

## **Willem F Duisenberg: The international role of the euro**

Keynote speech by Dr Willem F Duisenberg, President of the European Central Bank, at the European Banking Congress, held in Frankfurt on 17 November 2000.

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First of all, I should like to thank the organisers of this European Banking Congress for inviting me to speak before such a distinguished audience. I intend to deal with the two major topics of today's discussion, namely European integration and international financial market developments, by addressing the role of the euro as an international currency.

The title of this session, "the euro second to one" or "second to none", is certainly appealing, although it might be more apt for a beauty contest than for a cool-headed assessment of the role of the euro. It is true that, in the past, some economists advocated a Darwinian-style competition among privately issued currencies, resulting in the survival of the fittest.

However, developments so far have confirmed that the use of currencies, both domestically and internationally, remains very closely associated with state sovereignty. This holds true for the euro, which has been described by some as "a currency without a state". I shall return to this aspect later in my presentation. Given this link to sovereignty, the use of a currency is very much influenced by public policies, even in the current market-friendly environment created by increasing globalisation. It is true that public policies are subject to constant scrutiny by the financial markets, which introduces an element of competition among these policies. I personally see this market discipline as a sound incentive to pursue the right policies. As such, one could consider the international use of the euro as one yardstick among others against which to measure the appropriateness and credibility of public policies conducted in the euro area.

I should like to concentrate on these policy aspects in the first part of my presentation. Then, although statistical evidence remains scarce at this early stage of the euro's development, I should like to review briefly the international use of the euro by the private and official sectors.

### **Does the international role of the euro matter?**

The first question I should like to address concerns the ECB's policy stance with regard to the international use of the euro. This is a legitimate question, especially as some countries have tended to promote the internationalisation of their currency in the past. Such a promotion policy was motivated by several factors, including increased income from seigniorage, easier financing of balance of payments deficits and enhanced opportunities for the development of domestic financial markets. Nevertheless, these potential advantages should not be overrated. The additional seigniorage revenue generated by the international use of a currency remains limited. For the most widely used international currency, the US dollar, seigniorage originating from the use of the dollar by non-residents is estimated at around 1% of GDP. As for balance of payments financing, the international use of a currency may alleviate the external constraint for some time, but it cannot free an economy from market discipline. Finally, the development of the domestic capital market can be seen as a precondition as much as the outcome of the international use of a currency.

There are also historical examples of countries that resisted the internationalisation of their currency, particularly in view of increased uncertainties in the conduct of macroeconomic policies in general and monetary policy in particular. For its part, the ECB has adopted a neutral stance. It considers that the use of the euro as an international currency is and should remain the outcome of economic and financial developments and policies inside and outside the euro area. The ECB holds the view that it would be neither feasible nor desirable to directly promote or hinder the internationalisation of the euro.

This should not be interpreted as implying that the international dimension of the euro is irrelevant to the ECB. Indeed, there is at least one reason to monitor the international use of the euro, namely to take into account potential spillover effects on monetary policy. In particular, one can imagine that the internationalisation of the euro may have an influence on monetary policy transmission mechanisms. International developments in the use of the euro can enhance the breadth, depth and efficiency of euro area financial markets and lead to a reduction in transmission lags. It is also possible to imagine that monetary aggregates may become more difficult to interpret when part of the money stock is held outside the euro area.

However, the impact of the internationalisation of the euro on monetary policy should not be overemphasised. First, economic theory and historical experience suggest that the international use of a currency tends to change only very gradually over time. Second, the ECB's monetary policy strategy is sufficiently robust to take into account and accommodate potential implications of the international role of the euro.

Apart from its monetary policy implications, the international use of the euro may also provide a yardstick with which to assess the appropriateness and credibility of public policies conducted in the euro area. Of course, the euro can in part rely on the track record of its 11 legacy currencies. At the same time, the euro is a new currency used in the second largest economic area of the world. This size factor, particularly as far as the euro area capital markets are concerned, may influence cross-border uses of the euro, both by residents and non-residents. The internationalisation of the euro will be affected by the soundness and credibility of the economic policies pursued in the euro area.

