The euro as a catalyst for global financial market deepening

Speech by Malcolm D Knight at the Brussels Economic Forum 2008 on Economic and Monetary Union in Europe: 10 Years On

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1. Introduction

Ladies and gentlemen

It gives me great pleasure to address this distinguished group in the run-up to the 10th anniversary of European monetary union. Looking back on the past decade, we can certainly conclude that the realisation of monetary union has been a truly impressive achievement. It is difficult to imagine today the multitude of obstacles to monetary and financial union that existed when Europe first ventured down this road back in the 1950s. Those obstacles were gradually but surely removed, to the benefit of European economies and, indeed, the world. Along the way, the Bank for International Settlements sought to support this process, in particular as agent for the European Payments Union, which achieved convertibility of western European currencies for current account transactions by the late 1950s; as secretariat for the Committee of Governors of the Central Banks of the Member States of the European Economic Community from 1964 to 1993; and as home to the European Monetary Institute, precursor of the European Central Bank, until its move to Frankfurt in 1994. And, needless to say, the BIS has, since then, continued to support the present work of the ECB, and of the national central banks of the Eurosystem, and indeed also of the other national central banks in the European Union and around the world. We do this by pursuing the core mission of the BIS: promoting international monetary and financial cooperation, and hosting the secretariats of a number of international groupings – such as the Financial Stability Forum and the Basel Committee on Banking Supervision – that monitor financial markets and develop norms and standards of financial stability.

What has been the impact of the euro on financial markets within the euro area? First, the process of European financial integration was given tremendous impetus by the launch of the euro at the beginning of 1999. As I will discuss in a minute, one of the great successes of euro area monetary union over the past decade has been the development of deep and liquid European financial markets. This achievement, in turn, has supported the stability and allocative efficiency of the euro area financial system. Second, looking more broadly at the global financial system, the emergence of the euro – the currency of a region that is one of the largest economies in the world – can be characterised by three main features: the international use of the euro; its contribution to a multipolar global financial system; and the growing need for

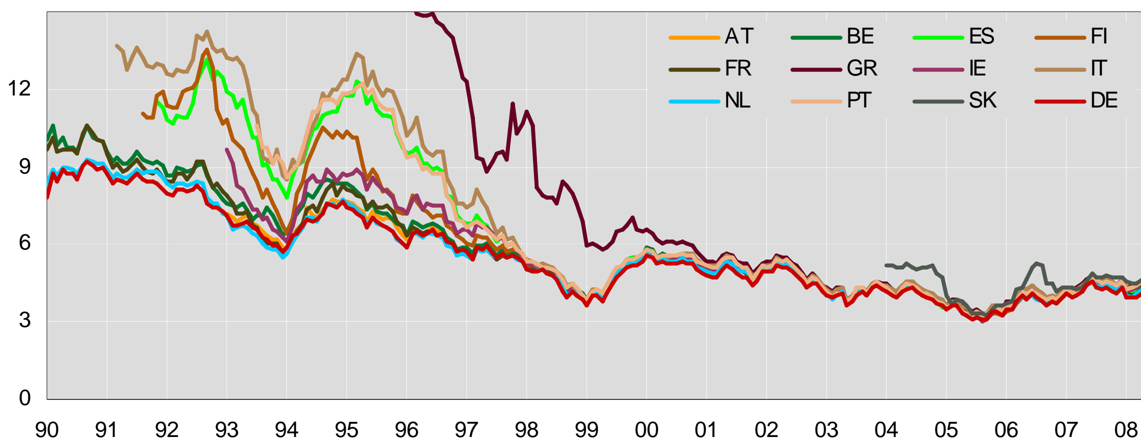
cooperation among currency zones, as highlighted by the recent financial market turmoil.

2. Deepening of euro area financial markets

The introduction of the single currency in 1999, backed by the ECB with its clear monetary policy mandate and underpinned by firm fiscal rules, greatly accelerated financial integration in Europe.

Graph 1

Government yields for euro area countries
10-year bond yields at month-end, in per cent



Source: National data.

It allowed the elimination of intra-euro area exchange rate risk, as can be seen in Graph 1, which shows the convergence of government bond yields in the currencies that were to form the euro area in the run-up to monetary union at the beginning of 1999. Even more interestingly, the graph also shows that the ECB was able to credibly anchor inflation expectations at a low and stable level from the start, so that euro area government bond yields converged to the low level prevailing in Germany, the member country that had achieved the best inflation performance among the prospective member countries prior to full monetary union. Furthermore, the willingness of European countries to commit themselves to financial and monetary stability, and, in parallel, to deepen the integrated European Union markets for goods, services, capital and labour, has greatly contributed to strengthening the status and credibility of the single currency.

