

The international role of the euro: Has COVID-19 affected the outlook?

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Webinar Report

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Speakers:

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Many in the EU call for a stronger role of the euro in the international economic, monetary and financial system, to better reflect Europe's important economic and political weight. Others are skeptical about whether this can likely be achieved: The US dollar benefits from its established leading role, and the Chinese renminbi might become a serious contender. What do the facts and analyses compiled in the latest ECB Report on the International Role of the Euro find? What impact may the COVID-19 crisis have? What are the pros and cons of a stronger international role for the euro? What are the factors and pre-conditions for the euro to gain a stronger global role? And what does this imply for the European policy agenda?

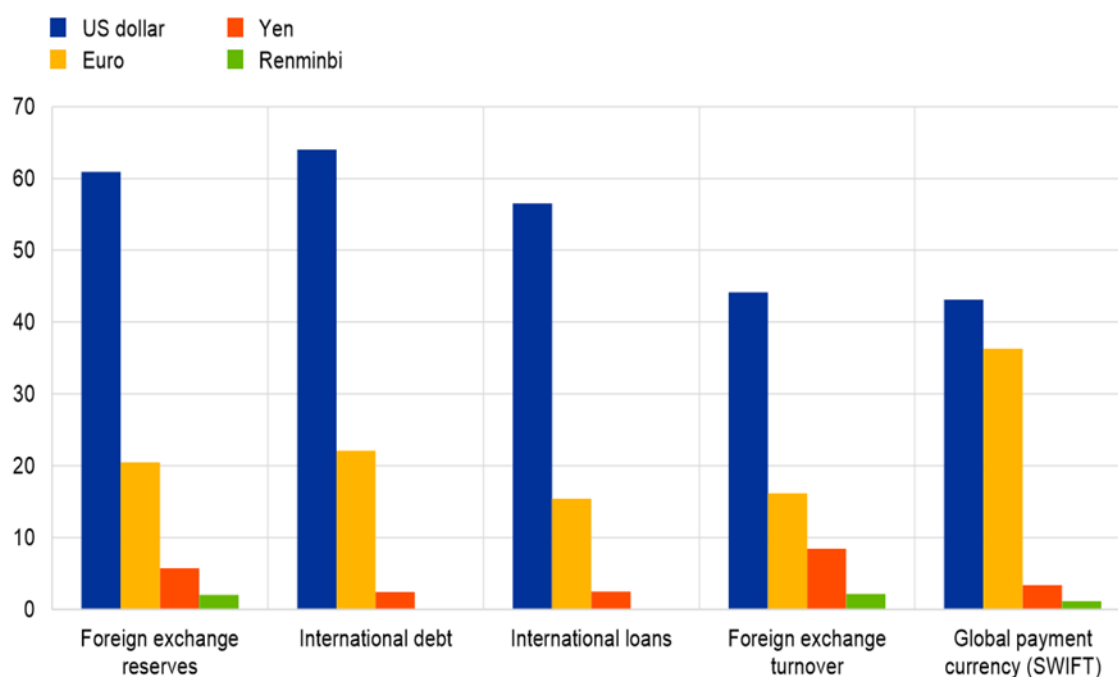
This webinar, which was jointly organized by SUERF and BAFFI Bocconi, brought together eminent experts in the field: Hans-Joachim Klöckers, Director General International and European Relations, ECB, and Peter McQuade, Senior Economist in the International Policy Analysis Division, ECB, presented main findings of the latest ECB Report on the International Role of the euro, and offered the newest thinking regarding the pros and cons of an international role of the euro. Sylvie Goulard, Deputy Governor of the Banque de France, drew on her experience as Member of the European Parliament and as French Minister of Defense and Vice-Governor of the Banque de France to combine European and French policy perspectives. Barry Eichengreen, Professor of Economics and Professor of Political Science at the University of California, Berkeley, offered a global political angle. Marco Buti, Chief of Staff of Commissioner Gentiloni, European Commission, moderated the meeting, building upon his rich experience as Director General of the European Commission's DG ECFIN.

¹ The views expressed in this webinar report are the authors' and speakers' only and do not represent those of the Oesterreichische Nationalbank, the ECB or the Eurosystem.

