

PROSPECTS FOR INTERNATIONAL CURRENCY USE OF THE EURO

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September 1999

The introduction of the euro on January 1, 1999 has been touted as a challenge to the dollar's current position as the undisputed premier international currency. What attributes would the euro need to display to displace the dollar? The properties of an international currency are both general and specific. Among the general properties are stability of the currency's value, and its widespread use in foreign trade and international financial transactions. The specific properties relate to the currency's role as a store of value, reserve currency, unit of account, medium of exchange, vehicle currency, and intervention currency.

General Properties

A basic requirement is stability in the value of the currency. The entity that issues the currency, in the case of the euro, the European Central Bank (ECB), should have a credible record of low inflation and low inflation variability. The record does not yet exist for the ECB's credentials in this regard, although the design of the institution was intended to give it presumptive credibility as an inflation fighter.

Another property of an international currency is that the domestic economy in which the currency is used should be a major trading participant in world foreign trade and be a major world exporter to both developing and advanced countries. Euroland qualifies. Its share of world exports exceeds that of the US by about a third.

One attribute that Euroland does not yet have is broad, deep, and resilient financial markets for private issues. International financial instruments should be denominated in euros for the euro to serve as an international currency. Euroland's securities markets for both corporate and government securities, however, are much less developed and less liquid than US securities markets. Bid-ask spreads on 10-year government bonds are far wider than in the US (4 in Germany and France compared to 1.5 in the US).

The equity and corporate bond markets are not Euroland-wide. Domestic firms will be the first beneficiaries of such a development, since it will lower the cost of capital for them. It remains to be seen whether governments will encourage the elimination of national securities markets. So the euro has some way to go before taking on the role of the dollar in financial markets.

Specific Properties

For the euro to serve as an international currency with store of value, liquid assets including international reserve assets of the official sector should be held in euros. Portfolio shifts must take place for the euro to establish itself in these roles. Euroland financial markets must operate with low transactions costs to encourage such shifts as will also use of the euro as a vehicle currency for intervention by the official sector. The US dollar now has a dominant share in official reserves of central banks. For the euro to become a major reserve currency, a lot will depend on the management of its balance of payments.

In pre-World War I conditions, sterling was the international currency. Britain had persistent current account surpluses and offsetting capital outflows. The dollar is an international currency, but for many years, the US has had current account deficits and has been a capital importer. Intermittently, concern about the widening US current account gap suggests that American and foreign investors will desert US markets and complicate funding the gap. The international use of the dollar has not thus far been affected by the difference in capital market behavior between the US and British historical experience. It is too early to tell which model the euro will follow and whether Euroland will be supplying euros to the rest of the world to finance a balance of payments deficit. The choice will depend on whether investment in Euroland is robust, attracting external funds, with domestic saving inadequate to finance investment activity, or the reverse.

As a unit of account, in respect of the official sector, a question for the euro is whether other countries will peg their own currencies against it. About half of the countries that have pegged their currencies have done so against the dollar. Recent currency crises suggest that pegged currencies may no longer be desirable exchange rate

choices. Invoicing practices in foreign trade also reflect the unit of account role of a currency. Countries tend to invoice their exports in their own currencies, and their imports in other currencies, mainly dollars. Euroland firms may follow this pattern, but countries that trade with Euroland firms may switch to euros. During an initial phase, the share of dollar-denominated trade may rise while intra-Euroland trade becomes domestic.

To serve as a medium of exchange the euro should be widely used in payment of international trade debts and international financial obligations and as a vehicle currency. The dollar now intermediates between the exchange of one national currency for another. Direct transactions on the bilateral foreign exchange market are uncommon. Transactions costs are lower when the first currency is exchanged for dollars and then the dollars are used to pay the amount due in the second currency. For the euro to play this role, Euroland financial markets must become integrated and the liquidity of these markets enhanced.

By 2002, when replacement of national currencies is scheduled to begin, the demand for euros will clearly expand. The ECB gains seigniorage from the issue of euros. Euroland's banking sector, however, is just at the start of a process of mergers and consolidation, so far within borders rather than cross-borders. If the scope of banks ultimately becomes Euroland-wide, they will benefit from international use of their services. Since transactions with foreigners are conducted in the home currency, Euroland's banking sector will enjoy this advantage.

At the beginning of the year, there was much hype to the effect that the euro would be a strong currency destined to rival the dollar if not to displace it in international use. The high value of the euro at the year's start was \$1.1827. Thereafter the value fell until a low in July of \$1.0148. The usual explanation of the weakness of the euro has been the weakness of the economies in Euroland. The market may have spurned euros in view of the interest differential of 1.2 percent in favor of the dollar on 10-year government bonds. It is also possible that Euroland policy makers may not have been displeased with a weak euro as a support for exports.

Since July, the value of the euro has recovered somewhat. The improvement is associated with the belief of market participants that the economic outlook of Germany, France, and Italy, the laggards in Euroland's level of activity, has brightened, and the

outlook for the US economy less buoyant after factoring in expected increases of the Fed Funds rate by the Fed. The interest rate differential in favor of the dollar has declined to 0.8 percent but still persists, even if narrowed. The explanation for the limited reversal of the value of the euro vis-à-vis the dollar is consistent with the behavior of the interest rate differential. As of mid-September, the euro's value was \$1.03.

Proponents of EMU seem to believe that the euro will challenge the dollar for international monetary supremacy in fairly short order. If that challenge is to occur, in my view, the time frame is likely to be long, not short.