Jürgen Stark: The role of the euro in the world - past developments and future perspectives

Speech by Dr Juergen Stark, Deputy President of the Deutsche Bundesbank, at the Joint Bundesbank/BIS conference on “Recent developments in financial systems and the challenges for economic policy”, held in Frankfurt, 28-29 September 2000.

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I. Introduction

Great expectations were attached to the international role of the euro, especially by politicians. However, a currency’s international importance is primarily determined by international financial markets. It depends on the policies pursued in the currency area and on the amount of confidence which financial market players have in the currency.

Both of these aspects are important for assessing the role of the euro in the world. Use of the euro by the international financial markets will be strengthened by *further progress towards an integrated European financial market*. But equally important are *credible policies* in the euro area, with a monetary policy geared towards price stability and fiscal and structural policies that promote sustained non-inflationary growth. In addition, the *Eurosystem’s involvement in international institutions and fora* contributes to a more stable international financial system.

It should be borne in mind that on the part of central banks there was no intention to displace the US dollar with the euro. The Eurosystem maintains a *neutral stance* regarding the international use of the euro - just as the Bundesbank did in the past with regard to the D-Mark. Confidence of the markets is gained by pursuing a credible policy. The crucial requirement, therefore, is that the contractual principles of monetary union are strictly applied and become a living reality; then it will be up to the markets to assess the currency’s international role.

The history of the international financial system taught us that a shift from one reserve currency to another takes time. This could be experienced when the US-Dollar took over the role of the leading reserve currency as successor of the Pound Sterling long after the US became the leading financial market. Since then also the D-Mark and the Yen became reserve currencies to some extent.

During the fifty years of its history, the D-Mark rose to the position of the second most important international currency after the dollar. At the end of 1998, 13% of the exchange reserves and 10½% of international bonds were denominated in D-Mark. As already mentioned, this process was not actively fostered by the German authorities. On the contrary, for a long time the Federal Government and the Bundesbank endeavoured to curb the development of the D-Mark into a reserve currency. Even so, on account of its stability advantage and the associated confidence of global investors, the D-Mark grew into the role of an international currency.

There can be no doubt that the international role of the euro has the potential to develop further. Notwithstanding the Eurosystem’s neutral stance of neither fostering nor hindering the international use of its currency, the euro does provide a potential alternative to the US dollar as an international currency.

The neutral stance is not incompatible with efforts to promote an efficient and fully integrated financial market for euro-denominated assets and liabilities, which may have the indirect effect of making the euro more attractive to international investors. As the euro’s international use is expected to gradually increase over time, this will have policy implications for the relationships of the euro area with outside countries.

II. The international use of the euro

Let me first turn to the *use of the euro as an official reserve*. The introduction of the euro caused a structural break in the composition of the foreign reserve assets of the euro area countries because those foreign reserves which had previously been held in the predecessor currencies of the euro - notably D-Mark - became domestic assets as soon as the single currency was introduced. If this effect is disregarded, the euro has held up well compared with its constituent predecessor currencies.

The euro has established itself as the world's second most important reserve currency. Our calculations show that - after eliminating the "automatic domestication effect" at the turn of 1998 - the D-Mark, French franc, Dutch guilder and private ECU had a combined share of 14½% in the global foreign exchange reserves at the end of 1998. By comparison, the corresponding share held by the euro at the end of March 1999 was just under 14% and in the subsequent four quarters it remained more or less constant at just over 13%. Based on the exchange rates prevailing at the start of 1999, however, the euro's share actually increased during 1999 by ¾ percentage point and in the first quarter of 2000 rose by a further ½ point to almost 16%. The euro has thus surpassed the combined share of its main constituent predecessor currencies.

The US dollar still is the unchallenged leading reserve currency - and will remain so for the foreseeable future. According to the latest figures 67½% of the global foreign exchange reserves in March 2000 were denominated in US dollars. However, eliminating exchange rate fluctuations, the share of the US dollar increased by just over 1 percentage point in the course of 1999 and then showed virtually no change up to March 2000.