This leads me to touch upon the notion of the euro being "a currency without a state", which I mentioned in my introduction. In this respect, one has to recognise the uniqueness of the overall policy framework in the euro area. It combines monetary policy conducted at the Community level with other macroeconomic and structural policies that remain national competencies. I do not see this unique policy framework as a factor which potentially hampers the acceptance and use of the euro domestically and internationally. Such a framework is consistent with the current level of institutional and political integration in the Community. Even if it may arguably be improved, it has already shown its effectiveness, based on some basic principles. I should like to recall just three of those principles that are of relevance to my presentation today. First, a clear assignment of policy responsibilities, both in terms of well-defined objectives and appropriate means to fulfil them, is required on grounds of efficacy, transparency and accountability. With regard to monetary policy, this is ensured through the ECB's independence in defining and implementing the euro area's monetary policy and related functions. Second, there is a need for the coordination of fiscal and structural policies that are conducted at the national level. In this respect, and without prejudice to their sovereignty, the Member States are increasingly taking into account a euro area-wide perspective when preparing their national policies. Third, this coordination should be based on best practices through the selection of those elements of national policies that are commonly regarded as being most efficient. This approach is broadly similar to the one used to design the ECB's monetary policy framework, drawing on the track record of the national central banks.

### **Evidence of the international use of the euro by the private sector**

Turning to less policy-related and more factual considerations, I should now like to recall briefly some developments in the international role of the euro since its introduction at the start of 1999. I shall begin with private sector use and shall then turn to the public sector. At the outset, let me make two preliminary points. The first is that my overview will only be partial, as statistical information is not available for all international uses of the euro. The second is that the flamboyant rhetoric used in some quarters to present the euro as the competitor of the US dollar may have generated false expectations that the international role of the euro would develop dramatically from the date of its creation. As emphasised from the beginning by the ECB, these expectations were unjustified. History teaches us that the internationalisation of a currency is a gradual process.

Starting with the overview of private uses, I would consider that the role of the euro in financing and investment operations by non-residents is one of the most interesting aspects. Moreover, it is of direct

relevance to today's audience, which consists of many prominent participants in the international financial markets.

The most complete data are available for the financing side. Statistics on international debt securities show that net issuance by non-residents denominated in euro doubled between 1998 and 1999. It was particularly strong in comparison with other currencies. Figures for the first half of 2000 indicate continued strong activity in euro-denominated securities issuance, although there was a moderate decline from the peak reached in 1999. This compares with fairly low issuance of Japanese yen-denominated paper. Interestingly, euro-denominated debt securities issuance had a variety of origins, with approximately 75% of borrowing originating from non-euro area advanced economies such as the United States, the United Kingdom, Sweden and Japan. The remaining 25% of issuance stemmed from emerging market economies. Moreover, both private and public sector issuers were active.

Developments have been more subdued in the banking sector, where euro-denominated liabilities in total cross-border liabilities witnessed a moderate increase, with a share of around 20%. Here again, the euro comes second to the US dollar, in which more than 50% of outstanding cross-border bank liabilities are denominated. The yen ranks third with a share somewhat below 10%.

Turning to the assets side, we come to the use of the euro as an investment currency. Unfortunately, statistical evidence is generally limited here. An analysis conducted by the ECB indicates that there was some growth in the use of the euro as an international investment currency over the course of 1999. In the banking sector, the volume of international assets denominated in euro increased only slightly, roughly in line with developments on the liabilities side.

One might try to examine the link between the role of the euro in international financial markets and recent trends in the euro area's balance of payments. Of course, there is no one-to-one correspondence between the two concepts. Nevertheless, one can observe a correlation, or co-movement, between the international role of the euro in financial markets and the euro area financial account. In particular, the euro area capital outflows in 1999 are consistent with indications that the euro was used more as a financing than as an investment currency. Likewise, smaller net capital outflows in the first half of 2000 would also appear consistent with a more balanced use of the euro as a financing and an investment currency. These findings are still preliminary, but they confirm the relevance of developments reflecting the international use of the euro.

