INTERNATIONAL ROLE OF THE EURO

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Executive summary

A currency has an international role when it is used on a large scale by non residents in exchange market transactions, investment tool, borrowings on international markets, anchor for foreign currencies, invoicing and settlement reference on international transactions.

If we consider some of these aspects, the euro is indisputably as from now a major worldwide money, but its situation remains far from that of the dollar, while it largely outdistances the other currencies. The use of the euro has significantly increased in foreign exchange reserves. The euro is also an important international debt instrument, and is an anchor for more than 40 currencies. But its role remains, even if it is important, far from that of the dollar on exchange market transactions. Finally, it still has a very little role as an invoicing/settlement vehicle for many strategic commodities.

A lot of economists and analysts consider the euro to be possibly a leading currency in the next 10/20 years, with a possible conceivable situation of quasi equilibrium between the two great worldwide moneys. In our sense, such an evolution is improbable. Concerning the GDP, which is a necessary but not sufficient condition for a major international role of a currency, the forecasts for the future are unfortunately less favourable for Europe with a weak demography, a too low working population and insufficient efforts in education, research and innovation. In the financial field, the size of the aggregate euro area bond market is not negligible, but investors consider mainly the Bund and the OAT. And there is no comparison with the US bill and bonds market which offers to the investors a wide diversity of fungible securities and the guarantee of an optimum liquidity.

In addition, and perhaps mainly, long term choices of international currency commitments by investors are also driven by political, diplomatic and strategic considerations. As the euro area is not a unified state, it is suffering from a heavy handicap in this field.

So, even if the role of the euro can still widen, our assessment is that a situation with a 30% international weight of the euro and a 60% weight of the dollar is likely to appear.

Moreover, one can seriously wonder if the coexistence, with broadly the same importance, of two major international currencies is thinkable: if it could theoretically incite US authorities to pay more attention to their external position, it could also cause much more instability. Moreover, historical evolution showed that the international monetary system needs only one dominant reference, even if this reference is not necessarily the best one. (unless deep reforms leads to total shifts in the system).

In fact, if a wider international utilisation of the euro would provide advantages in the statement of international transactions, especially in great commodities markets, one can wonder if the single currency area would have great interest in a significant surge of the euro share in investment foreign positions. The area has no external deficit and the international financial stability could be strongly affected if, in addition of the US, a major economic area pursued a policy of benign neglect and drained an additional part of the world wide saving, which would be better used in financing poor countries. Outstanding public debts already represent 65.5 % and 64.3% of the German and French GDP. So, it is obvious that such an orientation would foster market interest rates surges, as the euro area has not the political, diplomatic and strategic position allowing them to increase significantly its indebtedness without damaging its credibility.

1) The introduction of a single monetary policy together with a single currency in Europe has been the logical issue of the European Monetary System evolution, as it had become difficult and even counterproductive to try to deal with fixed exchange rates, free capital flows, and national autonomous monetary policies. In addition, the euro was susceptible to optimise the advantages of the single market, the price stability, and the dynamism of wealth production and exchanges in reducing the transactions costs and enhancing the level of market interest rates provided that the new currency was credible.

These considerations were obviously predominant and the ambition of creating a worldwide currency playing a major international role was not the first priority. At this time, one could not find out among numerous declarations and papers of European political, financial and monetary leaders, when they developed the advantages expected from the single currency, any explicit allusion to the creation of a worldwide currency and even less to the promotion of a challenger for the US dollar, while this argument was widely developed by journalists.

Yet, in first analysis, it could seem evident that the currency of more than 300 millions of inhabitants, accounting for 17% of the worldwide wealth, would have an important international statute.

But such a statute is not only depending of the size of an economy, which can be considered as a necessary but not sufficient condition, as has shown the example of the Japan: before the creation of the euro, this country was the second world economy, but the Yen has played a minor international role.

Indeed, having an international role for a currency requests a great use of it on a large scale by non residents in four areas:

- This currency is a vehicle for exchange market transactions, not only directly, against foreign currencies, but also indirectly, as an intermediate for purchases and sales of other currencies. This role is played on spot, forward, and derivative markets.
- This currency is an investment vehicle which means that the issuer country offers a large and permanent amount of diversified safe and liquid financial investments.
- This currency is an important international debt instrument as it can be used by borrowers on international markets such as firms or states of which the own currency market is less deep and less liquid.
- Finally, this currency is used as a reference, mainly in two different stances: political as it is an anchor, with diverse methods, for foreign currencies; economic as it is used for invoicing and settlement of international transactions, especially on commodities.

