Klaus Liebscher: Prospects for the international role of the euro

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Salzburg Seminar "Challenges to the International Monetary System", Salzburg, 1 October 2007.

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Ladies and Gentlemen!

Let me begin by thanking the organizers for inviting me to share with you my views on the "Prospects for the international role of the euro" in this marvelous and historic venue. I have accepted the invitation with pleasure.

Since the introduction of the single currency, the Eurosystem, i.e. the ECB and the National Central Banks of the euro area, was always of the opinion that the international use of the euro should neither be promoted nor hindered. It has taken a neutral stance and has left it to the market forces to determine the role of the euro as an international currency. To the extent that the Eurosystem has been successful in maintaining price stability, this in itself has fostered the use of the euro as an international currency.

Eight and a half years after its introduction, the euro has now established itself firmly as the second world currency.

Nearly one-third of all international debt securities are denominated in euro, and the euro accounts for more than 25% of global foreign exchange reserves. Moreover, with 646 billion banknotes and coins in circulation, the euro has already overtaken the US dollar.[1]

In international foreign exchange markets, the US-Dollar has retained its dominant role, however the euro has established itself as the second most often traded currency.

Notwithstanding its neutral stance, the ECB and the Eurosystem are following developments closely. Since 2001, the ECB has been publishing its so-called "Review of the international role of the euro" on a regular basis. This review provides a detailed description of the euro's use in the various segments of financial markets and in international trade.

The latest "Review of the international role of the euro", published in June 2007, reports that recent developments in the international use of the euro vary across global market segments.

While the international role of the euro has lessened slightly in some segments, namely international debt securities, international deposits and loans as well as foreign exchange, in other segments it has continued to be highly stable or even to grow gradually. In particular, the use of the euro as a reserve currency by third countries has increased somewhat. Moreover, demand for euro banknotes and for euro-denominated deposits by private agents in third countries has continued its gradual rise. The role of the euro as a settlement currency for exports of goods from euro area countries appears to have stabilized, while its share in the invoicing and settlement of imports of goods declined during the review period, probably in conjunction with developments in energy markets. In contrast, its upward trend seems to have continued for exports and imports of services.

As in earlier issues, this year's "Review of the International Role of the Euro" finds the internationalization of the euro to be characterized by a strong institutional and regional pattern.

During the review period, the euro maintained its role as an exchange rate anchor for countries in the geographical proximity of the EU and countries that have established special

[1] USD banknotes and coins: USD 810 bn = EUR 615 bn (all data and the exchange rate current at end-2006).

institutional arrangements with the EU or its Member States. Recent exchange rate regime changes involving the euro as an anchor currency have occurred in Slovenia, Slovakia and Russia. Slovenia adopted the euro on 1 January 2007. Slovakia joined the ERM II in November 2005. In Russia, the weight of the euro in the Russian central bank's operational basket for daily exchange rate management increased in two steps from 35 to 45%.

Regarding the role of the euro as an intervention currency, several central banks in EU neighboring countries – particularly some non-euro area EU Member States and EU candidate countries – continued to intervene in foreign exchange markets by using the euro as the intervention currency.

Nevertheless, the introduction of the euro has not yet resulted in a significant change in the currency composition of official reserve holdings. For the time being, the USD has maintained its place as the dominant reserve currency, supported by the edge that USD-based financial markets still have over euro-based markets, especially in terms of size and liquidity. Recent data show that about 64.7 percent of world currency reserves are held in US dollars and 25.8 percent in euro.

As regards the private use of the euro as a parallel currency, the stock of banknotes shipped by banks to destinations outside the euro area has continued to increase gradually. In addition, the share of euro-denominated deposits has increased in most new Member States and EU candidate countries. Having described briefly the latest developments in the international use of the euro, I now would like to explain the factors underlying the various roles of the euro.

It is widely agreed that well-developed financial markets are necessary for a currency to play a role as reserve asset. The introduction of the euro has greatly improved the functioning of euro area financial markets. In 2004, today's US Federal Reserve chairman Ben Bernanke[2] pointed out that the development of euro financial markets is frequently seen as the most tangible benefit of European Monetary Union (EMU). Moreover, studies by institutions such as the Bank for International Settlements[3] have confirmed that the liquidity and breadth of euro financial markets are fast approaching those of USD markets. The single currency and associated efforts to harmonize institutional structures have led to a reduction in transaction costs as well as a decline in country-specific macroeconomic risks.

According to the IMF classification, the euro area is the 3rd largest economic area in the world in terms of real GDP (15%), after the US (20%) and developing Asia (27%). Against this background, it is somewhat striking that the euro does not yet play in all segments of the international monetary system a role equal to its economic weight. How come?

