Note drafted by the Eurofi Secretariat

STRENGTHENING THE INTERNATIONAL ROLE OF THE EURO: HOW?

With 340 million inhabitants, Europe is the second largest developed world market for trade, after China and before the US. Providing this economic and commercial power with this common currency brings substantial advantages both for the international system and for European countries:

- While exchange rate disorder had reigned since the fall of the Bretton Woods system in 1971-73, a major economic area was the first to acquire a mechanism for the stability of internal exchange rates (the European Monetary System of 1979) and then a single currency (1999). As a result, Europe has made a significant contribution to stabilising the international monetary system;
- As for the countries of the Euro zone, they avoided the uncertainties and economic disorders associated with fluctuating exchange rates. They have therefore been able to benefit from stable benchmarks. Europeans identify the euro as one of the main symbols of the European Union. It has brought visible and very practical benefits to European households, businesses and governments alike: stable prices, lower transaction costs, more transparent and competitive markets, and increased trade. It makes travelling and living abroad easier, interest rates low and savings protected.

The euro is 20 years young and the EU Commission launched an initiative to strengthen the international role of the euro (Communication on 5 December 2018). The decision to use a currency is ultimately made by market participants. The objective of the Commission is not to interfere in commercial freedom or limit choice, but rather to expand the choice for market participants by ensuring that the euro represents a strong and reliable currency of choice.

This note is organised around four headings: The euro is today the second most important international currency (i). The increasing use of the dollar for American political purposes can only obscure its weakening (ii). However, several weaknesses hamper the global use of the euro (iii) and have to be addressed to insure its international development (iiii).

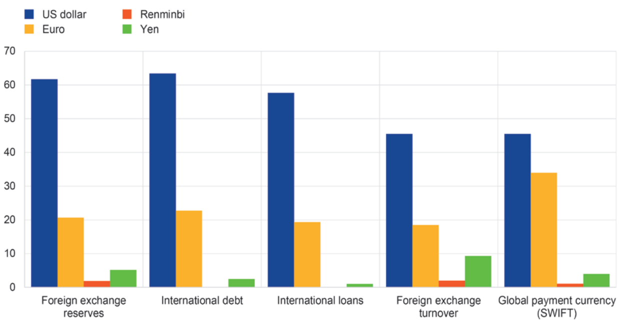
1. The European currency remains the second most important currency in the international monetary system

Since its introduction 20 years ago, the euro has remained unchallenged as the second most used currency after the dollar (***see chart 1***). Some 340 million European citizens use euro banknotes and coins every day across the euro area's 19 Member States. Public support for the euro has been significantly reinforced in the euro area according to the surveys and the «populist» parties no longer militate for the exit of the Euro.

Around 60 countries in the world use, will use or link their currency to the euro. It is a widely accepted currency for international payments, and a significant share of international reserves of foreign central banks and debt issuance on international markets are in euros.

Chart 1 The euro remains the second most important currency in the international monetary system

Snapshot of the international monetary system (percentages)



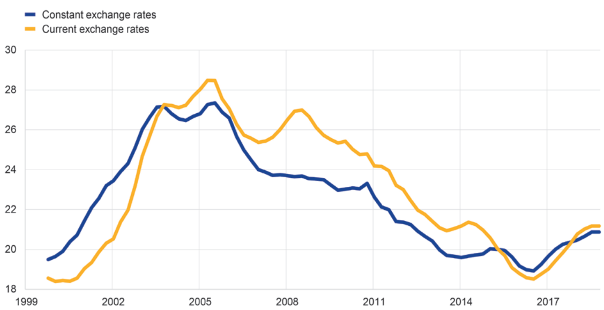
Sources: BIS, CLS Bank International, IMF, SWIFT and ECB calculations.

Note: The latest data are for the fourth quarter of 2018 or the latest available.

However, its usage declined after the global financial crisis (***see chart 2***). After bottoming out in 2016, the international use if the euro has recently slightly strengthened.

