

## **Willem F Duisenberg: The international role of the euro**

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the 2000 Spruce Meadows Round Table, held in Calgary, on 8 September 2000.

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Let me first thank the organisers of this conference for having invited me to share some thoughts with you on the international role of the euro. The euro was successfully launched 20 months ago as the single currency of 11 Member States of the European Union (EU) - known as the "euro area". On 1 January 1999 these Member States transferred their monetary sovereignty to a new supranational institution, the European Central Bank (ECB). Since then, the Eurosystem - composed of the ECB and the national central banks (NCBs) of the 11 countries that have adopted the euro - has been in charge of the euro area single monetary policy and related functions, such as foreign reserve management and operations and payment systems oversight.

The euro has brought about fundamental changes to the economic and financial environment in the euro area and beyond. By lowering transaction costs and enhancing price transparency, the single currency represents a major contribution to fostering competition and efficiency in goods and financial markets across the euro area. As such, the introduction of the euro represents a quantum leap towards completing a fully integrated Single Market in the EU and lays a solid basis for the improvement in the living standards of European citizens. Besides these welfare-enhancing effects on the "domestic" economy of the euro area, the new setting also has far-reaching consequences for the world economy and the international community.

Let me shed some light on the international ramifications of Monetary Union by highlighting three interrelated aspects. First, the use of the euro as an international currency in the global financial system; second, the growing role played by the Eurosystem in international policy cooperation; and, third, relevant aspects of the exchange rate of the euro. Before dealing with these points in turn, I should like to recall some key economic features of the euro area.

### **Key economic features of the euro area**

Let me begin by putting the euro area into an international perspective. The euro area represents a large and relatively closed economy. Given its population of almost 300 million people and its significant weight in the global economy, the euro area is broadly comparable with the United States. As regards its size and structure, the most striking fact is that the euro area economy has a share of world output of around 16%. This is more than three times that of its largest national component (namely Germany, which accounts for 4.7%), significantly higher than that of Japan (which accounts for about 8%), while being lower than that of the United States (which stands at 21%).

Being a large economy, the degree of trade openness of the euro area is much smaller than that of its constituent countries, even though it is still higher than in the United States and Japan. Measured by the average of exports and imports as a share of euro area output, the degree of openness is 16% in the euro area. By contrast, prior to Monetary Union, the average export ratio of all Member States including intra-euro area trade stood at around 35% in 1997, ranging from 20 to 60%. At the same time, the euro area remains more open than the United States and Japan, with ratios of 12% and 11% respectively. Another factor highlighting the role of the euro area in world trade is its share in world exports. With almost 20%, the euro area is the world's largest exporter, compared with 15% and 9% in the United States and Japan respectively.

As regards the structure of the euro area economy, the patterns of production are broadly similar to those of the United States and Japan. While primary production is rather negligible (around 2% of total output), the bulk lies with the euro area's services sector, accounting for almost 70% of total production, which is roughly equal to that of the United States (72%) and higher than that of Japan

(60%). The industrial sector accounts for around 30%, which is higher than in the United States but somewhat lower than in Japan.

Finally, if you look at the structure of financial markets on both sides of the Atlantic, you may note the difference between the “bank-based” system of finance on the European continent and the “market-based” system in the United States. Although there seems to be a trend away from banks towards non-bank financing in the euro area, reinforced by the introduction of the euro, banks still play a dominant role in providing financial services in the euro area. Domestic credit as a share of domestic output accounts for 130% in the euro area, compared with 80% in the United States. Correspondingly, stock and debt markets are much smaller in the euro area than in the United States. While the shares of euro area debt securities and stock market capitalisation relative to GDP remain clearly below 100% (91% and 63% respectively), the figures for the United States are in both cases well above 150% (155% and 172% respectively). This brings me to the use of the euro as an international currency in the global financial system.

### **The role of the euro as an international currency**

Given the weight of the euro area in the world economy and the legacy of the former national currencies, which have been replaced by the euro, it is no surprise that the euro is the second most widely used currency behind the US dollar. A number of observers have argued that one of the main motivations behind Economic and Monetary Union (EMU) was the development of the euro as a major international currency. This perception, however, is incorrect for a number of reasons.

