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Why and how to develop the international role of the euro?

Trade and financial globalisation, as well as the economic and health crises that have marked the international monetary system over the past decade, are leading us to re-examine the cost-benefit balance of the internationalisation of the euro. Developing the international role of the euro would result in a rebalancing of the international monetary system in favour of the euro, with potentially beneficial effects in terms of financial and macroeconomic stability. This article looks at the reasons for promoting the international role of the euro, but also the associated risk factors. While the balance remains neutral for European monetary policy, enhancing the international role of the euro would nevertheless shield the euro area from global fluctuations. Above all, policies that contribute to strengthening the international role of the euro, in particular the promotion of the capital markets union and green bonds, would also enhance the euro area's resilience and long-term growth.

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E42, F31,
F4, G15,
N22, N24

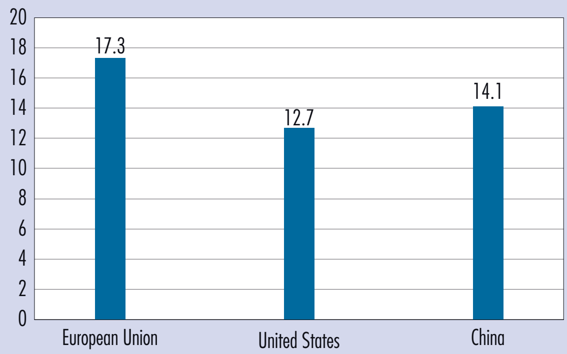
17%
share of the European Union in world exports

–11,000 billion dollars
net international investment position of the United States

6,700 billion dollars
foreign exchange reserves in dollars

Share of the European Union (EU), the United States and China in world exports of goods and services in 2018

(%)



Sources: Eurostat, IMF (DOTS), WTO.
Note: Excl. intra-EU trade.

The policy of neutrality endorsed in the early days of the euro implied that the European Central Bank (ECB) would neither hinder nor encourage the international role of the euro.[1] It was adopted following an assessment of the costs and benefits of the internationalisation of the euro. Since that first assessment, the geopolitical and institutional context, with in particular the decline in multilateralism, and the economic context, with globalisation, have changed, altering the cost-benefit balance of the internationalisation of the euro.

First of all, globalisation has taken the form of a rise not only in trade in goods and services, but also in capital flows. Commercially and financially open economies such as those of the euro area have greater incentives to protect themselves against import price fluctuations and to ensure stable external financing. Assuming that the current health crisis does not change previous views, which nobody can say at this point, growing trade openness also makes the euro area economy increasingly sensitive to developments in the rest of the world.

Globalisation has also resulted in a concentration of channels of exchange, as illustrated by the role of the small number of major bank card networks in retail payments or of SWIFT in interbank settlement messaging. This enhances the capacity of the country at the heart of the international monetary system to control trade and financial flows. More recently, the digital giants have multiplied initiatives to promote the use of means of payment sometimes referred to as "stablecoins", but in fact closer to crypto assets, based on the global networking effect of their digital platforms.

It is therefore legitimate today to address the issue of the position of the euro in the international monetary system (IMS). This article thus looks at the advantages of developing the international role of the euro and the policies that would contribute to this development.

1 Why strengthen the international role of the euro?

Strengthening the international role of the euro will mitigate the undesirable effects of the dominance of a single currency

Today, businesses, debt issuers and investors use the US dollar as it serves their interests: by concentrating on a single currency, they lower their financing costs and foreign exchange risks. Businesses are able to charge and settle their transactions while limiting foreign exchange costs, either because their revenues and expenses are in dollars or because dollar financing is particularly developed and plays a key role in foreign exchange markets. The dollar enables investors to benefit from deep and liquid financial markets for a wide range of securities. It enables debt issuers to attract investors by relieving them of currency risk, either because their liabilities are also in dollars or because there is a developed dollar hedging market. These powerful network effects give rise to inertia in the choice of currencies.

However, this concentration of transactions and investments in a single currency also has an adverse effect on financial stability, market depth and world trade.

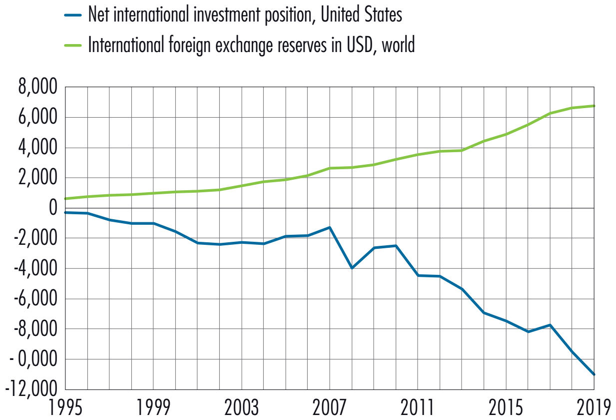
As regards financial stability, the disruptions in the US financial markets have a multiplier effect on the global economy. This risk is all the greater since the inflow of capital into the US financial system may generate asset price bubbles[2] and since foreign investors may have less knowledge of US investments than domestic investors.

