Lucas Papademos: The extended importance of the euro

Remarks by Mr Lucas Papademos, Vice President of the European Central Bank, at the Frankfurt European Banking Congress 2006 "Trade Center Europe", Frankfurt am Main, 17 November 2006.

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I. Introduction

I would first like to thank the organisers for inviting me to this prestigious event. It is both a privilege and a pleasure for me to participate in this year's European Banking Congress.

Let me start with two general remarks. First, the international importance of the euro, and that of any other currency, can be measured and assessed on the basis of several criteria, notably: the role it plays in international trade and in global financial markets; the extent of its use by authorities as a reserve, intervention and anchor currency; and its possible use by the public or firms outside the euro area as a parallel currency, held for transaction purposes in the form of cash or bank deposits. The share of the euro in global official reserves is an important criterion or indicator for judging its international role, but it is not the only one.

The second general point I would like to make concerns the position of the ECB with regard to the international role of the euro. As we have stressed in the past, the ECB considers the global use of the euro as a market-driven process that reflects all the factors influencing the preferences of global market participants and non-euro area authorities with regard to the functions it performs. So, we have a "neutral" view on the international role of the euro. Nevertheless, we carefully monitor and analyse pertinent developments in order to better understand the determinants of its global use and potential implications for the ECB's monetary policy.

II. The euro as reserve currency

After these preliminary remarks, let me focus on the importance of the euro in the global official reserves held by central banks. You correctly observed that the share of the euro in global official foreign exchange reserves increased during the first few years following its introduction, but has remained relatively unchanged in recent years. Specifically, the share of the euro rose from 18% in 1999 to 25% in 2003 and has been relatively stable since then, reaching 25.4% at the end of June 2006.

There are four pertinent remarks that I would like to make concerning these figures. First, the current share of the euro in global official reserves as calculated from the IMF statistics is higher than the share of the sum of all legacy currencies of the euro – notably that of the Deutsche Mark – in global official reserves at the end of 1998 before the euro was launched, which was about 18%. Second, the pertinent IMF statistics cover only about two-thirds of global foreign exchange reserves, because a number of countries with large holdings of reserves – mostly from Asia – do not fully participate in the IMF's survey. All countries, of course, provide figures for the total value of their reserves, but not all countries report their composition by currency. Third, it is interesting to note that the share of the euro in the total reserves held by those emerging market economies that do provide the relevant statistics rose from around 23% in 1999 to more than 33% at the end of June 2006. Finally, it is worth keeping in mind that the reported shares are influenced by valuation effects. Expressed in constant exchange rates (measured at the first quarter of 1994), the increase in the share of the euro is somewhat less pronounced (the share increased from 19% at the beginning of 1999 to 24% at the end of June 2006).

What are the main determinants of the currency composition of foreign exchange reserves? And how can we explain the observed gradual evolution of the share of different currencies in total official reserves? When discussing these questions, we need to distinguish, of course, between stocks and flows. Changes in the currency composition of the existing stock of foreign exchange reserves therefore might not only reflect a possible reallocation of part of the existing reserves held or the valuation effects that I mentioned before. They could also be due to changes in the currency composition of the flows of additional reserves. However, the latter – that is, the flow of additional reserves accumulated every year – is relatively small, at about 500 billion US dollars per year. The outstanding stock of global reserves, by comparison, amounts to about 4.6 trillion US dollars (at the end of June 2006). If we exclude large valuation effects, the effects of changes in the currency composition of the flows of reserves on the stock are likely to be relatively small and gradual.

A further important aspect in this discussion is that central banks' decisions on the currency composition of the stock of their reserves are mainly based on a number of criteria that are different than those that guide the decisions of private investors. For example, central banks of emerging market economies allocate their reserves only partly with a view to optimising the returns of their portfolio. Their decisions mainly reflect other considerations, such as the choice of a currency as a nominal anchor for the conduct of monetary policy, the currency composition of external debt or trade invoicing. In this context, allow me to draw your attention to the fact that some 25 countries use the euro as a reference currency for their exchange rate polices.[1] As those factors relate to long-term policy choices or economic developments, they can be expected to result in strong inertia in the allocation and management of reserves by central banks. There are, however, exceptions: for example, the authorities in Russia announced in December 2005 that they had increased the share of the euro in foreign exchange reserves to 40% (from 33% in mid-2005). To some extent, this decision may have been linked to a more prominent role of the euro in the Bank of Russia's currency basket for the management of exchange rate volatility. At the same time, in some countries, notably oil- or other commodity-exporting countries, an increasing proportion of the "official" foreign currency assets is held outside central banks by public investment agencies. These agencies may invest in a wide spectrum of assets denominated in various currencies, with the aim of maximising the expected return on their holdings.

