Lorenzo Bini Smaghi: The internationalisation of currencies – a central banking perspective

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Introduction[1]

Ladies and gentlemen,

It is an honour to be here to celebrate the approaching tenth anniversary of the euro. It is a privilege to represent the institution – the European Central Bank – which over the past ten years has watched over the first steps of the euro and brought it up to be the second most important international currency in the world. The euro is now leaving behind its childhood and entering the phase of adolescence. As with many adolescents, it is faced with a common question: "what would you like to do when you grow up?"

The ECB, like any parent, might tend to have an over-optimistic vision of its own child's future. This is why we have adopted a policy of neither encouraging nor discouraging the international use of the euro. It should be an entirely demand-driven process. Like modern parents, we recognise that the euro does not belong to us but should develop according to its own ambitions. We are here to ensure that it has a few key virtues, the first being stability.

There are already several people – including in the United States, where even the birth was considered improbable a decade ago – who predict a bright future for the euro, anticipating that it will surge to become the dominant international currency in the coming decades [Chinn and Frankel, 2008]. Others, however, think that the euro is unlikely to overtake the US dollar [Eichengreen and Flandreau, 2008a].

Today, I will not try to review what the euro has already achieved over the last decade. The ECB regularly publishes a report that can be easily consulted [ECB, 2008a].

What I would like to do instead is to assess what the implications are, in particular from a central banking point of view, of becoming an international currency. I will analyse both the advantages and the challenges. I will then try to assess whether the euro has the potential to further increase its role and examine what the main obstacles could be to achieving such a status.

Implications of an international currency

Even though the euro is currently not the dominant international currency, it has become an alternative to the US dollar as a reserve currency. Euro banknotes are a popular means of payment and store of value in the EU's neighbouring countries. What are the implications for the ECB and the euro area as a whole? I shall try to answer this question, drawing on the economic literature.

There are two well-identified advantages that countries can obtain from having an international currency. First, there are microeconomic gains stemming from lower transaction costs. Whether the currency is used for international trade, borrowing in the international markets or simply tourism, the costs of conversion to a foreign currency and the exchange

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rate risk attached to these operations are eliminated. Second, the monetary authority issuing an international currency has larger seigniorage revenues to the extent that foreigners hold that currency in the form of non-interest-bearing liabilities, in particular as coins and banknotes. These gains are, however, relatively small and are estimated to amount to less than 0.05% of GDP for the euro area, as only a small fraction of the total cash in circulation – 10% to 15% – is held by non-euro area residents. International seigniorage gains are only slightly larger for the United States, at about 0.1% of GDP, as more than half of their stock of currency is estimated to circulate abroad [EC, 2008 and ECB, 2007].

There are other, broader, implications of issuing an international currency, which are less well-documented and not as easily quantifiable. Both Britain in the period before the First World War – from 1870 to 1913 – and the United States in the period after the Second World War enjoyed a so-called “exorbitant privilege” from being at the centre of the international monetary system [Meissner and Taylor, 2006]. The privilege stems from the possibility to issue low-interest domestic currency-denominated liabilities to finance higher-yield investments abroad. Both Britain before 1913 and the United States until the end of the 1980s were net creditors towards the rest of the world, and this exorbitant privilege may be seen as their remuneration for being the so-called “bankers of the world”. Over the past 20 years, the United States has shifted to a relatively large debtor position vis-à-vis the rest of the world, but its income balance has stayed positive thanks to a positive return differential between its external assets and its liabilities. For some economists, this is the result of the transformation of the United States from world banker to “venture capitalist” with a “leveraged” position, where fixed-income domestic currency liabilities finance riskier foreign assets taking the form of equity and direct investment [Gourinchas and Rey, 2005].

The greater ability to issue domestic currency liabilities has another important implication from a macro-financial stability perspective. To the extent that external liabilities are mainly in domestic currency, whereas external assets are denominated in foreign currency – as in the case of equity and foreign direct investment, and often also debt securities – issuers of international currencies tend to have a “long” position in foreign currency. As a result, fluctuations in exchange rates tend to produce counter-cyclical valuation effects on net external assets. When the exchange rate appreciates, foreign currency assets shrink in domestic currency terms and as a share of GDP. Conversely, following sharp devaluations – often associated with economic and financial stress – the foreign currency-denominated assets grow in domestic currency terms and liabilities are unaffected, improving the overall investment position when it is more needed [Lane and Milesi-Ferretti, 2005]. As an example, after the currency crises in both 1949 and 1967, sterling’s status as an international currency – with most of the large overseas liabilities still denominated in pounds – allowed the United Kingdom to cushion somewhat the impact of the devaluations [Cairncross and Eichengreen, 2003].

