

Strengthening the role of the Euro



Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

Stronger global role of the euro calls for the right structural conditions

While the euro's international use has been declining following the onset of the global financial crisis, the latest ECB data shows signs of a turnaround. It remains to be seen whether this recent uptick is a one-off development or a new trend. For now, it appears to be mainly driven by processes outside the euro area, including international trade tensions and unilateral sanctions.

Recent developments have reaffirmed that there is potential to increase the global role of the euro. Today, being the second most widely used currency, the euro has all the necessary attributes to become a credible alternative to the US dollar. The results of the recent consultations of the European Commission suggest that market participants share this view as well – there is broad support for an elevated standing of the euro.

Ultimately, it is market participants, both private and public, who decide to use a certain currency. As policymakers, we can do our part by putting the right structural conditions in place and establishing a similar environment where the world's No1 currency exists. This includes rendering the European economic and financial architecture more resilient, as well as providing the markets with common Pan-EU infrastructure solutions – for example, in the payments area.

"To boost the global role of the euro, we must first «do our homework» in terms of deepening the EMU."

- VITAS VASILIAUSKAS

If we want to truly boost the global role of the euro, we must first “do our homework” in terms of deepening the Economic and Monetary Union (EMU). Without a breakthrough in this area, no other measures will be effective.

First of all, to increase confidence in our financial sector and the single currency, we have to complete the Banking Union (BU). A fully mutualised European Deposit Insurance Scheme is critical in this regard. Once in place, it could help to



>>> mitigate the sovereign bank loop, reduce risk, facilitate the expansion of pan-EU banking and reinforce the financial stability of the euro area as a whole.

Second, a deep and liquid Capital Markets Union (CMU) is of the utmost importance in fostering the euro's global use. It would enhance private risk sharing, provide alternative financing sources for the real economy and allow the EMU to withstand shocks more easily. To develop the CMU, we must address fundamental issues, such as fragmented insolvency regimes. This underscores the importance of a cross-country and inter-institutional dialogue, as well as discourse with policymakers in domains outside the economic and financial remit. Given the complexity of the issue, leveraging local initiatives seems to be a possible way forward in advancing the Pan-EU CMU agenda. The Baltic states' capital markets harmonisation initiative stands out as an early positive example in this regard.

Going forward, we should not shy away from the debate on creating an adequate supply of safe assets on the EU level. The lack of such assets, which would in practice be comparable to the US Treasury bonds, may be considered as one of the main obstacles for deeper European capital markets and a stronger global role of the euro.

All in all, in order to increase prominence of the euro internationally, we must first make substantial progress in deepening the EMU and I hope that efforts to complete the BU and CMU will feature as a top priority on the European agenda in the new legislative term. ●



Vítor Constâncio

Former Vice President, European Central Bank (ECB)
& Professor, University of Navarra Masters School, Madrid

The internationalisation of the euro requires CMU and a European safe asset

There are five key conditions for a currency to become a significant international currency. The first is having a very large economy, which engenders network externalities and lowers transaction costs. The second, is given by deep, efficient, and open financial markets for investors to cheaply and easily getting in and out from assets denominated in that currency. Third, good political and macroeconomic governance with low stable inflation to preserve the value of a currency. Fourth, full enforcement of the rule of law is equally crucial as it ensures the protection of investors' property rights. Fifth, one should not overlook the importance of geopolitical influence and political stability.

It is therefore not easy for a currency to fill all the conditions necessary for it to have an international role. Consequently, we will not see a major change in the hegemonic role of the US dollar over the next 10-15 years – though the conclusion may well be different over a longer horizon.

A simple composite indicator of the international place of the euro in different dimensions' shows that after a peak in 2005, the euro's position declined until 2016, recovering slightly after that. This clearly indicates that the world financial crisis and its specificities in the Euro Area were the decisive causes of this evolution. >>>

>>> Structurally, it is easy to see that the weakest feature for the euro to have a bigger role as an international currency, lies with low degree of integration and depth of capital markets. Consequently, transactions costs are higher, and periods of lower liquidity may occur more frequently. Both equity and bond markets are still fragmented as a result of legal and tax differences as well as the concerns regarding redenomination risk in the Euro Area.

