



COMPETING CURRENCIES: Can the Euro challenge the USD's leading global role? Or rather the renminbi?

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Can the Euro challenge the USD's leading global role? Or rather the renminbi?

1. Why internationalize? Or be a reserve currency?
 - A framing, with the pros and cons
2. The use of dollar vs euro
 - State of affairs: dollar zone, trade, financial transactions
3. Possible effects of rise in the euro
 - Implications for the euro and global aspects

1. Why internationalize? Or be a reserve currency?

Stepping Back: An Analytical Framing

- “Definitions:” **Internationalization**: use as unit/medium of account, transactions, invoice
Reserve currency: (large scale) store of value
- Three questions (review the thinking to date)
 - i. Can euro internationalize more, be more a reserve currency?
 - ii. Should euro internationalize more? Costs vs benefits
 - iii. How to internationalize more? What is the (best) path?
- If yes to i and ii, then iii
 - What matters more? What now? What can wait? How to balance? What else to do?
- P.S. Maybe/arguably these are not goals, but side-effects. So moot question?

i. Can euro (or renminbi) internationalize (more), be a larger reserve currency?

	Angeloni et al, ECB, Cœuré, Eichengreen, Kawai, Goldberg, Frankel, Prasad, etc.
Size, economic strength, share of world economy, trade, etc.	√√√√
Reliability of rules	√√√√
Strong financial markets	√√√
Quality and predictability of fiscal and monetary policies	√√√
Ability to respond to unexpected shocks	√√
Political cohesion	√√
Network externalities persistence, hysteresis	√√
Mountains, island, army, geopolitics...	√√

i. Can euro (or renminbi) internationalize (more), be a larger reserve currency?

Most say yes. But some caution

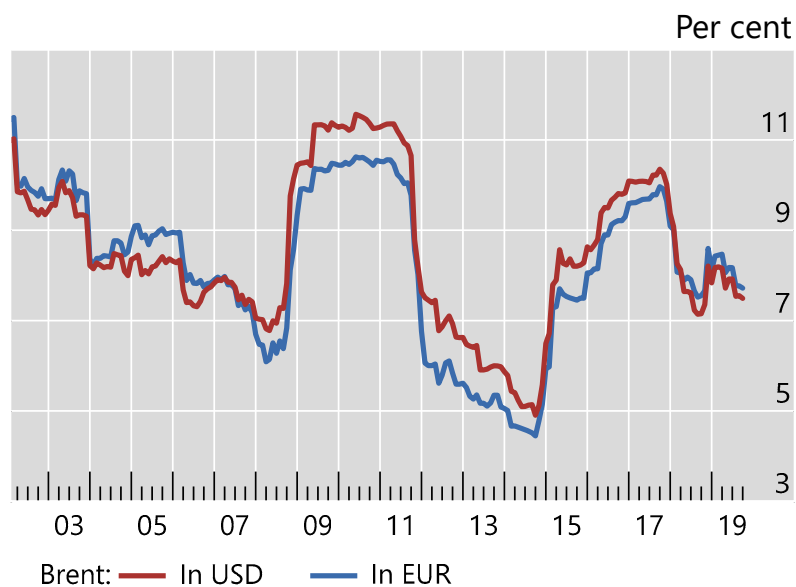
- Most say both “goals” are feasible, but take time, efforts (and luck)
 - Frankel (2011); Eichengreen (2015); Eichengreen and Kawai (2015); Eichengreen, Mehl and Chițu (2017, 2019): various steps
 - Goldberg (2012): path dependency, persistence of dollar. Prasad (2014): Dollar trap
- Key to **Internationalization** is policy coherence
 - Euro has advantages, but could (again) see some challenges
- Key to **Reserve** is (in addition) stability of domestic markets, esp. government bonds
 - Are euro’s government bond markets large, unified enough?
 - Have various governance reforms been (sufficiently) completed?
 - Banking union, fiscal union, financial integration?

ii. Should euro (or renminbi) internationalize? Gains and risks, for whom?