In terms of market depth, the supply of safe assets by a single country, consisting mainly of US Treasury securities, is insufficient to meet demand, which weighs on risk-free interest rates. Given the strong demand for safe assets, the United States is thus faced with a new "Triffin dilemma"[3]: in order to meet this growing demand, caused in particular by the accumulation of reserves

1 See Genre (V.), Lecat (R.) and Marsilli (C.), "The Euro in the History of the International Monetary System", *Banque de France Bulletin*, No. 229-6, May-June.
2 Bernanke, 2005; Shin, 2012. For a debate on this topic, see Borio and Disyatat (2011).
3 See the Triffin dilemma in the article "The Euro in the History of the International Monetary System" in this Bulletin.

C1 The new Triffin dilemma: US net international investment position and international foreign exchange reserves

(USD billions)



Source: IMF (balance of payments statistics, COFER database).

by emerging economies, the United States has to issue ever more government securities and thus inflate its government deficit, thereby undermining the sustainability of its debt and external position (see Chart 1). From this point of view, the existence of safe assets issued by a country other than the United States would benefit the functioning of the IMS (Farhi et al., 2011; Eichengreen et al., 2018).

As regards world trade, denominating prices in dollars, even when the transaction does not involve the United States, leads to risks of volatility. Indeed, when the dollar appreciates against all currencies, the price of dollar-denominated imports rises and demand falls, which may lead to a slowdown in overall world trade (Gopinath et al., 2020). This is all the more problematic as periods of global crisis and investor fallback onto safe assets lead to a general appreciation of the dollar, which exacerbates the downturn in world trade and accentuates the crisis.

Finally, as regards market risks, the concentration of dollar-denominated issues, given investor preferences, implies that emerging countries are highly vulnerable to fluctuations in a single currency. The appreciation of the dollar raises the cost of servicing the debt denominated in that currency and can lead to default.

In the diplomatic field, the United States has increasingly used the dollar's position in payment systems and in financial markets as an instrument of its foreign policy, as shown by the extra-territoriality of the sanctions against Iran and the compliance rules imposed on multinational companies.

These effects result from the concentration of transactions and investments in a single currency, the dollar. Today, the euro is the only currency that offers the possibility of diversification, combining sufficient depth and openness, both commercial and financial (see Section 2).

The development of the international role of the euro: an analysis of the costs and benefits for the euro area

The euro was not created as a rival currency to the dollar, but to complete the single European market and avoid the financial turbulence caused by the devaluation of European currencies. However, the question of the development of the euro's international role was raised as soon as the single currency was launched: the temptation to promote this role was countered by the fear of interfering with market mechanisms and the potentially adverse effects of such a development. In particular, the German experience after the end of the Bretton Woods system (which had been accompanied by an appreciation of the deutsche mark) had worried the German authorities. The ECB thus adopted a neutral stance as early as 1999, as expressed by its first President Wim Duisenberg.[4]

This development gives rise to both benefits and costs for the euro area, the measurement of which is often surrounded by substantial uncertainty. We look at two aspects of the international role of the euro: as an invoicing currency in international trade and as a currency of exchange in international capital flows. An expansion of the international role of the euro as an invoicing currency would introduce more price stability and thus protect citizens and businesses from excessive exchange rate fluctuations. Indeed, imports of goods and services denominated in a foreign currency lead to price fluctuations in euro when the exchange rate of these currencies fluctuates. Raw materials (such as oil)

4 See Eichengreen et al (2018), p. 172-173, for a summary of this debate.

whose prices are set in dollars are a good illustration of this mechanism: as the price of a barrel of oil is fixed at world level in dollars, a depreciation of the euro against the dollar raises the price in euro paid by importers in the same proportion (the pass through of the exchange rate to import prices is complete). For other goods, the pass through is not complete because exporters can lessen exchange rate movements by adjusting their margins; it is nevertheless substantial in the euro area.[5] Finally, the pass through to the HICP is lower due to the fact that most of the goods and services traded in the euro area are produced in euro area countries and also due to distribution costs, but it remains substantial at around 10%.[6] Similarly, on the export side, exchange rate fluctuations have a particularly significant effect when invoicing is carried out in foreign currency. Thus, a good exported and paid for in a currency other than the euro will see its value in euro fall if the euro appreciates, thus reducing the profits of exporting firms.