Chart 2 The international role of the euro rose from historic lows in the review period

Composite index of the international role of the euro (percentages; at current and Q4 2018 exchange rates; four-quarter moving averages)



Sources: BIS, IMF, CLS Bank International, Ilzetzki, Reinhart and Rogoff (2017) and ECB calculations.

Notes: Arithmetic average of the shares of the euro at constant (current) exchange rates in stocks of international bonds, loans by banks outside the euro area to borrowers outside the euro area, deposits with banks outside the euro area from creditors outside the euro area, foreign exchange settlements, global foreign exchange reserves and share of the euro in exchange rate regimes globally. Data at constant exchange rates were not available for foreign exchange settlements. Data for 2016 are used for 2017 and 2018 observations for the share of the euro in exchange rate regimes globally. The latest observations are for the fourth quarter of 2018.

1.1. The euro is a stable currency widely accepted for international payments but supplanted by the dollar as regards its function as a reserve currency

Stable currency

The euro does fluctuate on the foreign exchange market, because that is the system in which we operate. But, in fact, the variations between the euro and the dollar have been relatively small in the twenty years of the European currency's existence, fluctuating around parity (0. 86 November 2000/1, 12 May 2019).

Moreover, the euro has maintained its «internal stability»; and inflation has remained around 1.7% per year for the past twenty years.

The euro, as a currency of transactions, is at the level of the dollar

The euro has become a widely accepted currency for international payments. About 36% of the value of international transactions were invoiced or settled in euros in 2017, compared to about 40% for the US dollar.

As a reserve currency, the euro is far behind the dollar

The euro represents around 21% of international reserves of foreign central banks while the US dollar remains the leading global reserve currency and accounts for 62% of international reserves of foreign central banks. No other currency exceeds 5%.

1.2. The use of the euro as an invoicing currency is limited notably when transactions do not involve the euro area

The share of the euro as an invoicing currency has been stable in the past decade. Unlike other dimensions of the international use of the euro, the share of the euro in the invoicing of euro area international trade transactions in goods has hovered around 50-60% over the past decade. However, trade invoicing practices vary across euro area trading partners. For instance, the vast majority of euro area trade with the United States is invoiced and settled in US dollars, while the bulk of euro area trade with non-euro area EU countries is invoiced in euro.

Unlike the US dollar, use of the euro for the invoicing of international transactions between third countries is limited. The euro is used as an invoicing currency in more than 30% of global trade transactions in goods. However, unlike the US dollar, there is limited evidence that the euro is used for invoicing when transactions do not involve the euro area. The dominant role of the US dollar is particularly noteworthy in the global trade of oil and other commodity products.

1.3. The role of the US dollar in international debt markets and in international loan and deposits markets is dominant

Since the mid-2000, the share of the euro in the stock of international debt securities has declined by about 8 percentage points (at 23% at the end of 2017) while that of the US dollar has increased by close to 20 percentage points (to over 63%.) The share of the euro in stocks of international debt remains limited outside European countries.

Aside from developed Europe and Canada, the share of the euro in outstanding debt remains below 16%. The dominance of the US dollar in global debt markets is most pronounced in the Middle east and in offshore financial centres, where its share is typically close to 90%, in line with the US dollar's pre-eminence as an invoicing currency of energy products and in global financial transactions. The preference of emerging market borrowers for the US dollar as a funding currency is one persistent factor behind the decline in the share of the euro in international debt markets.

Between 2006 et 2014, the share of the euro international loans declined continuously, reflecting among other things deleveraging by euro area banks, as well as regulatory efforts to reduce exposures to foreign loans denominated in euro. This trend has partially been reversed in the past few years. The share of the euro in the stock of international loans stood at 19,3% at the end of 2018, an increase of 1% relative to the end of 2017, while the US dollar stood at around 60%.

1.4. The ECB's asset purchase programme (APP) has had significant impacts on global bond and deposit flows[1]

At the cessation of net purchases at end-December 2018, Eurosystem holdings of debt securities under the APP had reached €2.6 trillion, with holdings of public sector securities at €2.1 trillion, or 82% of the total. The ECB's massive interventions have changed the distribution between euro area and non-euro area investors holding government bonds of euro area countries.

