

Lucas Papademos: The international role of the euro – trends, determinants and prospects

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the Brussels Economic Forum 2008, at the panel on “The euro in a rapidly changing international environment”, organised by the European Commission, Brussels, 15 May 2008.

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I. Introduction

Ladies and Gentlemen,

I would first like to thank the European Commission and the organisers of the Brussels Economic Forum for inviting me to this important celebration of the 10th anniversary of the launch of the euro. It is indeed a privilege and a pleasure for me to participate in this very special event.

Many of us here remember vividly the famous words – spoken almost 40 years ago – that “one small step for (a) man” can be “one giant leap for mankind” (Neil Armstrong, Apollo 11 mission, 20 July 1969). The same event can have a varying degree of significance for different people, depending on their viewpoint. Anniversaries are occasions to take a step back and assess matters from a broader perspective and over an extended time horizon. They are occasions for celebrating the accomplishments of the past, as well as for reflecting on perspectives and objectives for the future. Allow me to make an analogy with the words of Neil Armstrong and say that the ten years since the introduction of the euro may seem like a small step in the long history of the global economy to some people, but they certainly represent a significant leap of progress for Europe. Over the past ten years, the euro has become an important pole of stability in the world economy.

The significance of the introduction of the euro has to be assessed first and foremost in terms of its contribution to the stability and growth of the euro area economy. And the euro’s performance as a currency must be fundamentally judged by its internal stability and credibility. At the same time, the single currency of a large economic area inevitably has a significant global role. Our task today is to assess the euro’s international role in a rapidly changing and integrating global economy.

My remarks will address a number of pertinent issues:

- the evolution of the international use of the euro over the past ten years;
- and the euro’s current status as an international currency;
- the key determinants of a currency’s international role and the prospects for the further internationalisation of the euro; and;
- the ECB’s position and the effects of macroeconomic and structural policies on the global role of the euro.

II. The evolving international use of the euro

The international importance of the euro can be measured and assessed by the role it plays in global financial markets and international trade, the extent of its use by authorities (and official institutions) as a reserve, intervention and anchor currency, and its possible use by the public or firms outside the euro area as a parallel currency.

A bird’s eye view of the evolution of the international use of the euro over the past ten years is presented in Chart 1 (Slide 3), which shows the share of the euro in international trade and in a number of financial markets for debt securities, derivatives, official foreign exchange

reserves, foreign exchange, and bank loans and deposits. In all of these markets, except for the foreign exchange market, the use of the euro has increased over the past ten years, particularly in international debt security markets, global official foreign exchange reserves and as a trade invoicing and settlement currency.

An examination of how the international use of the euro has evolved over time complements the abovementioned conclusions. This involves assessing the implications of valuation effects resulting from exchange rate movements on the measurement of its international use and identifying the geographic or regional character of the euro's international use.

Chart 2 shows that the euro's share in global official foreign reserves (the currency composition of which is known) reached around 25% at the end of December 2007. This was considerably higher than the corresponding share of the sum of all legacy currencies at the end of 1998, which accounted for about 18%. Overall, the evolution has been gradual: the share of the euro increased during the first five years following the introduction of the euro and has since remained relatively stable. If we adjust for valuation effects stemming from exchange rate movements (notably the significant depreciation of the US dollar against the euro), we see that the overall increase in the euro's share over the past ten years has been smaller, and its time profile smoother.¹ When interpreting these figures, it should be borne in mind that no official statistics are available on the currency composition of about one-third of global foreign exchange reserves, since a number of countries with large holdings of reserves – mostly in Asia – do not disclose their composition by currency. It is interesting to note that the share of the euro in the total official foreign exchange reserves held by the emerging market economies that provide the relevant statistics rose from around 18% in 1999 to about 28% at the end of 2007.

Similar conclusions are reached with regard to the evolution of the share of the euro in international debt security markets, as shown in Chart 3. The share of the euro in the “narrow measure” of international debt securities (which excludes debt securities issued in the home currency) increased to about 32% at the end of 2007 from around 19% at the end of 1998. The increase in this share is less pronounced, although still significant, after adjusting for valuation effects.

