

Hermann Remsperger: The importance of the European Monetary Union in transatlantic relations

Speech by Professor Hermann Remsperger, Member of the Board of the Deutsche Bundesbank, at the 7th Transatlantic Summer Academy on "Europe facing the 21st century: defining the central issues", Zentrum für Europäische Integrationsforschung, Rheinische Friedrich-Wilhelms-Universität in Bonn, on 26 June 2000.

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Ladies and gentlemen, I would like to begin my speech by quoting two of the sharpest critics of EMU. And you may imagine that I do not agree with these critics.

Before the start of the euro, MIT professor Rudi Dornbusch made the following statement:

*"So EMU has gone from being an improbable and bad idea to a bad idea that is about to come true... The struggle to achieve monetary union under the Maastricht formula may be remembered as one of the most useless battles in European history. The costs of getting there are large, the economic benefits minimal, and the prospects for disappointment major."*¹

Martin Feldstein, the former chairman of the Council of Economic Advisers, went even further and warned that EMU might increase intra-EU conflicts rather than foster political union. He concluded:

*"Although it is impossible to know for certain whether these conflicts would lead to war, it is too real a possibility to ignore in weighing the potential effects of EMU and the European political integration that would follow."*²

However, there were not only negative or sceptical views on EMU. One of the most prominent proponents of EMU, Nobel laureate Robert Mundell, describes the benefits of a successful EMU:

*"Members of the EMU will get not just a currency on par with the dollar and the right to share in international seigniorage but also greater influence in the running of the international monetary system. The rest of the world will get an alternative asset to the dollar to use in international reserves and a new and stable currency that could be used as the focus for stable exchange rates or currency boards. The US will get a needed relief from the eventually debilitating overuse of the dollar as an international currency, a single-currency continent that vastly simplifies trade and investment, and a strong partner in Europe with an equal stake in constructing an international monetary system suitable for the 21st century."*³

I think Mundell's statement is a very good starting point for my own considerations. In the following, I would like to discuss the advantages and disadvantages of the euro as an international currency and evaluate them on the basis of the empirical evidence available. I will then analyse what implications the broad international use of the euro might have for monetary policy. Finally, I will examine the possible impact of EMU on relations between Europe and the United States.

Given the limited time available, I will certainly be unable to give full coverage to all aspects of the subject matter. However, I will be glad to answer any questions at the end of my talk.

¹ R Dornbusch, *Euro Fantasies*, Foreign Affairs 75, September/October 1996, p 113.

² M Feldstein, *EMU and International Conflict*, Foreign Affairs 76, November/December 1997, p 62.

³ R Mundell, *The Case for the Euro - II*, Wall Street Journal, 25 March 1998, p A22. Cited by C R Henning, *U.S.-EU Relations after the Inception of the Monetary Union: Cooperation or Rivalry?*, in: C R Henning and P C Padoan, *Transatlantic Perspectives on the Euro*, Brookings Institution Press, Washington, 2000, p 10.

A striking feature of the transatlantic relations between “Europe” and the United States was the dominance of the US dollar in the area of international monetary policy during the second half of the 20th century. This was partly due to the institutional setting. In the post-war monetary system, the US currency was assigned a prominent role as the anchor currency. This - in addition to other factors - fostered the international use of the dollar. However, even after the end of the Bretton Woods system of fixed exchange rates at the beginning of the 1970s, the dollar maintained its position as the most important transaction, investment and reserve currency - and it did so despite its overall depreciation against staple currencies.

With the euro, market players now have an alternative currency which may become a serious competitor to the US dollar. Any currency, especially a new one, will only establish itself internationally - that is to say, outside its own currency area - if it provides its users with specific advantages over other currencies. Those advantages may be in the form of lower transaction costs, greater stability or more opportunity for diversification. There are at least four reasons supporting the argument that the euro could play an important role as an international currency:

- the economic size of the euro area;
- the euro area’s close trade and financial ties with countries outside the euro area;
- the favourable changes in the euro area financial markets;
- the institutional arrangements for maintaining price stability in the euro area.

The euro area has about the same economic weight as the United States; both economic areas are well ahead of Japan. The population of the euro area, at around 290 million, is larger than that of the United States (270 million) and Japan (125 million).

It is obvious that the size and capacity of an economic area is of importance to its currency: economies of scale play an important role, especially in the use of money. A large economic area generates a large “natural constituency” for its own currency. If a currency is widely accepted, this normally lowers transaction costs, which, in turn, attracts international customers and leads to a further spread of the currency beyond its domestic area.

The argument of size is important since the euro area is highly integrated into the world economy. The euro area accounts for one-fifth of world trade excluding trade within the euro area. This is more than the corresponding ratios for the United States with 15% or Japan, which is just under 9%.

