

Mr. Issing considers the future role of the euro in the international financial system Speech delivered by a member of the Directorate of the Deutsche Bundesbank, Professor Otmar Issing, at the conference of the Royal Institute of International Affairs in London on 24/10/97.

1. Momentous changes in the financial markets

The introduction of the euro is increasingly affecting expectations in the financial markets worldwide. We are little more than a year away from the start of the third stage of EMU on January 1, 1999, as laid down in the Maastricht Treaty; and in about six months' time the participating countries are to be selected.

From the viewpoint of financial market players, a multitude of questions arise: What will be the role of the euro as an international currency? How strong (or how weak) will the future European currency be? And what changes will there be in the business environment of market players owing to the advent of the euro?

Expecting reliable answers to these questions implies greatly overrating an economist's capabilities. Trustworthy forecasts at times of a change of regime -- and the monetary union in Europe undoubtedly constitutes such a change -- are, to say the least, extremely problematic, if not utterly impossible. Even so, the economist finds it appealing "to gaze into the future" and to ponder over possible patterns of development in terms of "informed guesses".

A conceivable starting point for such "brain-teasers" is the status quo: the role of the euro, as measured by the present position of potential EMU participants in the international financial markets and relative to the dollar.

But the analysis must not stop at that point. EMU will trigger changes in the financial markets which have to be taken into account in any dynamic survey. The single currency will eliminate market fragmentation in Europe in the important area of currencies, and will enhance the intensity of competition in the financial sector. That will have a major impact on the position of the euro.

But it is not only economic considerations that are of significance here, since the international role of a currency also depends crucially on political factors. It was not least political (i.e., foreign policy) considerations that prompted a fresh start in the direction of EMU in the late 1980s. The very aim of monetary union was to "*reduce dependency on the dollar*" and "*strengthen (the member states') scope for monetary policy action*".¹ A tripolar currency world is evidently what many people had (and some still have) in mind. The aim is for the euro to "*compete as an international vehicular currency with the dollar and the yen on an equal footing*".² The single currency will, it is claimed, finally give Europe its due weight in the concert of world powers. A rather cautious approach to the "key currency role", such as was still widespread in Germany in the seventies, is not discernible in Europe at the political level.

¹Genscher, H.D., (translated from) Memorandum für die Schaffung eines europäischen Währungsraumes und einer Europäischen Zentralbank: reprinted in Deutsche Bundesbank, Auszüge aus Presseartikeln (Press excerpts), No. 15, March 1, 1988, p. 6.

²EC Commission, One market, one money. An evaluation of the potential benefits and costs of forming an economic and monetary union. European Economy, No. 44, October 1990, p. 26.

2. The euro as an international currency

Claiming a prominent role for a currency, even before it comes into being, is one part -- the easier one. The other, unquestionably much more difficult part, is realising that claim. What role the euro will actually play in the concert of major currencies will be decided, first and foremost, in the international financial markets. It is only when the economic preconditions are right that investors will be prepared to hold assets denominated in euros, only then that cross-border transactions outside the EU will be settled in euros on a significant scale, and only then that the euro will become an international currency.

Expectations of the euro playing a major role in the international monetary system are chiefly predicated on the stability of the new currency. The euro must earn its position in the portfolios of public and private investors in competition with other currencies. That will hinge crucially on expected exchange rate movements relative to its major competitors -- above all, the US dollar. The key variables for exchange rate expectations are -- in the longer term -- anticipated inflation differentials, since a tendency for exchange rate movements to match purchasing power parity prevails in the long run.³

Those wishing to establish the euro as an international currency would therefore do well to make the maintenance of price stability their primary goal. The external trend of the euro is inseparably linked to the prerequisite of internal stability -- stability begins at home.

On the (often tacit) assumption that the anti-inflationary pre-conditions are met, widespread speculation is thriving at present about which market shares the euro might capture and whether there may be major portfolio shifts in the course of adjustment to the new conditions. Far-reaching conclusions are being drawn, in turn, as to the potential exchange rate trend of the euro. The starting point of these notions is the various functions performed by an international currency and the quantitative dimensions involved in the international financial markets.

