# Christian Noyer: Spheres of influence in the international monetary system

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Round-table 1 “Fragmentation Risk in Financial Services: A Retreat From Globalization?”, 21st Conference of Montreal, Montreal, 8 June 2015.

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For many casual observers, there is a close link between money and geopolitics. Historically, money is an attribute of the Sovereign. It can easily be seen as an instrument to project power and influence. There are numerous instances over the last two millennia where monetary power has been used to finance military expansion or, more simply, to assert and exercise government authority. I would not go as far as Michael Bordo and Angela Redish who state, in a recent paper, that “the chronology of monetary history is driven by warfare”; but there is some historical truth in their assertion.

Today, however, we live in a regime of fiat money with independent Central Banks in most advanced and emerging economies. Money is not supposed to serve any other purpose than help the economy to function and stabilize through its three main – technical – attributes: as a medium of exchange, a unit of account and a store of value. Yet, the language of geopolitics still permeates the discussion on the international monetary system. Eminent authorities, for instance, casually talk about “currency wars”. Similarly, many euro-sceptics characterize the euro as a pure “political” or geopolitical, project – clearly implying that it has no economic rationale. It will come as no surprise to you that I do not share this view. Obviously, the creation of the euro has been underpinned by a broad political vision and ambition. But there was – and still is – a strong economic rationale in solidifying economic and financial integration in Western Europe by the creation of a single currency. This economic rationale is clearly perceived by investors and market participants who have made the euro the second world currency for investing in financial assets and holding foreign exchange reserves.

This being said, history has also shown that the geography of the international monetary system may undergo fast and abrupt changes. Over decades and centuries, new currencies emerge and existing ones disappear as major vehicles for international trade and investment. Geopolitical changes may trigger such evolutions. But some endogenous dynamics are also at work. Past some stages, or “tipping points”, the use of a currency may expand or shrink quickly due to network and scale effects: the more people use a currency, the more attractive it becomes.

This begs the question of possible “spheres of influence” appearing in the future with significant evolutions in the respective role and weight of existing currencies. In my remarks, I will simply define such “spheres of influence” as parts of the world economic system where the use of a specific currency might dominate. With this strict definition in mind, I will make four main observations.

## An asymmetric world

First, the current world is highly asymmetric. Two major currencies – the US dollar and the Euro – account for most of the foreign exchange reserves. One of them, the dollar, clearly dominates in financial markets and payment systems. This asymmetry has many well-known and self-reinforcing consequences.

US monetary policy has significant effects well beyond the US economy. Those monetary spillovers may be especially important when unconventional monetary policies are implemented. They cast new doubts on the insulating properties of floating exchange rates.

They create new incentives, for many emerging economies, to manage their exchange rate and, for that purpose, accumulate dollar-denominated foreign exchange reserves. As a consequence, most, but not all, of the official liquidity provided through multilateral mechanisms is denominated in dollars.

### The rise of the euro

The major innovation of the last decade has been the rise of the euro. It offers some interesting insights and lessons. Most economic models and historical examples suggest that the appearance of new world currencies would trigger huge portfolio adjustments and create major turbulences. Economists also hypothesized that, in a multicurrency world, portfolio shifts would create permanent exchange rate instability. None of this has happened. In fact, the euro has neither stabilized nor disrupted the international monetary system. Exchange rates have moved significantly but, most of the time, in an orderly fashion and have followed low periodicity cycles. This may be, for the future, an interesting precedent: a new global currency can emerge without destabilizing the system.

It is also worth noticing that the euro crisis had no major effect on its international role. In particular, the share of foreign reserves invested in Euro securities has barely moved. And, when the Swiss authorities decided to peg their currency, they chose the euro as an anchor.

Does the euro have a “sphere of influence”? As you know, we have taken a very neutral stance on this issue and neither encouraged or discouraged the use of the euro as a reserve currency. In fact, the euro is increasingly used in international transactions and accepted for payments (including retail ones) in many countries – as European tourists can experience every day. Recently, the Eurozone seems to exert a stronger influence on global monetary conditions. For the first time in many decades, long-term rates in Europe have significantly

decoupled from those of the US. Also, there is some evidence of “reverse causality” with Euro long term rates increasingly impacting US rates, creating new channels for monetary spillovers and feedbacks. However, the euro is not yet widely used as a unit of account: most global transactions – especially in commodities – are denominated in dollar. A majority of new securities issuances are also denominated in dollars.

### New global currencies?

As the geography of the world economy changes, so will the shape of the international monetary system. Over the last two decades, China has grown into one of the two largest economies in the world. At the same time, authorities are constantly announcing new steps to increase the renminbi (RMB) convertibility and develop its use in international transactions. It is therefore natural to wonder whether the RMB will emerge as a major international currency in the foreseeable future. In line with my introductory remarks, I will refrain from any geopolitical speculation on this question and present a few technical – and personal – remarks on the nature of a global currency.

What does it take to become a reserve currency? It is generally assumed that this status brings important privileges, some of them “exorbitant”. It is also forgotten that it comes with significant obligations.

First, being a reserve asset means that the currency enjoys full and unconditional capital account convertibility towards both residents and non-residents. The economy is therefore fully integrated with global capital markets and fully exposed to external financial shocks. This creates a very demanding environment. Convertibility essentially means that you accept the judgment of “foreigners” as to the true value and purchasing power of your domestic currency. Although it is not often perceived as such, it entails some abandonment of sovereignty, through the loss of some independence in monetary policy. This is the famous “Mundell trilemma”: no country can simultaneously have a fixed exchange rate, full capital convertibility and monetary policy independence. Indeed, all reserve currencies today have fully flexible exchange rates.

The second condition may be even more stringent. Ultimately, what makes a reserve currency is the ability to serve unconditionally as a store of value. The country must therefore develop deep, liquid and unfettered financial markets. It also entails an ability to offer "benchmark" safe assets that keep their value in all circumstances, and may serve as vehicles for reserve accumulation. Typically, only government debt will be used as a reserve asset. So, being a reserve currency also means that "foreigners" will permanently hold a large part of Government debt and their judgment will ultimately prevail as to the true solvency of the Government.

Being a reserve currency therefore implies constraints as much as it brings benefits. That may be the reason why countries, including China, would proceed cautiously on the road towards full reserve currency status.

There is a distinction between being a reserve currency, on the one hand, and a global currency, on the other. The first concept refers to the currency as a store of value; the second may concern only its role as a medium of exchange. These are two different attributes. A currency may be widely used in transactions without being considered for reserve accumulation.

This distinction maybe relevant when looking at the composition of the special drawing rights (SDR). As you know, this is the "basket currency" that serves as a unit of account for the IMF and, to a limited extent, as medium of exchange between its member countries. The composition of the SDR is due for review at the next annual meeting of the Fund and experts are currently working on its preparation. This is a highly technical work. And so should be the decision. While the symbolism may be strong for some observers, the decision – whatever it is – should not be seen as politically inspired or motivated.

**Conclusion: a longer-term perspective**

Looking further into the future, will there be monetary "spheres of influence"? A lot will depend on whether the world will – or not – stay financially integrated.

Financial and regional fragmentation may lead to monetary fragmentation and some currencies being dominant in some parts of the world.

Another possibility is that financial integration will progress and the capital market becomes truly global. In that case, several major currencies could coexist with none having a dominant position in any part of the world or any segment of the financial system.

There are limits to the power of money to shape the international system. What matters is the depth, openness and interconnectedness of product and financial markets. Ultimately, the geopolitics of trade and finance will determine the future.