"The new Commission will have to relaunch the CMU project with priority and ambition."

- VÍTOR CONSTÂNCIO

The main initiative to foster the international role of the euro is therefore the implementation of a genuine Capital Markets Union (CMU), a project that unfortunately has not yet been taken seriously by European Governments. We should however, acknowledge that it is a difficult project because it implies deep integration, requiring a European safe asset, the harmonisation of taxes on financial products, a convergence of company law, including on bankruptcy, the creation of a single rule book of regulation for markets activity and ultimately a European Single Securities Market Supervisor. Another crucial component is the creation of a European safe asset to foster the integration of the bond market. There are proposals to do it without implying mutualisation of national debt. Unfortunately, until now, most of the initiatives related to CMU were directed more to the general development of capital markets than to integrate and unify financial markets in Europe. The new Commission will have to relaunch the CMU project with priority and ambition. ●

i. See Chart 1 in the ECB Report on "The international role of the euro" at <https://www.ecb.europa.eu/pub/pdf/ire/ecb.ire201906~foda2b823e.en.pdf?5e2f2979de08d8coe2d05b230dad4f1>



Gilles Moëc

Chief Economist, AXA Group

The Euro's international role: policy independence first!

Even if some progress was made last year, the Euro has not yet been able to decisively challenge the dollar's role as the world's dominant reserve currency. Some of the reasons are contingent. A negative interest rate since 2014 may be hard to swallow even for non-profit seeking reserve managers. Others – such as the lack of progress on banking, capital market and fiscal union, and the absence of a joint risk-free asset – are more structural. But a question is seldom asked: why would it be in the Euro area's interest to turn its currency into a "proper" reserve currency?

Reserve currency status comes with some potentially problematic conditions. One is that its issuer must provide the rest of the world with a decent quantity of assets to invest in. This normally entails running a current account deficit. The Euro area since the Great Recession has on the contrary been generating a current

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>>> account surplus. In those conditions, a permanent rise in the international demand for euros would take interest rates further into negative territory and trigger a significant appreciation in the euro's exchange rate. This would manage to both further irk savers in core countries such as Germany and price-sensitive exporters in France and Italy.

At the same time, a reserve currency provides its issuer with a crucial advantage: the ability to frame its policy stance fully independently. The Fed ultimately sets the tone for interest rates worldwide. It is not on the receiving end of financial spill-overs. The US fiscal policy is less concerned with counterproductive "crowding out" when supporting domestic demand given the structural overseas demand for US bonds. Moreover, given the number of currencies which are implicitly or explicitly pegged to the dollar, the US can largely ignore the impact of its policy decisions on its external financial conditions.

"A stronger reserve role for the euro would protect from uncooperative US approach."

- GILLES MOËC

We would make the point though that lately the Euro area has been able to "decouple" quite easily from the US, bringing market interest rates to extremely low levels irrespective of the Fed's stance. The existence of a massive current account surplus means that risks of crowding out if fiscal policy turns expansionary are close to nil. In short, not being the issuer of the world's top reserve currency has not been much of a hindrance for the Euro area.

Still, a lot of this decoupling owes to the ECB's unconventional policy at a time when monetary easing in one region was seen as a net positive for everyone. The Fed was supportive of the ECB's action even though they were not going in the same direction. Unfortunately, the US administration now sees any monetary accommodation elsewhere as "currency manipulation", with the possibility of retaliation via trade. A stronger reserve role for the euro would protect from uncooperative US approach.

We would insist though on the need to make this part of a holistic strategy. Finally setting up a common risk-free asset and some joint fiscal capability would make the euro more attractive as a reserve currency by helping to put the usual "existential concerns over the monetary union, while helping the Euro area to move away from high current account surpluses towards a more balanced model, more reliant on domestic demand, to make it less dependent on the gyrations in the global cycle. ●