Specifically, this concerns the role of the euro

- as a reserve currency
- as an investment currency
- as a transaction currency, and
- as an anchor currency for exchange rate arrangements

2.1 The euro as a reserve currency

World foreign currency reserves amounted to around US\$1,500 billion at the end of June 1997. The lion's share was accounted for by US dollar reserves (65%), followed at a considerable distance by reserves denominated in Deutsche Mark (13%). Smaller shares were also accounted for by the yen and the currencies of other EU member states.

³See Deutsche Bundesbank, "Overall determinants of the trends in the real external value of the Deutsche Mark", August 1995, pp. 17 - 37.

Upon entry into the third stage of monetary union (by 2002 at the latest), all assets that are still denominated in currencies participating in EMU will be converted into euro assets; that will apply, in principle, to central banks' asset holdings, too. From the point of view of the participating countries, "foreign currency reserves" denominated in these "in" currencies will become domestic euro assets.

Considered in isolation, the euro's potential as a reserve currency will therefore initially be lower than the market share of all "in" currencies taken together. Will third countries be able to fill that "gap"? For the "immediate neighbours" of the euro area, a major role will be played by the precise nature of the currency arrangement (i.e., EMS II). The more closely the exchange rate is pegged to the euro, and the greater the recourse to intervention is, the higher the demand for euro reserves is likely to be in the countries in question -- at least during the period up to their entry into EMU. From the present perspective, it is not possible to make a definite prediction as to whether other countries outside the monetary union will, in future, hold part of their reserves in euros. Portfolio-theoretical considerations argue, in principle, for a diversification of foreign exchange reserves. That would open up opportunities for the euro. Ultimately, the investment decisions of central banks will hinge chiefly on their assessment of the future European currency's stability.

The question of how the roles of the US dollar or the yen as reserve currencies will be affected by the euro's entry into the international financial markets is not all that easy to answer, either. On the one hand, shifts out of Deutsche Mark assets into US dollar assets are possible; that will apply -- as some anticipate -- to the introductory period in particular, when the euro's reputation still has to be established. On the other hand, the overall global demand for currency reserves might fall, because some of the EMS-related need for currency reserves will no longer exist, and because the degree of openness of those economies which are linked to one another by monetary integration will decline in purely arithmetical terms.⁴ That is because part of what was previously foreign trade -- already characterised separately as "intra-trade" in the single market -- will then durably become internal trade from the monetary point of view.

It is possible to conjecture that, for the group of participating countries, the "need" for currency reserves to cushion unforeseen events will not be as great as it is under the status quo of different currencies; this fall in demand is likely to affect the US dollar, in particular, primarily because the dollar has repeatedly played a major role in interventions in the EMS, too. It is not possible to state a priori what the ultimate outcome of these various effects will be on balance. In that respect, whether the other reserve currencies will benefit from the introduction of the euro, or not, must remain an open question. This applies all the more since a steeply rising share of global currency reserves is meanwhile being held by Asian central banks, which (at least up to now) have shown a preference for the US dollar.

2.2 The euro as an investment currency

Although the reserve holdings of monetary authorities are certainly a major factor, trends in the financial markets are determined to a much greater extent by the decisions of private investors. Currency reserves are accompanied by international bank loans which are

⁴At present, over 60 % of EU foreign trade is accounted for by cross-border transactions with other member states. Assuming that all member states will (sooner or later) enter the third stage of EMU, the share of foreign trade in GDP on an average of all EU countries will fall to around 10 %, and will thus correspond roughly to the ratio for the United States. But even if all the member states do not adopt the single currency immediately, the internal orientation in the euro economic area will be greater than it is at present in the EU.

(in net terms) more than three times as large and by international debt securities amounting to twice their size;⁵ on top of these, there are direct cross-border lending operations between non-banks that are not included in the above-mentioned international financial market data.

The US dollar is the dominant investment currency, too. The Deutsche Mark accounts for less than 15% of international financial assets. It is precisely in the international financial markets that a large number of other potential participating currencies in EMU, taken together, have a significant share, too. (The share of the pound sterling, for example, is about 5%.)

The structural changes in the international financial markets over the past 15 years, however, have been to the detriment of the US dollar, and have afforded the European currencies a rising market share. Theoretical considerations seem to suggest that this process might actually be reinforced by monetary union.