One special characteristic of the international use of the euro is that, so far, it has been concentrated in regions that are geographically close to the euro area. This fact reflects political, institutional and economic factors. It is not surprising that non-euro area EU countries account for a significant part of euro-denominated debt by non-residents or that the degree of currency substitution is high in the new EU Member States that have not yet adopted the euro or in the EU candidate and potential candidate countries. Moreover, some 29 countries² that use the euro as a reference currency for their exchange rate policies are close to the euro area. Chart 4 illustrates the regional dimension of the international role of the euro. The share of the euro in cross-border loans increased among the “old” non-euro area EU countries (UK, Denmark Sweden), but decreased in other parts of the world. At the same time, the rise in the share of the euro in international debt securities has also been most pronounced in the new EU Member States and the other non-euro area EU countries.

To sum up, over the past ten years, the euro has established itself as the second most important international currency after the US dollar. Its global role in international trade and global financial markets is greater than that of its legacy currencies combined. Its international use has gradually increased over time in most market segments but, in certain markets, it has remained relatively stable in recent years, when adjusted for valuation effects.

¹ Constant exchange rate figures are expressed in exchange rates prevailing at the end of the last available observation. As a result, current and constant exchange rate figures are by construction the same for the last observation.

² 40 countries, if we include the countries of the CFA Frank Zone in Western Africa.

The international role of the euro area is especially strong in neighbouring regions with special political and economic ties to the European Union.

III. Determinants of and prospects for the international role of the euro

What are the prospects for the euro's international role in the coming years? To address this question it is useful to recall the key determining factors that are likely to influence the demand for the euro by non-euro area market participants and authorities over time, also taking into account the potential effects of the ongoing and growing economic and financial integration of the global economy. These key determinants include, first, the size, growth and degree of openness of the euro area economy relative to the rest of the world; second, the size, depth and degree of development of the euro area financial markets, again relative to the markets of countries with international currencies; and, lastly and fundamentally, the attractiveness of the single European currency to non-euro area residents, as determined by its expected internal and external stability over the medium and long term.

The relative size of the euro area economy and its degree of openness are factors that support the international role of the euro. Chart 5 compares the size of the euro area economy as measured by its GDP and its population with that of the United States in 1999 and 2007. It shows that the ratio of the euro area's nominal GDP to that of the United States when measured in US dollar terms increased by 14 percentage points over that period to reach about 88% in 2007. With the expected enlargement of the euro area in coming years, the euro area's GDP will approach that of the United States. The chart also shows that the euro area economy's degree of openness is significantly higher than that of the United States and has risen over the past eight years, contrary to earlier expectations that the euro area would become an "isolated" trading bloc. Indeed, the euro area is the largest trading bloc in the world, accounting for over 13% of world trade in goods and services in 2006.

The potential growth of the euro area has been lower than that of the United States over the past decade, but the relative economic growth prospects seem more favourable as a result of the positive impact of reforms in Europe that have positively and significantly affected employment growth, and the rate of labour utilisation and, to a lesser extent, productivity growth. Clearly, the implementation of further reforms will be crucial for enhancing the growth potential and economic dynamism of the euro area economy in the future.

The overall size of the euro area's financial system in nominal terms is comparable to that of the United States. Nevertheless, it is less well developed, as measured by several indicators of financial developments, for example the ratio of total market capitalisation (including bank assets) to GDP. Chart 5 shows that the size of the equity and debt securities markets in the euro area was about 56% of that of the United States, reflecting the greater reliance of euro area firms on bank financing. Other indicators confirm that the depth and liquidity of the US financial markets are greater than that of the euro area.

At the same time, the efficiency of the euro area's financial system has improved significantly since the adoption of the euro. Indeed, the euro has contributed to the integration of financial markets in the euro area, which has increased their liquidity and efficiency, and made the euro more attractive to international investors. Policy initiatives by the European Commission and the ECB aim at fostering further integration and the development of the euro area's financial system, which will support the international use of the euro and will have positive feedback effects on the development and efficiency of the euro area's financial markets. Thus, the further integration and development of the euro area financial system and the internationalisation of the euro are processes that can be expected to be mutually reinforcing.

The process of financial globalisation and the rapid integration of emerging markets into the world economy, as illustrated in Chart 6, can also be expected to foster the development of

European financial markets and, other things being equal, could support the international use of the euro.

The abovementioned arguments should not lead to the conclusion that the expected positive effects of a number of determinants of the euro's international role are likely to lead to a significant and abrupt increase in the euro's relative importance as an international currency. There are other determining factors, and the effects of some of them imply that changes in the international use of a currency are likely to be very gradual. Let me point to two such factors.