III. Prospects for the further development of the international role of the euro

Given these observations, what can be expected with regard to the relative importance of the euro in global official reserves in the future? As is well-known, prediction is very difficult, especially about the future. And you will understand that I will not speculate on this. That said, I will explore, more generally, the prospects for the further development of the international role of the euro. On this point, allow me to make a general pertinent remark. Clearly, a necessary condition for fostering the international role of a currency is its credibility, as determined by the stability of its internal value. The ECB, by preserving price stability in the euro area, "sets the stage" and establishes a necessary condition for the wider international use of the euro. But whether or not the international importance of the euro will further increase depends on many other factors as well, in particular the investment decisions of private agents and public authorities.

Traditionally, a key determinant of the international use of a currency – especially as a means of exchange – has been trade, the very theme of this year's European Banking Congress. From the drachma in the kingdoms of the Hellenistic period, to the guilder during the heyday of the Dutch trading empire, to sterling in the 19th century and the dollar over the past half century until today, trade and international currency use went hand in hand: the larger the importance of a country or currency area in world trade, the greater the international importance of its currency. Given Europe's role as the world's largest trader, it is not surprising that the share of the euro in the invoicing and settlement of the euro area's trade with the rest of the world has increased significantly. The latest numbers collected by the Eurosystem show that most euro area countries conduct more than half of their trade with partners outside the euro area in euro. What is more striking is that trade taking place entirely outside the euro area – for instance, between EU countries that have not yet adopted the euro as well as between countries seeking to accede to the EU – is also being invoiced and settled in euro. As these developments cannot be fully explained by increasing trade linkages of these countries with the euro area, it would appear that the euro has started to become a vehicle currency in international trade. That said, recent ECB research on this issue has also shown that the euro does not display one of the characteristics typically associated with vehicle currencies – namely their use in the trade of commodities.

An international currency is not only used for trade purposes, but also for financing and investment purposes. And also in this respect, we observe wider use of the euro in international financial markets. For example, over the past seven years, the share of the euro in the stock of international debt

[1] If we include the countries of the CFA Franc Zone in Western Africa, this number rises to 40 countries which the IMF classifies as having exchange rate regimes that either use the euro as sole reference currency or as part of a currency basket.

securities gradually rose from 19% to slightly below 32%. Other market segments – for example the spot foreign exchange market – are characterised by a high degree of stability, possibly reflecting the importance of network externalities. However, market data (from the Continuous Linked Settlement system) show that the euro is the second most widely used currency, accounting on average for almost 22% of all daily transactions.

The increase in the use of the euro as a financing currency in international bond markets, has been a key feature of its international role. A geographical breakdown of the outstanding stock of international debt securities issued in euro shows that European entities (public authorities and private firms) in the vicinity of the euro area account for the largest share of such issues. What are the factors that influence the choice of currency by firms when issuing bonds? Research undertaken at the ECB (based on the analysis of 8,000 bonds issued by 1,500 companies in the United States, the euro area, Japan and the United Kingdom) suggests that these decisions are influenced by both strategic and cost-related considerations. The firm size and the investor base in the euro area affect a firm's decision in which currency to issue a bond. And a firm's exposure to the euro area also has a bearing on the currency choice for bond issuance. Thus, the increased use of the euro as a currency for bond issuance reflects firms' attempts to hedge their exposure to the euro area and to broaden their investor base by tapping euro area financial markets. This finding brings me to my last remark.

Whether or not private agents use the euro as their currency of choice when seeking finance or investment opportunities depends on the availability of large, integrated and liquid financial markets. While – as I said in the beginning – the ECB neither encourages nor hinders the international use of the euro, we do promote financial integration in Europe. We know from economic theory that more integrated and efficient financial markets can help raise productivity, foster innovation and thus enhance economic growth. But now we also have strong empirical evidence, based on ECB research analysing the available evidence for many countries and sectors, that the size and depth of capital markets have a significant positive impact on economic growth. For Europe, therefore, the creation of larger and more liquid financial markets is, and should be, a desirable end in itself. At the same time, more developed and efficient financial markets in the euro area will increase the attractiveness of our currency for international investors, and thus enhance the euro's global role.

IV. Concluding remarks

In market economies, people are free to choose among alternatives in line with their preferences. The fact that many economic agents – be they private individuals, investors, savers, traders or public authorities – outside the euro area increasingly choose the euro as their preferred currency testifies to the trust which they place in its stability and credibility. This is a sign of distinction. At the same time, it also serves as a constant reminder of the importance to preserve this confidence, by maintaining the euro's internal purchasing power, by enhancing the growth potential of our economy, and by further integrating and deepening Europe's financial markets.

Thank you very much for your attention.