Marco Buti introduced the topic. The euro withered the GFC, which posed an existential crisis for the euro, remarkably well as the second most important global currency. In periods of stress and uncertainty, there is a natural **safe-haven effect benefitting the incumbent, the US dollar**. Rating agencies may amplify this effect. The present crisis is different from the Global Financial Crisis (GFC). Policies responded very fast both at the member state and EU levels. Provided they become a reality, the recent EU Commission proposals for “Next Generation EU” and the recovery resilience facility will **increase the supply of safe assets denominated in euro**. The resulting EUR 850 billion of new euro denominated bonds would be ten times the volume of outstanding debt by the ESM, EIB, KfW and similar institutions. An important question is also whether the current greater political will to develop the EU further will also propel the process towards completing the European Banking Union and the Capital Markets Union. Two years ago, when the EU Commission relaunched the initiative to strengthen the international role of the euro, it made clear that you cannot achieve this by means of “gadgets”: the most important element is to **complete EMU**. We will have to ensure that this aim will be achieved as part of the response to the COVID-19 crisis. Showing **more political cohesion among member states is also crucial to bolster confidence of international markets and investors in the euro**. The international political environment in the current crisis is much more fragmented than during the GFC. The **“weaponization of currencies”** has become a relevant issue. In developing the euro’s international role, the EU should use a **more assertive** approach.

The COVID-19 crisis response has, opposed to the GFC response, been characterized by a **much broader and swifter policy response**. The ECB is no longer the only game in town. The EU is now relying much less on external demand for the recovery than ten years ago. Germany’s more positive view in this crisis towards actively using fiscal policy to counter the crisis is seen by international markets as a sign of **more euro area cohesion**. Also politically, the euro is now considered **more stable than in the past**.

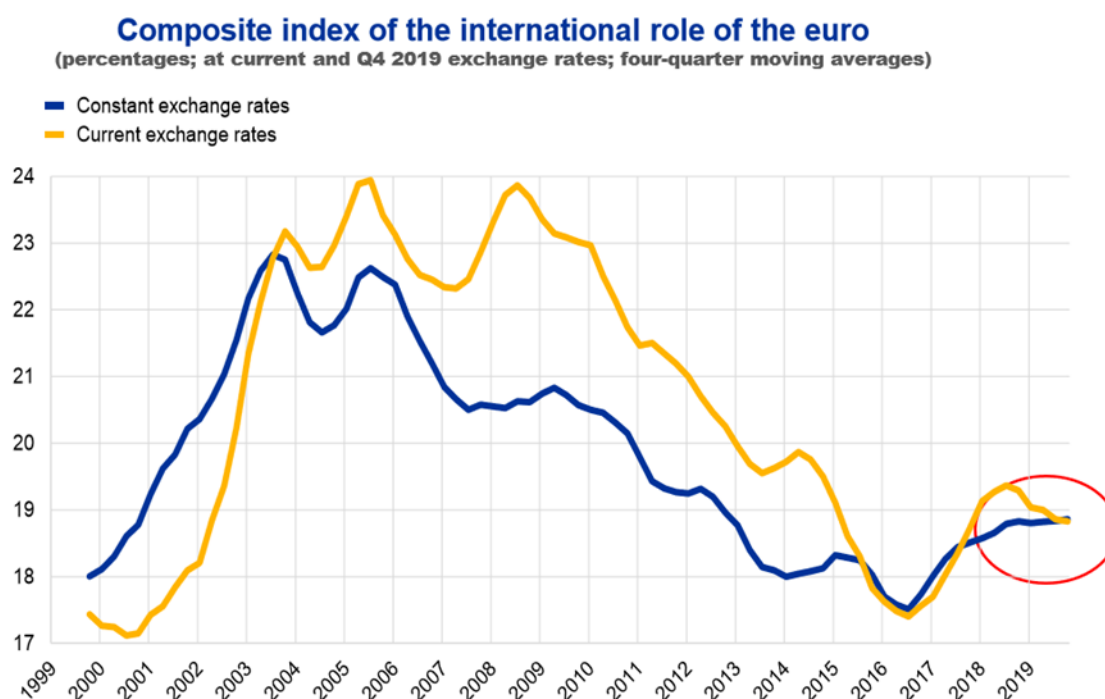
Snapshot of the international monetary system (percentages)



Sources: BIS, CLS, IMF, SWIFT and ECB calculations.
Note: The latest data are for the fourth quarter of 2019.

Source: Klöckers and McQuade, 2020.