The issuance of an international currency could potentially also have significant implications for the implementation of monetary policy. Let’s consider the experience of the euro over the past ten years in that regard.

On the one hand, it has been essential for the euro area to have its own monetary policy in order to face idiosyncratic shocks and focus on the maintenance of domestic price stability. This result would not have been possible without the introduction of the euro and the creation of a large internal economic and trade area free of exchange rate risk. On the other hand, the external demand for euro-denominated assets may affect domestic monetary aggregates, complicating their relationship with inflation over the long run. Recent ECB staff research shows that it is necessary to place money demand in the context of portfolio flows and international asset prices in order to explain euro area M3 dynamics and measure excess liquidity, which can pose risks to price stability [ECB, 2008b].

In addition, successful international currencies are used as external anchors by a number of countries that prefer to fix the exchange rate and relinquish their monetary independence.

Such currency pegs eliminate one channel of adjustment of external imbalances for the anchor currency. As long as the pegging countries are small relative to the issuing country, this might not be a major problem. However, when the aggregate economic weight of all pegging countries becomes large, the margin for adjustment of the nominal effective exchange rate of the anchor currency becomes constrained. As a consequence, the adjustment of the nominal effective exchange rate might require a more than proportional adjustment of the bilateral rates of the remaining floating currencies.

Moreover, fluctuations in the demand and supply of the euro among international investors, from both the private and public sectors, may have implications for the exchange rate. The increasing attractiveness of euro-denominated assets as a potential alternative to US dollar securities may generate sudden shifts in portfolio flows and unwelcome volatility in foreign exchange markets. Another potential indirect channel of disturbance in the dollar/euro exchange rate is possibly the role of the US dollar in the invoicing of oil and other major commodities. Over the past few years, the surge in oil prices and other commodities – in US dollar terms – has been associated with a negative relationship with the exchange rate of the US dollar against the euro. In the case of oil prices, this could be the result of policies by oil-exporting countries to try to defend the purchasing power of a barrel of oil in terms of a basket of international currencies, including, in particular, the euro. It must be acknowledged that it is difficult to detect and isolate the direction of causality between the oil price and the US dollar.

Overall, for the ECB and the euro area, the international role of the euro offers positive opportunities and serious challenges. This explains the ECB’s neutral stance aimed at neither directly promoting nor hindering the international use of the euro.

The determinants of the international use of currencies

What are the conditions that cause currencies to dominate international markets? Do these conditions favour a growing role for the euro?

There is a large body of literature on the determinants of the international use of currencies. Most studies focus either on the store of value function of currencies and their role in foreign exchange reserves [see Chinn and Frankel, 2008, for a recent review] or on the unit of account and means of payment functions, including the invoicing of international trade [see Kannan, 2007]. In the first case, users of an international currency are mainly concerned with its ability to maintain a stable purchasing power over time. In the second case, users care about transaction costs and the economies of scale that are obtained from tapping into a large network.

In both cases, a number of political, institutional, financial and economic factors contribute to increasing the popularity of an international currency. I will review these factors with particular reference to the euro.

Economic and financial conditions

Let me start with the economic and financial conditions supporting the international role of currencies. The size of the economy and its foreign trade flows are crucial to promoting the international status of a currency. This is because there are scale economies and network externalities in using the currency that is also used by other agents in international transactions. The larger the economy and its trade flows, the more likely it is that smaller economies will adopt the currency of the larger trading partner. In this respect, the critical mass of the euro area, in economic terms, is large enough to exert gravitational attraction on the rest of the world. In 2007, the euro area accounted for about 16% of world GDP, measured at purchasing power parity, and its external trade was equal to more than 18% of world trade, at current exchange rates.

In the invoicing of international trade, however, network externalities tend to generate only one "winner". For several decades, the US dollar has served as a medium of exchange and unit of account for homogeneous goods traded in organised exchanges, such as commodities and oil. In this case, inertia is very important and it is very difficult to dislodge the incumbent currency, whose use is associated with low information and transaction costs. Yet even in this case, it would be possible to switch to a parallel invoicing system, including the euro, if agents expected others to start using the new currency and technological progress diminished transaction and information costs [Mileva and Sigfried, 2007].