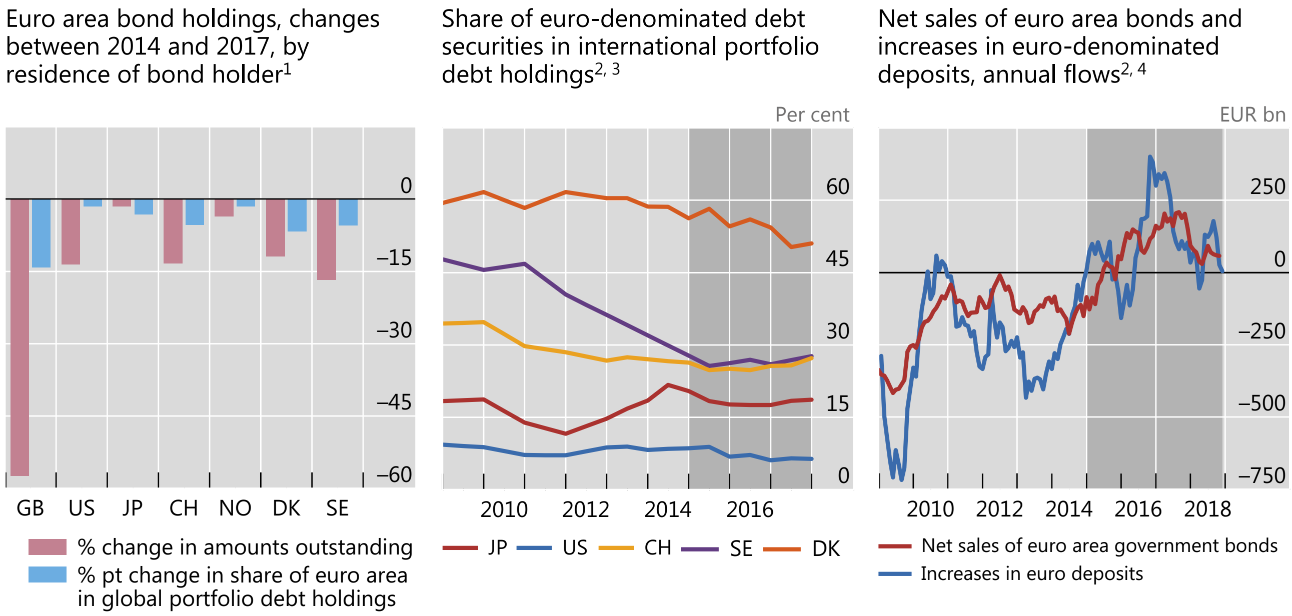
Non-euro area investors sold large amounts of euro area government bonds into the Eurosystem bid. In fact, these investors accounted for approximately half of net sales during this period. This represented a sharp reversal of the trend from the pre-APP period, when non-euro area investors were net purchasers. Investors located in the United Kingdom were the most active sellers located outside the euro area (***Chart 3, left-hand panel, red bars***). Their portfolio holdings of euro area debt contracted by more than 50% between end-2014 and end 2017.

Among individual sectors, non-bank financial institutions (NBFIs) sold the most euro area bonds during the period of the ECB's APP. NBFIs resident in the United Kingdom cut their holdings of euro area debt securities by approximately €300 billion between end-2014 and end-2017. NBFIs resident in Denmark and Sweden also reduced their holdings of euro area bonds considerably.

In contrast to the share of bonds issued by euro area residents, the share of euro-denominated bonds remained relatively stable for most major investor countries outside the euro area during the APP period (***Chart 3, centre panel***). This finding suggests that those investors purchased euro-denominated bonds issued by non-euro area residents.

[1] All the statistics and charts presented below are taken from the study, S. Avdjiev, M. Everett and H. Song Shin, "Following the imprint of the ECB's asset purchase programme on global bond and deposit flows, BIS Quarterly Review, March 2019.