At the end of the twentieth century, when the euro has been introduced on the markets, the US dollar was the only currency able to play these diverse roles. Other major currencies, namely Yen, Pound, French Franc, and even DM, had fewer diversified international functions or were used on an insufficient scale for being considered as having an international role.

In the following development we will firstly give a broad description of the present role of the euro in the various aspects of an international currency statute and assess its recent evolutions.

We will then evaluate the possible future evolution, which could be either a broad continuance of the present respective positions of the two major currencies, or an important and continuous growing international role of the euro, which could lead to a situation of twin worldwide currencies or even of a leading role of the euro, while the dollar would be dethroned. We will try to assess the likelihood and the consequences for the international financial system of these issues.

Finally we will discuss the consequences for a country and its economic and monetary policy to have its currency playing an important and rising international role. We will especially assess the possibility, and the opportunity of a policy aiming at strengthening strongly the international role of the euro.

2) If we consider the several aspects of the international use of a currency, it appears that the Euro is indisputably as from now a major worldwide money. But its situation remains far from that of the dollar, while it largely outdistances the other international currencies. An abstract globalisation of all the different positions could give a 65% weight of the dollar, a 25% share of the euro, a 10% share of the other moneys (of which Yen whose use has significantly decreased, Pound which remained stable and some shelter or regional currencies such as Swiss franc, Australian dollar…).

Without being exhaustive, one can list some main issues.[1]

Concerning the role of the euro as a vehicle for transactions on the exchange market, its share in daily settlements accounts for 39%, in slight diminution during the recent years (but the number of currencies traded within the Continuous Linked Settlement system – CLS – which is the statistical reference, has increased to 15 whereas it originally included 7 currencies). This share of almost 40%, superior to the aggregate shares of the former European currencies, can be considered as relatively important, especially if we compare this figure with the stake of the Japanese Yen (18%) and of the British Pound (14%), but remains far behind the dollar which represents 92.5% of the transactions and remains the dominant currency in global foreign exchange markets.

The share of the euro on the international bond market (therefore excluding residents' issuances) remains important but, after having been in a leading position until 2005, the use of the European currency in debt instruments issuances declined from 43% to 20% at the end of 2006. The amount of these operations has continued to grow, from USD 70 billions to 94 billions, but during the same period, the US dollar denominated borrowing by non US residents boomed from USD 60 billions to 284. As a result, the euro share in the stock of international debt securities, assessed at constant exchange rates, which had soared from 20% in 1999 to 34% in 2005, declined to 31.4% at the end of 2006, while the US dollar share rose from 41.5% to 44%. Investments banks in North America and financial institutions in the UK and Eastern and Nordic countries are the main issuers of euro denominated bonds. Non residents investments in euro bonds are mostly performed by non euro area Europe funds, as the euro share of debt securities portfolio managed by North America funds is still negligible.

Concerning the role of the Euro as an investment tool, the share of the European currency is broadly steady on the international deposits market, and growing in the reserve portfolio of foreign central banks.

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[1] Statistics come from the ECB "Review of the International Role of the Euro" of which the most recent publication is June 2007; these figures can be completed by more recent information provided by the IMF and the BIS.

Deposits from depositors located outside the euro area towards banks located outside the euro area represent between 20 and 18% of the international deposit market, while the share of similar deposits in US dollars is up to 50%. No real trend can be observed since the beginning of the century. From 18% in 2002 the euro market has increased to 21.3% in 2005, and decreased to 18% at the end of 2006.

The use of the euro in foreign exchange reserves by third countries has increased from 18% of the total reserves in 2000 to almost 25.8% at the end of 2006, while, during the same period the share of the dollar declined from 71% to 65%. A more recent estimation gives 27% for the euro and 61% for the dollar. But the progression of the euro, at constant exchange rate, is estimated by the ECB at 24% in 2007 against 19% in 2000, while the dollar share declined from 70% to 67% during the same period. Even if the US currency is “inch by inch” moving back, the progression of the euro is remarkable as, since 2000 the total amount of worldwide foreign exchange reserves has surged from two trillions of dollars to 5 trillions.

The role of the euro as an invoicing/settlement currency remains relatively weak. Of course, euro area countries use euro for a significant part of their importations – between 34% and 56% against 41% to 61% in 2004 – but the dollar remains by far the predominant invoicing currency for a lot of strategic commodities.

