

## **Jean-Claude Trichet: The international role of the euro**

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, delivered at the "Schierensee Gespräche", 14 May 2004.

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### **Introduction**

It is with particular pleasure I address this distinguished audience. Today, I will look beyond the confines of the single currency area. I will even go beyond the borders of the Baltic Sea region to which Minister-President Simonis has just referred, as I would like to share with you some thoughts on the international role of the euro.

When the euro was launched on 1 January 1999, the European Central Bank (ECB) assumed responsibility for monetary policy in the euro area - the second largest economic area in the world after the United States. The Eurosystem subsequently became the issuer of the second most widely used international currency, after the US dollar and ahead of the Japanese yen. This outcome was mainly a reflection of the legacy of the 12 former national currencies which the euro replaced.

Since the euro came into being, its international role has grown in a gradual but steady way. In that vein, I will first review the main developments in more detail, by characterising the key features of the use of the euro by non-euro area residents. I will then turn to the role of the euro and the Eurosystem in international cooperation on currencies.

This role is also reflected in our policy position vis-à-vis the internationalisation of the euro. The ECB sees the internationalisation of its currency beyond the borders of the euro area as a market-driven process. At the same time, the ECB also analyses developments closely, as we are keen to know how our currency is used and by whom. This applies in particular to the use of the euro in countries located in the immediate vicinity of the euro area, including the new EU Member States. As you know, these countries are expected to adopt the euro in due course once they are deemed to have fulfilled the conditions set out in the EU Treaty, and I will briefly comment on this process in my conclusion.

### **The gradual development of the international role of the euro**

Let us consider first the main developments in the international use of the euro since its inception in 1999. To briefly sketch the main traits, I will follow the standard approach that builds on the functions of money and distinguishes between the varied use of the euro outside the euro area, by public authorities on the one hand and private agents on the other.

Let me start with public authorities. There are about 50 countries with an exchange rate regime linked to the euro, including those EU Member States that have not yet joined the euro area. Non-EU countries that use the euro as an anchor currency are mainly located in the EU's neighbouring regions or are countries that have established special institutional arrangements with the EU or some of the EU Member States, like the CFA zone in Africa. In most of these countries, the euro is also the main or the sole intervention currency used by the authorities to stabilise the exchange rates of their respective currencies. Additionally, in these countries euro-denominated assets account for a substantial share of the foreign exchange reserves held by the respective authorities. Globally, at the end of 2002, the euro's share in foreign exchange reserve assets was close to one-fifth.

Turning to private users, the internationalisation of the euro has been most visible in global capital markets, in particular when it comes to the role of the euro as an international financing currency. Since the start of Stage Three of EMU, the stock of euro-denominated debt securities issued by non-euro area residents has risen by around EUR 800 billion. This represents an increase in the share of the euro in the stock of international bonds from around 20% in 1999 to more than 30% in 2003, while the share of dollar-denominated bonds has remained stable at around 45%. A significant share of euro-denominated securities have been targeted at, and purchased by, euro area investors. In using the euro as an issuance currency, financial institutions and corporations, mainly from mature economies, most notably the United States and the United Kingdom, have taken advantage of the greater size and liquidity provided by the increasingly integrated euro-denominated bond markets.

Besides the international financial markets, there is also evidence that the euro is increasingly being used as a settlement or invoicing currency in euro area countries' trade with non-euro area residents. For example, the share of the euro in the settlement and invoicing of Spain's extra-euro area exports rose from 49% in 2000 to close to 58% in 2002. Similar increases were recorded for France and for Belgium and Luxembourg. The use of the euro was most pronounced in settling and invoicing trade with the so-called "pre-ins" (the United Kingdom, Sweden and Denmark), the new EU Member States, and even Japan.

However, there is also evidence of inertia in some of the facets of the euro's international role. The share of the euro in foreign exchange transactions today has not significantly augmented in comparison with the previous national currencies, accounting for about one-fifth to one-quarter of all daily transactions. By way of comparison, the US dollar is used in more than forty percent of foreign exchange transactions.