Transaction costs are important not only in international trade but also in the use of currencies as financing or investment instruments. For this reason, truly international currencies must be backed by large, deep, liquid and efficient financial markets. In terms of size, credit quality and liquidity, US dollar financial markets still have an edge over the euro markets, although this gap seems to have narrowed since the launch of the euro in 1999 [Galati and Wooldridge, 2006]. The US Treasury bond market remains the most liquid segment of the global bond market, whereas sovereign issuances are inevitably fragmented in the euro area. However, this structural problem has been mitigated by the removal of exchange rate risk since the introduction of the euro. Government bond yields have converged across euro area countries and are increasingly driven by common factors, although local factors continue to play a role [ECB, 2008c]. Indeed, the bid-ask spreads of sovereign bonds denominated in euro are not much higher than the spreads of those denominated in US dollar [Dunne et al., 2006]. Interestingly, the euro area bond market for "corporate" issuance is quite well-integrated [ECB, 2008c] and effective bid-ask spreads are possibly even lower than in the United States [Biais et al., 2006].

I have argued so far that investors take into account liquidity and transaction costs when dealing with international currencies. Once these structural and cost differentials converge across currencies, traders and investors can discriminate among various alternatives on the basis of the return on their investment. In brief, international currencies must be able to preserve their external value, avoiding inflation and sharp nominal devaluations. It is well-known that the erosion of the status of sterling as leading international currency was caused by a series of large shocks accelerating a declining trend. The fading of the United Kingdom as a major political and imperial power was accelerated by the First and Second World Wars. The economic decline was highlighted by at least three devaluations in 1931, 1949 and 1967, which progressively undermined the confidence of international investors in the ability of sterling to preserve its external value. Recent evidence suggests that the pound sterling lost its dominance already in the mid-1920s, but then regained the lead in the second half of the 1930s [Eichengreen and Flandreau, 2008b]. The jury is still out on this case, but it is evident that inertia in the international use of currencies is much stronger in the case of the invoicing of trade, where network effects favour the use of only one currency. Inertia is somewhat less powerful when investors decide how to allocate their portfolio, leaving greater room for currency competition.

Evidently, inflation and devaluations accompanying the demise of world currencies are not natural accidents, but the result of wrong macroeconomic policies and structural weaknesses. These often take a long time to emerge in the form of an erosion of external competitiveness and a rise in external imbalances, fiscal profligacy and internal imbalances, low productivity and, eventually, sluggish growth and high unemployment. Conversely, strong and balanced economic performances foster the international status of currencies.

Where does the euro stand in terms of policies and their performance? The euro area fares relatively well compared with major economic partners, although a greater effort has to be made to raise productivity and lift the potential growth rate of the economy. The external position is fairly balanced. The emergence of public deficits and debt is guarded by the functioning of the Stability and Growth Pact. Over the past ten years, inflation has been kept relatively low in spite of large supply-side shocks. The institutional setting of the ECB, with its independence from political pressure and its mandate to preserve price stability, helped to rein in inflationary pressures and indirectly fostered the confidence of domestic and foreign residents in the capacity of the euro to preserve its value.

Political and institutional conditions

Let me turn to the political and institutional conditions for currencies to steadily take on an international role. This is clearly a more complicated issue.

Historically, countries with stable political systems and the capacity to enforce the rule of law, both inside and outside their borders, had currencies that were widely traded and accepted internationally. Certainty with regard to property rights, which may be undermined by political instability, and the ability of the issuer of the international currency to rule and to raise revenues to repay its financial obligations are crucial in this case.

The existence of "hard power" certainly contributes to the ability to enforce property rights, domestically and internationally, and thus helps in developing an international role for the currency. From this point of view, Europe cannot compete at present with other providers of "hard power". On the other hand, the success of Economic and Monetary Union provides Europe with a form of "soft power". Such soft power is translated in different ways, such as the anchoring of several currencies to the euro, the adoption of the independent central bank model contained in the Maastricht Treaty, technical assistance on issues related to monetary policy, payment systems, supervision, banknote issuance, etc.