One can mention a very particular area of international use, which concerns banknotes holdings by non residents. It is difficult to have precise information, but it seems that the amount of euro banknotes in circulation in thirds countries is presently equivalent to the amount of dollar denominated banknotes, while in 2002 the dollar circulation outside the US was three times above the outstanding amount of euro banknotes used outside the euro area.

Finally, let's remind that 40 currencies or territories have an exchange rate regime linked to the euro, with diverse modalities.

3) We have now to assess what could be the more probable evolution for the next ten or twenty years.

A decade ago, according to a lot of sceptical advices, at the very worst the European monetary union would not even be launched, and at the very best it would be a clone of the DM and of the Bundesbank, with a very limited number of members. The sceptics were wrong and everybody can now agree on the fact that the European Central Bank and the euro have played a definitely more worldwide role than the DM and the Bundesbank did (moreover the Bundesbank has no specific and no predominant influence on the institution).

Considering the evident growing role of the euro as an international currency during the last years, a lot of economists and analysts consider this trend is going to continue and the euro will be possibly a leading currency in the next 10/20 years. In addition to this recent evolution, they argue that the euro area has the first world GDP, that its financial market is well developed and, last but not the least , that the evidence of a constant commitment to low inflation ECB policy is very attractive for investors.

Few of these analysts forecast the dollar could be really dethroned and the euro become the leading worldwide money, but a lot of them consider as likely a situation of quasi equilibrium between the two great currencies. The dollar and the euro would cohabit during a rather long period before perhaps being challenged by other currencies, especially the Yuan.

In our sense, such an evolution is improbable for a lot of reasons.

First of all, it is obvious that the questionable US economic and monetary policies, the slightly decreasing but remaining huge current account deficit, the financial sector crisis, the weak growth forecasts (where not recession forecasts), and as a result the dollar weakness, can give the feeling that there is a context of durable and pronounced distrust movement vis-à-vis the American currency.

But one has to go beyond transitory situations and consider structural issues. And yet, these issues remain in favour of a predominant role of the dollar, at least during the next ten or even twenty years.

As mentioned previously, the economic size and dynamism of a country is an important factor for its currency to play a major international role. If the GDP of the euro area and of the United States are today broadly of the same size, the forecasts for the future are unfortunately less favourable for Europe, with a weaker demography and a lot of structural deficiencies, the most important being a too low working population and insufficient efforts in high education, research and innovation, all factors which are determinant for the potential growth of a country.

But economic size is not the only favourable factor: the size, the depth, the liquidity, the dynamism of the financial market is perhaps more determinant. In this field, the US market still has not serious challenger. Of course, the size of the aggregated euro area bond markets is not negligible, but in fact, the Bunds and the OAT markets are the most attractive for investors. There is no comparison with the US bill and bond markets, which "benefit" from almost eighty years of budget deficit and offers to investor a wide diversity of fungible securities and maturities, and the guarantee of an optimum liquidity, which is a determinant factor for most holders.

In addition, and perhaps mainly, one has to consider that long term choices of international currency commitment, by private as well by public decision makers, are not solely driven by economic and financial factors but also by political, diplomatic and strategic ones. As the euro area is not a unified state, it is suffering from a heavy handicap in these fields, whatever the individual strengths and assets of some European countries could be.

4) For all these reasons we don't think the dollar could be seriously challenged by the euro in the next ten/twenty years and our assessment is that the international role of the European currency could reach and remain at broadly half that of the US dollar. If reserve assets could be in the future less concentrated in dollars than currently, it is unlikely that the euro will supplant the dollar as a vehicle currency, that is to say the role in trading on the foreign exchange market and as the currency for global commodity trade. Concerning the role of the euro on international bond markets, we have seen that even if the European currency can be attractive and used on a large scale, US dollar denominated issuances continue to benefit from the exceptional liquidity of the American currency markets.

Accordingly, our assessment is that a situation with a 30% weight of the euro and a 60% weight of the dollar on the international markets is likely to appear.

Of course, one can imagine and hope that the Euro area will correct some of its major structural handicaps, with growth acceleration and consequently a more attractive euro. But, if such an evolution could increase the weight of the European currency, let's suppose to 35%, we don't believe, for the reasons we previously suggested, especially the fact that the euro is not the currency of a unified state, that one could arrive to a situation of 50/50 that some analyst are envisaging.