Chart 3 Non-euro area investors' holdings of euro area bonds, euro-denominated bonds and euro-denominated deposits



[1] Euro area government bond holdings for the countries that report a borrowing sector breakdown (US); euro area total (all sectors) bond holdings for the countries that do not report a borrowing sector breakdown (CH, DK, GB, JP, NO and SE). [2] The shaded area refers to the period of the ECB's expanded asset purchase programme. [3] The currency breakdowns for the portfolio debt holdings of NO and UK residents are not available. Missing observations have been filled using linear interpolation. [4] Net sales of euro area bonds by investors located outside the euro area. Increases in euro-denominated deposits by non-euro area residents in banks located in the euro area. Positive figures indicate net sales (red line) or net increases in deposits (blue line).

Sources: ECB, euro area balance of payments statistics; ECB, money, credit and banking statistics; IMF, CPIS.

The net sales of euro area securities by non-euro area investors during the APP have gone hand in hand with a significant rise in non-euro area-sourced euro-denominated deposits in euro area-resident banks (***Chart 3, right-hand panel***).

The increase in euro-denominated deposits outside the euro area between end 2014 and end-2017 was substantial. At approximately €190 billion, it amounted to almost 20% of the total volume of APP public sector securities sold by non-euro area investors. NBFIs accounted for the majority of the expansion in euro-denominated deposits. Most of those were placed in UK-resident banks.

2. Towards a reduction in the international use of the dollar?[2]

Despite the uncertainties of American policy, despite the considerable amount of US debt, and the existence of persistent current account deficits, despite the relative weakening of the US economy against China, the dollar is still the international currency par excellence as we have just seen in the previous chapter of this note.

This supremacy of the dollar does not reflect a «superiority»; it reflects the fact that only the United States, with a permanent balance of payments deficit, can offer the rest of the world a huge amount of debt securities issued in the world's largest market.

These securities, considered risk-free, are not only accepted but sought after: the strength of the American economy - flexible and competitive - as well as the military strength and political stability of the United States explain this preference.

At the moment, it is not clear what other currency could replace the dollar as an international currency.

The euro is the currency of a continent divided into 19 states, some of which are problematic. As for the renminbi, it is the currency of a major economic power whose financial market remains largely domestic and inconvertible.

Nevertheless, we must ask ourselves a question of the future in a new light, dictated by current events: «Can a key currency such as the dollar retain its status on a long-term basis if the issuing State deliberately engages in protectionist policies? ».

Until recently, the dollar had resisted the relative weakening of the US economy because the country had, on the whole, been able to preserve for non-resident dollar holders the rights that are normally attached to the use of an international currency.

Admittedly, the United States has long practiced a policy of sanctions (Cuba, Sudan, Iran...) against non-residents using the dollar for transactions prohibited by American law. This was already a strong incursion into extraterritoriality and the very negation of multilateralism.

But the current US Administration goes further: it threatens sanctions against foreign (and allied) states that use their own currencies (the Euro for example) to pay for purchases from countries on the list of US boycotted countries (such as Iran), but not subject to boycott outside the US.

This situation is far from anecdotal. A key currency is not a commodity. It must allow transactions to be settled through a clearing system open to all participants. It is a public good. But the fact that the US administration uses the dollar - or

[2] This section below is based on a recent speech delivered by Jacques de Larosière, "Tendances de l'économie mondiale", Swiss Life AM, 19 June 2019.

threatens to close the US market - as a means of diplomatic pressure for unilateral purposes changes the very nature of the international currency whose «privilege» has been recognized in the USA for so long.

As a result, some EU Member States are seeking to develop a financial mechanism that would allow Iran, for example, to export oil for Euros. But the attractiveness of the American market is so strong that large European companies (those that are highly dependent on their ability to sell in the USA) are reluctant to engage in such a mechanism.

Today, the «dollar system» is still holding up well. But its increasing use for American political purposes can only hasten its weakening. It is still too early to judge. But it is a fact that countries such as China and Russia are in the process of using non-dollar-centric settlement systems. In this respect, we can mention the following:

- China's growing presence in Africa and the Middle East, which is increasingly accompanied by commercial transactions in renminbi;
- The oil market for renminbi futures is expanding rapidly;
- The implementation of CIPS (Chinese cross-border interbank payment system) in 2015 has rapidly become internationalised (CIPS was connected to SWIFT in 2017). Since then, the network of international banks participating in CIPS has grown considerably (including Europe and North America).