Now let me focus more specifically on euro area financial markets. The launch of the euro created the second largest financial system in the world out of what had previously been a disparate group of national financial markets. Superficially, this was achieved overnight when contracts were redenominated in euros. But more meaningfully, the process of creating an integrated financial market was more complex and drawn out. Some financial market segments were quick to integrate, in particular those that are important for the implementation of monetary policy. For

example, a deep euro area-wide interbank market developed rapidly. So too did markets for government and corporate bonds. Other segments of the euro area financial system, such as retail banking and equity markets, were slower to integrate because of the persistence of legal, institutional and regulatory differences across member countries. But integrated they have nonetheless become, and there have been, in particular, notable signs of ongoing consolidation in the European banking system that should yield important efficiency gains in the long run. In a nutshell, in terms of their depth and breadth, many segments of euro financial markets are now comparable to their counterparts in US dollar markets.

Significantly, these euro financial markets have developed in innovative ways that are adapted to the structural characteristics of the euro area financial system. The use of interest rate swaps as pricing benchmarks was well established in Europe before it gained acceptance in other markets. The development of credit default swap markets advanced as rapidly in the euro market as in the US dollar market, even though the United States has a much larger corporate bond market and a longer history of trading credit risk. And, of course, Europe introduced Pfandbriefe, or covered bonds, to the world. These innovations were influenced by features of the euro area financial system that set it apart from the US system, including the relatively larger role of banks in the euro area, relative to institutional investors.

3. The international use of the euro

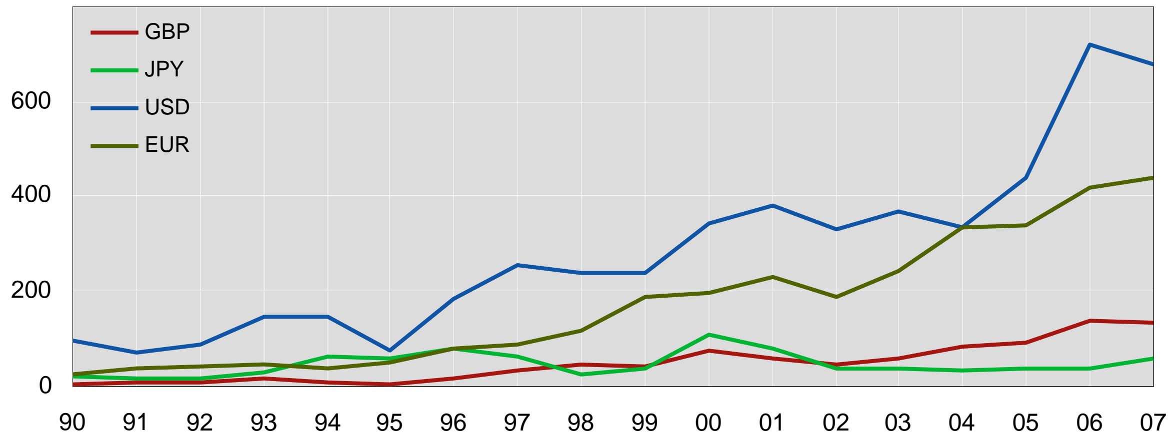
The deepening of euro financial markets has been accompanied by a larger role for the euro in financial markets outside the euro area. It is perhaps not surprising that this international use of the euro has grown beyond that of the Deutsche mark and other euro legacy currencies. Although the US dollar remains pre-eminent, the euro is the closest alternative to the dollar in terms of the functions it performs in international markets as a vehicle currency for international trade and financial transactions and as an international currency for holding official reserves. For example:

- Over the past decade or so, euro issuance by foreign borrowers has broadly kept pace with US dollar issuance in the international bond market, despite sizeable variations from one year to another. As can be seen in Graph 2, foreign issuance in euros is much greater than foreign issuance in any currency other than the dollar.
- According to the latest BIS Triennial Central Bank Survey of foreign exchange market activity, the euro was on one side of 37% of all foreign exchange transactions in 2007. This was below the US dollar's 86% share, but well above the share of the third most traded currency, the yen at 17%.[1]

[1] See BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 2007.

Graph 2

New international bond issues
Gross issuance of foreign currency bonds, in billions of euros[1]



[1] Issuance by non-residents of the currency's country of issue; excludes offshore issues in domestic currency by residents of the currency's country of issue but includes issues by offshore subsidiaries of residents.

Sources: Dealogic; Euroclear; ICMA; Thomson Financial; BIS.