Moreover, one can seriously wonder if such a situation of 50/50, that is to say the coexistence of two major international currencies, is thinkable, even if that could theoretically incite the US to pay more attention to its external position. Indeed, if it can make sense to have more diversified portfolio holdings (but a situation of equivalent share of the two moneys can create more instability on the exchange markets), owing to economies of scale and scope, it is difficult to imagine two currencies as vehicles in exchanges, commodities, derivatives markets. Briefly, and even if the statement is severe for European sensibilities, the international monetary system needs only one dominant reference, as historical evolutions showed (which does not mean such a situation and the sole reference to be necessarily ideal), unless deep reforms lead to total shifts in the system, with for example the abandoning of leading currencies as reference values and the adoption of new concepts like a commodities basket.

5) We have now to discuss about the advantages and the constraints for a country and its economic and monetary policy to issue a currency playing a major international role.

Considering the US example, everybody is conscious that the statute of the dollar provides the country the "exorbitant" privilege to pay for its current account deficit with its own currency. One cannot state that this situation is the main reason of the "benign neglect" attitude of the US government toward its huge deficit, but it is sure that for a country in which householders are deeply in debt and in which domestic demand is steadily exceeding production power, such an advantage does not create incentive for a more orthodox policy.

There is another benefit from this position. The unbalance between domestic demand and output should normally be source of inflationary tensions. The "valve" of the current account deficit contributes to moderate these tensions.

Another privilege, which is perhaps not automatic but is particularly evident in the case of the USA, is the existence of a positive difference between return on investments abroad and on foreign investments inside the country. Some analysts explain this situation by the fact that private decisions of investment in the US are supported by the desire to gain insider access to a key decision centre, which can motive the acceptation of a lesser return. Instead, our interpretation is that the possibility to finance an important external deficit which balances an insufficient domestic saving is a factor of pulling down interest rates.

Coming back to the constraints, and always considering the US example, one can have the feeling that they don't exist. In fact there is a constraint for maintaining the attractiveness of the financial market with a sound economic and financial policy. The US economic and financial authorities can escape from this constraint thanks to their political, diplomatic, strategic and financial worldwide leadership. But the example of the United Kingdom during the twenties and the thirties shows that such a constraint can be decisive: the UK had no (or had no more) leadership position and the role of international currency played by the Pound had been strongly and decisively affected by the weakness of the British economy and of the economic policy.

6) Finally, one has to assess if a substantial strengthening of the international role of the euro would be useful and profitable for the euro area.

An unquestionable field in which a wider international use of the European currency would provide advantages is the statement of international transactions. Such an evolution would give a better visibility and less erratic fluctuations in prices of imported commodities and in the financial situation of great exporters which presently buy row material charged in dollar and sell euro invoiced output.

A greater use of the euro on the exchange market could also, perhaps, contribute to increase the role of some euro area financial centres.

But except these specific points (whose evolutions depend on strategic and political factors and on private firms' commercial negotiations), one can wonder if the single currency area would have a great interest in a significant surge of the euro share in private and public investment positions.

The area has no external deficit and domestic European agents are net savers. Therefore, there is no need for attracting massive foreign savings. International financial stability would be strongly affected if, in addition to the US, a major economic area pursued a "benign neglect" policy and drained an additional part of the worldwide saving, which would be better used in financing poor countries.

However, some economists, without explicitly calling for a policy aiming to a more important international role for the euro, think that the euro area governments should take advantage of the present dynamic in favour of the European currency in increasing supply of bonds, in other words, in raising euro area external debt. Such a policy would reduce the supposed gap between demand and supply of euro financial instruments, contribute to soften the euro exchange rate, and provide resources for useful investments in crucial fields like, education, research or communications.

But which countries would be the issuers of these bonds? As there is no euro area common entity, except the European Investment Bank which has definitely not the size for such wide scale borrowings, one must admit that new bonds would be issued by national governments, mainly the German and French Treasuries, whose debt instruments are the most demanded by foreign investors. If we remind that these outstanding public debts already represent 65.5% of the German GDP and 64.3% of the French GDP, it is obvious that these operations would foster long term interest rates surge, and would actually weaken the credibility of the area. Once again, if the particular political, diplomatic and strategic position of the US allows them to increase their indebtedness without structurally damaging the credibility of the international role of the dollar, it is sure that the euro area is not in the same position.

As Jeffrey Frankel said: "Rankings of international currencies change only very slowly." So although the US surpassed the UK for GDP in 1872, in 1915 for exports and in 1917 as a financial centre; the dollar did not surpass the pound until 1945.

The euro is an unfinished strategic operation as the single currency has no unique economic government and still less a political government. It is remarkable for a so atypical concept to have such a great success and to acquire such great credibility. But to become the leading world wide currency it needs probably more decisive steps.