There are several factors explaining why some of the facets of a currency's international use are characterised by a high degree of stability rather than gradual change. The most prominent ones are what economists usually call "dynamic economies of scale" and "network externalities", which tend to freeze existing situations into steady states. Hence, any shift from the use of one currency to another currency would require a significant and exogenous shock. The foreign exchange market is one example; the invoicing of raw materials, such as oil, is another.

### **The euro and international cooperation on currencies**

To sum up, the euro has been firmly and credibly established as the world's second international currency during the first five years of Monetary Union, and its gradually increased use in several market segments highlights the degree of confidence non-euro area residents have in the euro. But the advent of the euro did not only involve the development of its international use. It also affected global policy cooperation, including cooperation on exchange rate issues. In this regard, it should be reiterated that the ECB and the Eurogroup share the responsibility for exchange rate consultation with third parties - for example at G7 level - and for communication policy. At the same time, the ECB is solely responsible for decisions on foreign exchange operations. In this way we give the euro area a single voice in international fora on exchange rate-related issues. In particular, we see the G7 as one of the major platforms for a reciprocal exchange of information and views on macroeconomic and exchange rate developments at global level. Cooperation is important given the interlinkages between economic areas in today's globalised world.

On the present exchange rates I will only say that the appropriate terms of reference are in the two last communiqués of the G7, in Boca Raton and Washington, where we reiterated exactly the same wording which captured very well our present consensus.

Against this background, I would say that the relationship between the two most widely used international currencies, the US dollar and the euro, should not be perceived as a zero-sum game, where a gain for one currency means a loss for the other. On the contrary, given the extent to which international goods and financial markets are integrated, there are net benefits from the "coexistence" of the US dollar and the euro. International investors can reduce risk by diversifying their asset portfolio, commodity traders can easily make international contracts using one of these two currencies as a numeraire. And all of them can trust the single monetary policy which, through its pursuit of price stability, safeguards the purchasing power of the euro.

### **The ECB and the international role of the euro**

This brings me to the policy approach adopted by the Eurosystem on the internationalisation of its currency. I will start by emphasising a key characteristic of the international use of any currency, namely that - contrary to its domestic use - it has no institutional foundations, as there is no "sovereign" power that can enforce its use. This is why the international use of a currency is, in essence, a market-driven process. The main economic factors underpinning the internationalisation of a currency are well known. The first factor is domestic stability, that is a low inflation rate, making the currency attractive as a store of value. The second factor is a high degree of openness to international trade and finance. This is a key determinant for the currency's use as a medium of exchange and a unit of account. And the third factor is a developed financial system with deep and liquid markets

offering participants a wide range of services and products in terms of borrowing, investing and hedging.

Against this background, the Eurosystem takes a neutral stance on the internationalisation of its currency. This means that we neither hinder nor actively promote the development of this role. For example, with the exception of the concept of ERM II to which I will refer in a moment, decisions taken by non-euro area authorities to use the euro as an anchor, reserve or intervention currency have to be fully seen as unilateral measures. They do not involve any commitment on the part of the Eurosystem.

At the same time, the Eurosystem contributes to the international role of the euro in indirect ways. Price stability is a key precondition for the development of the international role of a currency. Thus, the stability-oriented monetary policy of the ECB contributes to the euro's potential for expanding its international role. In this context, I would also like to stress the importance of the credibility of the overall policy framework, including the need for clear and enforceable fiscal rules and structural reforms in labour and goods markets.

The Eurosystem has also been a strong supporter of financial market integration in the EU. The introduction of the euro itself has undoubtedly led to a deeper and more integrated financial market. The evidence strongly suggests that this has supported the development of the international role of the euro. And when we refer to the fact that potential gains from monetary union will only be fully realised when European financial integration is fully achieved, this also applies to the euro's use as an international financing and investment currency.

Let me stress that by being neutral we are not indifferent to the international role of the euro. Indeed, we pay special attention to the international use of our currency and provide regular information to the public on related developments in the international financial arena, for example the recent build-up in foreign exchange reserves.

