POLICY BRIEF

DAHRENDORF FORUM
Debating Europe

An enhanced international role for the €uro

A real opportunity or wishful thinking?

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THE POLICY CHALLENGE

Since its launch in 1999, the euro has had a sizeable international role, but has lagged far behind the US dollar as an international currency. One key measure, the currency in which international reserves are held, illustrates the gap: the share of the euro has been around 20 percent while the dollar has consistently accounted for over 60 percent. A few other currencies, mainly the pound, the yen and – having grown in recent years – the renminbi share the balance.

Many in Europe bemoan the disparity, arguing that the pre-eminence of the dollar confers an 'exorbitant privilege' – a term coined by former French President, Valéry Giscard d'Estaing – on the US. By being the reserve currency of choice, the US is able to borrow easily and on very favourable terms from the rest of the world to finance its public debt. However, as Gourinchas, Rey and Godillot show, there can be a countervailing 'exorbitant duty' in times of financial instability, arising from the obligation to underpin the international financial system.

Nevertheless, the nub of the European argument is that, being rooted in an economy of comparable size and maturity, the euro should have a much greater international role. By doing so, it could expect to obtain some of the benefits of being a 'go-to' international currency, now enjoyed disproportionately by the US. A new impetus for change has come from concerns about the increasing willingness of the US authorities to use the power of the dollar belligerently. Examples are fines on European financial intermediaries and the threat of secondary sanctions on European companies which have the temerity to deal with regimes the US opposes. If they do any business in dollars, they have to comply, even though EU law is supposed to offer them a shield.

This policy brief assesses the case for active promotion of a greater international role for the euro. It discusses the necessary steps to enhance its prospects, explains why the time is now right to try and puts forward recommendations.

GROWING SUPPORT FOR INTERNATIONALISATION OF THE EURO

There is something of a consensus that Europe 'punches below its weight' on the world stage and a disposition to do something about it – see a recent Dahrendorf Forum scenario exercise. Ursula von der Leyen has signalled her intention to bolster Europe geo-politically. One of six priorities in her political guidelines for the 2019-2024 Commission is a 'Stronger Europe in the World', stressing her commitment to 'uphold and update the rules-based global order'.

KEY INSIGHTS

ALTHOUGH THE EURO IS ALREADY THE SECOND MOST IMPORTANT GLOBAL CURRENCY, AN ENHANCEMENT OF ITS GLOBAL ROLE IS OVERDUE

THE CURRENT POLITICAL AND ECONOMIC CONTEXT OFFERS AN OPPORTUNITY FOR THE EURO TO MAKE A STEP-CHANGE IN ITS ROLE

TO RIVAL THE DOLLAR, COMPLETING ECONOMIC AND MONETARY UNION IS A NECESSARY CONDITION, BUT COMPLEMENTARY INITIATIVES ARE NEEDED

THE EUROPEAN CENTRAL BANK AND NATIONAL GOVERNMENTS SHOULD WORK PRO-ACTIVELY WITH THE COMMISSION TO PROMOTE A GLOBAL ROLE FOR THE EURO

However, her aspirations for the euro are under another of her priorities: 'an economy that works for people'. Specifically, she wants 'to strengthen the international role of the euro, including its external representation', and she points to changes needed to enable 'the single currency to become more widely used internationally'.

This aim is fleshed out in her mission letter to Valdis Dombrovskis, the Commission Vice-President who has executive responsibility for economic matters. He is enjoined to strengthen 'the role of the euro as a strategic asset for our Union', a task which implies 'increasing the global use of the euro for payments, as a reserve currency and for debt issuance'. He is also expected, as a means of supporting 'our economic sovereignty […], to develop proposals to ensure Europe is more resilient to extraterritorial sanctions by third countries'.

A year before the new team took office, the Commission had issued a communication reviewing the international role of the euro and putting forward proposals for enhancing it. The December 2018 Euro Summit encouraged the Commission to pursue its actions; it did so through a consultative exercise summarised in a subsequent communication. The responses from those consulted were broadly supportive, though cautious about likely obstacles.

By contrast, the European Central Bank has consistently adopted a neutral stance towards the international role of the euro. Its approach has been to let markets decide, rather than seeking actively to promote euro use. There are, though, signs of a shift. At the launch of the 2019 issue of its annual publication on the international role of the euro, now former ECB Executive Board member, Benôit Coeuré, stated that the balance of benefits and costs, while not changing greatly, was more favourable 'to having an international currency now than in 1999'.