First, the “euro project” is to be seen as a further logical step in the European integration process, which started more than half a century ago, immediately after the Second World War. Its objectives were not - and are still not - purely economic, as European integration aims not only at the creation of a prosperous but also a stable and peaceful Europe. For a large part, trade, economic and financial integration aimed at the removal of all barriers to free competition has been the engine of this process. In this context, the euro is to be seen as a major contribution to the completion of the Single Market in Europe. The primary objective of the ECB is to maintain price stability in the euro area.

Second, the international use of the euro is, first and foremost, the outcome of a market-driven process, not to be steered by central banks or by political bodies. The ECB has adopted a neutral stance on the internationalisation of the euro. The ECB intends neither to foster nor to hinder the use of the euro. In the past, major countries have, at times, tended to promote the international use of their currency, primarily with a view to potential benefits for their national financial sectors. There have also been cases in which major countries have resisted the internationalisation of their currency, owing to the uncertainties that this process may imply for the conduct of monetary policy. However, by maintaining price stability, the ECB almost automatically fosters the attractiveness of the euro as an international currency.

Third, the international use of a currency is a complex phenomenon that does not lend itself to ad hoc promotion measures. A currency can be used not only for different functions, but also by different groups of economic agents. In this context, the use of the euro by private agents as an investment and financing currency, as well as a payment and vehicle currency, plays a prominent role. Although the euro is also used by the public sector as a nominal peg and reserve currency, the behaviour of the private sector dominates the internationalisation of the euro. The amount of financial assets managed by the private sector is many times larger than official reserve holdings. In addition, private agents usually adjust their asset management strategies more rapidly than most public sector institutions. But what are the factors behind the internationalisation of a currency?

In principle, two basic factors might eventually determine the international role of the euro - size and risk. With regard to the size factor, a broad, deep and liquid euro area capital market may lead to a greater use of the euro through lower transaction costs. This may, in turn, facilitate the development of the euro as a vehicle currency for trade and commodity pricing. Already at this early stage, the introduction of the euro has brought about fundamental structural changes in euro area capital markets. Progress in the harmonisation of certain market standards, practices and conventions across the euro

area is reflected in a capital market that is characterised by increased market liquidity, broader maturity spectrum and wider range of financial products. In addition, following the introduction of the euro, the euro area corporate bond market has grown significantly. The activity of private issuers has become more important than that of sovereign issuers, traditionally dominating the euro area bond markets. Positive network externalities and economies of scale have provided incentives for firms to issue their own securities instead of borrowing from banks. However, this trend away from banks towards markets - the so-called disintermediation process - will take time. The development of a broader spectrum of euro-denominated financial instruments will be a gradual process.

In addition to the size factor, the international use of a currency is determined by risk factors, since investors may use the euro to hedge their risks through diversification across international currencies. If international investors and issuers consider the euro to be a stable currency, they will hold euro assets to minimise risk in their internationally diversified portfolios. In this context, I should make clear that maintaining price stability not only makes a contribution to improving economic prospects and raising living standards in the euro area, but it is also a major precondition for a currency to play an international role. Only if investors outside the euro area are confident that their purchasing power will be preserved over time, will they engage in euro-denominated financial activities. Therefore the commitment of the ECB to pursue price stability in the medium term remains a key factor behind market confidence in the euro as a stable currency. Besides price stability, the current and expected growth performance of the euro area economy is an additional factor behind the attractiveness of the euro. Sustained non-inflationary growth in the euro area economy would have beneficial effects on market expectations and foster the international use of the euro.

As regards the private use of the euro, recent trends show that it has mainly been used as a financing currency. With regard to international debt securities, the euro is more widely used than the former national currencies of the euro area countries. The issuance of euro-denominated assets by residents outside the euro area accounted in 1999 for almost 30% of total issues denominated in a currency different from that of the borrowers' respective geographical residences. By comparison, the combined share of all former national currencies of the euro area countries and the ECU amounted to only 18% of total gross international issuance in 1998. The growing use of the euro was mainly mirrored in a decline in the share of US dollar-denominated issues from 58% to 48% between 1998 and 1999. These trends are even more striking if one focuses on the bonds and notes segment of the market. Accounting for 33% of all announced international bonds and notes issues in 1999, compared with 37% for the US dollar, the euro nearly matched the dollar in that year. In the second half of 1999 euro-denominated bond issues even exceeded those in the US dollar.