Hans-Joachim Klöckers and Peter McQuade presented the main results of the ECB's most recent report on the international role of the euro, and elaborated on the factors driving the international role of a currency as well as relevant policy issues linked to a currency's international role. By various criteria (foreign exchange reserves, international debt, international loans, foreign exchange turnover, payments), the euro is the second most important international currency, clearly far behind the US dollar, but far ahead of all other currencies, including the Japanese yen and the Chinese renminbi. The euro's international role had a great start after 1999, but lost importance after 2008, and bottomed out more recently from a historical low. The euro area sovereign debt crisis raised concerns about the euro area's sustainability. But investors also sought to diversify the currency mix of their portfolios towards the Australian dollar, Canadian dollar and Chinese renminbi. Low euro area interest rates reduced the attractiveness of euro-denominated assets. At the same time, emerging market economies have increased debt issuance, which is traditionally mostly denominated in US dollar. Higher currency swap costs reduced the attractiveness of the euro as a funding currency for acquiring US dollars. The use of euro cash outside the euro area has held up remarkably well over recent years, despite the rise of fintech and electronic payments.



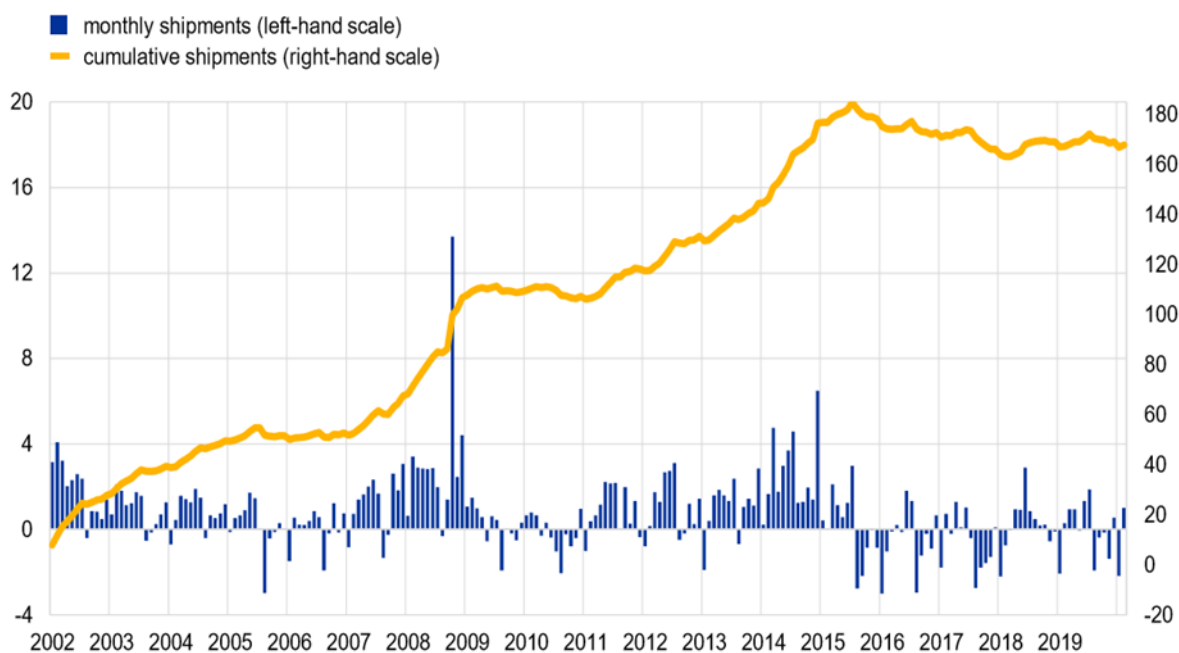
Sources: BIS, IMF, Ilzetzki, Reinhart and Rogoff (2019) and ECB calculations.

Notes: Arithmetic average of the shares of the euro at constant (current) exchange rates in stocks of international bonds, loans by banks outside the euro area to borrowers outside the euro area, deposits with banks outside the euro area from creditors outside the euro area, global foreign exchange turnover, global foreign exchange reserves and in global exchange rate regimes. Data at constant exchange rates are not available for global foreign exchange turnover. The estimates for the share of the euro in global exchange rate regimes between 2016 and 2019 were obtained by ECB staff using the same methodology as Ilzetzki, Ethan, Carmen Reinhart and Kenneth Rogoff (2019), "Exchange Arrangements Entering the 21st Century: Which Anchor Will Hold?" Quarterly Journal of Economics 134 (2), pp. 599-646. The latest observations are for the fourth quarter of 2019.