First, as historical experience suggests, inertia and the advantages of incumbency in various markets imply that change in the international role of a currency is likely to be very gradual. Network externalities favour the use of one currency for certain financial and real sector transactions. For example, the US dollar serves as a vehicle currency in foreign exchange markets, with most trades executed via the US dollar, even when neither of the two currencies exchanged is the US dollar, mainly due to the superior liquidity and thus lower costs involved in trading against the US dollar than for other currency pairs. Similarly, prices in international commodity markets are quoted in US dollars, ensuring transparency on a global scale and omitting costly pricing in two or more currencies.

Second, in the absence of a significant shock triggering an abrupt change in the international use of one currency, the sheer size of stocks relative to flows or turnover is likely to mean a gradual adjustment. Thus, changes in the currency composition in major market segments are likely to be gradual, because the respective stocks tend to be large, at least if we assume that such changes will occur only through a currency diversification of the respective flows. For example, the stock of global foreign exchange reserves at the end of 2007 amounted to USD 6.4 trillion. The respective average quarterly flow, i.e. additional reserve accumulation by central banks in 2007 was around USD 340 billion. Even if we assumed for illustrative purposes that from now on 50% of newly accumulated reserves would be invested in euro-denominated assets (which is unlikely to materialise in reality), the share of the euro in the stock of global foreign exchange reserves would rise only gradually, as illustrated in Chart 7. A similar hypothetical computation can be made for the international debt security market (see also Chart 7).

What role do macroeconomic and structural policies play in determining the euro's international potential and prospects? And, more specifically, what is the likely impact of the ECB's monetary policy and the performance of its other tasks on the attractiveness of the euro as an international currency? The position of the ECB on the international role of the euro has been clearly stated from the start. The ECB considers the global use of the euro as the outcome of a market-driven process that reflects all the factors influencing the demand by global market participants and non-euro area public authorities for the functions the euro performs. Therefore, the ECB takes a neutral stance and does not directly promote or hinder the international use of the euro. At the same time, the ECB may indirectly support the euro's international role by preserving price stability in the euro area and by performing other tasks that contribute to the integration, development and the safeguarding of the stability of the euro area's financial system. When international investors and savers choose the euro as their preferred international currency, they express their confidence in the ECB's ability to preserve the purchasing power of the single currency and in the ECB's credible commitment to maintain price stability.

The pursuit of sound fiscal policies by the euro area countries, and the implementation of reforms that enhance the growth potential and dynamism of the euro area economy, and foster the further integration and development of Europe's financial markets are also important for supporting the euro's international attractiveness and preserving confidence in its external value over the longer run. The EU's fiscal policy framework contributes to the conduct of sound budgetary policies that support the stability-oriented single monetary policy and help establish favourable conditions for sustained growth. International market

participants are aware of the importance of the effective functioning of the fiscal policy framework for the long-term stability and growth of the euro area's economy, which underpin the relative international attractiveness of its currency. Moreover, the implementation of structural reforms is essential to reduce the gap between the euro area and the United States with regard to productivity growth, the level of labour utilisation and the degree of financial development. In this way, the relative potential growth performance of the euro area economy will be strengthened. As the recent experience in European countries has demonstrated, reforms are paying off by contributing to significant employment growth and productivity gains, and there is growing acceptance by the public of such structural reforms.

IV. Concluding remarks

In conclusion, I would like to make two final points. First, the longer-term potential of the euro as an international currency will depend on the relative performance of the euro area economy and the euro's stability and credibility. The ECB is committed to preserving price stability and the prospects for enhanced efficiency and higher longer-term growth in the euro area are improving. The policies of the Federal Reserve System and the US economic authorities also aim at price stability and strong sustained growth. It is therefore difficult to assess the longer-term effects of economic policies and performances on the relative role of the euro and the US dollar as international currencies. Other determining factors will also play a role. The likely outcome is the coexistence of two strong international currencies in the longer run.

Second, a further expansion of the euro's international role and greater integration and development of the euro area's financial markets can be expected to positively contribute to global macroeconomic and financial stability, as a result of the impact of the euro area's stability-oriented monetary policy and increased international risk diversification. These observations highlight the importance of strengthening the cooperation between the Eurosystem and major central banks in the world.