- The euro's importance as a reserve currency seems, at first glance, to be no greater than that which the Deutsche mark enjoyed prior to 1999 (Graph 3). Although we do not have precise and timely data, the share of official reserves held in euros at the end of 2007, 27%, was about the same as that held in euro legacy currencies in the mid-1990s. This is consistent with the broader pattern of stability observed in the currency allocation of central bank reserves. For instance, these recent data are not dissimilar from those presented in the Princeton Essay that H Robert Heller and I published 30 years ago, containing the first comprehensive analysis of the data on the currency composition of central bank foreign exchange reserves.[2] Nevertheless, in my view, the current share of the euro in global official foreign exchange reserves is a remarkable development for a currency that was born only 10 years ago.
- Moreover, the euro's share in official forex reserves would probably be larger today were it not for the official net purchases of dollars by a number of countries in recent years to slow down the appreciation of their exchange rates against the US dollar.[3] As a result of these efforts, a relatively large portion of the rapid accumulation of official reserves in recent years has been in US dollars. Presumably, this large official accumulation of US dollars is at

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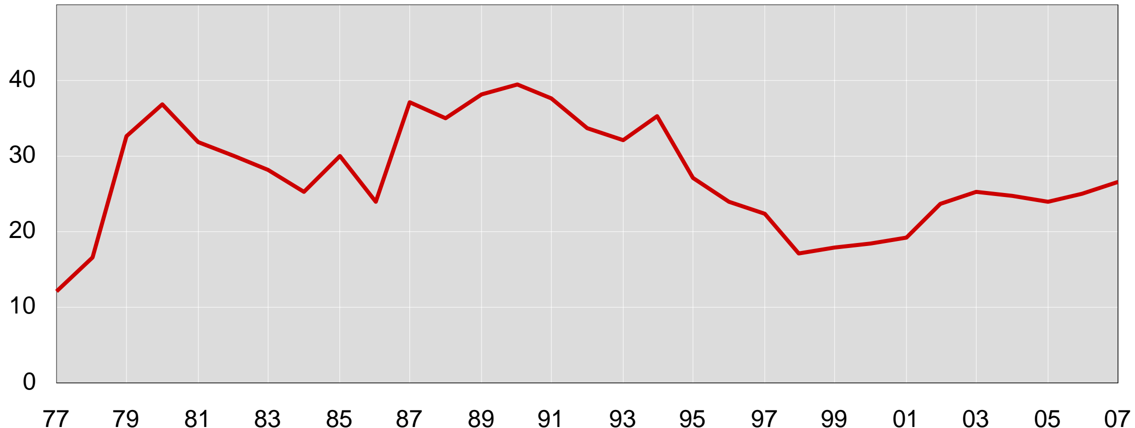
[2] H Robert Heller and Malcolm D Knight, "Reserve currency preferences of central banks", *Princeton Essays in International Finance*, no 131, December 1978.

[3] On the broader issue of international reserve composition, see "International reserve diversification and disclosure", speech given by Malcolm Knight, Swiss National Bank/Institute for International Economics Conference, 8 September 2006.

least partly the mirror image of weaker growth in the private sector's demand to hold US dollar-denominated assets. If this conjecture is correct, then a shift may have been taking place among private investors towards greater international diversification, away from the dollar and towards the euro.

Graph 3

Euro's share of foreign exchange reserves
As a percentage of allocated global reserves, at year-end[1]



[1] Valued at current exchange rates; prior to 1999, collective share of Deutsche mark, Dutch guilder, ECU and French franc; excludes several large (unidentified) holders of reserves; not adjusted for breaks in series in 1979, 1995 and 1999.

Source: IMF.

4. Single versus multiple international currencies in the global financial system

As I have just mentioned, the single currency of the euro area has clearly been a catalyst for the deepening of euro financial markets. It has also gained greater acceptance in global financial markets. The growing international use of the euro has much to do with its credibility, and with the valuable efforts of European policymakers. But to what extent has the euro contributed to the stability of financial markets globally? In considering this question, it is useful to step back and look at the forces that give rise to a global financial system that uses more than one key international currency.

In international, as in domestic, markets, there is a definite cost advantage to transacting in a single currency. The source of this advantage is twofold. First, the provision of liquidity is subject to economies of scale; therefore, average transaction costs tend to be lower in larger markets. This does favour a currency monopoly, with the choice of the vehicle currency for international transactions depending on such factors as economic size, trade openness and financial market size and liquidity in the respective countries. The use of a single vehicle currency reduces the costs of cross-border trade in goods and services as well as financial assets. Second, and perhaps more importantly, there is the key role played by network externalities. The willingness of a large number of participants to transact in a given market makes it

more attractive for other participants to do the same, and a self-reinforcing process ensues in which liquid markets become still more liquid.