From a monetary policy perspective, the international role of the euro does not provide any specific implications or challenges per se. However, we are closely monitoring developments which might have an impact on monetary policy. The demand for euro banknotes abroad is an example, even though currency in circulation represents only 6.5% of the monetary aggregate M3. Currently, there is evidence suggesting that non-euro area residents hold about 10% of the total amount of euro currency in circulation. This amount is roughly in line with estimates of the amount of euro legacy currencies circulating outside the euro area prior to the cash changeover in 2002.

### **The adoption of the euro by non-euro area EU member states**

I have already referred to the fact that the international role of the euro is most prominent in the EU's neighbouring regions. Indeed, it is in these regions where the relationship between the ECB's pursuit of a stability-oriented monetary policy and the euro's international use has been most visible. By granting monetary stability to an economic area that is by far the largest trading partner of our neighbours, the euro has helped anchor policies in the region. It has prevented a mismatch between trade and financial links and provided clear guidance to one of the most profound processes of economic transformation.

The anchoring effect has been most pronounced with regard to the ten new Member States that joined the Union two weeks ago. But let me also mention, en passant, that the EU's links with the Western Balkans, the Mediterranean countries and the countries of the Commonwealth of Independent States, notably Russia, have strengthened as well. In line with this, we have also observed significant use of the euro by public authorities and private agents in these countries.

Let me now turn to the ten new EU Member States. For the moment, any use of the euro by authorities and private agents in these countries - as in Denmark, Sweden and the United Kingdom - continues to be an "international" one, as the euro is still being used there by non-euro area residents. However, unlike Denmark and the United Kingdom, the ten new Member States have not asked to opt out of the single currency. Thus, they will adopt the euro once they have fulfilled the requirements as laid down in the Treaty establishing the European Community. This entails that, on their road to the euro, they will, at some point, join the Exchange Rate Mechanism II.

ERM II is a multilateral arrangement of fixed, but adjustable, exchange rates with a central rate and a standard fluctuation band of (15% against the euro. Thus, under ERM II, the official use of the euro in its role as an anchor currency by some non-euro area EU Member States will no longer represent a unilateral decision by the respective authorities. Rather, it will be based on a multilateral agreement

between the Member State concerned, the euro area member countries, the ECB and the other Member States participating in the mechanism. This is most evident with regard to the decisions on central rates, as they are taken by mutual agreement of the various parties to ERM II. Moreover, several exchange rate regimes are incompatible with ERM II participation, including pegs against anchors other than the euro.

The new Member States differ greatly in terms of their economic structures, current exchange rates and monetary regimes, and in the degree of nominal and real convergence already achieved. Thus, no single path towards ERM II and the adoption of the euro can be identified and recommended. Rather, a case-by-case approach - based on the principle of equal treatment - will be followed, in line with the stipulations laid down in the Treaty. This includes the criteria concerning the sustainability of nominal convergence, better known as the "Maastricht criteria". There will be no additional criteria but there will be no relaxation of the criteria either.

We are aware that the road to the euro will be demanding, with participation in ERM II being only one element of the overall policy framework in the process towards full monetary integration. In a document published at the end of last year, the Governing Council set out in detail the principles which will guide the prospective participation of new Member States in ERM II and later their adoption of the euro.

Once these countries are deemed to have fulfilled the conditions set by the Treaty, they will adopt the euro. By definition this will mark the end of the "international" role of the euro in these countries and lay the groundwork for a fully fledged "domestic" role of the single currency there. In the years ahead, we will work hard to ensure that this process of fully integrating new Member States into our common monetary area will unfold smoothly.

Over the last few years we prepared intensively for enlargement. Now it is time to reap the mutual benefits of a wider Union, in particular with the expanded internal market providing new opportunities for trade and investment flows. This can have a significantly positive impact on growth in the European economy. I am convinced that, with enlargement, prosperity will increase and living standards improve across the whole Union.

Thank you for your attention.