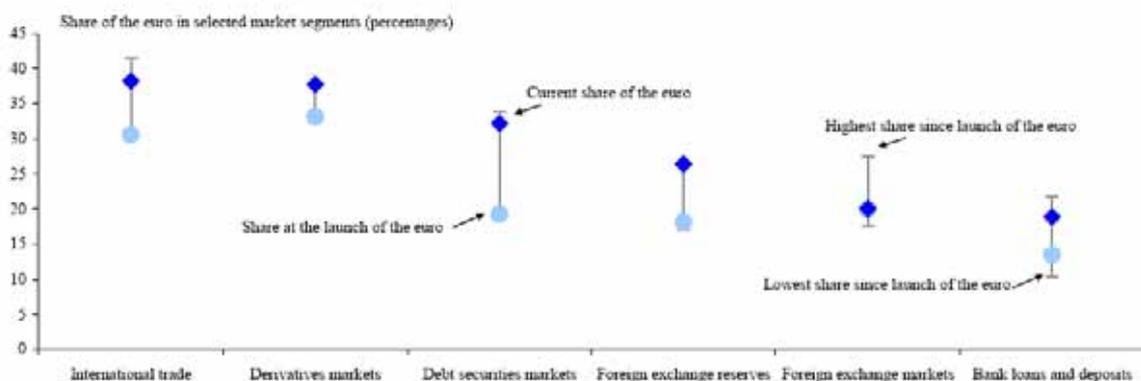
Thank you very much for your attention.

Outline

- Introduction
- The evolving international use of the euro
- The euro's current status as an international currency
- Key determinants of a currency's international role
- Prospects for the further internationalisation of the euro
- The ECB's position and the effects of policies

Chart 1: Share of the euro in selected markets

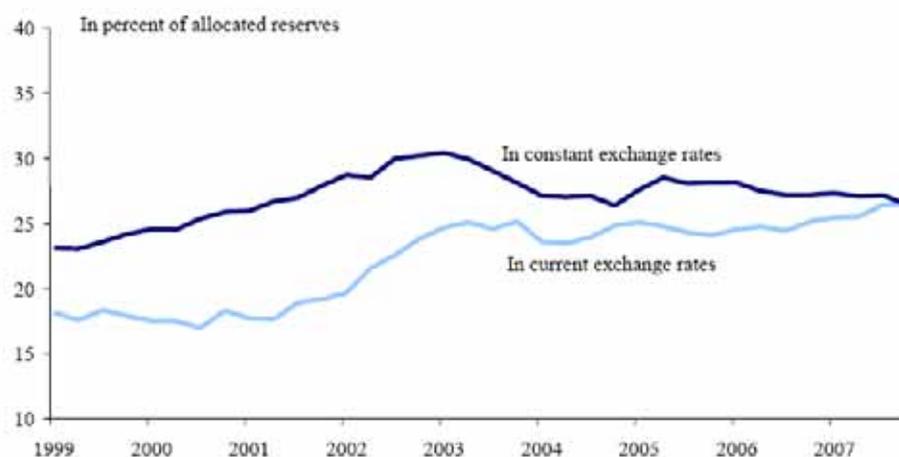
- Increase in the international use of the euro
- Consolidation of its role in many market segments



Sources: IMF, BIS, national sources and ECB calculations.

Notes: International trade: share of the euro in international trade invoicing and settlement; Derivatives: share of the euro in OTC interest rate derivatives; Foreign exchange reserves: share of the euro in global foreign exchange reserves (with disclosed currency composition at current exchange rates); Foreign exchange markets: share of the euro in CLS settlement, at current exchange rates.

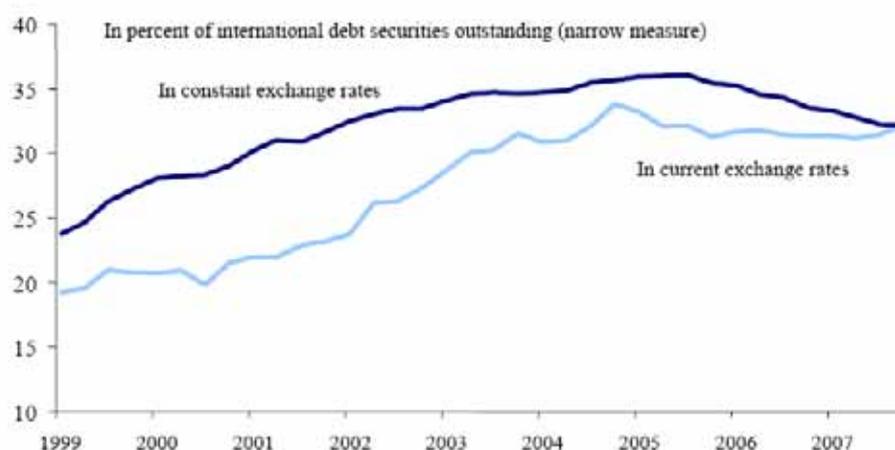
Chart 2: The share of the euro in global foreign exchange reserves



Sources: IMF and ECB calculations.