The story of the introduction of the single currency is a story of achievements and challenges. On the achievement side, it has to be mentioned that in a global perspective the EU and the euro area are unique. No other model of supra-national cooperation or agreement has become so highly integrated.

Earlier this year, we celebrated the 50th anniversary of the Treaty of Rome, which established the European Economic Community (EEC). The day the Treaty was signed, March 25, 1957, is considered the birthday of the European Union, which today unites around 490 million people in 27 countries.

The European Monetary Union (EMU) and the euro, which seemed to be very ambitious projects of European integration some decades ago, have since come to make a remarkable

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2 Bernanke, B., 2004, "What have we learned from the euro at five?", Remarks made at "Euro at Five: ready for a global role", Institute for International Economics, Washington DC, 26 February.

3 Galati, G., Wooldridge, P. 2006, "The euro as a reserve currency: a challenge to the pre-eminence of the US dollar?", BIS Working Paper No. 218.

contribution to both the stability and the international competitiveness of the European Union in general and the euro area in particular.

One of the factors behind the success of this milestone of European integration was the strong political will to establish the “stability architecture of EMU”, which rests on three pillars: a monetary policy oriented to price stability, a fiscal policy geared towards sound public finances (the so called “Stability and Growth Pact”) and structural policies designed to foster competitiveness and sustainable economic growth (the “Lisbon Agenda”).

The monetary policy framework of the Eurosystem is based on central bank independence, transparency, accountability and an explicit mandate to maintain price stability.

The Eurosystem goes to great lengths to communicate the ECB’s monetary policy strategy, the rationale for monetary policy decisions and our assessment of economic developments.

These communication efforts not only take the form of regular testimonies in the European and national Parliaments, periodic bulletins and speeches, but also take place in “real time”: ECB President Jean-Claude Trichet explains the monetary policy decisions and the underlying reasoning in press conferences which take place immediately after Governing Council meetings and which provide “question and answer sessions” for journalists.

In today’s euro area, about 317 million people in 13 countries benefit from a low inflation environment and stable inflation expectations, a high degree of confidence in their currency and moderate interest rates – all of which are elements of a business and investment-friendly economic environment. EMU and the euro can be seen as one of the EU’s most important strategic responses to the chances and challenges of a globalized world.

Since 1999, we have experienced a number of important shocks to the global economy, such as the millennium challenge, substantial oil price increases, the ups and downs of the euro exchange rate, the equity market boom and bust, global imbalances and the clouds of war and terrorism.

Amidst all of this, the Governing Council of the European Central Bank (ECB) has guided inflation expectations in a firmly manner consistent with price stability and thus provided a reliable anchor for the euro area economy, while the euro has sheltered euro area financial markets against those shocks.

Not least because of the growing international use of the euro, the stability culture formed by the single currency has already brought positive benefits to the non-euro area EU Member States and many Eastern European, Middle Eastern and African countries.

Moreover, the euro area has overcome a few years of economic sluggishness to become an ever larger player in the global economy, thereby contributing positively to a rebalancing in global economic growth. Economic activity, in fact, accelerated to 2.9% last year, and since the start of Monetary Union real GDP growth has averaged 2.1%. The ECB staff projections from September 2007 see growth ranging from 2.2% to 2.8% in 2007 and from 1.8% to 2.8% in 2008, even though risks are tilted to the downside. In a particularly welcome development, unemployment has declined significantly, from 9% in 1999 to 6.9% (July 2007). 12 million new jobs have been created since 1999.

Inflation has stood at 2.1% on average since the start of EMU, which shows that inflation expectations are firmly anchored. Hence, price stability has created a favorable environment for investment and growth in the euro area. Concerning the outlook for prices, ECB staff projects annual inflation to average between 1.9% and 2.1% this year and between 1.5% and 2.5% in 2008.

As already referred to earlier, a price stability-oriented monetary policy is a necessary precondition – but by no means the only precondition – for sustainable dynamic growth and employment. It needs the support of sound public finances, ambitious structural reforms and a competitive economic framework.

This last point brings me to the challenges the euro and the euro area are facing with a view to the international role of the euro.

It is important to understand that sustainable fiscal policies are a sine qua non for the success of EMU. For instance, higher risk premiums in response to unsustainable policies in one Member State could spill over to other euro area countries. Euro area membership thus also means compliance with a rigorous regulatory framework: the Stability and Growth Pact.

We are aware that structural improvements are only part of the reason for the current improvement in euro area fiscal balances, from -1.6% in 2006 to an expected -1.0% in 2007. It is much more a consequence of the favorable international economic environment.

Therefore, it is essential that any budgetary leeway granted by the current favorable economic environment should be used for lasting budgetary consolidation in order to prepare for challenges such as population ageing and to create room for maneuver for future economic downturns.