It is therefore likely that the rise of the Chinese economy will eventually lead to an increasing internationalisation of the renminbi. The American abuse of extraterritoriality will only accelerate this process.

History shows, moreover, that economic power always ends up extending to finance (the case of the British pound, the world's leading currency, which gave way to the dollar less than a hundred years ago).

3. The weaknesses of the euro which hamper its international use

The expected benefits of a wider use of the euro are significant but the strengthening of the international role of the euro faces multiple obstacles.

3.1. The benefits of a wider use of the euro are well known

A wider international use of the euro would benefit both European citizens and European companies. The latter would benefit from lower cost and risk in international trade, more reliable access to finance through more integrated and liquid financial markets. A greater role of the euro is also desirable because it would provide a greater degree of financial autonomy in the euro area reduce exposure to third country legal actions (through extraterritorial sanctions). It would notably shield the euro area from the increasing use of the dollar by the US administration as a foreign policy tool, possibly conflicting with European interests.

Strengthening the international role of the euro would increase Europe's ability to shape major world events. A currency with a global standing would not just be a symbol of European unity on the world stage, it would also be a tool to project global finance. Indeed, it would allow us to take advantage of the sovereignty of the euro zone in the international monetary system and also improve the resilience of the international financial system by expanding the choices available to market operators around the world.

3.2. The barriers to the euro's global role are in Europe

The euro zone is still facing structural challenges which are obstacles to the international use of the euro: there is a growing heterogeneity in productive specialisation between Member States[3], cross-border capital flows are almost inexistent, and the rebalancing with the Eurozone remains essentially asymmetric. In addition, European capital markets are currently too small and too fragmented, and the Banking Union is far from being completed.

- **The Euro zone is far from functioning as a true integrated monetary zone**

Indeed, in an integrated currency area (as in the case of the USA, for example), regions with a savings surplus transfer capital to deficit regions and thus contribute to investment and growth throughout the Union.

But in Europe, this is not the case. The divergences in economic policies between «core and periphery» during the first ten years of the euro's existence (2000-2010) have deteriorated confidence between states. Some of them, despite their recovery efforts and the fact that they have returned to balance in their external accounts, are still suffering from an accumulation of «non-performing»; bank loans and are subject to obvious structural weaknesses. As a result, savings surpluses from countries like Germany are channelled to the rest of the world (especially Asia), but not to Europe in search of investment.

- **European capital markets are currently too small and too fragmented**

Achieving developed, integrated EU markets that are open and attractive to international investors would reinforce the role of the euro on the international stage. But various legal and institutional barriers (disparate insolvency, securities laws and tax regimes) hinder the creation of a single pool of liquidity. European savings are over-invested in monetary assets (bank accounts, regulated savings accounts, bonds) and insufficiently invested in equities. The capital markets in Europe also suffer from the absence of pension funds.

The underfunding of innovative SMEs all along the financing chain is also a significant EU weakness: the number of IPO on SME dedicated markets have halved to what it used to be before the financial crisis; venture capital funds in Europe have an average size of around €56 million. This is too small to allow Eu start-ups to become bid companies. In the US, venture capital funds are 3x bigger than in the EU. The European private investment/venture capital market is not as well developed as in the US. The amount of money (venture capital) invested in the EU startup companies is 6x less than in the US.

[3] Jacques de Larosière and Didier Cahen, Ensuring a viable EMU: are we on the right track, Eurofi note, September 2018.

