

Nicholas C Garganas: International role of the euro

Address by Mr Nicholas C Garganas, Governor of the Bank of Greece, at the Conference of the European Commission "Europe, The Mediterranean and the euro", Athens, 4 February 2003.

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Introduction

Ladies and gentlemen it is a pleasure to participate in an event organised by the European Commission. I would like to thank the Commission for inviting me to address some of the basic considerations that confront the euro in its emergence as an international currency.

Let me begin by asking the question: "How does a currency acquire the status of an international currency?" This question is being asked more and more often as the euro takes on increasing importance in the global financial system.

The interwar period was dominated by two currencies - the US dollar and the pound sterling - while the postwar world has been dominated by the US dollar. Unlike the situation in national economies or monetary unions, where the currency used is determined by government decree, currencies are used internationally because of neither an Act of Parliament nor an Act of God. Rather the choice of currencies used for international transactions is mainly the result of invisible hand processes. Currencies attain international status because they meet the various needs of foreign official institutions and foreign private parties more effectively than do other financial assets.

What factors contribute to the use of a specific money as an international currency? Why was the Dutch guilder the dominant international currency in the 17th and 18th centuries, the British pound in the 19th and early 20th centuries, and the dollar since the end of the second world war? Several factors are essential if a currency is to be used internationally.

First and foremost, an international currency must be perceived as sound. To be acceptable, market participants must be willing to hold it as a store of value. This circumstance means that inflation in the country or monetary union issuing the currency must be low and stable relative to those of other currencies. Inflation reduces the purchasing power of a currency, discouraging its use internationally. It also leads to exchange-rate depreciation and uncertainty. A necessary condition for the international use of a currency, therefore, is that a currency's future value in terms of goods and services has to be perceived as predictable and stable.

Clearly, many currencies meet this test; yet few emerge as international currencies. Therefore, there must be - and there are - additional factors that help determine the internationalisation of a currency. One such factor has to do with size. The size factor relates to the relative economic and demographic area for which the currency serves as legal tender - in other words the "habitat" of the currency. A strong, competitive economy, open to, and active in, international trade and finance will naturally generate a large quantity of foreign exchange transactions with at least one leg in the home economy to support its wide-ranging business activity.

Another factor underlying the international use of a currency is the presence of an open, well-developed financial system. This factor is a necessary part of a strong, competitive, and open economy. Just as relatively low levels of inflation and inflation variability contribute to the international demand for a currency, well-developed financial markets supply assets appropriate for international use, and strengthen the demand for additional assets as well. Well-developed financial markets in the currency's issuing jurisdiction contribute to the international use of that currency. Central banks and other investors have preferences for safe, liquid financial instruments; deep and liquid financial markets that offer a full array of instruments and services will attract business from abroad that might otherwise have stayed at home.

Money as a conveyer of information

History has shown that the forgoing three factors - a stable currency, a strong, competitive economy, and deep, broad and liquid financial markets - are necessary for the international use of a currency. History has also shown, however, that only a single currency, or at most a few currencies, emerge as major international currencies at any one time. To understand why this is so, we need to consider a

key function of money. Money conveys information about prices. When you are in Greece, for example, and you want to compare the prices of two hotel rooms, you compare them in euros. The euro, in other words, conveys essential information which allows you to make price comparisons so that you can reach a decision.

Money, in its capacity as a transmitter of information, performs a function similar to that of an international language. The greater the number of people who speak a language, the more it can facilitate communication. The same is true with money. A currency would hardly do you any good if you are the only person who uses it. The utility of money depends, in part, on how many others use it. When a Saudi Arabian exporter, who does not speak Italian, sells crude oil to an Italian importer who does not speak Arabic, the transaction may well be conducted using the English language and it may well be denominated and settled in US dollars. The US dollar, in this case, is used as a "vehicle" currency, that is, it is used to denominate and execute foreign trade transactions that do not involve direct transactions with the issuing economy. This use leads, as does the use of English, to easier communication in transmitting information. As is the case with a language, the more popular is a currency the more useful it is to those who use it. Because the attractiveness of any international currency grows as its use increases, an international currency has a tendency to become a natural monopoly. This circumstance explains why only a single money, or a few moneys, are used as international currencies at a particular time.