What is more, the end of currency segmentation has led to a dramatic change on the euro area’s financial markets. The range of financial products is expanding, and the markets are becoming more liquid. The money market, in particular, is now unified. Concerning the European stock exchanges, mergers are being planned, and greater attention is being paid to the wishes of market participants. All that tends to have a favourable impact on the efficiency of the euro financial markets, although they are still lagging behind the US markets in that respect.

Despite the introduction of a single currency and cooperation among the stock exchanges, the financial markets in the euro area continue to be segmented to a larger extent than those in the United States. In particular, issuing on the bond market is heavily fragmented; in the euro area, there is no issuer comparable to the US Treasury. The existence of different securities settlement systems continues to entail higher costs than in the United States. Finally, purchasing securities across borders in the euro area is still more expensive than buying them in a particular member state.

The size and openness of the economic area as well as the dynamism and efficiency of the financial markets are definitely important factors in determining a currency’s international success. Ultimately, however, the euro will hold its own in competition with other currencies only if it can be kept stable over the long term. The relevant institutional requirements have been met: the ECB is an independent central bank which is primarily committed to the objective of price stability.

The euro’s greatest success to date has been as an issue currency on the international financial markets. Between January 1999, the start of EMU, and March 2000, 47% of the net issuance in international debt securities was denominated in euro, compared with a dollar ratio of 45%. It seems

that the large issuers took advantage of the low euro interest rates in order to raise large amounts of funds in euro. However, it is also apparent that the euro's success in terms of new issues increased its share of all international debt securities outstanding only slightly compared with its predecessor currencies, namely from 25% at the end of 1997 to 30% at the end of March 2000. At this reference date, the share of the dollar stood at 47%.

The euro's share of international banking business is somewhat smaller than on international securities markets, amounting to 28% in the case of bank assets and 24% in the case of bank liabilities, compared with a dollar market share of 40% and 42%, respectively. Relative to the share that the euro's predecessor currencies had previously, the euro comes off much better in international banking business.⁴

From the perspective of a central bank, it would be especially interesting to know the euro's share of the official foreign exchange reserves. It is precisely as a reserve currency that the dollar has traditionally had the largest lead over all other currencies, with a recent share of more than 60%. Unfortunately, the corresponding share of the euro cannot currently be quantified reliably, since the underlying database is decidedly incomplete.

The euro has developed very quickly into an - at least numerically - important international anchor currency. The ECB has recently listed some 50 countries in whose currency regime the euro is playing a role. The arrangements stretch from D-Mark or euro-based currency boards (Bosnia-Herzegovina, Bulgaria, Estonia) and mutual agreements as part of ERM II (Denmark, Greece) to rather informal exchange rate links, which are geared to baskets that, in addition to the euro, include other currencies, too.

Two results of my empirical analysis merit particular attention. Firstly, the dollar continues to be the leading international currency in virtually all functions, even though the euro has reduced the gap here and there. Secondly, the role that the euro is playing on the international financial markets is now already clearly more important than that of its predecessor currencies. The weight that the euro area lends to its currency is evidently greater than the simple sum of the 11 participating countries.

The euro's growing importance on the international financial markets contrasts sharply with its exchange rate movements until mid-May. Between January 1999 and its trough in May, the single currency lost around one-quarter of its value against the dollar, and as a weighted average against the currencies of the euro area's 13 most important trading partners, it did not come off much better either. How can the euro gain market shares on the international financial markets while losing so much of its value?

Taking a look back into the past may be helpful in providing an explanation. The dollar has always been able to maintain its position as the leading world currency despite the ups and downs in the dollar exchange rate. Apparently, the individual currencies' positions on the international financial markets are determined, at least to some extent, by factors other than the exchange rate. In addition, the time horizons underlying decisions on the foreign exchange market and the (long-term) capital market are probably different as a rule.

If you ask me, Ladies and Gentlemen, what my analysis up to now means for the transatlantic relations, I would not deny that the exchange rate between the euro and the US dollar will always play a central role. However, it is essential to add that the external value of the euro cannot nearly be seen as the sole indicator for the importance of EMU within the transatlantic relationship. I shall return to this point soon again but from rather an American perspective.

Before I continue, please allow me to emphasise that the expanding international use of the euro could have far-reaching consequences for monetary policy. Indeed, there is some evidence to suggest that the capital markets might play an increasing role in the transmission of monetary policy (at the

⁴ For some methodological problems connected with the data, see *International Banking and Financial Market Developments*, BIS Quarterly Review, February 2000, p 33ff and June 2000.

expense of the banking system). This might enhance the efficiency of monetary policy by reducing the time lags in the transmission process, since the capital markets usually respond more quickly to interest rate changes than does the banking system.

The exchange rate channel might likewise lose in importance if other countries, for example future accession countries, pegged their currencies to the euro. This primary effect would be diminished by the fact that the Eurosystem's monetary policy would, in that event, have an immediate impact on the real economy in those countries, which would feed back to the euro area on account of the close trade links. However, in the light of the small weight of the countries which may be willing to peg their currencies to the euro, the overall effect should not be overstated.