The use of a currency as an official reserve is one important factor in determining its international role. However, its *use by the private sector* as an investment and financing, a payment and vehicle currency is pivotal.

The introduction of the euro accentuated the integration of European capital markets and the trend towards securitisation and the associated disintermediation of the banking sector. The euro also acted as a catalyst in diversifying European portfolios away from local-market-based to euro-based issues.

Developments in the international financial markets show that the euro quickly established itself for *new issues*. Thus, in the first nine months following its introduction, the euro accounted for a large share of international bonds and notes issues and almost equalled the dollar: according to BIS data, in 1999:

- net issues of bonds and notes in euro amounted to US$ 521.2 bn;
- US$ 543.9 bn of net bonds and notes issues were dominated in US$;
- for the second quarter of 2000 the BIS reports net issues of bonds and notes in euro equal to US$ 95.8 bn;
- compared with a net issue in US-Dollar equal to US$ 96.1 bn.

But the euro is still a young currency: according to the BIS, by end of June 2000 *stocks* of all bonds and notes amounted to:

- US$ 2,615.6 bn denominated in US$;
- compared with US$ 1,616.0 bn denominated in euro;
- which means a share of the US$ of 47.7% compared to a share of the euro of 29.7%.

That shows that adjustments in the portfolios of international investors or in official reserves of the public sector will take much longer as much bigger sums have to be moved and large-scale portfolio shifts would have implications for securities prices and exchange rates.

It is also highly unlikely that the euro will displace the dollar as an investment and reserve currency in the foreseeable future because there is no public issuer in the euro area comparable to the US-Treasury and because the European capital markets are still fragmented to some extent - despite monetary union.

Considering the first point, it has been suggested recently that national governments in the euro area should pool their debt issuing in one *central agency*, acting on behalf of borrowing governments. This suggestion was made with reference to the greater liquidity that such a procedure would create for the euro-denominated government bond market and the savings in borrowing costs it would allow.

You will hardly be surprised that I do not agree with this proposal. Admittedly, a few basis points might perhaps be saved in the debt management of some governments of small countries or countries with low debt levels in the short run. However, a pooling of debt issuance would also mean pooling risks and liabilities of the debtors. This would be a violation of Article 103 of the European Union Treaty, the so-called "no-bail-out clause", which prevents governments from assuming any liability for other governments' debt. Such sharing of liabilities, in my view, could create moral hazard that would undermine the credibility of the new currency. The result would be higher rather than lower long-term interest rates, leading to higher borrowing costs for member states.

Concerning the development of a single European capital market it is obvious that transnational integration in capital markets is a gradual process. Nevertheless, this process has already, within the first months of the new currency, acquired considerable momentum. In fact, the development of broad, deep and liquid capital markets covering the whole of the euro area is one of the great potentials of European Monetary Union (EMU). However, despite a greater degree of coordination, the fiscal, economic and social policies of the participating countries will, for the present, remain a national responsibility. Therefore, a euro-denominated government debt market of similar liquidity and homogeneity as the market for Treasury bonds in the US might emerge only as the long-term result of a sustained evolutionary process of political integration.

A single market for financial services has been under construction in the EU since 1973. With the introduction of the euro there has been a two-fold development on capital markets concerning bond and stock markets. The immediate conversion of goverment issues into euro and the large degree of harmonisation in market conventions due to competition have played a major part in the market becoming more homogeneous. On the other hand the European stock market landscape is still distinctly fragmented with a large number of market models, trading and settlement systems, despite the cooperation and merger activities which have been initiated.

Furthermore, businesses and consumers continue to be denied cross-border access to financial institutions. It is therefore crucial that - in addition to the self-regulation of the markets, which will lead to a further consolidation of the stock market landscape in Europe - the action plan adopted by the European Council to implement the internal market for financial services by 2002 is also rigorously applied.

III. Credible policies in the euro area

The further development of the international role of the euro will depend in the first place on the confidence which the financial markets place in the new currency. In the long run this trust in a currency can only be earned by pursuing credible policies.