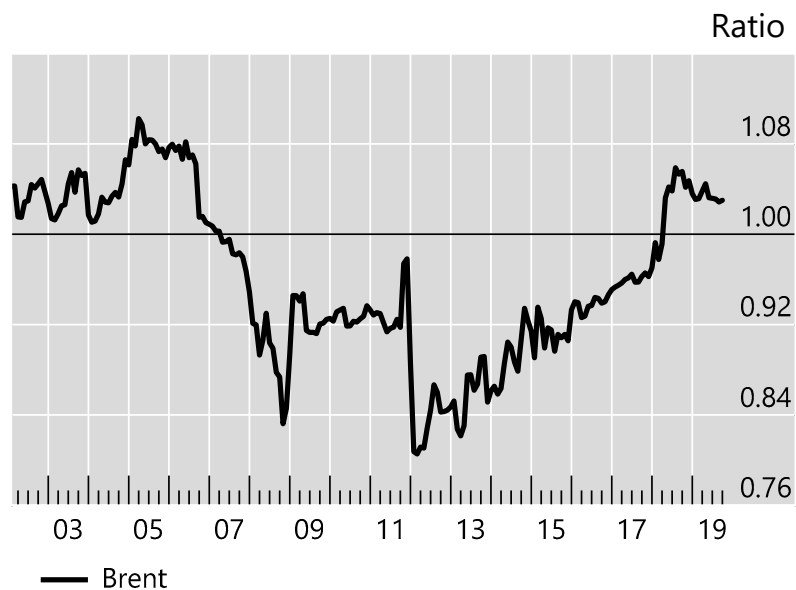
Gains	Risks
<ul style="list-style-type: none">• Benefits for local financial markets' development and monetary policy• More market discipline• Better scope for diversification, insulation from shocks, less valuation effects• Increased spillbacks in trade• Lower cost of funding (debt)• "Seignorage"• "Global influence"	<ul style="list-style-type: none">• More challenges managing internal and external balances• Spillovers, more importing of global financial cycles, FCIs• Financial instability• Greater international responsibilities• Hard to reverse policies (easier to lose than to gain)

Invoicing in euros does not lower volatility (exchange rate is a partial hedge)

Volatility of Brent oil price



Ratio of volatilities in EUR and USD



Sources: Datastream; BIS calculations.

ii. Should euro (or renminbi) be a large reserve currency?

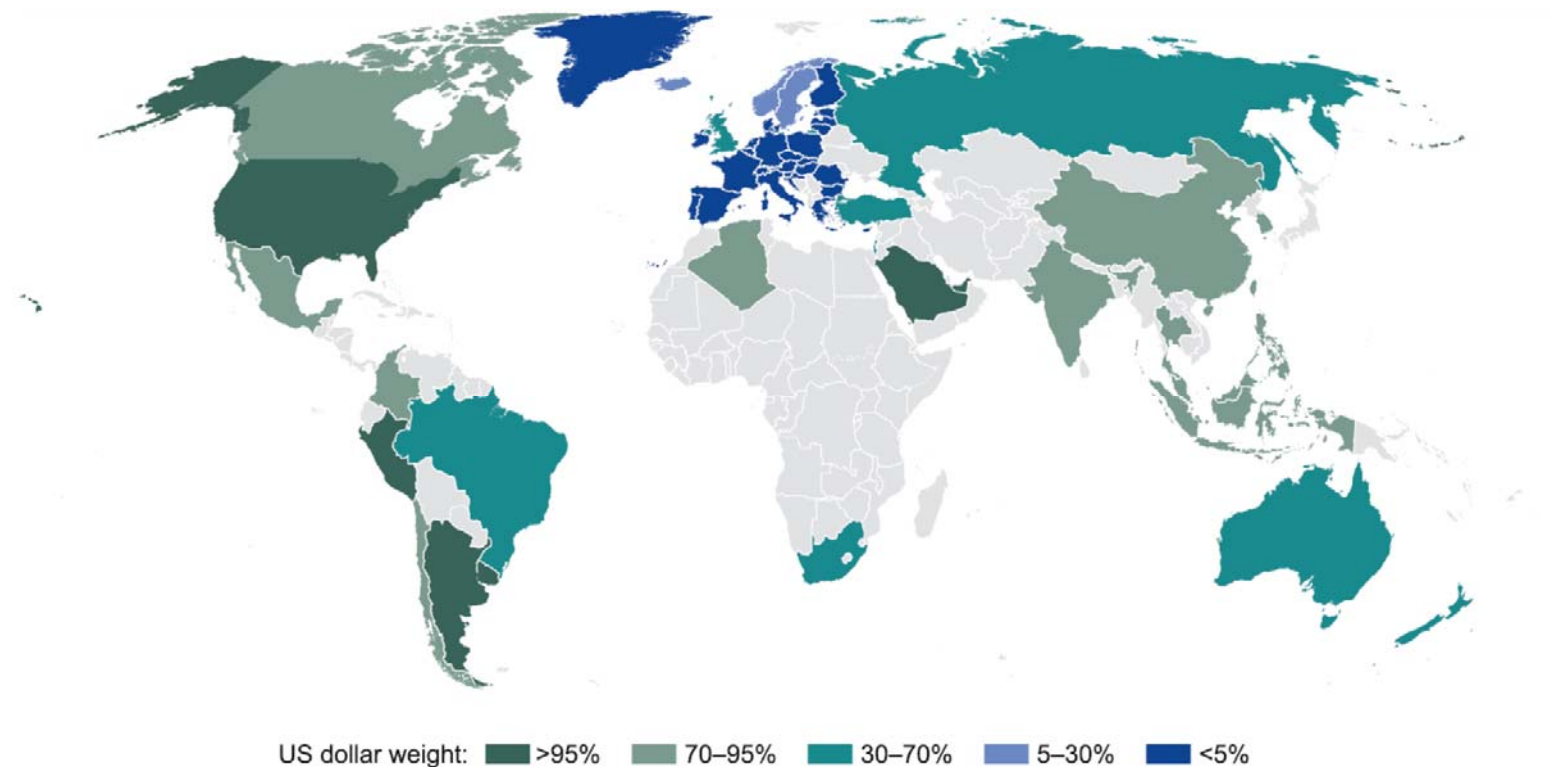
Yes, likely. Although given costs, some have said "no". So maybe...