Source: Klöckers and McQuade, 2020.

Net monthly shipments of euro banknotes to destinations outside the euro area

(EUR billions; adjusted for seasonal effects)



Source: Eurosystem.

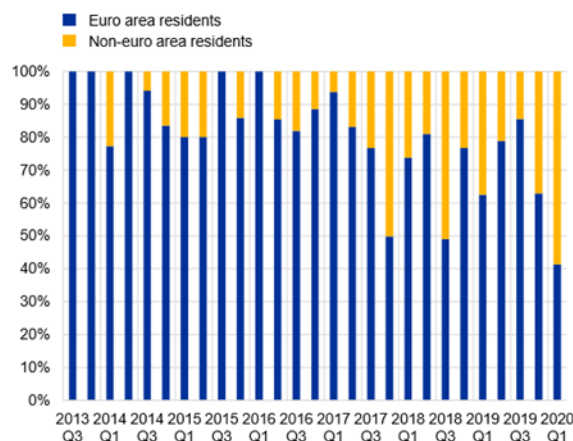
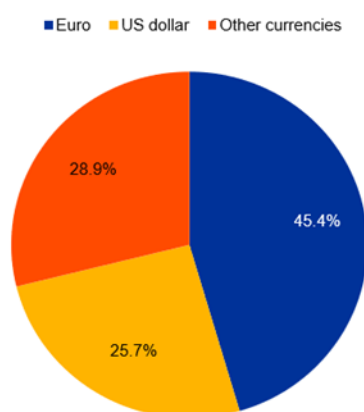
Notes: Net shipments are euro banknotes sent to destinations outside the euro area minus euro banknotes received from outside the euro area. The latest observation is for February 2020.

Source: Klöckers and McQuade, 2020.

The **euro holds a very strong position in the green bond market**. In 2019, 45% of international green bonds were issued in euro. The issue of euro-denominated green bonds is also quite strong among non-euro area residents. The establishment of the EU as a hub for green bond issuance bears the potential of boosting the euro's future weight as an international bond issuance currency.

Currency breakdown of green bond issuance in 2019 (left panel) and evolution of the share of euro area and non-euro area issuers of green bonds in euro (right panel)

(percentages)



Sources: Dealogic and ECB calculations.

Note: Last observation 31 January 2020.

Source: Klöckers and McQuade, 2020.

Klöckers then went on recapitulating the established **driving factors for a currency's international role**: the economic size of its underlying country, a country's stability (economic, financial, political), sound institutions, financial openness, the liquidity and depth of financial markets, efficient financial market infrastructures for payments and settlements, but also broader factors such as the geopolitical outreach of the underlying country, as well as, finally, inertia and network effects, which favor the incumbent currency.

USA, euro area and China in comparison

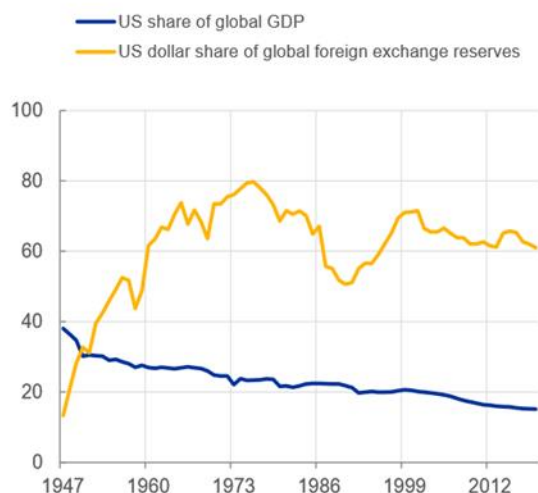
	Size	Stability	Openness	Market depth/liquidity
	GDP / world GDP	Public debt / GDP	Trade / GDP	Stock of government bonds
US	15%	106%	10%	\$ 20 trn
Euro area	11%	84%	19%	\$ 9 trn
China	19%	56%	18%	\$ 6 trn

Source: Klöckers and McQuade, 2020.