For *monetary policy* this means safeguarding price stability. The Maastricht Treaty created the institutional framework for the European Central Bank (ECB) to pursue a credible, stability oriented policy. And with the transparent monetary policy strategy and instruments the ECB Governing Council and the ECB have the means to fulfill their mandate of safeguarding the internal value of the euro.

However, other policies, particularly *fiscal and structural policies* are equally important for the euro to earn credibility. Now that the instruments of exchange rate policy are no longer available within the euro area, negative effects of a lax budgetary policy can be passed on much more easily to other member countries and also impair monetary policy. The Treaty therefore contains a procedure designed to avoid excessive deficits. The Stability and Growth Pact has spelled out these requirements in greater detail and envisages the imposition of sanctions.

Although monetary policy became centralised with the introduction of the euro, budgetary and other economic policies remain largely decentralised. Given the different economic structures and different adjustment problems of the individual regions, however, it is an advantage that these policies remain a national responsibility in keeping with the principle of subsidiarity. While coordination is necessary to ensure that economic policy measures do not adversely affect the other countries, there is no need for extensive centralisation.

If the agents keep to the institutional and contractual provisions, an optimum policy mix will emerge almost automatically. From a monetary policy point of view, the key requirement is to ensure that the euro's internal value remains strong. Fiscal policies, which remain a national matter, must remain committed to the goal of stability and - given the current favourable macroeconomic situation - the consolidation efforts need to be stepped up even further. The other policy fields must steadfastly continue along the path of growth-promoting structural reforms upon which they have embarked.

The existing structural problems on the labour markets differ from one member state to another and can therefore only be solved by each of the member states themselves. In major areas such as structural reforms or wage policy, decentralised decisions are thus necessary. All demands for "more harmonisation" at the European level have to be met with scepticism. By contrast, competition between the countries of the euro area is desirable in the field of economic policy because the euro area countries must not forget that they must also hold their own in global competition. Thus, I am very much in agreement with the so called "best-practices" approach of the Cardiff-process.

IV. EU enlargement and the role of the euro

As far as the role of the euro in the countries of Central and Eastern Europe (CEE) and of the Community of Independent States (CIS) is concerned, it is - in its national denominations, in particular the

D-Mark - already used as a parallel currency. It plays a special role on the Balkans. The euro also serves as an anchor in currency board regimes there. The ongoing *process of enlargement* of the EU will have important repercussions for the international role of the euro. Now that accession talks and negotiations have started the question of the monetary policy relations between the euro area and the accession countries has become a major issue.

A clear distinction is to be made between becoming a member in the EU and the joining of the euro-area. An extended transitional period is needed between a country's accession to the EU and its entry into the final stage of monetary union without a derogation. Moreover, an immediate introduction of the euro would be impossible on legal grounds, too. Only after a country has joined the EU can it begin to participate in the deficit procedure. And an assessment of whether a country meets the convergence criteria may be made, at the earliest, two years after its accession to the EU.

But over and above these minimum periods, the accession countries must go through a process of nominal and real convergence, without which entry into the monetary union would be neither in the interest of the current members of EMU nor in the interest of the accession countries themselves. Particularly real or structural convergence is a process that takes time and continues after accession to the EU. Portugal may serve as an example: after membership, it took Portugal seven years to enter ERM I in 1992 and fully liberalise capital flows and another seven years to enter EMU. In the early nineties, at the time of the Maastricht treaty, Portugal and Spain appeared to be at a higher level of structural convergence than the accession countries at the current stage. It seems unlikely that at the time of accession a sufficient level of structural or real convergence can be guaranteed in order to be able to commit to EMU. Therefore a higher degree of real convergence with focus on specific structural and administrative convergence issues after accession seems to be crucial.

Concerning monetary policy, at a very early stage - preferably even before joining the EU - the accession countries must adopt the Community's *acquis communautaire*. From the point of view of the ESCB this particularly concerns the legal underpinning of the central bank's independence. At the same time, particular attention should be given to the stability of the banking system and the financial markets in the accession countries. Even prior to accession, the economic policy of candidate countries must be geared towards stability-oriented monetary and budgetary policies coupled with the necessary structural reforms. On the other hand, no universally valid rules can be laid down for exchange rate policy prior to accession.

