The role of Euro in the International Monetary System

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The introduction of the euro at the beginning of 1999 promised to mark a turning point in the international monetary system. It is often compared with the transformation of the international monetary system in the early 1970s from the system of fixed exchange rates endorsed at the Bretton Woods conference to the regime of managed flexible exchange rates. But in fact its significance is deeper. Dollar was the dominant currency. The introduction of the euro, on the other hand, challenged the status of the dollar and alter the power configuration of the system. For this reason the introduction of the euro is the most important development in the international monetary system since the dollar replaced the pound sterling as the dominant international currency. The introduction of the euro is undoubtedly the most profound change in the international monetary system since the collapse of the Bretton Woods system in 1973. It is therefore understandable that a great deal of interest is being shown in the prospective role of the euro as an international currency . It have taken some time for traders, investors, analysts and other financial market agents to become accustomed to a new currency and decide on the weight which they will assign to it for various purposes.

1. Factors determining the international role of the Euro

The creation of the euro was a major change to the International Monetary System, for at least three reasons (Eiteman D. et.al.1998, 31): First, the euro is the currency of a large economic zone and acquires some of the fundamental attributes which characterizes an international currency. Secondly, the monetary policy of EMU members involve a major institutional shift which affects the behavior of the trans-Atlantic exchange rate. Finally, the emergence of the euro as an international currency, together with institutional changes and with the strong commitment of the European Central Bank (ECB) to maintain stable prices, should lead to a shift in the practice of international cooperation. These shifts may have three implications for the euro:

- *The euro became as an international currency*. International status of US dollar has declined since 1973, especially as a store of value. But the euro became an important challenger. Having an international currency has advantages for economic agents, but may sometimes complicate monetary policy. For example, one aspect is that the currency is circulating to a much greater extent outside the own-currency area. This makes monetary aggregates harder to interpret and control. Such holdings may aggravate any distortions to the relationship between money and economic variables that could result from the "structural break" that Monetary Union may represent. Furthermore, there has been some debate as to whether the euro could initially be vulnerable to transitional problems owing to portfolio shifts. Certainly, it cannot be totally ruled out that large movements in the value of the dollar may have undesirable effects on the domestic situation of the euro area, at a time when the ESCB would be in the process of establishing its credibility.

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- *The external value of the euro differs from the average value of previous European currencies.*
- *The international policy co-ordination is also affected*. International policy co-ordination has not been very successful in the past.

The decline of the dollar as an international currency is already taking place, leaving some room for the euro. However, the extent of this decline varies across the various functions of an international currency. In practice, the international importance of a currency is mainly determined by three distinct factors:

- the size of the economy backing the currency;
- the economic policies of the country (or countries) where the currency is issued; and
- the efficiency and competitiveness of the financial markets in which instruments denominated in the currency are traded.

Turning first to the size of the euro area economy, it may be of interest to make a brief comparison between the size of the euro area and that of the United States: the population of the euro area (292 million) is slightly larger than that of the United States (270 million), while the GDP of the euro area (EUR 5,800 billion) is somewhat smaller than the GDP of the United States (EUR 7,600 billion). The euro area is, however, a more open economy than the United States in the sense that foreign trade (exports and imports) amounts to 25% of GDP, while in the United States the corresponding figure is just below 20%. Altogether, the size of the euro area, regardless of which measure is applied, is comparable with that of the US economy. The large size of the euro area would suggest that the euro should, from the outset, assume the role of one of the world's leading currencies (Eiteman D, et.al.1998, 39).

However, outside the euro area, capital markets in euro have developed mainly in London where they represent a major share of turnover, but not in other financial centers, such as New York, Tokyo, Singapore or Hong Kong. Non euro area issuers have targeted global investors when issuing securities in the US dollar. The euro circulate as a parallel currency in central and south eastern Europe and around the Mediterranean. This regional role is in line with so called gravity models, which use geography as an explanatory factor in economic developments. It is also necessary for euro area economic policies to be perceived as ensuring stability and credibility

2. The role of the euro in the spot and forward foreign exchange markets

Turning to the role of the euro in different segments of the international financial markets, I should first like to say a few words about the spot and forward foreign exchange markets. In these markets, the US dollar has been the most important currency since it overtook the pound sterling in the 1930s. It is estimated that in 1997 the dollar was involved in 84% of all foreign exchange transactions. This compares with 55% for the currencies which were replaced by the euro and 24% for the Japanese yen (Eiteman D.et.al. 1998, 91).

The introduction of the euro immediately produced major changes in the functioning of foreign exchange markets. The disappearance of 11 national currencies and the introduction of the euro as a major international currency had an impact, in itself, on the turnover and focus of attention in the global foreign exchange markets. Euro/dollar trading has, from the start, established itself as the most active and liquid segment of the foreign exchange market. By contrast, the development of euro/yen trading has so far been surprisingly slow.

