Erkki Liikanen: The euro at 10 – the next global currency?

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When Europe's Economic and Monetary Union (EMU) was launched nearly a decade ago, the euro was seen as having the potential to challenge the role of the dollar as a global currency. Views differed a lot, however, and the debate was lively. Some argued that the euro could become a major counterpart to the US dollar within relatively short period of time. Others argued that it would take a long time. And some even predicted that the EMU would not be sustainable.

Those who highlighted the potential role of the euro stressed the relative and increasing size of the euro area economy, its growth and low inflation. Moreover, there was a strong conviction that the creation of the EMU would eventually enhance the deepening and integration of euro area financial markets. All this was seen necessary for the euro to become an international currency in its own right. In addition, many pointed to opportunities and needs for portfolio diversification.

The launch of the euro took place in the wake of rapidly surging globalization. This beyond doubt facilitated the euro's role in international foreign exchange and capital markets. Over the past decade international trade has continued to grow. Perhaps more importantly, international capital flows have grown dramatically and the foreign exchange market turnover has continued to increase at an unpredictable pace. All this has coincided with large and persistent global imbalances, soaring foreign exchange reserves and rapidly growing Sovereign Wealth Funds.

Now ten years later, it is time to sit down and try to make an initial assessment of the role of the euro as an international currency. For those who argued that the euro would become quickly a major international currency, developments have fallen somewhat short of expectations. Likewise those who expressed skepticism towards the historic decision to launch the euro were clearly misguided. The answer lies somewhere in between.

In my view, the euro is a success and, on balance, the euro has firmly established itself as an international currency with a wide acceptance outside the euro area. It gradually emerged as the second most important currency after the US dollar. As the number of countries that share the euro is set to increase one might expect that euro's role as an international currency continues to strengthen.

Widespread acceptability of the euro has of course been beneficial to euro area countries. Countries running current account deficits which previously needed foreign currency can now be financed with Europe's own currency. A situation that was previously prevailing only in the United States.

The dollar's dominance is very visible **in commodities markets**. A good example is of course oil but many other commodities, in fact most, are currently invoiced in dollars. It is difficult to foresee what could change the situation in the near-term due to inertia. But some observers have pointed out that the euro might become an invoicing currency in a fast developing natural gas market. Be it as it may, Russia is the world's largest gas exporter and an important gas supplier for Europe. The EU is currently world's second largest energy market and will remain Russia's most important energy export market.

As regards **foreign exchange reserves**, it is well known that the choice of the currency composition in foreign exchange reserves depends on several factors such as market liquidity, country's exchange rate regime and diversification strategies. The recent ECB study and data from the IMF suggest that the share of the euro in global foreign exchange reserves have reached over 25 per cent. The share has gradually increased over the years, but recently stabilized.

When interpreting these results one has to keep in mind that full data on the currency breakdown of reserves is not available. There are still many countries that do not disclose such data to the IMF. Therefore as regards foreign reserves the picture is somewhat blurred which is a fruitful ground for many kinds of speculative assessments. This is clearly an unsatisfactory situation and more transparency is urgently needed.

There is evidence that some large Asian reserve holders with tightly managed exchange rates against the US dollar do not report their currency composition to the IMF. Because of the anchor currency (the US dollar) there are good reasons to expect that these countries have a certain bias towards the dollar.

The euro's international role is geographically concentrated in regions that are close to the euro area. Most EU neighboring countries that disclose the currency composition of their foreign exchange reserves predominantly hold euro. Also in this context it is interesting to note that the Central Bank of Russia recently increased the euro weight in their currency basket to 45%.

When discussing the role of the international currencies, we should not underestimate the importance of **Sovereign Wealth Funds**. These funds have recently markedly changed the landscape of international finance. These funds are by no means small. Currently the total assets of SWFs are estimated to be 2-3 trillion US dollars which compares roughly to around 5 trillion US dollars accumulated as traditional international reserves. SWFs are an important and growing "player" in the international monetary and financial system. The potential growth of SWFs is significant. Their aggregate size could reach 10 – 15 trillion US dollars by 2015.

SWFs typically employ a set of investment strategies which include investing in foreign assets. Is this a problem? Many believe that such funds could create new risks for the international financial system. In their view, the sheer size and potential growth of these funds is a concern. They consider that a major portfolio shift from dollar-denominated assets to those denominated in the euro or in other currencies could significantly affect exchange rates and risk market stability. Perhaps more worrying still, the growth of these funds may give rise to protectionist pressures. To counterbalance these worries the SWFs can be very beneficial in times of financial market turmoil. The ability to ride out business cycles with a long-term view of their investments (no leverage) brings diversity to global markets.

It goes without saying that we do not know much of SWFs investment strategies to say nothing of their currency distribution. However, Norwegian Government Pension Fund has been a front-runner as regards the transparency of the Fund's investment strategy. Last year (Sept.) their assets denominated in euro accounted for almost 40% of the Fund's total assets whereas the share of US dollar-denominated assets was just above 30%.

As regards **international debt markets**, the euro accounted for a substantial share of the outstanding stock of international debt securities, both in bonds and notes as well as money market instruments. In fact, euro-denominated debt was roughly one third of total debt issued outside euro area.