The timetable from accession to the EU until the introduction of the euro must then be based on the individual progress made by each accession country. At present there is a broad range of exchange rate regimes in CEE countries. In our view membership of ERM II is of crucial importance. Under the terms of ERM II the accession countries are responsible for ensuring the stability of their currencies vis-à-vis the euro. Pegs to currencies other than the euro or a crawling peg are incompatible with participation in ERM II. The goal is the stabilisation of the exchange rate; in this system, adjustments of the central rate are the exception, not the rule.

A more difficult question in this context is how currency board arrangements should be assessed. On the one hand, a successful currency board can indicate that fiscal and wage policy makers are prepared to subject themselves to the constraints of a single monetary policy and that necessary adjustments occur via the real economy. On the other hand, however, experience shows that inflation frequently remains higher in currency board countries than in the country with the anchor currency, thus resulting in a real appreciation of the currency. The task of setting the right exchange rate via a currency board is made harder by the fact that no role is assigned to the market. Once such a country joins the monetary union, there is then a danger that its parity does not correspond to the fundamentals and that the country consequently joins EMU at the “wrong” exchange rate.

From a formal point of view a currency board is hardly compatible with the framework of ERM II. Euro-based currency board arrangements cannot be regarded as an acceptable substitute for participation in ERM II, neither can be any form of “euroization”. However, currency boards can be seen as a unilateral formal *ex ante* commitment augmenting the commitment to exchange rate stability deriving from participation in ERM II. The appropriateness of euro-based currency board arrangements therefore will have to be assessed on a case-by-case basis, avoiding any general encouragement to introduce such arrangements.

V. The international role of the Eurosystem

Allow me to discuss some institutional aspects of the role of the euro, in particular the Eurosystem’s *responsibility for the global monetary system.* In this respect the question of the international representation of the Eurosystem is relevant for the international role of the euro.

The Eurosystem as a new regime of global importance in the field of monetary and foreign exchange policy has to be represented externally in an appropriate manner and have commensurate representation in international bodies.

At its meeting in *December 1998 in Vienna*, the European Council agreed on the *principles* for the external representation of the Community in Stage 3 of EMU in international fora such as the G7 and the IMF by endorsing the Report of the Ecofin Council on this issue.

Since the external representation in Stage 3 implied changes in the organisation of international fora, it was clear to the Council that third countries and institutions would need to be persuaded to accept the solutions proposed by the EU. The Council called for a pragmatic approach that should minimise the adoption of rules and practices, provided that it resulted in an outcome which gave proper recognition to the role of the euro.

For representation concerning issues of particular relevance to EMU (Article 109 section (4)), the Council suggested using early pragmatic solutions that should be developed over time and adhere to the following principles:

- the Community must speak with one voice;
- the Community shall be represented at the Council/ministerial level and at the central banking level; and

- the Commission "will be involved in the Community's external representation to the extent required to enable it to perform the role assigned to it by the Treaty".

At their meeting on 12 June 1999 in Frankfurt, the G7 finance ministers agreed on changes to the format of *meetings of G7 finance ministers and central bank governors,* and stated:

- Future meetings will consist of two parts. Part One will cover the world economy/multilateral surveillance and exchange rate matters. Part Two will be open for the discussion of all other issues concerning the international financial system.
- The presidency of the Euro-Group (minister and deputy) and the President of the ECB will attend Part one of the meetings because of the importance of surveillance and exchange rate issues to EMU. They will thus replace the governors of national central banks of the Eurosystem.
- The governors of NCBs will in turn participate in Part Two, that is when issues concerning the international financial system are discussed.
- Consistent with current practice, the European Commission will not participate in the meetings except on specific issues as determined by the finance ministers.

Concerning the representation at the *International Monetary Fund*, the Council suggested considering solutions that do not require an amendment to the Articles of Agreement of the IMF. In this regard, a first step had already been taken at the time of the Council's Report:

- The IMF Executive Board had agreed to grant the ECB a position as an observer on the Board.
- Furthermore, the Council suggested that views of the European Community and EMU would be presented to the IMF Board by the Executive Director of the member state holding the Euro-Group presidency. He would be assisted by a representative from the Commission (so-called Vienna Compromise on the IMF).

