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The Future Role of the Euro

Jakob de Vries

Abstract

Although the euro has stimulated European financial markets by lowering the barriers to cross-border transactions, thus encouraging the emergence of a money market and a pan-European private bond market; the euro-denominated asset market is far from the existing types of international markets for the dollar. In the world currency markets, the emergence of the euro has not changed the relative position of the old European currencies vis-à-vis the dollar and the yen. And the shares in the official reserves of Central Banks also remained stable. In the future, three questions arise, which this article tries to answer: Do Europeans want the euro to become an international currency? Is the euro able to occupy such a position? If the euro could acquire an international status, would this contribute to improving the stability of the international monetary system?

The birth of the euro was the major event on the international monetary scene since the disappearance of the Bretton Woods system in 1971. Nearly three years after its launch, and a few weeks before the passage of notes and coins, it seems interesting to analyze its current situation on the international financial scene and try to predict what we can expect from its international takeoff.

When we look back at the third and last phase of the European Monetary Union (EMU), we cannot help but be struck by two paradoxes. The euro, as the world's second-largest currency, is the domestic currency of 285 million people (1 vs. 272 million for the United States), of which Gross Domestic Product (GDP) was \$7 trillion in 1999 (compared with \$ 9.1 trillion for the United States). Nevertheless, over the past three years, the European Central Bank's monetary policy has appeared preoccupied with international developments concerning the euro in the sole event of a risk to the internal stability of the euro area. Moreover, although the Eurosystem deliberately adopted a neutral stance in this regard, neither seeking to hinder or encourage the international use of its currency, nor did it attach importance to its exchange rate in the conduct. As a result of its monetary policy, to the extent that it affects internal price stability (Coœuré and Pisani-Ferry), the media, and consequently the general public, have focused their attention on its external value.

This situation highlights another paradox. While the single currency could claim from the outset a leading international position, it has not yet progressed significantly. Figures recently published by two economists of the BIS show that "two and a half years after its launch, the role of the euro looks like the mark in the markets of changes. At present, the impact of the euro on the financial markets has remained confined within the borders of the euro area. The figures also confirm the

positive impact the euro has had on the interbank market and the bond market, and indicate that its real success has been the influx of euro-denominated bonds. But they also illustrate that in terms of portfolio management, while euro-denominated assets have enjoyed significant interest within the euro area, external players (with the exception of Japanese investors) have so far hardly shown enthusiasm.

Although the euro has stimulated European financial markets by lowering cross-border transaction barriers, thereby encouraging the emergence of a pan-European private bond market and bond market, there is no doubt that euro-denominated assets (whether government bonds or private assets), we are far from the types of liquid, efficient and active international markets existing for the dollar. In the currency markets, the emergence of the euro has not really changed the relative position of the old European currencies (mainly the mark) vis-à-vis the dollar and the yen. And shares in the official reserves of central banks have also remained relatively stable.

In the future, three major questions arise. 1. Do Europeans really want the euro to become an international currency? 2. Is the euro also able to occupy such a position? 3. And if the euro could acquire an international status for itself, would this contribute to improving the stability of the international monetary system?

DO EUROPEANS WANT THE EURO TO BECOME AN INTERNATIONAL CURRENCY?

In fact, the answer is not as simple as it looks. It is not too hasty to conclude that a stellar currency role on the international scene is always a very enviable position. The fact that a currency has an international status implies global responsibilities with disadvantages for the management of monetary policy. In a time of foreign exchange and interest rate expectations, the ECB warns, large foreign holdings of short-term euro deposits could expose the euro area to cash flow shocks. Increased holdings of shares in the euro area by foreigners could cause more volatility in asset prices.

After all, neither Japan nor Germany has ever been very active in promoting an international status for their own currencies. Nor has there been any deliberate intention on the part of the fathers of the Maastricht Treaty to question the supremacy of the dollar, (Kirrane, C. 1996).

CAN THE EURO BECOME AN INTERNATIONAL CURRENCY? Looking at the scenarios for the future, the real question is whether it is desirable that one day, the European currency plays an international role in relation to the economic importance of the euro area in the world. euro then shares with the dollar the world's monetary responsibilities. However, this new situation can only be envisaged if the euro is indeed able to one day accede to this status of international currency.

The fact that the US dollar has been the main global currency for more than half of the past century is certainly related to the size of the US economy. But this parameter alone cannot explain this predominant role. In 1998, it was estimated that the dollar was used as a currency for about 48% of world trade, while the US market share accounted for only 18% of the world market! The preferred use of the dollar worldwide for the billing of private international transactions, reserves official dollars held by central banks (\$1.290 billion on a total of \$ 1.869 billion in the third quarter 2000), and as a means of payment in international transactions, are all signs that the preeminent position of the dollar far exceeds the relative size of the US economy in the world.

On the other hand, almost three years after its launch, the international role of the euro is far from what we thought we would expect, given the weight of the euro zone in the world. Some

even claim that as long as the euro zone is not able to assume the external management of its currency politically, it will not be able to acquire enough international credibility to play a major role in the world. As stated by Jürgen Stark, vice-president of the Bundesbank, "the basis for strengthening the international role of the euro will only be established at the cost of greater political integration of the union".