As far as the euro's share in overall official reserves is concerned, the euro also represents the second most widely used currency behind the US dollar. According to the latest available data, at the end of 1999 the euro accounted for around 13% of the official foreign currency holdings of the world. Apart from some technical corrections on account of the conversion of the Eurosystem's reserves into euro, which led to a slight decline in the euro's share in overall reserves, there is no evidence of any reallocation of foreign reserves at this stage. It should also be noted that more than 50 countries in the world are currently using the euro as a nominal anchor.

### **International cooperation**

Let me now turn to the institutional side. The introduction of the euro has brought about a major change to the institutional framework in which international cooperation takes place. In view of the rapid process of globalisation and episodes of crises in a number of systemically important emerging market economies, international cooperation should play a role in strengthening the international financial architecture. In this respect, the new institutional setting in Europe is to be taken into account.

By reducing the number of key players, the introduction of the euro will simplify the international policy cooperation process between the major economies. In particular, it should make this process more efficient by facilitating the reciprocal exchange of information and views, as well as the formulation of common understandings on economic and financial issues at the global level. Each of

the main partners - the United States, the euro area and Japan - is in a position to speak for a comparatively large economic area. A more balanced relationship between the major players might help to induce each of them to take on responsibility for contributing to a stable global environment.

In many ways, the ECB - which as a rule represents the Eurosystem externally - is already involved in the work of international institutions and fora in the area of competencies of the Eurosystem. Formal and informal agreements have already been reached with the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), the Bank for International Settlements (BIS), the Financial Stability Forum (FSF), and the several groupings of ministers and central bank governors (G7, G10 and G20).

The involvement of the ECB was relatively straightforward for groupings created after the introduction of the euro, such as the FSF or G20. In the case of pre-existing international fora and organisations, however, the arrangements to be made were more complicated. The introduction of the euro heightened the need for international financial institutions - such as the IMF and the OECD, whose internal procedures are organised on the basis of the "one country, one currency" principle - to accommodate in their bilateral and multilateral surveillance exercises the existence of regional entities. In December 1998, for example, the IMF granted observer status to the ECB. Since February 1999 the ECB observer at the IMF has been involved in all relevant work of the Fund on issues falling within the competence of the ECB and of mutual interest to both institutions.

The fact that the ECB's overriding objective is the maintenance of price stability has three main implications for its participation in international policy cooperation.

First, a reciprocal exchange of information and views is a substantial component of the Eurosystem's cooperation with the international organisations and fora. Regular consultation on external economic developments enhances the ability of the ECB to analyse the outlook for price developments in the euro area, which in turn provides useful input into the effective implementation of its monetary policy. By taking into account possible spillover effects from third countries' policy actions, consultation contributes to reducing the likelihood of misinterpreting the impact of foreign developments on domestic variables. Given its voluntary nature, consultation does not compel the ECB to adopt a monetary policy inconsistent with its objective of price stability.

Second, a reciprocal exchange of information and views is supplemented by international surveillance. In this case, a third and independent party, such as the IMF or OECD, regularly monitors and assesses the economic policies of its members. The ECB participates in the surveillance process for policies falling within its competence (e.g. monetary policy, payment systems oversight). This means that, whenever monetary policy is under surveillance, the ECB is solely responsible for its interaction with the IMF and OECD. Standards and codes recently adopted by the IMF and other relevant international institutions are a way of defining best policy practices and enhancing transparency in the field of monetary and financial policy. In this respect, the ECB's involvement in regular surveillance further strengthens its accountability through being transparent.