A crucial factor determining the widespread international use of a currency is the degree of sophistication and openness of its financial markets. Financial markets that guarantee a wide range of products, a broad maturity range and a high level of market liquidity exercise a magnetic attraction internationally. If cross-border capital transactions are free of restrictions, funds are attracted, on the one hand, and, on the other, the currency concerned becomes available for borrowing by non-residents, too. In short, the international use of that currency is fostered.

In that respect, the introduction of the euro is likely to have a further positive impact on capital markets within EMU. The currency-related segmentation of the markets will be eliminated, there will be a broader range of investment opportunities available, and the liquidity of the individual products will increase. Already, in the run-up to EMU, member states are gearing themselves to intensifying competition, and are “updating” both their financial markets and their financial instruments.

In terms of its total volume, the euro bond market will probably be the second largest after the US dollar bond market; if all the EU member states ultimately participate in EMU, bonds denominated in euros will amount to around 60% of the volume of the US market. Even if the third stage starts with only a limited number of participants, the increase in the financial market’s efficiency will be important in fostering the euro. This effect would be reinforced if the larger euro currency area succeeded in dissociating itself more than previously from developments in the United States.

On the other hand, the euro will face greater problems than the US dollar inasmuch as the euro will not have the backing of a centralised European government, and as it therefore still remains to be seen which securities will be able to perform a benchmark function in the euro bond market.

2.3 The euro as a transaction currency

An international payment medium’s function as a transaction currency plays a role in transactions in goods and in foreign exchange trading.

⁵See BIS, *International Banking and Financial Market Developments*, Basle, August 1997.

There are no up-to-date and reliable figures on the worldwide invoicing shares of individual currencies in foreign trade. Estimates (for 1992) assume that about one-half of aggregate global exports are settled in US dollars, just over 15% in Deutsche Mark and around 6% each in French francs and pounds sterling.⁶ These figures should be put into perspective, however, since they are influenced to a great extent by individual countries' respective shares in world trade; in general, every country has a comparatively large invoicing share of its own exports in domestic currency. If the figures are adjusted to allow for that effect, only the US dollar and the Deutsche Mark can be classed as "international invoicing currencies".

Since, as explained above, a considerable part of what is now foreign trade will become internal trade in the euro area under EMU, the euro is likely, if anything, to account for smaller market shares in "genuine foreign trade" in the first few years than the participating currencies do at present. In the longer term, however, it is quite possible to foresee the euro assuming growing importance, since it will be backed by a large economic area -- particularly as it is precisely in the case of invoicing currencies that market size is obviously a major factor.⁷

The economic advantages of invoicing in one's own currency should not be overrated, however. Given short-term exchange rate fluctuations, it may be an advantage to settle in one's own currency than in a foreign one. In the medium to long term, however, any exchange risks are to be borne by the counterparties, irrespective of the invoicing currency, in line with market conditions.

Transaction currencies are often referred to in connection with their use in international foreign exchange trading. In order to facilitate bilateral transactions between different currencies in narrow markets, "vehicle currencies" have developed, through which foreign exchange market transactions are settled.

After the US dollar, the Deutsche Mark is the most frequently employed currency in the foreign exchange markets -- in particular, as a vehicle in transactions between European currencies.⁸ How important the euro is in foreign exchange trading will hinge crucially on its market shares as an investment and reserve currency, as well as on its role as a potential anchor currency in Europe. If it does establish itself in those areas, it certainly has the potential to go on to become a major transaction currency in foreign exchange trading, albeit without being able to deprive the US dollar of significant market shares in the short term. Under those conditions, it is likewise predestined to become a vehicle currency for transactions in other European currencies. It is also clear, however, that a major segment of European foreign exchange trading will cease to exist as a result of the merging of currencies.

2.4 The euro as an anchor currency

The last function of the euro which is to be scrutinised -- and to which I have already referred -- is that of being an anchor in the international monetary system. There is no longer merely speculation to rely on in that area, as some of the broad outlines are already taking shape. An exchange rate arrangement with the euro at its centre is envisaged for those EU countries which are not going to participate in the single currency from the outset. Above and

⁶See ECU Institute (ed.), *International Currency Competition and the Future Role of the Single European Currency*, London 1995, p. 70.

⁷The EU is larger than the United States in terms of its population, and more or less on an equal footing in terms of GDP and foreign trade.