However, the lower transaction costs associated with the use of a single vehicle currency may be offset by other factors. Foremost among these is uncertainty about future exchange rates. The willingness to use a given national currency as an international currency also depends critically on macroeconomic developments. If exchange rates are not fully flexible, then liquidity in the main international currency tends to increase most strongly when the country that issues it is running an overall balance of payments deficit. While this configuration may initially foster increased use of the main international currency, such a deficit may at some point undermine market participants' confidence in its international value. This tension tends to lead private investors to diversify their portfolios away from a single international currency towards holdings of a multiplicity of currencies.

One benefit of an international financial system that uses more than one key currency to transact and hold financial assets is that it can reduce the incidence of currency crises by providing alternative monetary anchors for those countries that choose to peg their exchange rates. Indeed, several emerging market financial crises have reflected the risks of pegging the exchange rate to an international currency when this was not fully consistent with the country's "fundamentals", in particular its trade pattern. For example, countries with deep trade and financial links to the euro area are likely to find a peg to the euro more sustainable than one to the US dollar. This is particularly true for countries that experience the same sorts of economic shocks as those that impact on the euro area. Many emerging countries may prefer to establish a peg to a basket of currencies for similar reasons. Consequently, over time they are likely to increase the weight of the euro in their monetary regime. And as a further consequence, such countries may also align the currency composition of their foreign exchange reserves with their trade shares in order to better stabilise the value of their reserve portfolio in terms of their international trade basket.

A second way in which a multiplicity of international currencies could improve the resilience of the international financial system is by providing alternative means of undertaking international financial transactions if there are disturbances in US dollar financial markets, because there is less risk of financial markets in different currency zones seizing up simultaneously. The availability of a diversity of international financing and investment channels can therefore lessen the global impact of idiosyncratic shocks in any one financial market. Indeed, the current financial market turmoil may itself suggest some advantages that a multipolar international financial system offers. When the global financial turmoil broke out in August 2007, euro financial markets were disrupted along with US dollar markets even though the initial shock originated in US markets. But the dislocation experienced in the international financial system – and also within the European financial markets – would probably have been even more severe if not for the existence of the euro. Thanks to their size, sophistication and growing internationalisation, euro financial markets were able to absorb part of the shock originating in the US subprime mortgage sector and closely related dollar credit markets.

To summarise, there is a clear trade-off between the gains of having a single international currency and the benefits of a multiplicity of international currencies. The actual outcome depends on whether market participants believe that the benefits of a multipolar system exceed the costs of a fragmentation of liquidity. We cannot

know for sure how the present system will evolve, since an international currency emerges endogenously from the trading and investment decisions of market participants.

5. The euro and a multipolar international financial system: lessons from the current turmoil

In conclusion, let me repeat that I believe that an open, market-based global financial system like the one we have today creates incentives for holding and transacting more than one international currency. Moreover, if a truly multipolar international financial system does emerge, then there are reasons to think that it will be robust to shocks. A key reason is that the existence of more than one key international currency, and the associated prospect of diversification away from an established vehicle currency, should strengthen both market discipline and the incentive for national authorities to commit to implementing macroeconomic policies that are seen by market participants as being credible and sustainable over the long term. This contributes to the stability of the international financial system.

But there are also at least three major policy challenges posed by a multipolar system. One challenge is the pursuit of internationally consistent macroeconomic policies. In today's open, market-based global financial system, macroeconomic imbalances in one country can lead to distortions in other countries' economies, greater volatility in foreign exchange and asset markets, and incentives for official intervention in foreign exchange markets. The implementation of macroeconomic policies that take into account potential cross-border economic and financial spillovers mitigates this risk and makes the international financial system less vulnerable to swings in confidence.

A second key policy challenge is greater coordination of financial regulation and supervision across financial institutions, markets and national borders. The need for such coordination obviously results from the various cross-border linkages that derive from the existence of a number of different international currencies and the fact that many financial institutions now act globally. The recent report of the Financial Stability Forum's Working Group on Enhancing Market Functioning and Resilience, of which I was a member and which presented its conclusions to the G7 finance ministers and central bank Governors in Washington in April, identified this as one of several areas where major improvements are needed to strengthen the stability of the global financial system.

And the third challenge is that central banks can no longer focus on liquidity conditions in markets for domestic currency alone, because liquidity problems in foreign currency markets can spill over to domestic financial markets. For example, it was recognised early on in the current turmoil that European commercial banks tended to be structurally short of US dollars, especially before the opening of US markets. Hence even the provision of liquidity to the domestic financial system now requires greater international coordination. Indeed, the effectiveness of the coordinated actions of the ECB, the US Federal Reserve and several other central banks in December, March and April to stabilise money markets was undoubtedly greater than the actions of a single central bank would have been.

As the achievements of 10 years of European monetary union attest, the whole is sometimes greater than the sum of its parts.

Thank you.