THERE IS A NEW WILLINGNESS TO BOLSTER THE INTERNATIONAL ROLE OF THE EURO

All these developments suggest a new willingness to bolster the international role of the euro, with two distinct justifications: to make better use of the euro as a crucial instrument of economic policy; but also to achieve geo-political objectives. Increasing worries about the drift of US policy, notably 'weaponisation' of the dollar and its implications for global governance, lie behind the second motivation.

Why the slow euro internationalisation?

As Barry Eichengreen, the leading historian of international monetary arrangements, explains in his book *Exorbitant Privilege*, there is no inevitability about the dominance of a single international currency. He also draws attention to the co-existence during the interwar years of the twentieth century of the dollar and the pound as international currencies, although the rapid eclipse of the latter after 1945 is striking and salutary.

There are several explanations for the limited internationalisation of the euro. First, despite reaching the traditional age of maturity, twenty-one, the euro is still a young currency. Prior to the succession of crises after 2007, some commentators thought it would soon rival the dollar, though others were much more sceptical. Clearly, the depth and duration of the sovereign debt crisis after 2010 was a major reverse.

Second, internationalisation has not hitherto been a priority and, in the last decade, much more attention has gone into reforming the architecture of the euro so as to render it more resilient after the flaws exposed by the crisis.

The euro is, in addition, an oddity as a currency because it is a supranational construction in a European Union lacking a strong political centre comparable with the Federal government in the US or the central government in Japan or the UK. China, another potential rival for the dollar has a powerful central government, but is lacking in other respects. Eichengreen puts it succinctly, if harshly: the 'Euro is a currency without a state', while the renminbi 'is a currency with too much state'.

The opportunity

In a recent paper, Eichengreen argues that the international financial system is

> 'evolving away from the U.S. and the dollar, toward a multipolar world in which several consequential international and reserve currencies will coexist, other countries will no longer rely exclusively or even mainly on the United States for international liquidity, and governance will be a collective endeavor'.

He regards the dollar dominance of the last 75 years as having been the anomaly, although he also stresses that does not 'mean that international currency status necessarily is or will be shared *equally* by competing currencies'.

His analysis leads him to favour 'a multipolar system backed by sound and stable policies on the part of the central banks and governments of the reserve-currency issuers. This is not a perfect world. But it is at least a feasible one'.

The dollar is unusually vulnerable at present for diverse reasons. One derives from internal US politics, especially if the US leadership either loses interest in the global role or comes to the conclusion that the balance of costs and benefits has worsened. Another may be a loss of ability to provide sufficient reserves, if other countries grow more rapidly. Very low interest rates may aggravate this latter problem by making safe assets scarcer. The sharp economic downturn expected from Covid-19 will test these propositions.

According to Acedo Montoya and Buti, a potential gain for the international financial system is that 'the presence of a competitor currency would reduce monopolistic rents from global users of dollar-based payment systems, such as by correspondent banks, card payment providers, or reserve asset issuers'. There may also be benefits from enabling the ECB to be a more effective lender of last resort in times of crisis by support the financial system through 'swap lines'. As Riccardo Reis explains in the context of the March 2020 coordinated central bank action in responding to Covid-19, it is the FED which has generally led in this respect.

But Poul Thomsen, the IMF's director for Europe, is among those who have urged patience. He says policies to foster internationalisation will be much the same as those 'needed to strengthen the resilience of the euro area in any event: namely, to reduce the zone's vulnerability to country-specific shocks and to foster convergence within the monetary union'. In this view, policymakers should concentrate on internal reforms and regard the impact on internationalisation as – in Thomsen's words – a 'bi-product'.

Requirements and Pre-conditions

For the euro to become a more credible international currency it would have to fulfil a number of requirements. First and foremost, as most commentators stress, the gaps in the framework for the governance of the single currency will have to be filled. These are well known and there has already been considerable reform aimed at increasing the resilience and credibility of the system.

Europe's leaders have a reasonable sense of what they ought to do to complete EMU and several of the reforms agreed in the last decade have made the euro more complete and resilient. However, the members of the Eurozone remain divided on the sequencing of further reform and the distribution of the short-term burden. It may be that the medium-term fallout from Brexit, if it results in the transfer from London to European centres, will focus minds.

To adapt Jean-Claude Juncker's oft-quoted aphorism, they all know what needs to be done, but they want someone else to bear the political costs.

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Apart from these political constraints, other likely hindrances, according to the Commission consultation and other sources, include:

- A bias towards the status quo in continuing a tradition of using a given currency, such as the dollar for oil pricing. It is simply convenient not to change;
- Legal requirements or accounting rules obliging economic actors to adopt a particular currency;
- The exercise by major trading entities of market power to impose the currency of their choice
- Dominance of a currency in certain sectors where a key concern is to avoid exchange rate risk, especially in relation to long-term contracts;
- Economies of scope in using a currency, not least in provision of deep and liquid financial markets, creating a barrier to the emergence of competitors;
- The lack of a safe asset comparable to US Treasury bills (T-bonds), especially in periods of instability;
- Europe not speaking with one voice on international matters, including national security.