The current solutions for the Eurosystem's representation within the G7 and in the IMF might be rather transitional in nature. Negotiations on this issue are of paramount importance, since the Council stated in its report that solutions for the G7 will provide a basis for finding solutions for other groupings.

An important step in preparing for future negotiations with non-European partners is judging whether Europe's position has been strengthened or weakened by the Vienna compromise and its implementation.

The outcome of the G7 negotiations in June 1999 has clearly reduced and fragmented Europe's presence: The NCBs of France, Germany and Italy have been removed from the surveillance and exchange rate sessions, while the ECB and the Euro-Group have not been granted regular access to the other parts of G7 meetings.

Bearing that in mind, Europeans might ask whether it would have been better to maintain the status quo or to make France, Germany and Italy speak for Europe on an alternating basis. But, who should represent Europe on the political level? To be clear on that subject, in the longer run, common external representation of the euro area is not possible without progress towards a political union.

VI. Future perspectives - does the euro need a political union?

The future international role of the euro will depend not least on the extent to which *European integration* can be successfully deepened; only in this way can monetary union be credible in future, too. At first sight this view appears to contradict the view that there is no need for extensive centralisation. As I see it, however, this is not a contradiction as these are quite separate issues: on the one hand ensuring healthy competition in economic, tax and structural policies, and on the other hand continuing the process of political integration. This is a logical implication of the step towards integration represented by a monetary union. A monetary union is more than a technical federation for the management of the single currency. A monetary union must be based on a joint political commitment on the part of the countries participating in it.

This inevitably raises the question as to the outlook beyond monetary union and, in particular, as to the finality of the integration process. Against the backdrop of EU enlargement, too, it is important and necessary to present credible prospects leading towards a political union.

The Maastricht Treaty created the technical preconditions for the functional viability of monetary union. These are based on the fundamental principle of the single market as the overarching regulatory framework and are also underpinned by the principle of subsidiarity. They therefore manage with a minimum of the constructional elements of political union - but nevertheless comprise all the mechanisms needed to guard against potential conflicts between a single monetary policy and fiscal policies, which remain the responsibilities of the member states. Technically, the construction of the monetary union is thus adequately secured.

Why then is progress towards a political union necessary? A stable internal structure of the union can ultimately only develop from a growing *awareness of community*. This awareness of community should be based on accepted political institutions and transparent decision-making processes, but should also permit the coexistence of the many different nationally and culturally determined special features without conflicting with or being in opposition to the Community's tasks. Admittedly, such a political integration does not leave room for national self-centredness. But complete harmonisation and standardisation with the objective of a firmly fixed European state structure would not have any chance of becoming a reality either.

By contrast, it will be much more important on the external side to present the union as a single economic area and, politically, as an economic power factor. To do this, it will be necessary to develop the relevant arrangements and to strengthen the political representation of the currency area on the external side.

From a legal point of view, this boils down to the question of a future constitution of Europe. Against that background, it is much less complex and detailed than might be assumed at a first glance. Here, the most important thing will be to continue developing regulations that already exist and to divide responsibilities among nation states and the Union.

Community institutions with clearly defined tasks and responsibilities might be helpful beyond the narrow area of economic policy. But, at present, it has to remain an open question whether the nation states are actually prepared to transfer powers to European bodies in the core area of state sovereignty.

Without a political union there cannot be a uniform external representation of the euro area. A benchmark in this connection might be a permanent seat on the United Nations Security Council. An indication from France and the United Kingdom of their willingness to give up their seats in favour of a European seat on this body would be a very clear signal of the willingness to make progress towards a political union.

The basis for extending the international role of the euro will be improved by making further advances in integration on the way towards a political union. The euro is not merely the result of a technical exchange rate arrangement but also is an expression of the willingness and determination to achieve further integration. Such further progress is therefore the precondition for the credibility of the monetary union and an appropriate international role of the euro in future.