The role of the euro in the foreign exchange markets must be seen against the background of the exchange rate policy of the Euro system. By contrast with most of the currencies which it replaced, the euro is a freely floating currency. In the absence of any policy co-ordination between the three main currency blocs, the euro exchange rate reflected the outcome of all relevant economic policies rather than being an objective in itself. Of course, the ECB will monitor exchange rate developments as part of its overall assessment of a broad range of economic and financial indicators which are relevant for inflation developments.

3. The role of the euro as an investment currency

How important the euro became, though, as an investment currency in the global money and capital markets№First, the US dollar was the predominant international investment currency. In 1997 the share of dollar-denominated instruments of the bonds outstanding in the international bond markets amounted to 46%, followed by Japanese yen-denominated debt (11%) and debt denominated in Deutsche Mark (10%). All the euro area currencies together accounted for approximately 24% of the international bond market.

Several arguments seem to indicate that the euro became a more attractive currency for bond issuers than all the currencies which it replaced taken together. In fact, the euro was the most popular currency for bonds issued in the international markets in the first month after its introduction, accounting for approximately 55% of the volume of new bond issues, compared with 40% for the US dollar. However, the high figures for euro-denominated bond issuance in January 1999 may, to a certain extent, reflect a particularly high level of initial interest in euro-denominated instruments during the new currency's first month of existence. We may therefore experience a drop in the euros market share of new bond issues from the high level experienced last month.

As I mentioned in my introduction, a key element in determining the longer-term attractiveness of the euro as an investment currency is the emergence of efficient, large and integrated financial markets in the euro area. The introduction of the euro removed currency risk, increase cross-border competition and provide an incentive for the harmonization of market practices, thereby generally reducing transaction costs. The conditions for financial market integration in the euro area seem to be best at the short end of the yield curve. In fact, the conduct of a single monetary policy by the Euro system gave market agents an incentive to start large-scale cross-border trade right from the outset, thereby creating an almost fully integrated money market in the euro area. The integration of the previous national money markets was made possible thanks to the target system, which connects the national real-time gross settlement systems in the euro area. It thereby facilitates banks' cross-border dealing and accessing of funds in euro. The existence of an integrated money market implies that arbitrage should eliminate any cross-border differences in interest rates. At the longer end of the yield curve, cross-border integration is likely to take more time. Before the introduction of the euro, European bond markets were highly segmented. Traditionally, this segmentation was a result partly of different currency denominations and partly of other market-specific conditions, such as differences in national regulations, tax regimes, practices and market conventions. The introduction of the euro did remove the foreign currency risks and has been accompanied by an increased harmonization of market conventions. As a consequence, the substitutability between bonds traded in different national markets improved. In fact, the trading of euro area government bonds can already be considered to be largely integrated (Bodie Z.et.al.1996, 44).

However, the markets for private bonds, and in particular for mortgage bonds, are still highly segmented owing to the differing institutional and regulatory frameworks across Member States. Nevertheless, the tendency towards increased cross-border competition and lower transaction costs in the national markets may also provide an incentive for increased issuance volumes of private bonds. We experienced a virtuous circle in which the increased issuance of bonds denominated in euro drew the attention of international investors to euro-denominated assets, thereby making the euro an increasingly attractive currency for private as well as public bond issuers.

In this context, it is interesting to compare the current sizes of the bond markets in the euro area and the United States. The market value of the bonds issued in the United States (USD 10,700 billion) is currently twice as large as in the euro area (USD 5,300 billion). While the market value of government bonds is of a comparable magnitude in the United States and the euro area, there are large differences in the markets for corporate bonds. The market value of corporate bonds outstanding in the United States is, at present, almost ten times larger than in the euro area. These figures seem to indicate that there is plenty of scope for further securitization in the euro area. The introduction of the euro certainly underpins this development. The establishment of a benchmark for government bonds, increasing economies of scale, narrower bid-ask spreads, lower hedging costs for debt securities issued by private firms and more competitive underwriting are likely to provide incentives for European corporations to issue their own securities instead of borrowing from banks.

Moreover, the euro area financial markets now offer a more diversified set of financial instruments than that which was previously available in any national market in the euro area. This gave international investors greater scope for portfolio diversification for investments in euro-denominated assets without their having to incur additional foreign exchange risk. To the extent that the euro area is a large and rather closed economy, yields on bonds denominated in euro are likely to become increasingly independent of changes in US yields compared with the present situation for bonds denominated in the national currencies. If this is the case, euro area bonds provide an attractive opportunity for investors who would like to achieve increased risk diversification in relation to US financial instruments (Duisenberg. 2002).