Benefits and costs

An international currency provides several major benefits to the issuing economy. First, the economy derives seigniorage, because the non interest-bearing claims on it are denominated in its own currency. When Argentina, for example, imports autos from Japan, it must pay for them with foreign exchange it earned through its exports; it is highly unlikely that the Japanese importer would be willing to accept the Argentina currency, the peso. When the US, however, imports Japanese autos, it can pay for them with Federal Reserve notes, which are just a paper claim on the US government. The Board of Governors of the US Federal Reserve System estimates that seigniorage revenue for the United States amounts to between \$11 billion and \$15 billion per year.

Second, as the international use of a currency expands, loans, investments, and purchases of goods and services - both foreign and domestic - will increasingly be executed through the financial institutions of the issuing economy. Thus, the earnings of its financial sector are likely to increase.

Third, the tendency of world trade to be denominated in the international currency means that the issuing economy will be less vulnerable to changes in the value of its currency than are other economies. If the US dollar, for example, depreciates sharply against other currencies, this will have a smaller effect on US inflation than is the case in other economies. This is because most US imports are denominated in dollars. Therefore, when the dollar declines on the foreign exchange market, the price of US imports - in dollars - need not change.

The main cost of having an international currency is that it can complicate the conduct of monetary policy. Because foreigners hold a substantial share of the currency, a portfolio shift away from the currency, for example, can lead to large capital outflows and/or large declines in the exchange rate. Concerns about the effects of changes in portfolio preferences caused both the German and the Japanese governments to take measures to restrict the international uses of the deutsche mark and yen, respectively, during the 1970s and early 1980s. Concerns that the imbalances in the US economy, including the large current account deficit, could lead to a massive sell-off by foreigners of their holdings of US dollar balances have underpinned concerns of a possible hard landing for the US currency.

The international role of the euro

Let me now turn to the specific focus of this session - the international role of the euro. It is important to note that the ECB has adopted a neutral stance concerning the internationalization of its currency, implying that it neither fosters nor hinders the process. It accepts the view that the international role of the euro is primarily determined by the decisions of market participants. How, then, does the euro stack up in terms of the conditions that determine an international currency?

The first factor I mentioned that determines international currency use is a stable currency. The mandate of the ECB is to maintain the purchasing power of its currency. Since its inception, therefore,

the ECB has sought, and it has attained, stability of its currency. This stability is proof that the institution is performing well.

Yet, in the quest for stability, monetary policy cannot go it alone. It needs to be complimented by a consistent fiscal-policy stance. Indeed, the academic literature has coined a name for the connection between monetary and fiscal policies, calling it "fiscal dominance". The implication of this connection for the international role of the euro is that, to ensure the future stability of the euro, member states will need to adhere to the Stability and Growth Pact.

The second factor determining international currency-status is size. Measured in terms of population, the euro area is one of the largest economies in the world, with more than 300 million inhabitants. By comparison, the populations of the United States and Japan are about 270 million and 125 million, respectively. The euro area is the largest trading partner of the world economy, accounting for almost 20% of world exports, compared with about 15% for the United States and 9% for Japan. The GDP of the euro area is equivalent to some 16% of world GDP, about 6 percentage points less than the share of the United States but more than twice the share of Japan. However, even more important than the current figures is the potential for the future development of the euro area, in terms of population and GDP, if and when the so-called "pre-ins" (Denmark, Sweden and the United Kingdom) join the Eurosystem. The entry of these countries would result in a monetary union of some 376 million inhabitants, about 40% larger than the United States and almost triple the size of Japan, with a GDP only slightly less than that of the United States and 2¼ times that of Japan. All these facts and figures, which demonstrate the demographic and economic importance of the European Union, will be further strengthened by EU enlargement.