As regards international trade, extending the international role of the euro as an invoicing currency would clearly lower the price volatility of imported goods and services and thus of inflation; it would also lower fluctuations in export profits. These two mechanisms would together considerably reduce the economic uncertainty generated by exchange rate fluctuations.

However, these potential benefits are also associated with costs. Indeed, the exchange rate channel is an element of monetary policy transmission mechanisms, indeed, a very important one. For example, when the inflation outlook is below target (which is defined in the euro area as “below” but “close to” 2%), the central bank will adjust its monetary policy stance to make it more accommodative, which will contribute to depreciating the exchange rate. This exchange rate depreciation will increase inflation via the above-mentioned mechanism, which is particularly strong when imports are invoiced in foreign currency (and therefore when the international role of the euro is weak). Similarly, another monetary policy transmission channel is via net exports: an exchange rate depreciation will spur exports and slow imports, thus contributing to raise domestic demand and thus inflation. But here again, this effect is all the stronger as trade is predominantly denominated in foreign currency. Paradoxically, the inflation target is thus reached faster when the international role for the euro is less developed – all other things being equal.

The international role of the euro in international financial flows here again generates costs and benefits. On the one hand, increasing the role of the currency in international capital flows contributes to financial stability and the autonomy of monetary policy. For example, the United States benefits from the fact that the bulk of the liabilities of its international investment position is denominated in dollars (a depreciation of the dollar therefore represents a loss for foreign investors, which is according to some a real “exorbitant privilege”). On the other hand, however, the international role of the dollar becomes an “exorbitant duty” in the event of a global crisis: at the time of the 2008 global financial crisis or, more recently, the Covid-19 crisis, the dollar appreciated (as international investors sought to buy US assets, considered as safe), leading to a net transfer to the rest of the world. This “duty” has also taken the form of decisions by the Federal Reserve to facilitate foreign central banks’ access to international liquidity in dollars. If the international role of the euro were to develop, this duty and this privilege would therefore have to be taken into account.

2 How to develop the international role of the euro?

In order to strengthen the international role of the euro, the European Union (EU) must develop its own model, focusing on developing multilateralism, deepening its economic and financial integration, and paving the way for sustainable growth based on green finance. It must implement certain reforms, most of which are desirable in themselves – and the urgency of which has been brought to the fore by the Covid-19 crisis and in which the Eurosystem has a significant role to play. Brexit is both an impediment, with the loss of the Union’s main financial centre, and a

5 See Ortega and Osbat (2020) for a recent summary of the work on pass through in the euro area and an analysis of the different methods used to estimate it. According to Ortega and Osbat, the pass through for import prices in the euro area would be around 30%, but several studies suggest a significantly higher figure.

6 See in particular the simulations presented by Aldama and Ouvrard (2020). Ortega and Osbat (2020) find a lower figure, around 4%.

stimulus, with the need to have an alternative through a genuine financing union, which fully achieves both the banking union and the capital markets union.

The advantages of the euro

The euro is the currency of 340 million citizens in the 19 countries of the euro area, and a reference for 25 other countries and territories around the world that have pegged their currencies to the euro. As the world's largest trading "bloc" (see Chart 2),[7] the European Union is also the largest trading partner of many other economies, which explains why the respective shares of the dollar and the euro are similar in the invoicing of world trade. The size and openness of the European Union (EU), and of the euro area in particular, are key features underpinning the scale and network effects that contribute to establishing the euro as an international currency. However, due to the catching-up dynamics that emerging economies will eventually benefit from, together with long-term demographic trends, Europe's relative weight in the global economy is likely to decrease. As the ECB has stressed (Coeuré, 2019 and ECB, 2020), the international role of a currency also fundamentally depends on the stability of its economy, the depth and liquidity of the financial markets underpinning it, and its ability to speak with one voice. This diplomatic dimension covers the ability to convince ("soft power") and to promote one's own standards; it is all the more important for an economic area that grows less quickly than others.