Beyond completing EMU, there are several other requirements, all of which can be related to the three basic functions of money explained to generations of students in Economics 101 courses: as a unit of account, a medium of exchange and a store of value.

As a unit of account, the euro works well internally for retail activities and in financial markets: if there are any citizens still prone to recalculate into their respective national currencies, they must be a dying breed. Some countries close to the EU also make some use of the euro for pricing, especially in tourist areas. But elsewhere and in global markets such as oil, it is rare to see the euro used as the unit of account, as confirmed in empirical data assembled by the ECB. Changing the status quo in this regard will not be easy.

Regarding the medium of exchange function of money, the euro has the necessary attributes of being acceptable for conducting transactions in retail, wholesale and financial markets, holding its value, and being freely convertible. However, while easily out-shining other putative global currencies (including the renminbi), it lacks the reach and network advantages of the dollar. An open question is whether, with the proliferation of new forms of electronic payment, the choice of currency will become less important.

To be a successful global contender as a store of value, a currency has to possess three main characteristics. First, it needs financial instruments potential investors regard as safe in holding their value, the US Treasury bond being the leading exemplar. The second is a deep pool of liquidity and the third is the support of a stable macroeconomic policy. The euro lacks the first, but now fares well enough on the latter two, although it remains to be seen whether the Covid-19 crisis rekindles concerns about Eurozone stability.

The quality of governance and institutions is also vital. To have confidence in a currency as a store of value, investors need reassurance that the authorities behind the currency will not only ensure stability, but also be transparent and operate according to the rule of law. In several respects, the euro fulfils these expectations. The ECB is a respected custodian of the currency, with a clear mandate to deliver price stability, and has become a more complete central bank as a result of some of the reforms adopted in recent years.

Conclusions and recommendations

Hitherto, there have been good reasons not to push for a substantially greater international role for the euro: initially, to allow the currency to establish itself; and subsequently, because of the imperative of dealing with the years of crisis and enacting the many governance reforms initiated in response to it. Now, however, the changing international context is propitious for a decisive shift of gear and there is a more compelling case for strategic moves to challenge the dollar.

Plainly, doing so will not be easy, because not only is the US likely to resist, but China also aspires to a greater international role for the renminbi and could quickly become a formidable competitor. To make progress, the EU needs to combine further action to complete EMU and strengthen its governance with active promotion of the euro on the global stage.

Although many of the relevant actions are on the table, a realistic timetable should be set, including appropriate milestones. A ten year plan would make sense. The recommendations which follow suggest specific initiatives and measures able to advance the internationalisation of the euro.

First, a necessary condition for progress is to complete EMU to a sufficient extent to confer the attributes of an international currency on the euro. Banking union, capital markets union and the creation of a robust safe asset all need to be achieved, and a more effective mix of policy instruments to stabilise the Eurozone would be desirable. All these are on the EU policy agenda, albeit difficult to take forward because of the continuing division between, on the one hand, creditor and debtor members, and on the other, between proponents of risk sharing and risk reduction.

Second, as suggested by Marco Buti three further sets of initiatives should be pursued. These are: economic diplomacy aimed at stimulating euro use by other countries; specific measures to encourage the use of the euro in key sectors of activity; and European agencies and institutions leading by example by using the euro in their operations.

Third, the ambivalence of certain actors towards internationalising the euro needs to become active support. The ECB, in particular, has the capacity to complement the measures proposed by the Commission, while reluctant member states should look afresh at the advantages. Boosting the sovereignty of the euro (implying the ability to act unilaterally, without hindrance, as opposed to the narrower notion of independence in taking and implementing monetary policy decisions) needs a concerted effort to strengthen the currency's status.

There is an immediate opportunity for the ECB and the euro. The world economy is facing a new crisis and, as Danae Kyriakopoulou explains, what the US authorities offer by way of credit for the global financial system is constrained. An enhanced role in providing swap lines could be desirable for global financial stability and strategically helpful for internationalisation ambitions.

A fourth recommendation is to 'speak with one voice', whether in advancing the euro, representation in global fora, or in resisting unreasonable impositions from global rivals. It is time to set aside the differences among Eurozone members and interests and to 'do'.

FURTHER READING

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THE DAHRENDORF FORUM

The Dahrendorf Forum is a joint initiative by the Hertie School of Governance and the London School of Economics and Political Science, funded by Stiftung Mercator. It recognises expert knowledge and public debate can each benefit from mutual exposition.

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