- **The persistent non-conventional monetary policy weakens the EU financial industry, discourages the development of savings products and therefore complicates the relaunch of the CMU project**

Lasting zero and event negative interest rates are an obstacle to the relaunch of the CMU project. Indeed, they encourage retail savers to keep their savings in standard deposit accounts as much as possible, such as checking accounts instead of other investment options (to avoid the tax» levied on securities invested in risk-free assets). In other words, persistent zero interest rates discourage savers from investing in financial investments and encourage preference for liquidity (hoarding). One can observe that retail investors in the EU indeed prefer cash savings over bond purchasing, which do not generate enough return and higher safety. At the same time, the gloomy economic outlook and high levels of equity markets do not encourage equity investment in Europe.

Persistent zero interest rates are « de facto » insufficient for taking risks. Moreover, they weaken the profitability of the financial industry (in particular retail banks and life insurance companies), eventually blur risk premiums and discourage investment.

- **Let us not forget either that the Banking Union is far from being completed**

- Despite the implementation of the SSM and the SRM, ring fencing policies still apply to capital, liquidity and bailinable liabilities of subsidiaries of EU transnational banking groups. This clearly distort banking markets, fragments them and impedes the restructuring of the banking sector in Europe, which cannot benefit from the economies of scale of the single market compared to US banks for instance, which rely on a large unified domestic market.
- The amount of NPLs, although decreasing since the peak of 1. 2 trillion in 2013, remains a major source of vulnerabilities in some member states (Greece, Cyprus, Italy, Portugal...).
- The treatment of bank failures is not sufficiently harmonised, consistent and predictable.

4. Ways to further strengthen the euro's global role

The EU has the means to erode at least some of the dollar's privilege, but strength abroad reflects unity at home. The EU needs to make the eurozone a properly managed currency area and to implement serious reforms. Then the implementation of the initiatives listed in the Communication of the EU Commission issued on December 2018 would certainly boost the international role of the euro.

4.1. Sound domestic economic policies in all parts of the euro area would boost the global role of the euro

Implementing structural reforms within each Member State with a view to achieving a steady convergence towards resilient economies is fundamental for improving the functioning of the EMU and the international use of the euro. Reducing vulnerabilities whilst enhancing the capacity to absorb shocks and reallocate resources will require comprehensive structural reforms.

A monetary Union cannot work without fiscal discipline and the enforcement of the Stability and Growth Pact has been too lenient since 2003[4]. It is difficult to make progress to deepen the EMU and the use of the euro as long as existing rules have not been met by all Member States. Eurozone fiscal rules should be more effective and binding. This would help to rebuild buffers and ensure debt sustainability.

4.2. Correcting in a symmetric way the current disequilibrium in the Monetary union in order to ensure the long-term viability of the euro and facilitate its international development

The current economic situation is problematic in the euro area. Germany, the Netherlands and others now have major current account surpluses, while other countries have great difficulty in balancing their external accounts.

And the effects of specialisation go in this direction: countries like Germany with a strong industrial tradition, low costs and exemplary economic governance benefit from the existence of the Euro zone, in which devaluations are impossible.

Without the Euro, the markets would have strongly revalued the currencies of these creditor countries (the virtual DM would be undervalued by 15 to 20% compared to the peripheral countries). But since the euro exchange rate is the result of an average of countries (strong and weak), it follows that highly competitive economies benefit from an additional export strength, due to the relatively low appreciation of the euro. And this can only maintain the «dynamic of heterogeneity».

It is time to correct these imbalances in a symmetric way:

This implies:

- That countries in deficit and whose debts are not «sustainable», gradually take credible measures to put their public accounts in order; sound economic and fiscal policies and structural measures[5] in all parts of the euro area would ensure mutual trust among member states, strengthen and upgrade the credit quality of outstanding debt, and would contribute to increasing the supply of safe euro area debt[6] and raising the euro's global role.
- But that structurally surplus countries such as Germany and the Netherlands also take measures to reduce their savings surplus relative to their investments (by stimulating their infrastructure investments, a more equitable share of European defence and security spending, the implementation of planned intra-European financial solidarity mechanisms, etc.). The aim is to put more symmetry into the adjustment process, and to make the whole area contribute to a more harmonious policy.

[4] The weak implementation and lax enforcement of the rules have undermined the credibility of the fiscal framework. This, in turn, has weakened countries' incentives to respect the rules, as well as the European institution's ability to enforce them.