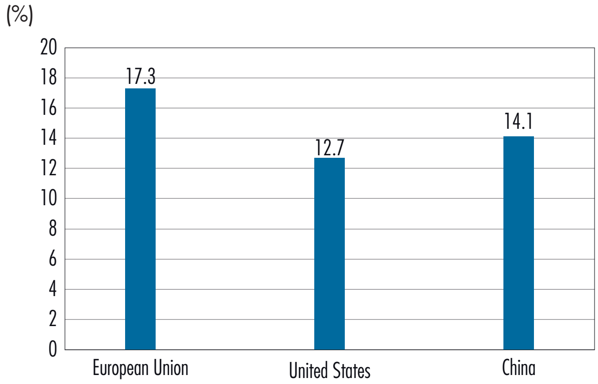
The stability of the euro area and the EU has been put to the test by the crises, and adjustments to the institutional framework have been necessary. The Eurosystem has played a decisive role within the framework of its mandate, and the euro area architecture has been enriched with a mechanism for financial assistance in times of crisis (the European Stability Mechanism or ESM) and single supervisory and resolution mechanisms for the banking system. By contrast, the instruments for collective fiscal action remain underdeveloped.

Finally, although euro financial markets are among the most developed in the world, they have not yet acquired the depth and liquidity of dollar markets (see Chart 3), due to their persistent fragmentation between national segments – whether in terms of bank lending or equity financing – and the lack of a safe benchmark asset comparable to US Treasury securities.

Necessary political decisions

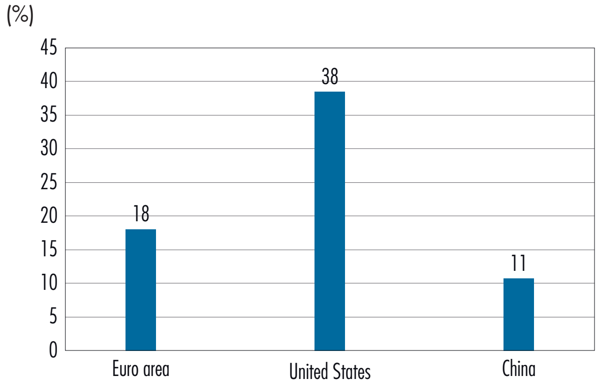
Promoting the international role of the euro requires taking political decisions, in particular concerning Europe's budgetary instruments, its financial markets,

C2 Share of the European Union (EU), the United States and China in world exports of goods and services in 2018



Sources: Eurostat, IMF (DOTS), WTO.
Note: Excl. intra-EU trade.

C3 Share of the European Union, the United States and China in the global outstanding amount of debt issuance markets, in September 2018



Source: Bank for International Settlements.

7 Following the exit of the United Kingdom from the EU in 2020, the EU's share of world trade has declined but is nevertheless expected to remain significant.

and its external representation. These decisions will make the euro more attractive to private agents, who will then adjust their invoicing and investment behaviour.

The absence of political consensus between European States was particularly apparent in the area of budgetary instruments just before the crisis, be it the creation of a "euro area budget" (with the Budgetary Instrument for Convergence and Competitiveness – BICC), or the volume and content of the next EU multiannual financial framework. However, the absence of a common budgetary capacity is an obstacle to the possibility of issuing European safe assets on a large scale.

The crisis triggered by the Covid-19 epidemic provided a new opportunity to acknowledge the incompleteness of Economic and Monetary Union, which is the main impediment to the development of the euro's international role. The debate that took place within the Eurogroup on the need to finance via joint debt issuance first the immediate response to the crisis, then the expenditure necessary for recovery, illustrated the persistent reluctance to resource pooling and public risk sharing. This reluctance could only be overcome as EU leaders became aware of the risk that a crisis of such magnitude could pose for the Union. The Franco-German initiative in favour of a recovery fund powered by the EU budget, and the proposals subsequently put forward by the European Commission, were an important step in this direction. For the time being, the market for euro-denominated "risk-free" securities remains fragmented, mainly between issues by the ESM, those of the European Investment Bank (EIB) and those of governments that manage to preserve their creditworthiness even in times of stress.

The stability, depth and liquidity of financial markets needed to establish the euro as a reference currency require, in addition to the development of secure public assets, closer integration of banking and private capital markets in Europe. The enhanced efficiency of a truly pan-European banking system would also contribute to improving the liquidity of financial transactions in euro. To this end, the national reflexes of ringfencing liquidity and capital would need to be overcome. As regards the Capital Markets Union, following Brexit, an alternative to the London financial centre is to be developed for a number of activities. On the one hand, it is necessary to develop certain activities within the framework of a network of European financial centres and, on the other, to be able to repatriate certain systemic activities. The euro area's ability to ensure its financial stability would be at stake if systemic activities remained outside its prudential supervision, while requiring the intervention of the Eurosystem as lender of last resort in the event of a crisis.[8] In order to promote the international role of the euro and the financial stability of the euro area after Brexit, it is therefore desirable to develop a system of European financial centres characterised by a high degree of fluidity in the movement of capital within the euro area. From this point of view, certain technical elements still need to be put in place or improved, such as access to information on companies or securitisation. However, key decisions on taxation or bankruptcy law remain within the remit of national governments.