The relevance of these latter factors is illustrated by the **US dollar's continued importance** as an international official reserve currency **despite the US economy's trend decline** in relative economic importance and diminishing stability in the light of soaring US government debt. At the same time, the

large amount of outstanding US central government debt (USD 20 trillion) ensures high **liquidity** of this market. By contrast, EU sovereign debt markets are fragmented.

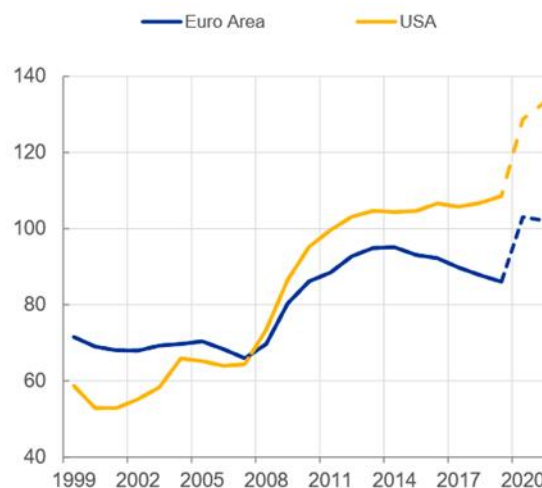
Importance of the US and the US dollar in the global economy (percentages)



Sources: Maddison project, Haver analytics and Eichengreen, Mehl and Chițu (2016).
Note: share of the US in global GDP is in PPP terms.
Latest observation: 2019.

Source: Klöckers and McQuade, 2020.

Gross government debt (percentage of GDP)



Sources: OECD, Economic Outlook.
Notes: Dashed lines are forecast values. Forecast for the single-hit scenario.
Latest observation: 2019, forecast values for 2020 and 2021.

The **euro already satisfies several of the above-mentioned criteria for a strong international role**: it has a strong track record of price stability and financial stability. At the same time, **further measures to ensure fiscal stability and further structural reforms** are needed. The process of **deepening EMU** and the European Banking Union as well as the European Capital Markets Union needs to proceed. We probably will need a common debt issuance to generate **common safe assets**. The ECB has now provided **euro liquidity lines** to some countries to provide a safety net for other central banks that use the euro in their countries. And there are a number of initiatives on markets and payments infrastructure.

Regarding resilience of the euro area, the most important step is to **reduce vulnerabilities of euro area economies**. There are still too many imbalances in the euro area as a whole and too many vulnerabilities in individual countries. Reforms need to be continued. It is very helpful that the European Commission plans to link access to EU Recovery Fund finance to compliance with the European Semester guidelines for reforms. The **euro's international role will be supported by recent measures** envisaged by the EU. "Next Generation EU" (notably the Recovery Fund) and common European short-term safety nets related to the Covid-19 crisis (ESM, EIB, SURE) should help strengthen the euro area's resilience and the euro's international role. There are two channels at play: first, they increase the credibility of the EU and the euro by **showing there is the necessary political will** for sustaining and developing them. Second, since this is a debt-financed program, it creates a common asset, which may become the **nucleus of some bigger safe asset in the future**.

But, of course, the **European policy agenda is not finished**. There is still work to be done on completing the European Banking Union. The COVID-19 crisis underscores the urgency of these policies and

reform efforts. Regarding monetary union, we need to make fiscal and structural policy instruments more effective. We should also work towards a **common fiscal capacity with a stabilization function** and conclude the ESM reform. **Capital Markets Union** is a key element to support the euro's international role. There are two aspects: the development and the integration of the market. For this, **framework conditions**, including insolvency regimes and taxation, need to converge if not be fully harmonized. The harmonization of products including green bonds will foster the euro's international role. Market supervision and regulation as well as market infrastructures need to be harmonized. The new **Final Report of the High-Level Forum on the Capital Markets Union** by the High Level Forum (see also the **SUERF BAFFI Bocconi e-lecture on 29 June 2020**) is very welcome in this respect. We have already very good market infrastructures in the form of Target 2 and Target 2 Securities (T2S) and the instant payment settlement system TARGET Instant Payment Settlement (TIPS), operated by the Eurosystem. The European Payments Strategy should help achieve a pan-European payments union. All these measures will make euro denominated assets more attractive to international market participants. In the medium run, also **global stable coins and the introduction of central bank digital currencies (CBDC) will play a role**. The original Libra multi-basket concept had a share of 18% for the euro and 50% for the US dollar. The new Libra proposal is a single-currency approach, so now you can have a Libra in US dollar or in euro. As long as euro interest rates are negative, the euro has a disadvantage there. Regarding CBDC, there may be a first-mover advantage for the currency of the central bank that first launches a CBDC successfully.