Based on a recent BIS survey (2007) the euro was the second most traded currency in the **foreign exchange markets** after the US dollar and ahead of Japanese yen. The euro was on one side in 37% of all foreign exchange transactions worldwide. Euro/dollar currency pair represented 74% of all transactions involving the euro.

Also in the **international loan and deposit market** the euro plays an important role. While the share of the euro in the international loan markets has stabilized to around 21%, their volume has increased markedly. In particular, emerging Europe is playing an increasing role in attracting euro-denominated loans. Euro’s share in international deposits has declined somewhat since mid-2005 and the share stood at 20% in 2007 (Sept).

As regards of the euro role in international trade, the euro is used extensively to invoice and settle trade transactions. For instance, in most of the euro-area countries the share of euro-denominated merchandise exports stood above 55%. The euro share in the euro area’s trade with countries outside the EU is slightly lower than its share in trade with EU countries outside euro-area. The US dollar remains the major currency of denomination of trade between third countries.

That was the past – what about the present and the future?

In the last few weeks, we have been witnessing an unprecedented unraveling of the global financial system. The storm has been worldwide, but its eye has been in the US, where it looks now obvious that, once the storm has finally passed, it leaves a financial landscape that looks very different from what there was still a year ago.

The role of the US dollar as the world's no. 1 global currency is being thoroughly tested. And curiously enough, it looks like the dollar is so far holding its own. Even when the US economy and its financial markets are being thoroughly battered, and there seem to be very few safe US assets available, the dollar keeps appreciating. The dollar still remains a safe haven of last resort.

Finally the future. Regarding the international role of the euro, the eurosystem is a bystander. It has no particular policy goals in this regard. It is nevertheless interesting to speculate what might happen once the dust has settled and global financial markets will start function once again, as they undoubtedly will.

We can conclude that the US dollar has retained its dominance as a foreign reserve currency. However, if and when countries with tightly managed exchange rates adopt more flexible currency regimes this picture may change. Moreover, credit risk concerns with growing US liabilities and ongoing deepening and integration of euro area financial markets may at some point trigger a further diversification away from dollar to other currencies such as the euro.

There are a number of factors that come into play in determining the future international role of currencies. I will go through some of them.

First, and obvious, is size. Being a global currency requires sufficient size to back it up. That limits the list of potential contenders to a handful, at most. In this regard, the euro is clearly very well positioned.

Second, size is not enough, there needs to be some dynamism in the economy, some trust in the capability of the economy to sustain a strong currency for the long term. Also in this regard, the euro has progressed quite well. The strategic goals set in Lisbon in March 2000 served to focus attention on structural rigidities. Although the Lisbon project is not finished, there has been a tangible change to the better.

The third precondition is a credible monetary policy to underpin the stability of the currency. In last summer's celebrations of the tenth anniversary of the euro the general assessment of the single monetary policy was overwhelmingly positive. I'd like to think the praise was sincere, and not just out of politeness. The future of this aspect is in the hands of the Governing Council of the ECB. The honeymoon for the single monetary policy is clearly over, and the ECB, as other central banks, is today facing the most challenging times for monetary policy in the history of its existence. Yet, the determination of the Governing Council to safeguard the purchasing power of the euro is strong and very well accepted throughout the euro area. So I think we can safely tick the third box as well.

The forth precondition for a global currency is a deep and well-developed financial system, capable of generating high-quality assets. Now I'm aware that, spoken today, that sentence risks sounding completely out of touch with reality. Out there, what certainly was the deepest and looked like the best-developed financial system in the world is coming apart in a fairly spectacular manner. But storms pass, and so will this one. And after this storm has passed, there will still be countries with a surplus and those with a deficit, and there will be wealth looking for assets with a good combination of safety and return. This is not the end of financial globalization.

So when fear and paranoia eventually subside, the industry of financial intermediation will rebound. It will likely look different but it will grow and prosper again. And when that happens, the financial system that is best positioned to respond to the emerging opportunities will benefit and provide strong support for the global role of its currency.

In this respect, the euro area financial industry has some way to go. Despite progress over the last ten years, the euro area financial industry remains fragmented, and to a large extent along national borders. To reap the benefits of a single market in financial services, barriers must be removed. Mainly, this consists of a great deal of harmonization.

The current crisis also demonstrates the importance what the IMF has been underlining for quite a while: that regulatory and supervisory structures must follow the reality of the financial markets. As national financial institutions merge into multinationals, financial supervision must follow. There is a lot of work ongoing in this regard, and the financial crisis has given this work new impetus.

As I said, the eurosystem is agnostic about the international role of the euro. Global usage of the euro is not policy goal. That said, the euro does have several strengths as an international currency. There is also work under way, aimed at improving the single market, that should, as a byproduct, make it an even stronger contender.

The US dollar is not likely to lose its dominating role any time soon. But partly because of the ongoing crisis, partly due to progress in financial integration and structural reform in the euro area, it looks likely that the no. 2 position of the euro could well be growing stronger in the coming years.