Third, in the area of macroeconomic policies, consultation and surveillance are the only forms of international cooperation that are relevant to the Eurosystem. Any form of ex ante policy coordination of monetary with other macroeconomic policies would neither be advisable for the Eurosystem nor be compatible with the ECB's mandate and independence. Apart from the well-known recognition and decision lags in policy-making, attempts to coordinate ex ante would not only blur the specific responsibilities of individual policy-makers, but also reduce their accountability. In determining its monetary policy stance, the ECB should and does take into account all relevant information. It cannot let its policy solely be determined by the current and future course of other policies. This could easily compromise the maintenance of price stability.

The ECB's active participation in the ongoing process aimed at strengthening the international financial architecture is to be seen against this background. The Eurosystem supports such a process for two reasons: first, since the achievement of its primary objective of safeguarding price stability in the euro area would be facilitated by a sounder and more resilient international financial system; and, second, because the Eurosystem is expected to contribute to the smooth conduct of policies relating to the stability of the financial system.

Putting one's own house in order must be at the basis of the stability of the "global village". In this context, I should like, if you would allow me, to draw attention to the fact that the introduction of the euro also contributes to international financial and economic stability in a more subtle way. The process towards EMU is not only concerned with irrevocably merging 11 national currencies. It also means building up a sound institutional framework based on monetary stability and fiscal sustainability. The EMU process provides evidence of how effective properly organised policy and institutional cooperation can be in fostering economic stability in each individual country. In addition, EMU shows that regional policy cooperation may go well beyond trade matters.

One should not be surprised by the number of countries that regard EMU as a relevant example of regional cooperation. In Europe, EMU represents a powerful magnet for many central and eastern European countries. For these countries, accession to the EU will mark the completion of the transition from the former centrally planned economies to fully-fledged market economies. The prospect of EU membership is an incentive for transition efforts of accession countries and the ultimate adoption of the euro is already taken into account in their monetary and exchange rate policy strategies. However, the countries concerned will not adopt the euro by the date of their entry into the EU and the timing for this step might be quite different from country to country. The path towards full euro area participation implies progress towards nominal and real convergence. Ultimately, these countries are required to observe the same convergence criteria with regard to public finance, long-term interest rates, exchange rate stability and inflation as the current euro area countries. In the legal area, accession countries will be required to provide their central banks with the same degree of independence as today in the euro area. In the technical area, preparations will require long lead times, and the ECB has already established a dialogue with them, to assist when requested.

Outside the euro area, an ongoing debate on deepening regional integration beyond trade liberalisation is taking place among Mercosur countries. The relative economic conditions of these countries appeared even more differentiated than those of European countries when the integration process started more than fifty years ago. However, this seems to reinforce their conviction that regional cooperation is necessary to achieve stable and non-inflationary growth and to overcome latent economic conflicts with their trading partners. As in the case of the regional process of integration in Europe, it may well be that the final objective of the Mercosur regional agreement goes beyond that of trade cooperation.

The international community should support regional cooperation efforts among countries that have strong trade relationships and are willing to achieve progress in economic convergence. These efforts have significant positive externalities and could contribute to greater effectiveness of multilateral and bilateral surveillance.

### **The exchange rate of the euro**

To complete the picture of the international role of the euro, let me finally refer to the exchange rate of the euro vis-à-vis other major currencies, namely the US dollar and the Japanese yen. I should like to take the opportunity to reaffirm that the ECB does not pursue any exchange rate target in its stability-oriented monetary policy strategy. Our objective is to maintain stable prices in the euro area and not a specific level of the euro's exchange rate. According to our strategy, the exchange rate of the euro is the outcome of current and expected economic policies pursued in the euro area, and economic developments in both the euro area and abroad.

### **Conclusions**

To summarise, the new institutional monetary setting in Europe has consequential implications for international capital markets and international policy cooperation. The pace at which the role of the euro as an international currency will develop is hard to predict. But what can be said is that the global acceptance of the euro in the international financial markets depends first and foremost on market confidence in the stability of the euro. In this context, the ECB's monetary policy committed to the pursuit of price stability provides an important contribution. In the same vein, by participating in

international policy cooperation, the ECB contributes to reducing the risks of negative externalities and to fostering the adoption of best policy practices at the international level. This is an important contribution of Europe to a more stable international financial system.