From a **monetary policy perspective**, a stronger international role for the euro involves both **benefits and costs**. The ECB's assessment has undergone some revisions over the past two decades since the start of EMU in 1999. In 1999, the main advantage perceived were seigniorage revenue, lower transaction and hedging costs, as well as the "exorbitant privilege" (lower external financing costs). On the costs side, mainly blurred monetary aggregate signals as well as capital flow volatility were seen. On balance, the ECB two decades ago took a neutral stance, not fostering the euro's international role. **Now, the ECB puts question marks on the earlier perceived costs and emphasizes several advantages more strongly**: an international currency increases monetary policy autonomy, it provides a better shield against foreign shocks, and it entails a stronger international transmission of monetary policy with positive spillbacks. Among costs which have emerged in the newer debate is that the "exorbitant duty" has become more obvious. If you are the main safe haven in the world, then in a crisis the currency may come under appreciation pressure, when this is not warranted from a domestic macroeconomic perspective. We have seen this during the Lehman crisis and recently in the COVID-19 crisis, when USD hoarding led to an appreciation of the US currency. The status as a dominant currency may also lead to fire sales in global stress episodes. In the recent crisis, there was so much demand for US dollar liquidity that several foreign central banks had to sell their US Treasury bills and securities, which then led the Fed to introduce liquidity backstop facilities for foreign central banks in the form of swaps. An international currency also implies a lower pass-through of exchange rate shocks on inflation, while as a corollary it also entails lower effects of monetary policy on import prices. Finally, at a political level, a stronger international role of the euro would imply less exposure to unilateral decisions from the US, e.g. in the case of sanctions against third countries. Overall, thus **the ECB's assessment of the cost-benefit balance of a stronger international role for the euro is now much more favorable now than at the outset of EMU**.

Benefits and costs of the euro gaining a stronger international role

1999 assessment in blue

2020 assessment in red

Benefits

Seigniorage

Lower transaction and hedging costs

Exorbitant privilege

(lower external financing costs)

Greater monetary policy autonomy

Stronger international transmission of
monetary policy with positive
spillbacks

Lower pass-through reduces impact
of FX shocks on CPI

Reduced exposure to unilateral
decisions from third countries

Costs

Blurred monetary aggregate signals (?)

Capital flow volatility (?)

Exorbitant duty

(stronger exchange rate and risk of asset fire sales
in global stress episodes; need for provision of
liquidity backstop)

Lower effects of monetary policy on
import prices

Source: Klöckers and McQuade, 2020.

The ECB has agreed swap and repo lines with all G-10 central banks, so there are also non-EU countries included. But what you see in practice is that there is primarily a need for US dollar liquidity in large parts of the world, but not for euro. The ECB has received a number of requests for swap lines, the decision process is still ongoing, so the list is still developing. As an international currency, you need to provide the respective safety net, so that those who need euro can also obtain them in crises.

You cannot just create a stronger international role for the euro by just wanting it. **You need to have the right policies in place.** These are key, and desirable in themselves. **In the end, we have to convince market actors and influence market decisions.** The lack of progress of the Peoples Bank of China (PBC) in fostering the renminbi's progress as an international currency bears testimony to this. The political and economic fundamentals are not right.

Sylvie Goulard started out by stating that uncertain times require a high degree of creativity. The **situation of the US at the time of Hamilton is not comparable to the EU's situation today**, Europe has to make up its mind on how to design its future from today's perspective. Solutions to the current challenges need to be pragmatic and relevant for workers' and entrepreneurs' life. So far, we have not even tried to make the euro a currency as strong as the US dollar. Maybe this was due to the youth of the currency. But the euro is here to stay. In the most recent crisis, many investors again piled their assets in US securities. But maybe a broader diversification among currencies might be better. Emerging markets suffered strongly from strong capital outflows into the US dollar, raising concerns about global financial stability, despite the Fed's fast and effective action to provide US dollar liquidity. **The strong position of the euro in the green bond market is promising, since climate protection is the future.** An economy which misses this trend and continues to invest in brown industries has no future. There are **geopolitical costs to having only the second most important global currency.** In the context of the US sanctions against Iran the USA forced companies from third countries to implement

measures that were decided unilaterally by the USA. It is uncertain how global trade will work after COVID-19. There is a certain mood for “taking back control”, e.g. in the production of sanitary goods. As an important player in global trade, Europe would benefit from a stronger international role of the euro.