- Reserve currency comes with benefits, but also some "costs"
 - Demand volatility due to "safe haven," as in GFC
 - Demand and need to internalize monetary policy spillovers
 - Responsibilities
 - Extend/maintain swap lines/ILoLR. Ship cash. Have repos, settlement, etc. Help countries with eurorization, etc.
- Japan, Germany at some times were reluctant to "reservize"
 - Frankel (2011): "costs outweigh benefits"
 - Also optimal timing can be "elusive"
 - Inflation, exchange rate dynamics, financial stability
 - Eg euro lost influence in int. dimension after its stress
 - But so has the US dollar since GFC

iii. How to internationalize? Evidence suggests caution

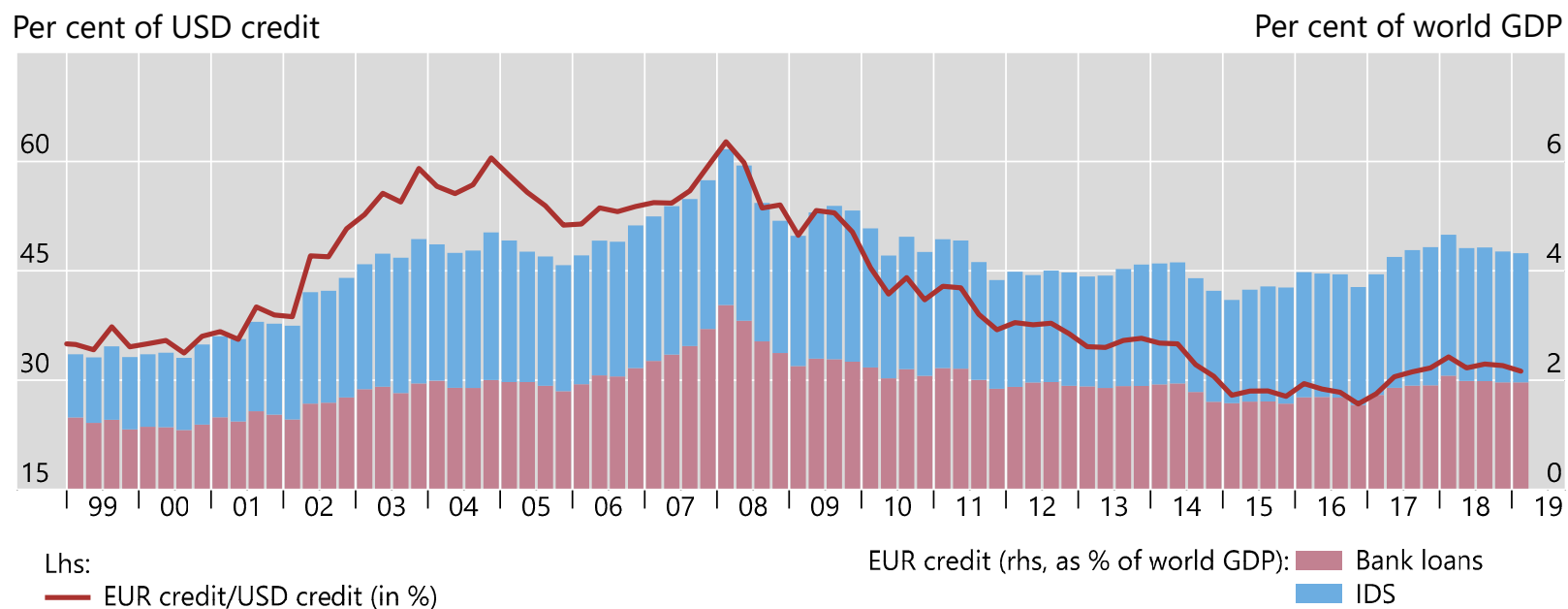
- Evidence on what to do is limited (and “every country is unique”)
 - Experience suggests it can be very complex, more art than science
 - Overall consistent approach, starting with domestic financial market development, not just size. But also political economy
- Need to consider various strategic and technical dimensions
 - Integrated approach: sequencing, consistency (eg BU, FU, i.e., again “politics”)
 - Adapt monetary, financial policy (eg to account for less pass-through with LCP, to deal with more FCI spillovers)
 - Keep/adapt macroprudential, financial stability policies (cannot reverse)