Notes: Constant exchange rate figures are expressed in exchange rates prevailing at the end of the last available observation. As a result, current and constant exchange rate figures are by construction the same for the last observation.

Chart 3: The share of the euro in international debt markets



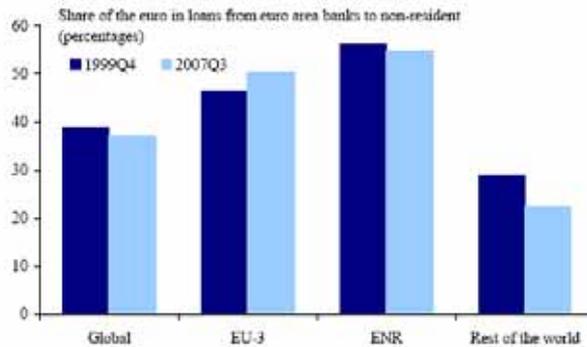
Sources: BIS and ECB calculations.

Notes: Constant exchange rate figures are expressed in exchange rates prevailing at the end of the last available observation. As a result, current and constant exchange rate figures are by construction the same for the last observation. The "narrow measure" of international debt excludes home currency issuance.

Chart 4: The regional dimension of the international use of the euro

Share of the euro in...

...cross-border loans

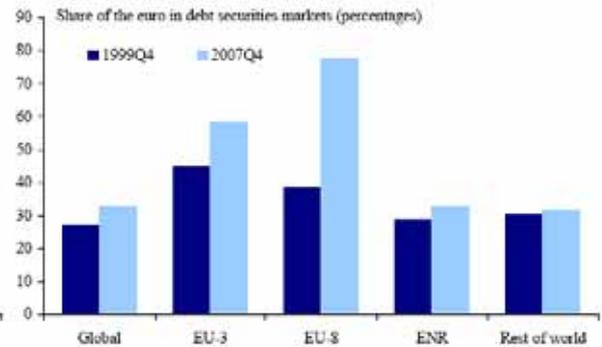


Sources: BIS and ECB calculations.

EU-3: UK, Denmark, Sweden

ENR: Other EU, other Europe, Africa, Middle East

... international debt securities

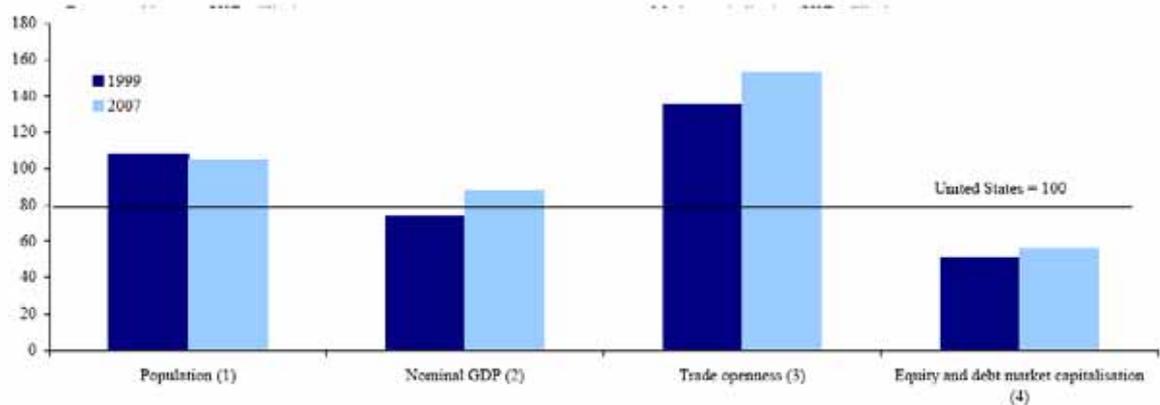


EU-3: UK, Denmark, Sweden

EU-8: Other non-euro area EU Member States

ENR: Other Europe, Africa, Middle East

Chart 5: The euro area in comparison with the United States



Sources: IMF, Eurostat, BIS and ECB calculations.