Let me now turn to financial markets in the euro area. The introduction of the euro and the successful implementation of the TARGET payment system have contributed to the potential for highly integrated financial markets within the euro area.

With regard to capital markets, the euro has seen a strong development in the bond market. The launch of the euro seems to have acted as a catalyst for the development of a bond market in which corporations can issue debt securities of unprecedented size. As a result, the introduction of the euro has created the second largest bond market in the world. This circumstance has led to declining transactions costs, as bid-ask spreads have narrowed, and increased diversity, as new types of issuers participated in the market.

The integration of the euro area bond market, and the associated reduction of borrowing costs in euro, have meant that the euro has been playing an increasingly significant role as a financing currency. In the international debt securities market, recent data indicate that the share in outstanding amounts of euro-denominated instruments issued by non-residents totals 29%, compared with 44% for the US dollar and 13% for the Japanese yen.

In contrast to borrowers, investors are interested in income prospects and they demand high efficiency and liquidity of the financial markets in which they invest. These market characteristics exist only if the financial markets are deep and wide. Such is not yet the case in euro-area equity markets. These markets tend to be smaller, on average, than their counterparts in many other industrialised countries and they account for a commensurately smaller share of trading activity. This situation is very much a result of the segmentation of national markets, which have been built around national securities depositories and settlement systems intimately connected to the national payment infrastructures

The challenge is to remove institutional and economic factors that raise the cost of cross-border operations. In particular, further integration will require harmonization of accounting rules, tax regimes, and legal frameworks, and the acquisition of the necessary technical infrastructure for handling cross-border holdings and settling securities. The costs of these regulatory obstacles are identified in the Financial Services Action Plan, issued by the European Commission. The Action Plan lists priorities and time-scales for legislative and other measure to tackle three strategic objectives: (1) completing a single wholesale market; (2) developing open and secure markets for retail services; and (3) ensuring the continued stability of EU financial markets. It also addresses the importance of eliminating tax obstacles and distortions for the creation of an optimal single financial market. To date, 30 of 42 measures contained in the Action Plan have been completed. I hope the remaining obstacles identified in the Action Plan will be removed within the scheduled deadlines.

As I mentioned, the relatively narrow euro-area financial markets have meant that the euro area has not approached its full potential as an international asset. As of the end of 2001, 13% of the identified official holdings foreign reserves were in euro, compared with about 68% for the US dollar and about

5% for the Japanese yen. As a medium-of-exchange and asset vehicle in the foreign exchange markets, the US dollar remains the dominant global vehicle; the euro's share in global spot trading amounts to about 20%.

Concluding remarks

The other speakers on this panel will provide specific information about the current state of play of the euro as an international currency. The evidence they will present will confirm that the euro has emerged as the world's second most important international currency. Yet, the evidence will also confirm that the dollar is still far ahead of the euro. Before I turn the lectern over, let me make a few remarks about future prospects.

Two essential, inter-related elements will help the euro attain equal status with the U.S dollar. First, improved productivity and competitiveness of the euro area will raise the rate of return on euro area assets, boosting the role of the euro as in investment currency. This prediction is predicated on profound changes in areas such as product and labour market regulations, public debt and fiscal deficits, and social security systems. Second, continued financial market integration, a necessary condition for further investments in euro assets, will require changes in, and harmonisation of, legislations, regulations, market practices, and infrastructures.

The euro has made an impressive debut on the global stage. To a significant extent, this situation reflects the credibility credentials earned by the ECB in its first several years of existence. It also reflects the perceptions of market participants of the euro area as an economy with strong growth potential. Determined efforts in the remaining areas I have discussed would fulfil these perceptions and add to the attractiveness of the euro in the international arena, allowing it to seriously challenge the hegemonic role now played by the US dollar.

Ladies and gentlemen, thank you for your attention.