Another aspect may prove to be very important. The more the euro gains acceptance internationally, the more difficult it may be in certain circumstances to interpret monetary growth. Transfers of funds from euro area monetary financial institutions to the banking systems of third countries (and vice versa) and - from 2002 - the circulation of euro banknotes outside the euro area might prove to be potential sources of distortions. However, the Bundesbank's past experience suggests that, although such problems may cause uncertainty in the short run and thus make higher demands on the central bank's analysis and communication policy, over the longer term they are controllable by monetary policymakers. Judging from the experience gained from the Bretton Woods system and the EMS, however, this applies in an environment of generally flexible exchange rates only.

Now, let me take the opportunity to talk about some of the American interests that may be affected by EMU - interests which are divided into three categories: political, institutional, and economic.⁵

Regarding the political aspects, the United States is highly interested in stabilising central and eastern Europe. If EMU paves the way for economic and institutional reforms that will ultimately lead to higher growth in Europe, then EMU is clearly in the political interest of the United States.

With regard to institutional issues, pragmatic solutions have been found for the question of representation, with the result that the ECB represents EMU monetary policy in international bodies. Apart from this, potential changes in the decision-making process in an enlarged European Union have received attention in the US due to the substantial implications they have on European-American relations. The US seems to be interested in institutional arrangements within Europe that lead to greater efficiency in international cooperation.

As regards the economic interests of the United States that might be affected by EMU there are at least four points that ought to be distinguished:

First, some US economists seem to be anxious that EMU in combination with the Stability and Growth Pact might be detrimental to growth in Europe. I think the opposite is true. In addition, structural reform in Europe would stimulate growth in the long run and create positive spill-over effects in other regions, too. The transformation of the euro area into a "New Economy", characterised by more flexibility, higher growth rates and low inflation rates would definitely be much appreciated by our American partners - and not only by them. Whereas some observers expect EMU to increase the necessity for and the feasibility of structural reform, others argue that an intensified competition in a currency union might call for more social protection.

Second, the smooth financing of the American current account deficit seems to be an issue of concern on both sides of the Atlantic. With the euro potentially rivalling the dollar, some economists have been expecting huge shifts in international portfolios which might limit the ability of the US to finance its current account deficit. However, in the light of my remarks about international capital flows, I think that external financing constraints for the United States will not be too narrow as long as a reasonable economic policy is pursued.

⁵ See, for example, C R Henning (2000), p 17ff.

Third, the US is interested in the smooth functioning of the international monetary system. In principle, US authorities prefer flexible exchange rates. In the case of a crisis, however, the US is interested in an efficient decision-making process at international level.

Fourth, systemic stability is an objective with high priority for US policy. The question as to whether the emergence of the euro as an international currency might indirectly contribute to systemic risks has already been raised. In particular, large and rapid shifts out of the dollar have been seen as problematic, whereas gradual changes in market shares are not an issue of concern.

In the run-up to monetary union, there was much speculation about how the launch of the euro would influence volatility on the foreign exchange markets. It was said that the rivalry between a few major international investment currencies might lead to stronger short-term exchange rate fluctuations, since changing market sentiments would immediately turn out to the advantage of one currency and disadvantage of the other. It was further argued that the euro area's degree of openness in foreign trade would be smaller than that of the individual participating countries prior to their entry into EMU and that the Eurosystem would therefore probably be more inclined to pursue a policy of benign neglect than, for example, the Bundesbank had been in the past. Apart from the fact that some of those theoretical considerations are on shaky ground, the empirical findings argue against them, too. In a larger and more liquid euro capital market, the reallocation of assets does not necessarily lead to increased exchange rate fluctuations, and a generally increased exchange rate volatility has not been observed so far either. On the contrary, measured in terms of the standard deviation of daily percentage changes, the average volatility of the euro's rate against the US dollar between January 1999 and May 2000 was actually somewhat lower than the volatility of the D-Mark against the US dollar between 1991 and 1998.

In concluding, I would like to emphasise that although the interests of Europeans and Americans may differ here and there, I do not see any fundamental differences, at least not in the economic fields that I have just discussed: smooth balance of payments financing, higher growth rates in Europe, stability of the financial system and flexible exchange rates between the major currencies. I think most Europeans would subscribe to these objectives as well.

However, EMU will not automatically help to achieve these objectives. Consequently, major challenges for European and American policymakers still exist, some of which could be dealt with by competing for better policies. Others, such as maintaining the stability of the global financial system, argue in favour of closer cooperation. At many levels - for example, the IMF, the Financial Stability Forum, the BIS - such cooperation actually takes place without being ultimately hampered by the complex political structures in Europe.

Competition and cooperation will presumably remain the salient features of transatlantic relations in the foreseeable future. Interpreted as the struggle for the best solutions and by assuming joint responsibility, these two guiding principles - competition and cooperation - might complement each other almost ideally.