While the European Union speaks with one voice on international trade, the external representation of the euro area or the European Union is far from unified within international financial institutions. The Five Presidents' Report (2015) deplored this in particular in the case of the IMF. In a 2016 own-initiative report, the European Parliament concluded that "beyond the sole case of the IMF, progressive streamlining of the EU representation should be implemented over the next years, first through enhanced coordination" before eventually considering a unification of seats.[9]

Finally, history shows that the international role of a currency depends more generally on the ability and willingness of the issuing country to deploy its geopolitical power. Europe is among the most fervent defenders of multilateral order, but the expansion of the role of the euro will depend on whether or not the Union is determined to exercise its

8 This concern is well integrated into the EMIR II directive for clearing houses: the directive sets three levels of systemicity and requires for the last level the relocation of activities in the euro area.

9 See Goulard (S.), "The International Role of the Euro", *Banque de France Bulletin*, No. 229/5, May-June 2020.

sovereignty jointly and implement a common security and defence policy. This is not a question of reproducing models that are based on unilateralism and give an extra-territorial dimension to their legislation, but rather of giving Europe its full weight in a multilateral system.

Concrete incentives would also be useful

In December 2018, the European Commission, then chaired by Jean-Claude Juncker, called for more to be done to ensure that the euro could play its full international role. This call was accompanied by a recommendation on the use of the euro in contracts and transactions in the energy sector, and leading to a series of sectoral consultations focusing on the foreign exchange market, commodity markets and the transport sector (European Commission, 2018). The outcome of these consultations highlighted the need for a series of concrete actions aimed at:

- promoting the liquidity of transactions in currency pairs involving the euro in the different segments of foreign exchange markets (spot, forward, derivatives);
- working with commodity exchanges to promote the emergence of euro benchmark prices for oil and natural gas, as well as for mining and agricultural commodities;
- facilitating the euro financing of transactions in the aircraft manufacturing sector.

The ambition to strengthen the international role of the euro was reaffirmed by the Commission –characterised as "geopolitical"– chaired by Ursula von der Leyen, for whom this would be both an expected outcome of the deepening of economic and financial integration and a contribution to improving the business environment for European companies.

The Covid-19 crisis has led to such volatility in commodity prices, and such a major shock to the transport industries (especially aeronautics), that it could result in a disruption in the functioning of these markets, not only in supply chains, but also in microstructures such as invoicing and financing methods.

The "green deal" put forward by the Commission concerns all sectors of the economy, but is primarily aimed at decarbonising the energy sector, which may provide an opportunity to change practices as regards the choice of transaction currency in this sector. The financing that will have to be mobilised for this transition will also be a first-rate vector for developing euro-denominated "green" bonds (half of the issues of this type are already denominated in the European currency). An important first step in this direction will be taken with the adoption of a European classification system (or taxonomy), which will enable investors to redirect their investments towards technologies and companies that may be considered as environmentally sustainable, while avoiding the pitfall of "greenwashing". Transparency recommendations regarding the financial sector's exposures to climate risk and the development of standards for green bond issuance are the first elements of a framework that should foster the emergence of a true European green financial centre. This centre would be a global benchmark for green market standards and would be largely denominated in euro. Standardised green sovereign bond issues, or even, where needed, joint European issues aimed at financing investments in the climate transition, would also provide international investors with risk-free euro-denominated securities that would act as a benchmark for this market.

Eurosystem central banks, within their mandate, also have a role to play in the policies that help to strengthen the international role of the currency that they issue. This is particularly the case with regard to payment infrastructures and systems, financial stability and, more generally, the functioning of financial markets. This includes, in particular, the implementation of the full range of benchmark indices for interest rate products, as illustrated by the introduction of the short-term reference rate €STER in October 2019. Above all, the consolidation of the infrastructures for the settlement of payments and securities in central bank money (TARGET2 and T2S), as well as the roll-out of the TARGET Instant Payment Settlement platform (TIPS), will play a central role in the provision of safe and efficient settlement services, which is a key function of any currency. The development of a European strategy for retail payment systems will also be crucial, in order to safeguard Europe's independence and the security of users vis-à-vis non-European payment service networks and providers. This includes ensuring that European transaction data are not held and used outside Europe by the digital giants. Faced with the development of competing offers of digital crypto assets linked more or less closely to the dollar or a basket of currencies, ensuring the security and efficiency of euro payment systems is a major challenge in order to secure European citizens' confidence in their currency.

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