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The Euro's international role: policy independence first!

Even if some progress was made last year, the Euro has not yet been able to decisively challenge the dollar's role as the world's dominant reserve currency. Some of the reasons are contingent. A negative interest rate since 2014 may be hard to swallow even for non-profit seeking reserve managers. Others – such as the lack of progress on banking, capital market and fiscal union, and the absence of a joint risk-free asset – are more structural. But a question is seldom asked: why would it be in the Euro area's interest to turn its currency into a "proper" reserve currency?

Reserve currency status comes with some potentially problematic conditions. One is that its issuer must provide the rest of the world with a decent quantity of assets to invest in. This normally entails running a current account deficit. The Euro area since the Great Recession has on the contrary been generating a current account surplus. In those conditions, a permanent rise in the international demand for euros would take interest rates further into negative territory and trigger a significant appreciation in the euro's exchange rate. This would manage to both further irk savers in core countries such as Germany and price-sensitive exporters in France and Italy.

At the same time, a reserve currency provides its issuer with a crucial advantage: the ability to frame its policy stance fully independently. The Fed ultimately sets the tone for interest rates worldwide. It is not on the receiving end of financial spill-overs. The US fiscal policy is less concerned with counterproductive "crowding out" when supporting domestic demand given the structural overseas demand for US bonds. Moreover, given the number of currencies which are implicitly or explicitly pegged to the dollar, the US can largely ignore the impact of its policy decisions on its external financial conditions.

We would make the point though that lately the Euro area has been able to "decouple" quite easily from the US, bringing market interest rates to extremely low levels irrespective of the Fed's stance. The existence of a massive current account surplus means that risks of crowding out if fiscal policy turns expansionary are close to nil. In short, not being the issuer of the world's top reserve currency has not been much of a hindrance for the Euro area.

Still, a lot of this decoupling owes to the ECB's unconventional policy at a time when monetary easing in one region was seen as a net positive for everyone. The Fed was supportive of the ECB's action even though they were not going in the same direction. Unfortunately, the US administration now sees any monetary accommodation elsewhere as "currency manipulation", with the possibility of retaliation via trade. A stronger reserve role for the euro would protect from uncooperative US approach.

We would insist though on the need to make this part of a holistic strategy. Finally setting up a common risk-free asset and some joint fiscal capability would make the euro more attractive as a reserve currency by helping to put the usual "existential concerns over the monetary union, while helping the Euro area to move away from high current account surpluses towards a more balanced model, more reliant on domestic demand, to make it less dependent on the gyrations in the global cycle. ●