2. The use of dollar vs euro. Dollar zone is more than half the global economy



Source: BIS calculation based on average elasticities of the national currency's dollar exchange rate with respect to euro/dollar and yen/dollar rates for 2011-14, inclusive.

The euro's role as an international funding currency has seen ups and downs

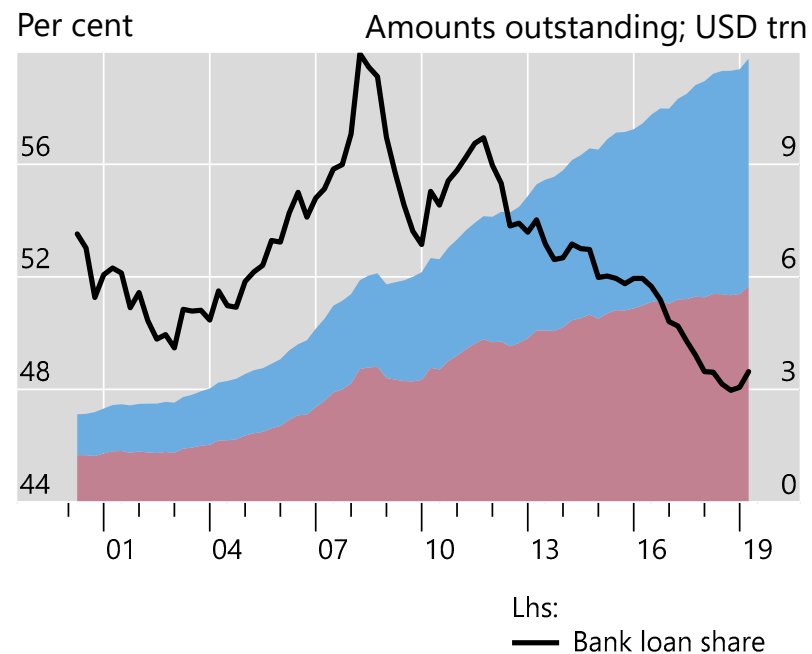


Sources: IMF, World Economic Outlook; Dealogic; Euroclear; Refinitiv; Xtrakter Ltd; BIS locational banking statistics and global liquidity indicators; BIS calculations.