Today, because of the explosion of international financial transactions in relation to real transactions (but also cross-border transactions in bonds and equities), the majority of international transactions are of the financial type. If following Richard Portes, "we accept that the international use of a currency is determined by the behavior of private market, the use of one currency for carrying out financial transactions as well as the name financial assets become a decisive factor for a currency to acquire international status. The use of a currency, when the markets are very liquid, benefits from a phenomenon of "network externality" because there are many buyers and sellers, the transaction costs are low ... which encourages even more people to use this market. "

According to this approach, the international future of the euro will undoubtedly depend on the progress of the integration of financial markets in Europe. It is true that in recent times huge capital flows have moved from the euro zone to the US markets. During the first four months of 2001, the euro zone generated a net disbursement of investments of more than €100 billion (the vast majority being invested in US equities). There is no doubt that improving the functioning of the European financial markets will help to reverse this trend. In this respect, the current policy at European level (the action plan for the financial markets, the Lamfalussy Committee proposals, the directives in preparation ...) are going in the right direction, even if many experts think that the integration needs to be accelerated.

INTERNATIONAL STABILITY? Can we consider that the emergence of the euro will bring more or less stability to the international monetary system? According to an argument that is often used, the euro zone - where trade with foreign countries accounts for about 17% of GDP - behaves like a closed economy when compared to countries that are part of it, such as Germany or France, where foreign trade accounts for a much larger share of GNP (over 25%). Monetary policy in Euroland should therefore be less sensitive to external developments, especially exchange rates. This would lead to more volatility. But for this argument to be entirely valid, even before the launch of the euro, the 12 euro countries should have adopted a fully flexible interest rate system. In fact, the European Monetary System was a fixed exchange rate system between its members and operated in this way even after the widening of the band of permitted fluctuations in 1993, see Kirrane, C. (2003). In Germany, the only country that operated in fact at the time with flexible rates, the share of foreign trade (outside the EMS or the euro zone) hardly changed.

This remark is perfectly in line with the evolution of the euro as observed by BRI economists. "Nothing indicates that the models of short-term volatility of its exchange rate were very different from those of the mark before 1999".

Another approach (the hegemonic argument) argues that international monetary stability is best achieved when a currency dominates the European monetary system. In this policy, the international emergence of the euro would in fact lead to more instability. If there is a response to the manifestation of these fears, it lies in the controversial role of coordinated exchange rate policies, (Kirrane, C. (2003).

We must recognize that currently, there is - among those who are in charge of monetary policy - no desire to return to a management of exchange rates "to the Bretton Woods" (target areas ..). Thus, when Wim Duisenberg, the President of the ECB, acknowledges that "the euro and the eurosystem will inevitably play an important role in the world economy", he completes his statement by reporting that "the pursuit of a goal of exchange rate would be likely to jeopardize price stability, and could thus have a negative impact on the development of the real economy".

Few would dare to deny that the best contribution the euro can make to international stability is to preserve price stability in the euro area. But we could ask ourselves if the door is not too firmly locked when Wim Duisenberg adds: "Attempts to coordinate international politics beyond the framework I have just delineated (in other words, those that exist today in international meetings) could easily defeat the purpose, compromising both the Eurosystem's mandate and international stability itself." In retrospect, it seems likely that this cautious attitude was initially inevitable politically if one wanted to give the Eurosystem optimal credibility as to its commitment to price stability as well as to the independence of the European Central Bank.

Nevertheless, in the international monetary context created by the emergence of the euro, it seems legitimate to wonder whether we should accept the system as it currently operates, or whether we should strive to create a new system, institutional framework better adapted to the new environment. There is no obvious answer to this complex question. After all, for the first time, significant fluctuations in exchange rates have not hindered economic prosperity. Moreover, as I have already pointed out, the prerequisite for a balanced and "successful" monetary dialogue on both sides of the Atlantic (ie one euro of a weight and international credibility sufficient against the dollar) does not seem to be fully met.

As a first step towards greater exchange rate concentration, the leaders of the world's major currencies (US, the Eurozone, Japan) should probably begin - as suggested by Robert Mundell - Analysis of the interaction and coordination in the conduct of monetary policies, between internal objectives (price stability) and foreign exchange transactions.

In the current conduct of monetary policy, there is a very marked dichotomy between internal management designed to ensure internal stability, on the one hand, and on the other hand interventions in foreign exchange markets which are only intended to remedy defects of excessive imbalances. Robert Mundell questioned this traditional rule of wisdom. He pointed out that a "central bank can tighten or loosen its monetary policy by mobilizing either its domestic assets (typically, government securities or other domestic assets), or assets" from outside "(typically currencies, but also gold and special drawing rights). And he recommended that instead of being sporadic, interventions could become systematic, concerted, and unsterilized, so that market participants could perceive coherence between the internal and external objectives of monetary policy.

For example, would it have been wise in the autumn of 2000, when the ECB opted for a more restrictive monetary policy at a time when the euro was clearly weak, that it should go in the desired direction by buying euros? Against dollars, thus triggering both a rise in the euro and a contraction of internal liquidity in the euro zone? Current monetary and economic developments in Japan and the United States could raise similar questions. Needless to say, the exploration of this new approach presupposes a deeper understanding of the functioning of the exchange markets.

More fundamentally, drawing lessons from the experience of the last three years, we can argue indisputably that the future of the euro on the international stage ultimately depends on the political will of the Europeans themselves. At present, the Eurogroup has not expressed a clear intention on this crucial issue. Unlike the United States, he remained silent in the debate on the international financial architecture. Even on the issue of exchange rates that is critical to their economy, eurozone leaders have been unable to speak with one voice.

One may wonder if this global attitude of benign neglect is really compatible with the size and weight of the economy of the zone euro. Sooner or later Europeans will have to answer these questions. But in advance, they will probably be required to put in place an institutional framework where they will be able to define and follow a coherent and clear approach on international financial issues of common interest.

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