In addition, structural polices are needed to ensure that countries can flexibly react to asymmetric shocks, as the single monetary regime makes adjustment to asymmetric shocks a painful and drawn-out process.

In 2000 the European Council adopted the Lisbon Agenda. Broadly speaking, the Lisbon strategy aims to make Europe, by 2010, “the most competitive and dynamic knowledge-based economy in the world”. In 2005, after the mid-term review, European policymakers renewed their commitment to the ambitious goals.

Even though a number of Member States have achieved significant progress in several areas(such as the liberalization of the electricity market and the progress in pension and labor market reforms), much remains to be done. More effective and efficient investment in knowledge and innovation is necessary, and labor and product markets need to be made more flexible. Indeed, research by the ECB[4] suggests that euro area countries typically have undertaken more comprehensive and far-reaching reforms than other OECD countries over the past decade. However, a comparison of reform progress across policy areas shows that euro area countries have generally not made more progress than other OECD countries in reforming the “difficult” areas, where political resistance is strong.

These “difficult” areas have included – for instance – the modification of employment protection legislation (EPL), i.e. relaxing the rules governing temporary contracts, as well as extending the working age while reducing incentives for early retirement or scaling back the automatic indexation of wages.[5]

The reform process therefore appears to have slowed down in many euro area countries. For EMU to continue to be a success, structural reforms remain essential to raise factor productivity and potential output, create new jobs and achieve lower prices and higher real incomes!

It goes without saying that further improvements in the euro area international competitiveness would evidently ensure that the euro area will – sustainably – play a role in the international monetary system equal to its economic weight. Moreover, such improvements are vital to master the challenges facing EMU in the years to come.

To date, the 8 new Member States from Central and Eastern Europe which joined the European Union in 2004, and the two which became members in 2007, have succeeded in

[4] Duval, Elmeskov, 2006, “The effects of EMU on structural reforms in labour and product markets”, ECB WP No 596.

[5] See e.g., Rajan, G.R, 2005, “Revitalising reforms in Europe”, The Ludwig Erhard Lecture, Brussels, 8 December.

transforming their economies from centrally planned systems to market economies. Substantial progress has been achieved in the areas of property rights and privatization as well as capital and trade liberalization. As the 12 new EU member States – including Cyprus and Malta – have anchored their institutional structures to the EU, they are being viewed as increasingly secure places for investing and doing business in general.

Moreover, the euro anchors monetary stability in the region, often directly, for instance through the European Exchange Rate Mechanism ERM II. Currently, six of the 12 new Member States are members of ERM II: Cyprus, Estonia, Latvia, Lithuania, Malta, and Slovakia.

Slovenia became the 13th member of the euro area at the beginning of this year. In July 2007, the European Council has approved the requests of Malta of Cyprus to adopt the single currency at the beginning of 2008.

Full monetary integration and membership in the euro area will be the ultimate goal of all new Member States depending on their progress towards sustainable convergence. However, the application of the convergence criteria for the new Member States must not be less strict – but also no more strict – than for the current euro area countries. Moreover, when adopting the euro, quality must not be compromised for the sake of speed.

The euro also has an anchoring effect for many other countries located in the neighborhood of the euro area. Increasingly closer financial and institutional links are an integral part of the EU's Stabilization and Association process with the countries of the Western Balkans. This process is assessed regularly.

Let me now turn to the global dimension of EMU. Financial institutions, in particular from the United States, Canada and Great Britain, are increasingly benefiting from the greater size and liquidity of an integrated euro bond market. In addition to this financial market perspective, the euro contributes to global monetary and financial stability.

The euro area is a constructive element in the post-Bretton Woods international setting and is actively committed to multilateral cooperation. Let me draw your attention to the IMF's review of the Medium Term Strategy, currently under way, where strengthening the IMF surveillance framework figures prominently on the agenda. Recently, the IMF concluded the first of its proposed multilateral consultations, and the main issue is how to address global imbalances while maintaining robust global growth.

We define global imbalances as external positions, i.e. current account and financial balances, of systemically important economies that reflect distortions or entail risks for the global economy.

Global imbalances figure most prominently in the US, with a large current account deficit of some 6% of GDP, which is balanced on a global basis by significant current account surpluses in China (some 10% of GDP and rising), Japan (some 4%) and the oil exporting countries.

Global imbalances became a central policy concern only a couple of years ago. Since then, the discussion about the causes and consequences of the global imbalances has evolved, even though many aspects remain open. In particular, there is no consensus over whether, when and how these imbalances will adjust.

The widening of the current account imbalances has been driven by both structural and cyclical determinants. The structural determinants of global imbalances relate for instance to incomplete financial globalisation, related in particular to the lower stage of financial development in some regions of the world.

