary participant will receive the payment message in its domestic message format.

The advantage of using TARGET can be summarized as (a) Flexible liquidity management, (b) Risk reduction, (c) Real time operation, (d) Operating times to suit everyone, (e) The possibility of reaching almost any EU credit institution, (f) Full end-to-end transmission of information in TARGET, (g) The cost of making a payment.

The National RTGS Systems

TARGET will provide the necessary infrastructure to carry the single monetary policy of the ECB, by linking the domestic Real-Time Gross Settlement (RTGS) systems of the individual countries. With RTGS, payment instructions between banks are processed and settled individually and continuously throughout the day. Since payments under RTGS are immediate and irrevocable, systems risks are greatly reduced. TARGET payments can be made via the following systems."

- Denmark (DEBES)
- Germany (ELS)
- Sweden (ERIX)
- Finland (Bof-RTGS)
- UK (CHAPS euro)
- Belgium (ELLIPS)
- Portugal (SPGT)
- Ireland (IRIS)
- Spain (SLBE)
- Italy (BI-REL)
- Austria (ARTIS)
- France (TBF)
- Netherlands(TOP)
- Greece (HERMES euro)
- Luxembourg (LIPS-Gross)

SECTION 3

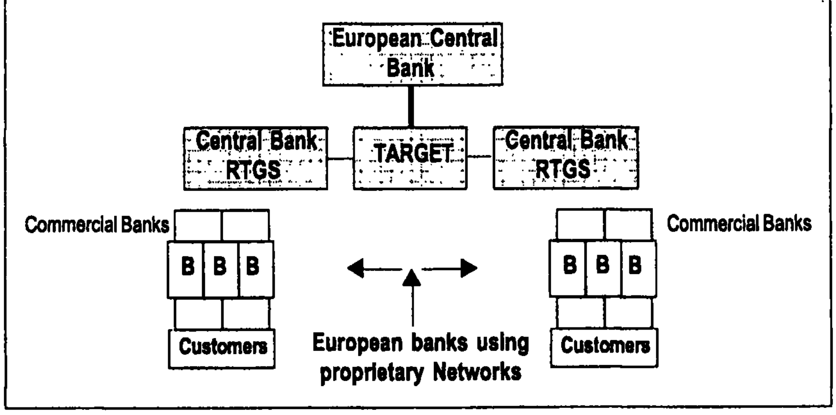
Implications of Euro for the World Economy Euroland and Sri Lankan Economy

The euro is more than 'just another currency'. It is becoming a cliché, therefore, to say that the introduction of the single currency throughout much of the EU is the biggest economic challenge of our generation. But it is also true that no one can really be sure just how far-reaching the implications will prove to be.

Euro as a single currency

The move towards using "Euro" as the single currency in EU will be completed and the use of national currencies will cease on 1st July,

CHART 3 **TARGET : European Clearing**



2002. The advantages of a single currency are numerous. **First**, it means that travelers across no longer have to change money, while losing money on every transaction, as in the case now. **Second**, Exchange margins paid to banks will simply disappear. **Third**, Small business in particular will benefit as payments and transfers in member states will be quicker, more reliable and cheaper. **Fourth**, For business and consumers, a single currency will also take away the uncertainity about the price for which goods are sold. As has been seen sudden exchange rate movements can wipe out profit margins in a matter of hours. All this will make it easier for businessmen big or small to operate throughout the Euro Zone. **Fifth**, if goods and services are priced in one and the same currency the competitive effect of the single currency will turnout to be beneficial for the consumer in terms of prices. In addition, an added advantage of having a single currency for Europe was the long-term objective of displacing the United States Dollar as the major reserve currency in the world and the replacement of it by "Euro".

Euro as reserve Currency?

The dollar has for many years been the dominant reserve currency, the currency in which countries around the world hold their foreign exchange reserves. At present, 65 % official foreign exchange reserves worldwide were held in dollars. The deutsche mark accounted for 12.8% and French franc for 1.2% while the yen accounted for 4.9% of foreign exchange reserves.

Are countries likely to shift their official reserves out of dollars into Euros? Those countries that link their exchange rates to European currencies – by a currency board, a fixed or crawling peg, or a managed float probably already hold deutsche marks or other European currencies in their reserves. That applies mainly to countries in Eastern Europe, most of which link their currencies to the deutsche mark since much of their trade is with Germany. They will very likely hold their reserves mainly is euros.