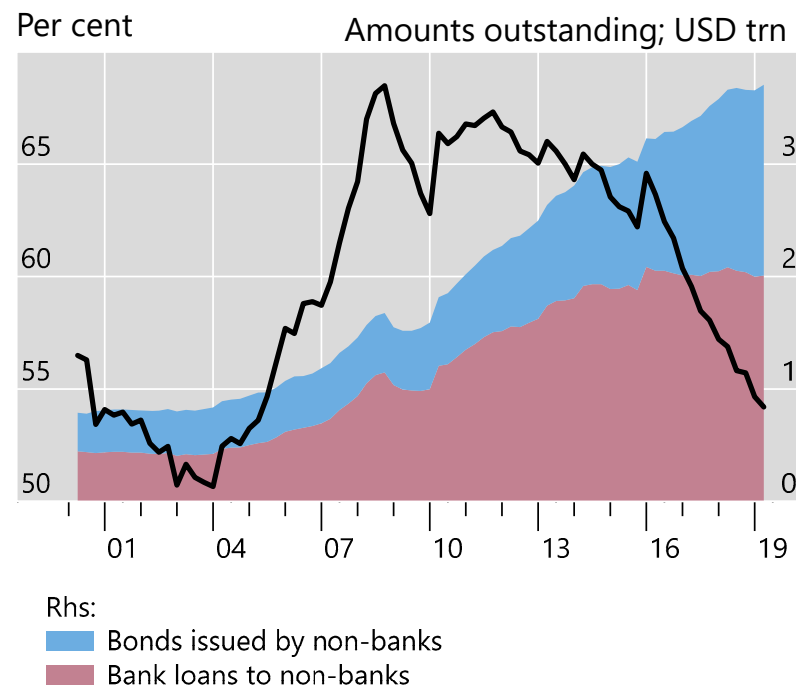
Dollar still large, esp. for EMEs, although share of bank loans lower

Dollar denominated credit to non-banks outside the United States

World



EMEs

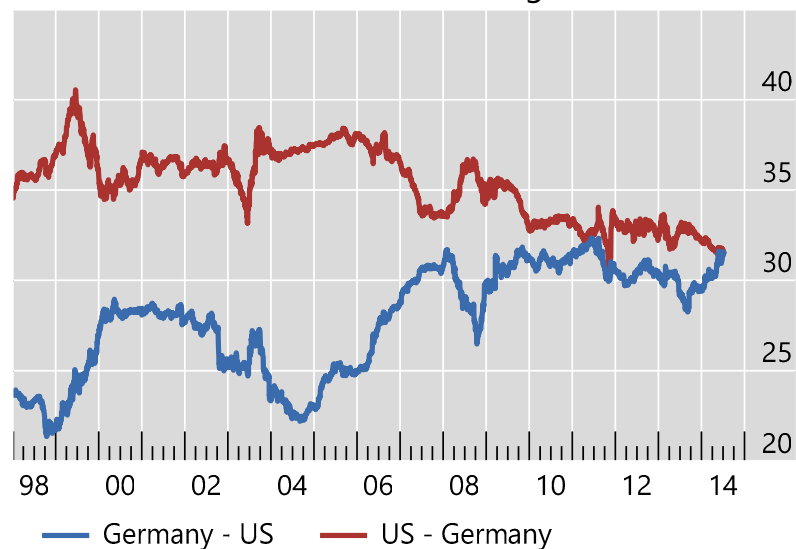


Sources: Datastream; Dealogic; Euroclear; Refinitiv; Xtrakter Ltd; national data; BIS locational banking statistics (LBS); BIS calculations.

Euro and dollar exert symmetric effects, risk premiums move in close tandem

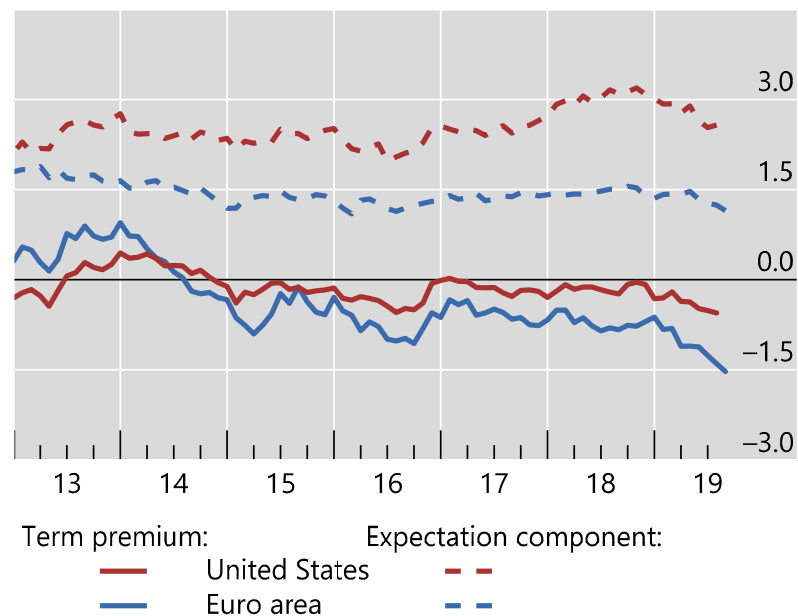
Spillovers of euro area yields to the United States