Financial market imperfections in fast growing emerging economies, combined with rising incomes resulted in higher savings ratios in these regions. Together with the rapid process of financial globalisation this had an impact on international capital flows, with capital flowing from emerging to industrial countries.

Actually, this is at odds with economic theory, as emerging markets should attract capital, instead of providing capital, because the potential returns to investment in those countries should be higher. Another debatable development is the increasing reliance of the US on official capital inflows, i.e. portfolio investments by foreign central banks and treasury departments, relative to private capital inflows.

Beside these factors, several emerging markets focus on an export led growth strategy, e.g. by keeping their exchange rates very competitive. The equilibrium generated by these structural factors cannot last forever, but is probably sustainable in the short and medium term.

Thus, structural reforms in the countries concerned, e.g. in order to make their financial systems more stable and efficient, as well as measures to improve the framework for domestic demand and to reduce the reliance on exports, are not only in the interest of these countries, but also in respect to global imbalances.

Cyclical factors have further fuelled widening external positions. These cyclical factors relate, for instance, to saving-investment patterns in the private sector in the US. Private consumption boomed due to a productivity-induced increase in US permanent income and due to wealth effects from rapid asset price increases, which allowed for significantly lower saving ratios. At the same time, the public sector of the US did exhibit budget deficits.

Considering most recent developments related to the US sub-prime market, it appears that the ability of US agents to borrow has undergone some adjustment, as lending to private households has become more restrictive. In addition, productivity increases in the US have become less impressive. Overall, this suggests a cyclical moderation of the US current account deficit in the months to come.

Another noteworthy development are rising oil prices from some 10 US-Dollar per barrel in the late 90ies, to some 80 US-Dollar today. At first, rising oil prices led to a significant worsening of trade balances for energy importers, and to considerable trade balance improvements for oil exporters, which were perceived as a mainly cyclical development. In the meantime, high oil prices are perceived as a rather structural and probably lasting event, which is going to allow oil exporters to spend more of their energy-related income on imports, thereby ameliorating global imbalances.

Finally, let me also touch upon the euro area. For several years the euro area's balance of payments has been broadly balanced. Nevertheless, the euro area has to contribute to and prepare for the orderly resolution of the global imbalances.

Why? Because ultimately, the – at least in the longer term – necessary rebalancing of the imbalances will be accompanied by significant shifts of productive factors from and to traded- and non-traded sectors, respectively shifting resources between export orientated- and domestic demand orientated sectors.

In particular, this will hold true for countries with large current account imbalances, but also for the euro area, as there are significant current account imbalances within our region. As you would expect, flexible and productive economies with sound and well structured public finances certainly will cope better with these challenges.

Albeit important structural reforms in Europe have been implemented already, much remains to be done in order to improve potential growth, thereby reducing growth differentials lastingly. We have to respond with policies designed to use opportunities of globalization, particularly to increase productivity and competitiveness, while minimizing unavoidable adjustment costs. The right answer to globalization and international competition is therefore to continue and intensify the Lisbon process already mentioned.

There is no doubt that globalization has worked well for the people of Europe. After nearly nine years of experience, Economic and Monetary Union has proven to be Europe's most forceful strategic response to global economic change. However, we have to concede that big changes rarely only create winners. In many EU countries, regrettably, people are critical and see little benefit from globalization. There has been an undue proliferation of fears that increased import competition from low-wage countries would put too much pressure on domestic producers and workers and that economic activity would allegedly be relocated abroad.

Sometimes, these concerns have been reflected in a relative lack of confidence in Europe's future. However, backsliding into protectionism, as has been called for by some, would be like traveling back in time. There is no other way to reap the potential gains from globalization but to evolve towards further specialization, innovation and diversification into new areas of comparative advantage.

In this context, let me mention the moribund Doha round, which has even cast doubt on the future of the World Trade Organization (WTO). Although calls for protectionist measures to counter the increasing competition from Asian economies should be taken seriously, I stand on the side of free trade and believe that protectionist pressures need to be firmly resisted.

Eight and a half years after its introduction, the euro has now firmly established itself as the second world currency. The increasing globalization of the world economy, with new players emerging on the world stage, has contributed to the very impressive expansion of the world economy in the recent past. Yet, this dynamic growth has also spurred economic challenges, such as strongly rising commodity prices and significant current account imbalances.

The economic upswing recorded in the euro area can be attributed, at least partly, to improved economic structures and is based on the stability-orientated framework of Economic and Monetary Union.

The ECB and the Eurosystem respectively, will continue to support economic growth in the euro area by vigorously pursuing price stability. Following this approach also guarantees that the euro can contribute most effectively to international stability.