THE INTERNATIONAL ROLE OF THE EURO

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Economic history shows that very few currencies have been able to become dominant in the world. For two centuries the Dutch guilder was the dominant currency and only after the First Industrial Revolution the English pound was able to displace the guilder as the dominant currency. The pound was able to keep this position until the First World War, when the US dollar took the leading position. There are a few lessons to be learned from this experience:

The first one is that this displacement process of the dominant currency by the new one takes a long time to materialize. Usually, the incumbent currency tends to coexist with the emerging currency for decades, before and after the emerging one becomes dominant. The guilder and the pound did so for almost a century and the pound and the dollar coexisted as the two major currencies for some time at the end of the Nineteenth century and later between the two world wars.

The second one is that, only those countries that are more open and more active in the international trade of goods, services and capital and that have developed large trade and financial centres are able to get its own currency to a dominant position, independently of which country was military wise the dominant at that moment. Spain was the biggest military power in the world for more than a century, invading even the Low Countries. Nevertheless, at the same time, the latter were the largest economic and financial power, Amsterdam was the world's financial centre and the guilder was the dominant currency. The US was the dominant military power many years before its currency became dominant, because England was still the economic and financial power and London the world's trade and financial centre.

The third lesson is that, although in every country the currency is used because it has the full guaranty of the State that issues it, in the international markets this guaranty is not a sufficient condition to make it of preferred use. The private economic agents are the ones that, in the last instance, decide which currency to use for their international transactions. There are a number of requisites that these agents demand for deciding which currency to use. The first one is that it is issued by a strong, open and competitive economy that takes itself a large share of the world's trade and financial transactions. The second one is that the country that issues that currency has a very large and efficient financial system well developed and regulated, very deep and liquid that allows the economic agents to finance at very competitive costs and at high speed their transactions. Large volumes and low transaction costs are the key drivers for private economic agents to prefer a foreign currency to their own national one and a different financial market than their national one to transact.

The fourth lesson is that the same dominance of a currency in the world markets tends to create the necessary conditions for other currency or currencies to emerge as its competitors. In a world of multiple currencies and free multilateral trade, those agents that engage in international transactions between countries have the problem of coordinating the purchases and sales of the currencies they need. As the purchase of a currency by an agent is not easily compensated by the simultaneous sale of another currency by another agent, the financial intermediaries must make their clients to wait or need to hold large inventories of different currencies. Nevertheless, when the volume of transactions in one currency is very large, the waiting time or the inventory volumes are very low, reducing the costs of the transaction. The larger the use of a currency the larger is its liquidity, the lower are the bid and ask spreads and the more attractive it becomes until it ends up in a kind of natural monopoly. That is, the currencies, which are able to reach a high level of international use, tend to become monopolists through the work of the centripetal forces derived from the economies of scale and agglomeration.

However, fortunately for other leading currencies, it becomes increasingly difficult for the dominant currency to maintain such a monopoly position since these centripetal forces are increasingly counterbalanced by the opposing centrifugal forces that emerge as a consequence of the portfolio diversification of financial assets, which tend to reduce the risk of the concentration by investors on one single currency by diversifying their allocations into other currencies. These centrifugal forces are very powerful given that currencies offer much larger diversification opportunities than any other financial instrument such as fixed income or equities. The average price of all currencies, by definition, does not show any trend and therefore diversifying tends to reduce the covariance and the risk of a portfolio. The more globalized are the financial markets the more fixed income securities and equities prices tend to evolve in the same direction given the increasing interconnection and contagion of the different financial markets, as it happened in the build up to the recent financial bubble. Therefore, currency diversification becomes increasingly necessary to reduce portfolio risk. This is the reason why the euro is becoming a growing alternative to the dollar, in terms of the asset allocation by portfolio managers and the yen keeps being still a third choice, in spite of the dollar dominance.