It is unlikely that the rest of the world with large reserves in U.S. dollars, or, as with Latin America, strong trading ties with the United States will dump dollars for euros would pose serious competition to the dollar as a reserve asset.

At this point, it is very difficult to predict just how the euro will fit into the constellation of other reserve currencies. However, it can be safely assumed that its position will depend largely on the strength of its domestic foundations – that is, on the continued macroeconomic conversions of its member countries, the pace of structural reform, the depth and breadth of euro denominated financial markets and the degree of political cohesion among EMU members on key policy issues. However, on account of the strengths of the US economy, as discussed in section 2, the economics of European countries, it is doubtful that EU would be able to achieve the target i.e. world's major reserve currency by 'Euro", in the near future. However, the competition, which "Euro" is expected to provide to US Dollar in the future would be forced to improve their positions and to maintain their relative value and significance as a reserve currency in the world.

Implications for the SDR

The SDR plays a crucial role in the IMFs accounts and as a unit of account in its financial relations with its members. The IMF defines the SDR as a basket of the five most important currencies, which are periodically adjusted in terms of their amount. Their shares in the basket are intended to roughly represent the external weight of these currencies. According to the principles for valuing the SDR, adopted by the IMF's Executive Board in 1980, the SDR basket includes the currencies of the five IMF members with the largest exports of goods and services during the five year period ending one year before the date of the latest revision to the valuation basket. Since 1981 SDR basket has included the U.S. dollar, the deutsche mark, the Japanese yen, the French franc, and the pound sterling. Beginning on January 1, 1996, the weights in the SDR basket were 39 per cent for the U.S. dollar, 21 per cent for the deutsche mark, 18 per cent for the Japanese yen, and 11 percent each for the French franc and pound sterling. On January 1, 1999 the SDR valuation basket weights are the sum of the values of the amounts of each currency in the following amounts. 39 per cent for the US dollar, 32 percent for the euro (in replacement of the 21 percent for the deutshe mark and 11 percent for the French franc.) 18 percent for the Japanese yen, and 11 percent for the pound sterling.

Implications for IMF surreillance and International Cooperation.

The introduction of the euro has led to a number of changes in the euro area countries' relations with IMF. The Article of Agreement of the International Monetary Fund (IMF) were signed in Bretton Woods on July 22, 1944 and entered into force on December 27, 1945. The IMF Articles of Agreement Provide only for sovereign states to become members but not dependent territories or supranational unions or institutions such as the EC or currency areas such as the euro area. Each member nation is assigned a quota that is designed to broadly reflect the relative size of its economy in the world. It is on that basis that a country's financial rights and obligations within the IMF and its voting rights are determined. The 15 EU nations have a combined quota share of slightly over 30 % and the 11 euro area countries a quota share of well over 23%. At present the Executive Board of the IMF is made up of 24 Executive Directors and Managing Director. Five of the Directors are appointed by the five members having the largest quotas (the US, Japan, Germany, France and the UK). This means twelve EU countries cannot appoint their own Execitive Director. As far as the representation of the ESCB in the IMF is concerned, the euro area countries, the ECB Governing Council and the IMF Executive Board and Management, after weighing various options and following extensive discussions among the euro are countries and with the IMF, ended up reaching the pragmatic conclusion that the ECB should be represented in the Executive Board of the IMF by an observer. Accordingly, the Executive Board of the IMF decided on December 21, 1998 to give the ECB observer status at its meetings. The modalities of this observer status are as follows:

(a) The observer is invited to attend Executive Board meetings where euro area monetary policy is concerned.
(b) The observer is invited on a case-by case basis whenever deemed appropriate by the ECB and the Fund.
(c) The observer will be able to address the Board with the permission of the Chairman on matters within the responsibility of the ECB.
(d) The observer status shall be reviewed within a year at the latest
(e) The observer has no right to vote in the IMF Executive Board.

Consultations on euro area monetary policy

The introduction of the euro also directly affects the consultations provided for an Article IV of the IMF articles of Agreement. Since the individual euro area countries are no longer solely responsible for all aspects of economic & monetary policy, the consultation procedure with the IMF had to be modified. The first round of consultations on the euro area's monetary and exchange rate policy was held at the beginning of 1999 and completed at the end of March.