(1) measured in millions of citizens.

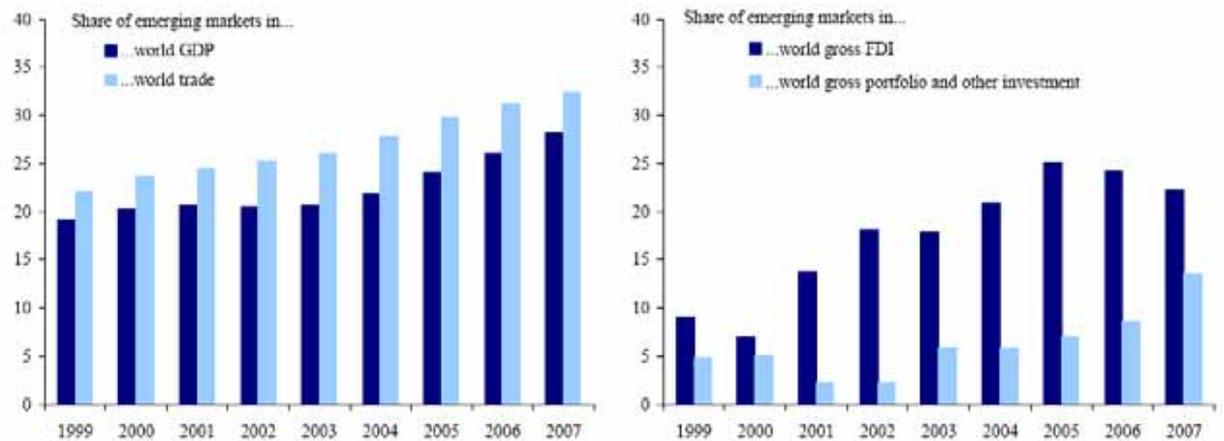
(2) measured in billions of dollars.

(3) measured as a percentage of GDP.

(4) measured as a percentage of GDP, latest data as of 2006.

Chart 6: Rapid change in international environment

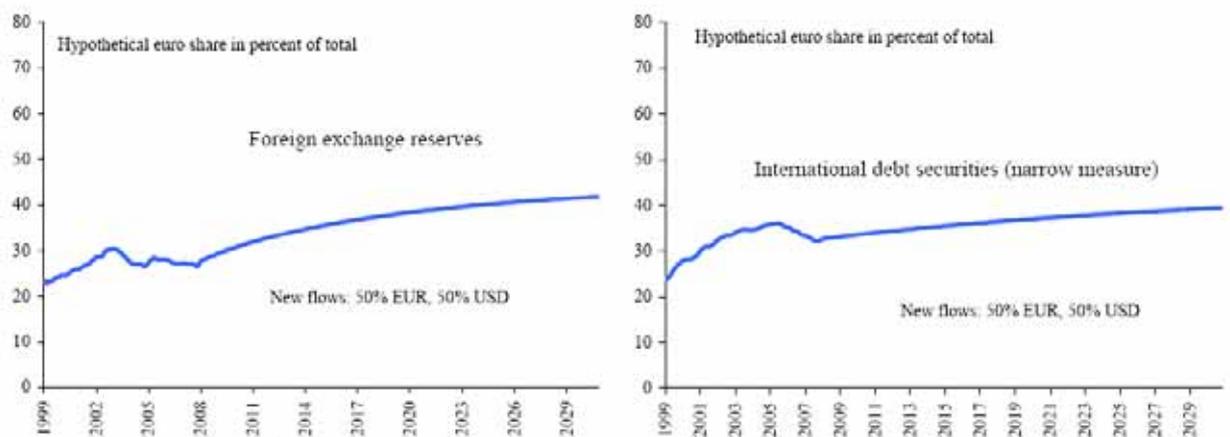
- Rising economic status of emerging markets
- Rapid integration of emerging markets into the world economy



Source: IMF.

Chart 7: Effects of the relationship between stocks and flows

- Stocks in many markets large (e.g. reserves USD 6.4 trillion)
- Gradual changes in currency composition of stocks likely



Sources: IMF, BIS and ECB calculations.