The fifth lesson is that the expected investment return in the different currencies is also a very important factor for any currency to become dominant. For instance, if today investors expect that the US economy is going to keep growing faster than the Euro Area because its productivity is growing at a higher rate and its economy keeps being more dynamic and flexible, they will prefer to invest in dollars, despite its larger fiscal and current account deficit, because they now that returns will tend to be higher given that the present disequilibria in the US economy are of a more cyclical character while the economic problems in the Euro Area are of a more structural and trendy character.

Finally, for a currency to achieve a leading or dominant position it needs not only to be strong but also to have a very well proven record of stability. This is a very important distinction. Naturally, the optimum for a dominant currency is to achieve both features, but in reality this is not always the case, sometimes one currency can be very stable but loosing value versus another currency that is more volatile. However, in the long run, investors tend to prime stability versus temporary strength, because by definition they are, on average, risk averse. Importers and exporters of goods and services and long term savers and financial investors tend to give much more importance to the currency stability because they are not speculators and do not want any exchange risk. Only more opportunistic investors prime short-term value versus long-term stability.

The real proof for a dominant currency is when there is a large financial crisis and risk aversion is at its highest. Then, not always the true dominant currency is able to reach the status of "safe heaven". In times of financial stress, volatility and risk aversion, investors tend, on the one hand, to unwind trades and return home and, on the other hand, to look for a safe heaven. If the country of issuance of the dominant currency is very large, then the homeward-bound effect makes its currency to appreciate versus other currencies in riskier times, but it does not mean that it has achieved the status of safe heaven, which results when a currency strengthens by attracting investors which had not a prior national attachment with that currency. This has been traditionally the case of the Swiss franc and sometimes of the US dollar, the Deutsche mark and the yen or even the Norwegian krone.

The best way to measure the role of the euro as an international currency is through its relative presence in three international different markets: the international liability management market, the international asset management market and the foreign exchange market. The underlying concept, based on a portfolio balance framework, is that the international weight of a currency is determined by the balance between the demand for assets and the supply of liabilities, denominated in that currency.

In the international liability market, the supply of euro-denominated securities in the international markets shows a very large surge in its issuance since the introduction of the euro. However, its relative weight in the fixed income markets is still far more important than in the equity markets. The reason for this asymmetry is the persistence of national, structural and institutional impediments to achieve a pan-European equity-trading framework. It is true that European equity markets are increasingly pricing company stocks on the basis of pan-European economic factors, taking into account the industrial sector effects more than the pure national ones, but still the "home exchange bias" remains the rule for most European shares. As a consequence of this very slow process of integration of the European equity markets, the Euro Area equity markets remain smaller than the US and the UK counterparts, even taking into consideration the relative size of their economies. At the same time, trading activity is thinner and transaction costs are higher both in trading and post-trade settlement. Therefore, it is taking more time than the expected to reach a relative size big enough to compete with the US market. In June 1997, the market capitalization of the US equity market was 7.2 trillion dollars and the Euro Area one was 1.9 trillion euros. In January 2003, the US market value was 10.1 trillion dollars and the Euro Area was 3.6 trillion euros. The gap has increased in absolute terms but it has narrowed in relative terms, given that the rate of growth of the Euro Area equity market has been faster, although coming from a much lower figure.

On the contrary, fixed income markets have been much faster in realizing the greater potential gains of introducing a single currency. The elimination of the exchange rate risk and the convergence of the yield curves within the Euro Area have reduced the importance of economic factors that had previously led to the segmentation of the European bond markets. Therefore, borrowers can now tap on a very large and expanded investor base with a single issue making the euro an attractive alternative to the dollar as a currency of denomination for debt, and as a consequence, the bond issuance has soared. Euro Area borrowers, both public and private have accounted for most of the increase in issuance volumes, but the biggest shift has been the increasing share of the private sector borrowers. In June 1997 the market capitalization of the US government bond market was 2.1 trillion dollars and the Euro Area one was 2.2 trillion euros. In January 2003 the US one was down to 2 trillion dollars and the Euro Area was up to 2.9 trillion. Taking into account the total international bonds outstanding (both government and corporate) the increase in the euro denominated bonds has been huge. In December 1996 the value of euro denominated bonds outstanding accounted for 75 billion and in June 2003 had reached 4 trillion. The same figures for the US denominated bonds outstanding were 1.2 trillion and 4.2 trillion respectively in both dates. The fact that the dollar denominated outstanding stock was still higher was due to the much larger size of corporate issuance in dollars. The issue of global debt by currency, in 2003 up to end of October, was 66.4% in dollars and 22.9% in euros.