Percentage of error variance



Ten-year nominal yield decomposition

Per cent



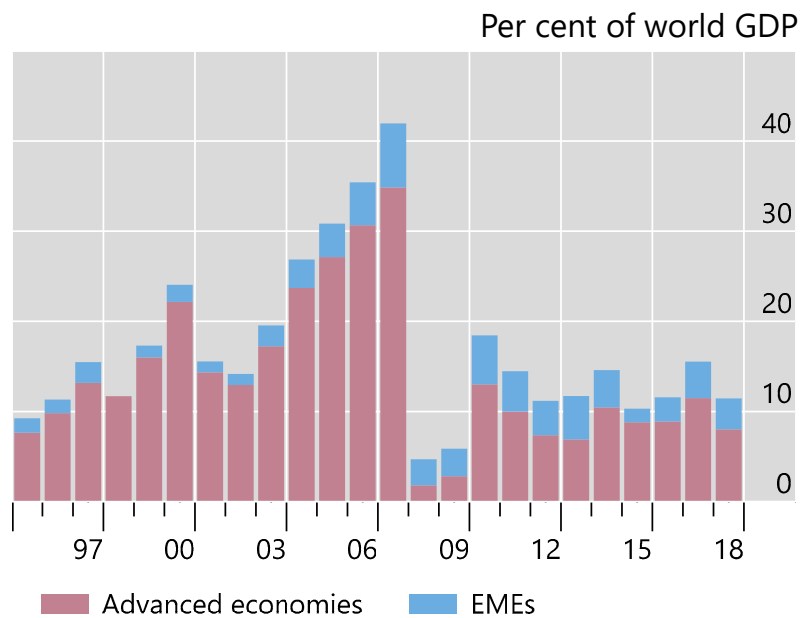
Sources: Bloomberg; national data; BIS calculations.

3. Possible effects of rise in the euro

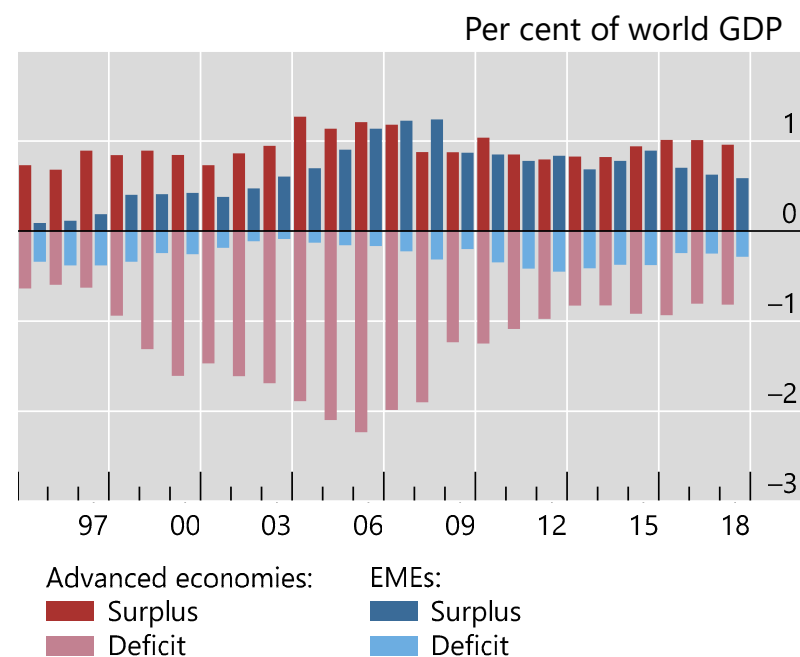
- Multiple reserve currencies could affect global financial stability
 - Would rise of euro make global system more or less stable?
 - Yes, as a means for easier/better global risk-sharing
 - But maybe also greater risk of tipping, booms/busts, due to market failures, externalities, bubbles
- Policy implications, both for euro and rest of the world
 - Need to do more ex-ante, on managing the risks of stocks
 - Better GFSN, more swaps (but effective?). Better infrastructure
 - For some countries
 - Full financial integration w/ BU, to avoid more “trilemmas”
 - Interim “smart” MAP/CFM, as ring-fencing not desirable/feasible

Gross capital flows matter more than current account balances

Gross capital flows



Current account



Sources: IMF, World Economic Outlook; BIS calculations.