

16/07/1998

The Euro challenge

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IN places as diverse as Istanbul and Phnom Penh, I've been told by native carpet sellers and soft-drink hawkers, 'Please to pay in US dollars.' And it's not just third-world businessmen who cherish this monetary icon of America. Equally, the greenback is the currency of choice among sprawling global multinationals and paradoxically, anti-American governments. Just how dominant is the US dollar in global trade and finance? Call the greenback Godzilla. Latest statistics show that the dollar is used in 50 per cent of global trade transactions, even though America's current share of world trade is only 20 per cent.

But the dollar's heyday of hegemony might be drawing to an end. The usurper? The euro, Europe's eponymous single currency, which is being touted as the new challenger to the dollar in the global boxing ring of hard currencies. Surmises Jaafar Carrim, executive director and senior vice-president of ABN-AMRO Bank, 'The euro will be a very strong currency.'

The sheer size of Euroland's economy should give the euro financial clout (see table). The euro will be the sole currency of an area that will rival Japan and the United States in economic weight. Says Stephen Li, Citibank Berhad's vice-president of treasury marketing, 'The EMU countries combined in 1996 had a 20.9 per cent share of world trade, with about US\$ 349.8 billion in forex reserves.'

Currency strength will also be marshalled by what Deutsche Bank calls the 'Dream Team', the governing council of the European Central Bank (ECB). Says Jaafar, 'Assuming that the ECB will be modelled on the Bundesbank, the euro will be strong.' Deutsche Bank Group chief international economist Peter Cornelius believes the ECB will control the euro using Bundesbank tactics of tight inflation and slack fiscal policies. So far, the mark has been a very strong and stable currency given tight Bundesbank policies. Eventually, says Cornelius, EMU interest rates will go up over time. Deutsche Bank believes three-month money market rates in Euroland will converge to 3.8 per cent in 1998 and rise to about 4.5 per cent in 1999. This will further strengthen the euro.

Even if the euro doesn't displace the dollar, it will still serve as a viable alternative to the latter. Individual economies will have another reserve currency to play with. So from Jan 1, 1999, foreign reserves might change in composition. The Bank of America estimates that 'a broad approximation' of international Asian reserves puts about 62 per cent in the US dollar, eight per cent in the yen, and 20 per cent in European currencies. For instance, about 60 per cent of China's foreign reserves - the world's second largest after Japan - is reportedly held in US dollars, with 15 per cent each in deutschemark and yen. Last October, Chinese monetary officials said they would wait until the euro proved stable before shifting their reserve allocations.

Here at home, analysts believe that Prime Minister Datuk Seri Dr Mahathir Mohamad's comments on the euro and the possibility of an Asian single currency indicate that the Malaysian government might be pro-euro as an alternate reserve currency for the greenback. What's the composition of Malaysia's foreign reserves? It's speculated that US dollars make up a portion of Malaysian reserves with yen and deutschemark as the remainder, but 'the actual allocations are a secret Bank Negara keeps close to its chest,' says one analyst. Latest reports place Malaysia's foreign reserves

at about RM57 billion.

The beauty of the euro, say proponents, will be its role in helping to stabilise currency exchange rates. Since the euro would ideally balance out the US dollar's role as the predominant reserve currency, currencies backed by the triumvirate of euro, dollar and yen might not react quite so wildly to dollar and yen exchange rate volatility. Will the euro's debut see the strong US dollar depreciating? Since the euro isn't traded yet, the 'synthetic' exchange rate of one euro to US\$ 1.10 'sounds about right,' says Jaafar. When the euro is introduced on New Year's Day 1999, Jaafar believes that the US dollar will be stronger against the euro. But the euro should stabilise in about 12 to 24 months, says Jaafar, following which the euro should appreciate against the dollar.

With a projected weakening of the dollar in the next one to two years, will regional currencies strengthen, particularly beleaguered Asian money? Says Li, 'It is difficult to say if the euro will appreciate against regional currencies as one would need to look at the current and future trade figures as well as the macroeconomics of each country. What the euro will provide is an alternative for the market to trade.' Li notes that trade payments can be made in the euro currency, if one chooses, during the three-year transition period of 'no compulsion, no prohibition'. 'No one can be forced to use or be prevented from using either euro or national currency denominations,' says Li. By July 1, 2002, at the very latest, the changeover to the euro should be completed.

In addition, central banks should be encouraged to use the euro as a reserve currency because the euro will offer unique cost-saving opportunities. Says Li, 'A substantial reduction in the amount of foreign exchange transactions and switching in the EMU currencies will allow central banks to scale down their reserve allocation activity and save on transaction costs.' Li also points out that Euroland's debt market will be one of the world's largest. The domestic bond market will be worth some US\$ 4.8 trillion and the sovereign sector will be valued at about US\$ 2.9 trillion. With a deeper Euroland bond market, foreign investment might not necessarily flow to the world's current default favourite, benchmark US government treasury bonds.

Banking experts also say the euro can shave banking transaction costs. Efficiency will rise as well because multiple currency accounts won't be needed anymore, reducing the size of companies' corporate treasury functions. 'Instead of having several currencies in different countries, there will only be one currency that can be centrally managed,' says Li. A Bank of America report on EMU estimates that worldwide savings on forex transactions could hit US\$ 30 billion a year through consolidating and centralising cash management, invoicing, payments, credit control and payroll.

However, Jaafar says the euro's local degree of impact depends on that particular country or company's volume of European bilateral trade. But the Bank of America holds a different view. 'Even Asian corporates and financial institutions with few or no EU transactions will still need to hold euro balances since the euro will probably become an important unit of accounting and international payments.'

In addition, pundits project that the euro will boost bilateral trade with Asia. Some analysts believe that trade with Europe will increase, since the hugely depreciated Asian currencies will make Asian exports cheaper. In Malaysia, the volume of trade with EMU 'in' countries was RM47 billion in 1997. Citibank Bhd's projections indicate that the EMU will become Malaysia's third largest trading market behind the US and Japan, accounting for 10.6 per cent of Malaysia's trade based on 1997 figures. The euro will also iron out exchange rate variabilities somewhat, which

is good for business but bad for currency traders. With the euro, says Li, 'Companies will see significant savings in foreign exchange.' On the other hand, Bank of America notes that 'Changes affecting costs and benefits may become a zero-sum game in which one participant's gain must be balanced by the loss of another.' Example: eliminating 11 forex rates lessens forex costs for trading companies but at the cost of forex traders' jobs and banks' forex trading revenue.

And global banks have certainly been working very hard trying to milk this new euro market. Panels of EMU experts from banks like Deutsche Bank, Citibank and ABN-AMRO have been globetrotting, holding roadshows and seminars. Why should clients choose one over another? Deutsche Bank and ABN-AMRO are touting their European heritage and early involvement with the development of the euro as prime advantages while Citibank's Li says 'our country neutrality ensures we provide the optimum euro solutions' for customers.

When should companies start implementing euro-friendly systems? As soon as possible, apparently, especially if you're involved in finance. Warns Bank of America, 'For Asian banks in particular, the transition could be more abrupt as their European clients start to shift rapidly into euro balances from US dollars or deutschemarks. Waiting until the euro is introduced to implement accounting and payment systems could be a costly mistake.'