Strengthening the euro’s international role not only requires big steps, but also a lot of “plumbing” in the area of market and payments infrastructure. **Brexit** also matters, since the euro is not only a currency without a state, but it was also a currency without a financial center within its own borders. Post-Brexit we are forced to create something new. A liquid euro **safe asset** would strongly support the euro’s potential as an international currency. To further develop the euro as a **hub for green bonds**, the **ECB should play its role** in the context of the ongoing ECB monetary policy strategy review. Finally, the euro area needs a **single representation** in various international bodies, to make its interests heard in a more consistent and effective way.

Success of the euro area and a stronger global role for the euro requires **looking at the whole and the bigger picture on the joint benefits reaped from the euro**. In the end, the EU and the euro are a political project, there is no use in juxtaposing the “south” against the “north” among EU or euro area countries.

Barry Eichengreen asked whether a stable situation of the euro’s international role is a positive development or actually a sign of lack of progress. Regarding the various determinants for a currency’s international role, in terms of size, stability and liquidity, the euro is actually not so far behind the US dollar. It is much further behind in terms of actual international use. The reasons for this may be the US dollar’s incumbency advantage and geopolitics. **Foreign policy and the international status of a country’s currency go together**. Countries that rely on the USA for their security umbrella hold a larger share of their reserves in US dollars than their trade and investment links with the USA would lead one to predict. Historically, there are complementarities between different international functions of a currency. For instance, if you hold reserves in a currency, you will be more inclined to let your banks do cross-border business in that currency. So, the question arises whether the EU needs a foreign policy for the euro to assume a stronger international role. Or will the fraying of US security alliances in any case threaten the dollar’s exorbitant privilege?

Do things look different post COVID? In the short run, the **US dollar benefitted** from the generalized flight to safety. Liquidity turned out to be more valuable than ever. The **US dollar proved to be a safe haven again**, which was reflected in the appreciation of the US dollar’s exchange rate. The **Fed’s swaps, repos and sweetened terms for foreign central banks all helped to solidify the US dollar’s preferred position as an international currency**. The ECB did the same for Romania, Bulgaria, Croatia and Denmark, but not much more widely. So, is the **euro an international or rather a regional currency?** We already see some signs of central banks hedging their bets by diversifying their foreign reserve currency composition into smaller currencies. Statements coming out of US Congress suggesting, for instance, that the USA should stop paying interest on the PBP’s holdings of US Treasury bonds as compensation for spreading COVID-19 may weaken confidence in the US dollar. As the US government manages the COVID-19 crisis so poorly, this will lead to a **loss of the US dollar’s “competence premium”**. The US dollar’s international role may also suffer from the **erosion of US democracy due to a weakening of checks and balances and the withdrawal by the USA from major international multilateral institutions such as the WTO, the WHO etc.**

The important question arises whether recent European initiatives for a European recovery program are just temporary in response to exceptional events or **truly a “Hamiltonian moment”**, setting in process a permanent deeper European integration process. Hamilton created the US customs service

and a dedicated source of federal government revenues. It will be decisive **whether there will be a dedicated source of finance for these new EU financing instruments.**

Regarding the **global role of the renminbi**, it is peculiar that China is the most important trading country in the world, while its currency accounts for only 2% of funds cleared through SWIFT. The PBC will be the first major central bank to issue a CBDC. Will this make a difference? A recent survey in South Korea asked whether users of Alipay would be happy to use a CBDC issued by the PBC. The answer was “no”, given events in Hong Kong and the fear that a Chinese CBDC would have features included which would reveal the users’ identity and come packaged with a surveillance technology. **Every first-class global currency in the world has been the currency of a political democracy or republic, with checks on arbitrary action of the executive. That will clearly hold the renminbi back. At the same time, it may help the euro’s rise as a global currency.**

References and further resources:

SUERF - BAFFI Bocconi e-lecture website

E-lecture video replay

Klöckers and McQuade (2020): Power point presentation

Barry Eichengreen’s power point presentation

ECB’s June 2020 Report on the international Role of the euro

www.suerf.org/webinars