Good economic governance is also a fundamental ingredient of successful international currencies. The Dutch guilder in the 17th and 18th century, the British pound in the 19th and early 20th century, the US dollar in the late 20th century: all were (or are) international currencies backed by strong empires and states, but also supported by the economic power and success of their issuers.

Some academics regard political and economic governance as the "Achilles heel" of the euro [e.g. Cohen, 2007]. They claim that the delegation of monetary and economic responsibilities across Member States and EU institutions is unclear and they lament the lack of a single unitary governance structure, the so-called "commander in chief", behind the euro. Over the past year, the financial turbulence has posed a serious test for the monetary authorities throughout the world. The reaction of the ECB has shown that the central bank can act rapidly and effectively to address liquidity issues.

As the crisis has evolved from a liquidity to a solvency problem, the challenge has moved increasingly to supervisory authorities and finance ministers. The ability to provide a coordinated European response is being tested. On specific occasions, such as the bail-out of the banks Fortis and Dexia, the framework has functioned properly. On the more general response to the crisis of confidence in the financial system, it is paradoxical that the relatively healthier European banking system might have to suffer more because of the uncoordinated and piecemeal reaction of national authorities. There is also a risk of a re-nationalisation of the single market for financial services, as a result of different solutions being implemented in different countries.

The fear of many academics and observers has long been that, without a specific framework for crisis resolution, the European banking system would be unable to address major shocks. The problem might turn out to be a different one. The absence of a crisis resolution framework does not prevent effective solutions from being found and implemented. But since these solutions are different from country to country, they may lead to problems of discrimination and difference of treatment, undermining the functioning of the single market. This certainly would not contribute to the international role of the euro. And this is confirmed by the weakening of the exchange rate over the last two weeks.

Another important institutional condition for the international success of currencies – closely linked to good economic governance – is trade and financial liberalisation. By definition, only currencies that can be freely converted for trade or investment purposes have the potential to achieve the status of international currencies. According to Barry Eichengreen, the US dollar owes part of its success in maintaining its position as main reserve currency to the absence of truly convertible competitors after the Second World War. In his view, the international use of potential reserve currencies – such as the French franc, the Japanese yen or the Deutsche Mark – was directly or indirectly discouraged by the respective governments [Eichengreen, 2005].

Convertibility is not an issue in Europe, but protectionism, especially against foreign capital, might be. We are currently observing attempts in different countries to limit the inflow of capital from foreign countries, in particular in so-called "strategic sectors". However, the definition of "strategic" remains vague and can give rise to quite imaginative interpretations.

Concluding remarks

To sum up, currencies emerge as international players thanks to a combination of a large number of conditions. These include geopolitical influence, political stability and the enforcement of the rule of law, as well as good political and economic governance. Only large economies generating meaningful network externalities possess international currencies. They must also be economies with deep, efficient and open financial markets where it is possible to invest without the risk of incurring large transaction costs or capital losses. Eventually, once all these factors have been accounted for, the quality of economic governance and economic institutions and the ability to devise policies which support confidence in the external value of the currency can make the difference. Obviously, inertia in the international use of currencies is strong and sudden changes in their relative position are unlikely, barring very large shocks.

Since its introduction ten years ago, the euro has emerged as the second most important currency in the world. The euro area offers the opportunity of a large, deep and increasingly integrated financial market for foreign operators willing to hold euro-denominated assets. The monetary policy conducted by the ECB has certainly contributed to supporting confidence in the euro. We now face a different type of challenge, related to the integrity and sustainability of the single market in the face of a major financial crisis.

Given the dimension of the current turmoil, it is not surprising that market participants view the ongoing developments with some concern. After all, the birth of the euro was followed by a substantial depreciation of the euro against all other currencies. The young currency and the young central bank needed to be tested in good and in bad times. The premature death of the euro was pre-announced several times. The sceptics had to concede.

In my view, one element has to be taken into account in analysing the current situation, in the light of Europe's past experience. Either a strong response is provided to the challenges posed by the current turmoil to the single financial market within the existing institutional framework, or the framework itself will be changed in favour of a more centralised system of supervision and crisis resolution. This is how the euro was born, after all, as it became clear, in particular after the 1992-93 foreign exchange crisis, that it was not sustainable to run different monetary policies within a single market. The same logic could apply in the case of financial regulation and supervision. And national authorities know it.

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