[5] Structural reforms to foster entrepreneurship, support SMEs and advance digitalization would encourage domestic investment and improve potential growth.

[6] In the longer term, the creation of a common euro area safe asset, in a way that does not undermine incentives for sound national fiscal policies, could also contribute to this objective.

We are at the moment of the «last chance». If nothing is done towards greater cohesion, imbalances will accumulate and some parts of the Union will sink even deeper into under-productivity and deindustrialisation. Let us not forget that, over the last ten years, the per capita income of the poorest European countries has been falling relative to that of the richest countries.

Without wishing to create a supranational arsenal of too great an ambition, and without falling into the unrealistic trap of a complete pooling of risks, existing cooperation mechanisms should be applied more seriously (Macroeconomic Imbalance Procedure…) than we do today, and the necessary economic adjustments should be implemented in a more symmetrical and mutually supportive manner between debtors and creditors.

4.3. Implementing the initiatives of the EU Commission presented in its Communication (December 2018)

to the extent that Europe is implementing the reforms mentioned above, the initiatives mentioned in this Communication would effectively boost the international use of the euro.

It is about:

- Completing Europe's Economic and Monetary Union, Banking Union and Capital Markets Union.
- Additional measures to foster a deep European financial sector, including more efficient European financial market infrastructures; solid interest rate benchmarks and an integrated instant payment system in the EU.
- Initiatives linked to the international financial sector: ongoing cooperation between central banks to safeguard financial stability; increasing the share of euro denominated debt issued by European entities; fostering economic diplomacy to promote the use of the euro and providing technical assistance to improve access to the euro payment system by foreign entities, notably in the context of the European External Investment Plan.
- Promoting the wider use of the euro in strategic sectors and notably in international energy agreements and transactions.

Initiatives to strengthen the international role of the euro include:

1	Completing the Economic and Monetary Union, Banking Union, Capital Markets Union	
2	Measures to foster a deep European financial sector	• Strengthening the liquidity and resilience of European market infrastructure • Ensuring a reliable framework for a trustworthy interest rate benchmark • Supporting a fully integrated instant payment system in the EU • Consultation about euro liquidity in foreign exchange markets
3	Initiatives linked to the international financial sector	• Supporting Central Banks' collaboration to safeguard global financial stability • Increasing the share of euro denominated debt by European bodies • Fostering economic diplomacy to promote the use of the euro in payments and as a reserve currency • Technical support to improve access of developing countries to the euro payment system

4	Promoting the use of the euro in key strategic sectors	• Energy:
		  • Recommendation to promote a wider use of the euro in international energy agreements and transactions
		  • Consultation on expanding use of euro-denominated transactions in oil, refined products and gas
		• Consultation on increasing use of the euro in raw materials and food commodity trading
		• Consultation on expanding use of the euro by transport sector manufacturers (aircraft, maritime and railways)

Source: European Commission, Factsheet "Further strengthening the euro's role in the world", December 2018

Promoting the euro internationally attempts to counter the US-led retreat from globalisation and free markets. The European Commission has argued for a more global role for the euro amid concerns that elements of US foreign policy, such as "America first" and sanctions on Iran, cannot be bypassed in a world order where most global trade and financial transactions are priced in dollars.

The euro is a natural candidate for a diversification of the US dollar as the euro Is the second largest global reserve currency. But the US dollar is used in reserves, in payment systems and for funding banks because it has a massive pool of safe assets in the form of US Treasuries and stable and tested monetary and political governance.

Europeans should not ignore the fact that a currency cannot be given reserve status by administrative fiat. Strength abroad reflects unity at home. To erode some of the dollar privilege, the member states should implement structural reforms and make the euro zone a properly managed currency area. Only steadfast and balanced efforts both in deficit and surplus countries reinforced by actions to deepen EMU and to develop private risk sharing will galvanise growth and stability in the euro area and assure that Europe becomes a beacon of hope and a place of prosperity in a troubled world. The problem with the euro is that it does not lack assets but unity...