⁸See BIS, *Central Bank Survey of Foreign Exchange and Derivative Market Activity*, Basle, May 1996.

beyond that, orientation to the euro is to be expected, above all, in the countries of central and eastern Europe, either in the form of unilateral pegging exclusively to the euro or by gearing exchange rate policy to a basket of currencies in which the euro has a heavy weighting. The euro will be highly attractive to potential candidates for accession to monetary union, in particular.

3. Some reflections on the external value of the Euro

The introduction of the euro represents a radical change in the international monetary system. It will call into question positions in world financial markets which have developed over a period of decades; the conditions which obtain at present in global financial markets can serve, at most, as rough guidelines for the moment of conversion to euros. Which direction future trends will take -- and this is an important implication of the preceding section -- cannot be readily predicted in every case, as different forces are at work.

That applies to monetary reserves and to private financial assets alike. And it also applies to the external value of the euro. The analysis has shown that, especially in the initial stages, the euro will have to build up a reputation of being a trustworthy currency. This is occasionally interpreted as implying that a weakness of the euro is to be expected initially. Diametrically opposed to this hypothesis are the forecasts which prophesy a considerable appreciation potential for the euro on account of expected massive shifts in international portfolios owing to the increasing efficiency of the financial markets in Europe and possible diversification advantages, with interest rates being only weakly correlated with other currencies.

Both these arguments seem to me to fall short of the truth. Certainly, a high degree of uncertainty can be expected in the early stages of EMU. However, the ECB, given its independence and single-minded commitment to the objective of price stability, deserves a measure of confidence in advance. That applies all the more as -- viewed from the present vantage point -- the starting conditions for EMU, with low inflation rates in virtually all potential participating countries, are decidedly favourable. Risks to the euro are to be seen, rather, in the general political environment, where in some quarters -- with an eye on the high level of unemployment in Europe -- talk of a weak euro is widespread. However, (verbal) exchange rate manipulations will serve neither to solve the serious employment problems nor to establish the euro as an internationally respected currency.

The high level of unemployment in Europe is largely structural and can only be overcome by energetic, far-reaching reforms -- for which responsibility lies more or less entirely at the national level. The hope that EMU will make a lasting contribution to reducing unemployment should rest on the expectation of low interest rates and a high level of investment. These, in turn, depend crucially on investors' confidence in the long-term stability of the euro. The misuse of the currency for employment (or trade) policy purposes would not only jeopardise price stability in the euro area, it might also provoke retaliation from other countries. This, after all, would be of no use to anybody.

Some commentators are inferring from an expected substitution of euro for dollar-denominated assets that the single currency will have a substantial appreciation potential. Such thinking is predicated on a portfolio structure that is in line with other macroeconomic benchmarks, such as the ratio to GDP or the share of the euro area in world trade. In my view, these rather mechanistic approaches take too little account of the supply side in the financial markets. The broader and deeper European financial market will not only attract investment capital, it will also result in enhanced cross-border borrowing in euros, which, in itself, tends to

dampen rates.⁹ Which effect will prevail in the end, and what the consequent time profile will be for the movement of the euro rate relative to other currencies, can hardly be forecast reliably *a priori*. In the long run -- as already stated -- relative inflation differentials will largely determine the nominal euro rate.

4. Concluding remarks

The statute of the ECB -- above all, central bank independence and the priority given to the objective of price stability -- establishes crucial prerequisites for a stable euro at the institutional level. It is now up to those responsible to fill this monetary constitution with life, to implement its targets in the real world. Especially in the difficult start-up phase, it will be important to appoint the right people -- people who are regarded in the public eye, and particularly in the financial markets, as guarantors of a stability-oriented monetary policy. Any lack of confidence in the management of the ECB would be reflected in corresponding risk premiums on interest rates, and hence might cost the participants in EMU dear.

Thus we come full circle: the political objective of establishing the euro as an international currency will be attained only if the market accepts the newcomer. Investors, for their part, will prefer a strong euro, which presupposes stability within EMU. That is a challenge to the ECB, but the other economic policy players, especially the fiscal policy makers, must likewise do their bit to (continue to) keep inflationary risks as low as possible.

⁹For a critical discussion see also McCauley, P.N., White, W.R., "The Euro and European Financial Markets", BIS Working Papers No. 41, Basle, May 1997, pp. 18 - 20.