For all this very large progress, the euro bond market is still far from reaching its full potential. There are several reasons for it: the legacy of its national origins still presents some obstacles for full integration and for further deepening; there is no central debt agency for government bonds and, hence, no co-ordination of the new issuance schedule; the lack of single benchmark yield curve in the euro bond market is symptomatic of these factors because no single borrower can provide the necessary volume and liquidity across the maturity spectrum in order to fulfill this role. While swaps have provided some proxy reference for a yield curve, it remains an imperfect one because of the less than perfect link between the swaps market, which is based on corporate issues and the futures market, which is based on government issues.

In the international asset management market, the currency diversification has notably increased. Investors inside the Euro Area have been keen buyers of foreign securities denominated in euros, especially bonds, but euro denominated assets have been less successful with non Euro Area based investors. Japanese asset managers have been much more attracted initially by euro denominated assets, but later, the fall of the relative value of the euro discouraged them. On the contrary, investors in the Euro Area have been large buyers of dollar denominated US securities. Although bonds have been the major instruments of non-European attraction, the surge in euro equities purchases by foreigners has been increasing.

All these comments are quite impressionistic for the difficulty of knowing the exact figures of the currency denomination of the stock of assets managed by private companies. We know that the net portfolio inflows into the Euro Area in euros (that is, the Euro Area investors purchases of foreign bonds and equities minus the foreign purchases of euro denominated assets) has been negative in the case of US-Euro Area investors flows for the last four years and even in the case of the rest of foreign-Euro Area investors flows. The only exact data available are the foreign currency reserves managed by the central banks. The latest data from the IMF indicate that there has been only a small change in the composition of international reserves. In 1995, the relative shares of the US dollar, the DM and the Yen were 57%, 13.7% and 6.8% of the total, respectively. At the end of 2002, the share of US dollar has risen to 64.8% and the Yen has fallen to 4.5% and the euro share has improved from 12.6% in 1999 to 14.6% in 2002. However, changes in exchange rates over the period mask an underlying increase in the share of the euro in the global currency reserves. The IMF divides the changes in reserve holdings into valuation effect and quantity changes. The most accurate way of analyzing the relative change in central bank holdings is to look at the ratio of these quantities. At the start of 1999, there were 5.4 times more dollars held than euros and at the end of 2002 central banks held only 4.4 dollars per euro.

In 1998, the share of the present Euro Area currencies was the following: DM 12.2%, French Franc 1.4% Netherlands guilder 0.4% and ECU 5%. In total 19%, that is 4.4% more than the present 14.6% held in euros. Nevertheless, this comparison is not fully accurate given that it excludes the euros received by the Euro Area members when their previous holdings of other Euro Area legacy currencies were converted into euros on January 1999. The main explanation for this large, but declining, difference between the US dollar and euro central bank holdings is due to the fact that the Asian central banks are by far the biggest holders of foreign exchange reserves. At the end of 2002, they were holding 1.6 trillion, about twice the amount held by Europe and the Americas combined. If Asian central banks hold US dollar and euro reserves in the same proportion than the total central banks, that is 65% versus 15%, then a strong case for raising the reserves held in euros can be made by looking at the relative importance of the Euro Area and the US trade with Asia. The reserves held by Asian central banks in US dollars are four times greater than in euros while the US is less than twice as important as the Euro Area in trade with Asia. Total US trade with Asia represents 17% of Asian trade while the Euro Area accounts for 10%. Since EMU began the importance of the US trade has fallen from 20% of Asian trade to 17% while the Euro Area trade has fallen from 12% to 10%. The governor of the Central Bank of China has commented recently that a shift to a trade-weighted Yuan exchange rate system is still under consideration. Such a development, if implemented, would clearly lead to the need for the Chinese monetary authorities to raise notably the share of euros in their FX holdings, if this potential decision by China would be followed by other Asian countries, the net effect on their euro reserves holdings would be very extremely important.