Let me now touch upon some other international private uses of the euro. Examples are the role of the euro as a payment currency in the exchange of goods and services, as an invoicing currency in international trade, as a vehicle currency in foreign exchange markets and as a quotation currency in international commodities markets. Despite the scarcity of reliable statistical evidence, a few observations can be made. First, the US dollar continues to play a leading role in these areas. Second, rapid changes cannot be expected, as these functions of an international currency are driven by scale and network effects and therefore tend to develop only slowly over time. Third, the euro has a prominent role in those transactions that directly involve euro area residents. For example, the euro tends to be used for invoicing or payments linked to trade flows to or from the euro area.

Rounding off this overview of the international use of the euro by the private sector, I should also mention foreign currency cash holdings in a number of Central and Eastern European countries, in which the Deutsche Mark takes the lion's share. These cash holdings will be converted into euro as the banknotes and coins are introduced in a year's time. The stability of the euro indeed makes it an attractive medium of exchange and store of value for the general public in countries that have a history of unstable prices. Nevertheless, as confidence grows in the domestic monetary policies conducted in these countries, this specific international role of the euro should not develop further.

### **Evidence on the international use of the euro by the public sector**

Not only the private sector, but also the public sector may use the euro as an international currency. This encompasses the use of the euro for official reserve holdings and as a reference currency for exchange rate arrangements. Statistics related to official reserves were published in the most recent

International Monetary Fund Annual Report, and indicated that the share of the euro was around 13% at the end of 1999. This is comparable with the weight of the legacy currencies one year earlier. The fact that stability is prevailing is consistent with the notion that central banks tend to be conservative in managing their reserve holdings.

Remaining in the sphere of international official reserves, the International Monetary Fund has recently decided on a new valuation method for the special drawing rights (SDRs), which comes into force on 1 January 2001. The SDR basket traditionally comprised five currencies of individual countries, including the Deutsche Mark and the French franc. The weight of each currency in the basket was determined on the basis of trade and financial data of these countries. In order to reflect the new economic area resulting from the introduction of the euro, the SDR basket will henceforth include the euro, instead of the Deutsche Mark and the French franc. Its weight will be based on the importance of the euro area as a single economic entity. Similarly, the EURIBOR will be substituted for the German and French national interest rates in the determination of the SDR's interest rate. These modifications underscore how the official international financial community is gradually adjusting to the new reality of the euro.

As a last point, let me deal with the use of the euro as a reference currency for exchange rate regimes adopted by third countries. Today, over 50 countries are managing exchange rate arrangements that include a reference to the euro. This involves a variety of regimes, ranging from very tight pegs (ie currency boards) to managed floating policies. Geographically, these countries are located on the European and African continents. This is a difference with the US dollar, which is also used by a few countries outside the Western Hemisphere. The intensive trade and financial links with the euro area are the main factor behind the choice of the euro in the definition of exchange rate policies. For some countries, the European Union accession process provides an additional impetus to select an exchange rate arrangement based on the euro. I should highlight that the choice of a euro-based exchange rate arrangement is a unilateral decision, and does not involve any commitment on the part of the ECB. However, this use of the euro as a reference currency may be seen as a sign of confidence in the stability-oriented macroeconomic policies of the euro area.

## **Conclusions**

Summarising almost two years of experience with the euro, one might consider that it has started playing an international role in line with the economic and financial size of the euro area in a rather smooth manner.

As I have highlighted today, developments in the international use of the euro are, of course, only gradual. Nevertheless, looking ahead, one can expect the international role of the euro to develop further. An established track record of the Eurosystem with reference to its primary objective of price stability and continuing integration of financial markets in the euro area will undoubtedly contribute to the further internationalisation of the euro.