4. The role of the euro as an official reserve currency

Firstly, reserves may be held for transaction needs**,** i.e. to finance imports and repay external debt. In this case, authorities tend to match the currency composition of reserves with the currency denomination of their imports and financial liabilities. Secondly, reserves may be used to carry out foreign exchange interventions**.** In this case, authorities orient themselves towards the currency to which they peg their exchange rate. In this respect, the US dollar is not only the reference international currency for some of the largest reserve holders (China, Taiwan and Hong Kong), but also a vehicle currency which may be universally used to transact in almost all currency pairs in the world. Moreover, many countries continue to manage the exchange rate against the US dollar, and need US foreign reserves for this purpose, even after they have discontinued formal pegs to the US dollar (so-called "fear of floating").Thirdly, reserves are an instrument for authorities to store value and to yield a return on investment**.** To this end, authorities follow a portfolio approach and try to optimize their risk-return combination. Currency diversification of the portfolio is part of this strategy. But one important technical factor limiting the scope for diversification is the need to measure the return of a portfolio in one *numeraire* currency. Risk-averse central banks tend to favor the US dollar as their *numeraire* currency, and therefore attribute a large share of their foreign reserves to the US dollar to protect the ex-post return of their portfolio from fluctuations due to exchange rate volatility. Finally, authorities may hold reserves for precautionary reasons, for example, to respond to exceptional events (wars, embargoes, banking crises) and to deter possible speculative attacks against the country's currency That said, I am aware that, besides these elements of inertia, there certainly exist factors susceptible of stimulating currency diversification, even if they have not been reflected in available IMF data yet. I should like to briefly mention three of them.The euro became an attractive currency for the investment of official reserves. Currently the US dollar is by far the most important official reserve currency world-wide; at the end of 1996 the share of dollar-denominated instruments in official reserves amounted to approximately 64%, while the euro area currencies accounted for 25% and the Japanese yen for 6%. The euros share of world-wide official reserves is likely to have fallen at the start of Stage Three since the Deutsche Mark reserves previously held by euro area national central banks have become domestic euro area assets (Padoa Schioppa, 2002).

However, the euros share of the global official reserves increases again. The euro is likely to become an important anchor currency in other European countries which, formally or informally, might find it useful to peg their exchange rate to the euro or to a basket of currencies in which the euro is a large component. This is the case at present for the "pre-in countries" participating in ERM II as well as for several countries in central and eastern Europe which link their currencies to the euro, whether by a currency board, a fixed or crawling peg or a managed float.

In addition, other countries will also have to reassess their reserve management strategies in the light of the improved diversification opportunities offered by the new currency. It is possible that countries in Asia and Latin America, which traditionally have predominantly held US dollar reserves, may find it useful to diversify their reserve holdings gradually by acquiring euro.

5. The role of the euro as a trade currency

A further aspect of the internationalization of the euro is its developing role as an invoicing currency for foreign trade. Today, the US dollar is by far the most important international transaction currency. It is estimated that approximately 50% of world trade is currently priced in dollars, compared with less than one-third in the currencies which were replaced by the euro and 5% in Japanese yen. Initially, the "market share" of the euro will have fallen compared with the previous combined "market shares" of the currencies which it replaced. This was a result of the elimination of intra-euro area trade from the statistics on foreign trade and exchange transactions. However, in the longer term, the euro may become an important currency for the invoicing of foreign trade. It should be emphasized, though, that at the global level, it clearly took time for the euro to attain a stature comparable with that of the US dollar as the leading international transaction currency. The dollar has an established reputation and is used as a standard for pricing in several areas, in particular in commodities trading. It usually takes a long time for changes in such conventions to take place (Mishkin, 1996, 156).

In conclusion, I should like to underline that the euro area is eventually larger than the dollar area. Introduction of the euro contributed to further development of the euro area financial markets with a view to achieving higher efficiency and international competitiveness. The euro stand up very well. It has two great strengths: a large and expanding transactions size; and a culture of stability. From the standpoint of monetary policies, there is also not much to choose between the two areas. The euro also has also two weaknesses: it is not backed by a central state, and it has no fallback value. Against this background, there was little doubt that the euro will play a major role as an international currency. In an unstable world, these weaknesses would be fatal I am convinced that the mandate of the Euro system to maintain price stability in the euro area and its institutional framework, ensuring a high degree of independence, is a good base for developing the international role of the euro.

Resources:

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Abstract

Modern currencies differ from the great currencies of the past, which were all either gold or silver or convertible into one or both of those metals. These currencies had a fall back value if the state collapsed. Until the advent of the dollar, there is no historical record of any fiat currency achieving great international significance. Before the twentieth century all the great international currencies were metallic. The predecessor of the dollar, the pound sterling, achieved its great luster as a metallic currency. The dollar achieved its international importance as a gold currency and still now dollar has an established reputation. What makes a currency important internationally№Obviously, confidence in its stability is a key characteristic. But stability depends on several factors: size of transactions domain, stability of monetary policy, absence of controls, strength and continuity of the issuing state, and fall back value. A currency is "international" when it is used outside the domain in which it is legal tender, or when its fractions or multiplies are imitated elsewhere. So introduction of the euro removed currency risk, increased cross- border competition and provided an incentive for the harmonization of market practices, reduced transaction costs and removed foreign currency risks. Euro became a strong international currency because of its large and expanding transaction size and a culture of stability, and attractive currency for international investors and for private as well as public bond issuers.