Another argument for the euro holdings to grow in the future is the based on the relative return on investing in the three alternative international currencies. Using relative returns of the three major international currencies, measured by the one-month interest rate on deposits, between 1995-2002, the optimal currency shares would be 61% for the US dollar, 32% for the euro and 7% for the yen. If the share of global reserves were to increase accordingly this would amount to a rise of the euro from 15% to 32%, that is, almost 300 billion dollars at today's exchange rates.

A final argument for the raise of the euro as a reserve currency is the "excess of reserves" in the Euro Area system of central banks derived from the introduction of the euro, which reduces the need to have large foreign currency reserves in every individual central bank, which are denominated in dollars. A reduction in the reserve holdings of Euro Area central banks would raise the demand for euros relative to the US dollars. The "excess reserves" in dollars are estimated in 165 billion US dollars, as for June 2003 (excluding the 27.3 US dollar billion held by the ECB). Since the start of EMU the IMF data reveal that the national central banks have reduced their holdings of foreign exchange reserves by only 38.3 US dollar billion. If the total excess would be eliminated, it would imply important consequences for the asset markets. For example, to sterilize the shrinkage in the foreign asset component of the monetary base, central banks could purchase own-currency government debt. The net result would be a run-down of foreign currency reserves to finance a reduction in the stock of outstanding domestic government debt, resulting in a stronger euro and lower bond yields.

Finally, in the foreign exchange market, the main impact of the introduction of the euro has been the elimination of intra-EMS trading, which its disappearance resulted in a trading decline of 11% of the global turnover. This drop has not been compensated yet by the euro trading, which still is lower than the accumulated of all euro constituents together, while the US dollar has increased its trading market share. The euro has been gaining market share in Eastern Europe exchange markets while the dollar still remains the dominant currency in the rest of the emerging foreign exchange markets. In the rest, the introduction of the euro has not changed substantially the foreign exchange market conditions. Bid-ask spreads remain similar and market liquidity keeps more or less the same. The US dollar market share in the global foreign exchange market turnover has increased from 83.3% in 1995, to 87.3% in 1998 and to 90.4% in 2001. The euro share in 2001 has been only of 37.6%, which is lower than the combined 52.5%, reached in 1998, of the DM (30.1%) the French franc (5.1%) and the rest of EMS currencies plus the ECU (17.3%) that is, a difference of more than the 11% justified by the elimination of intra EMS trading.

In my personal view, the ECB policy of neutrality with regards to the euro international use is completely the right one. The ECB should try to make the euro the most stable currency by maintaining long-term price stability. That is a task hard enough for the ECB to make the euro attractive as an international currency. The international role of the euro is the outcome of a market driven process and not the result of interference by central banks and political authorities. To try to impose to importers and/or exporters of major commodities, such as oil and gas to invoice in euros is going to be perceived by the markets as an intolerable interference by politicians. The private companies engaged in these activities know better what is the optimal (and workable) decision for them and they would change the present situation if they think that it is convenient for their competitiveness and for their shareholders returns.

The economic authorities of the Euro Area should only concentrate in integrating their still segmented banking and capital markets to achieve a larger and more competitive size to be able to attract more issuers and investors from the rest of the world and compete on equal terms with the US markets. Unfortunately, until now their shortsighted and short-terminist view, derived from an old fashion and nationalistic understanding of the markets, completely incongruent with an increasingly globalized economy, is retarding the surge of the euro as an international currency comparable to the weight of the GDP and the trade share of the Euro Area in the world.

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