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From start-up to scale-up: the global role of the euro

"Great powers have great currencies."
(Robert Mundell, Nobel Prize laureate)

The EU is a great power

The European Union (EU) covers over 4 million km² with 508 million inhabitants, which makes it the world's third largest population after China and India. The EU is also responsible for around 16% of global GDP. It is the biggest global market as well as the biggest trading block, and the top trading partner for 80 countries. A stable business and legal environment without capital account restrictions makes the euro area a particularly reliable and attractive partner.

The euro is a great currency

The euro area (EA) covers 19 countries. Around 60 countries have linked their currencies in one way or another to the euro. The euro area alone represents 340 million people. In its first 20 years of existence, the euro has become a leading reserve currency, invoicing currency and issuing currency. Since its beginning, Europe's common currency has been the second most important global currency. Nowadays it constitutes around 20% of global reserves and around 20% of debt issuance. What is more, 36% of global invoicing and settlement are processed in euro. Europeans identify the euro as one of the main symbols of the EU. The euro brings benefits like lower exchange rate and currency conversion costs, a reduced interest rate on euro denominated assets, price transparency and more robust access to funding in times of stress in the markets.

Yet, it is important to acknowledge that the financial crisis, which shook the world, also affected the international attractiveness of the euro. Since that time, the architecture of Europe's Economic and Monetary Union (EMU) has been significantly reinforced.

Is the euro "great enough"?

Here the answer is: not yet. If the euro played a more international role there would be less dependence on the US dollar and other currencies. But, a more prominent role on the global scene for the euro is not a question of "if" but rather of "when".

Strengthening the global role of the euro would have a positive impact on the countries of the euro area countries and on the other EU Member States, but also globally, by enhancing financial stability worldwide and offering stakeholders, particularly investors, more choice. That is why the European Commission issued a Communication "Towards a stronger international role of the euro" in December 2018.[2]

Let us try putting on "inventor lenses" for a moment and look at the euro from that perspective. Any invention starts with a great idea. We can thank Francois Mitterrand and Helmut Kohl for that. The idea needs capital (in our case, political capital) in order to go from proof of concept to market introduction. For the euro it meant building the institutions and creating the regulatory environment. There is no doubt that the first 20 years of the euro were a success.

Were the inventors of the euro zooming in on the global importance of the euro?

At the time of a creation of a single currency, the internationalisation of the euro was not the priority for policymakers. Given the strength of the multilateral rules-based order in the early

[2] https://ec.europa.eu/commission/sites/beta-political/files/communication_-_towards_a_stronger_international_role_of_the_euro.pdf.

2000s, European leaders considered that promoting the internationalisation of the euro was not a necessary condition to foster European economic growth and trade. But that picture has changed dramatically.

The EU economy was hit by the financial and sovereign crisis, which was triggered in the USA but had a global impact. Quick technological change is re-shaping the functioning of financial markets. The rules-based multilateral system is being challenged and new economic powers are emerging.

The world order appears to be shifting from a rules-based multilateral system towards a multi-polar world in which Europe needs to define its new role. This means also revisiting the global role of the euro. It is time for the euro to move from start-up phase to scale-up phase. This means zooming in on how to increase the global role of the euro and give it global impact.

How do you take a successful product from start up to scale-up?

Let's put our inventor lenses on again. Scaling up a successful product means:

Chart 1

The global role of the euro: from start-up to scale-up

Source: European Union (2019).

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- working with your suppliers to do more,
- understanding how to engage your customers in a broader way,
- extending your distribution channels,
- improving your after sales service,
- above all, it means finding capital.

Let us look at each of these five in relation to the euro.

1 Suppliers

Suppliers are all those who bring euro-denominated products to the market. Among bond issuers, sovereign debt issuance stands out. ECB data show that on average 98% of the outstanding government debt securities issued by euro area member states is denominated in euro. Yet, there are large differences among the euro area member states, ranging from 100% to 69%. Unsurprisingly, the same data show much lower euro-denominated issuance in non-euro member states. Here, the average is that 22% of the debt issued in these countries is denominated in euro and some countries, like the UK or Denmark, do not issue euro-denominated government debt at all.

European organisations "owned" by the EU member states have a slightly less good record than their shareholders. The EIB and the EBRD issued respectively 34% and 50% of their debt in US dollars in 2018.

2 Customers

The customers are those who use the euro for payments/settlements as well as holding reserves. Despite the euro's relatively wide use in international payments, less than 60% of the euro area's external exports are actually invoiced in euro. This is in stark contrast with the United States, where about 90% of exports are invoiced in US dollars. Along with encouraging issuance in euro, promoting its use as an invoicing currency will also be important.

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There is a sectoral dimension to this. Some markets such as energy, transportation (aircraft) and commodities are subject to very strong US dollar dominance, sometimes for mostly historical reasons. Tackling these possible inefficiencies in specific sectors could improve euro liquidity.

However, the example of the aircraft industry also shows the challenges and limitations of fostering an enhanced role for the euro. A consultation launched by the European Commission at the beginning of the year shows that companies tend to accept US dollars even when their cost base is largely in euro and even if it implies difficult and costly hedging operations.[3] One key reason for this is the prevalence of global supply chains and financing options that are predominantly denominated in US dollars.

Inertia in these markets is a significant barrier to greater use of the euro.

3 Distribution channels

Distribution channels are the euro payment infrastructures and market places. Recent EU reforms to Europe's clearing and settlement systems, as well as the introduction of an instant payments system last year, have equipped the euro with the safest and most efficient, open and large payment infrastructure in the world. For the development of the market place, completing the Capital Markets Union will be crucial. The ease with which financial assets can be bought and sold is essential for the financial system to work properly and to support investment and economic growth. The liquidity of a currency is therefore a significant characteristic of a healthy distribution channel.

In addition, there is an increasing competition for distribution channels. China, for example, is creating incentives along the Belt and Road Initiative (BRI) to allow for greater use of the Renminbi. In a recent bilateral agreement with Pakistan creating the China-Pakistan Economic Corridor, the two countries agreed to conduct bilateral trade transactions in their own currencies.

4 After sales servicing

Strengthening the international position of the euro will not be possible without strengthening the euro area from inside. This means completing the Economic and Monetary Union, including the Banking and Capital Markets Union.

Deepening EMU is critical for the international attractiveness of the euro for three key reasons. First, *confidence in the value of the euro is ensured by the predictability and credibility of the EU's monetary and economic policies*, as well as the medium- and long-term growth prospects of the euro area. By improving economic resilience and boosting growth potential, initiatives seeking to deepen the EMU can support the attractiveness of the euro to international investors. This is why we need to promote growth-enhancing reforms and take steps at national level to fully implement the

[3] *After the conference, the European Commission has published the results to the consultation: https://ec.europa.eu/info/sites/info/files/strengthening-international-role-euro-swd-2019_en.pdf.*

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Country-Specific Recommendations. We need to be able to create predictability around investment. These considerations are also at the heart of the current discussions on a Budgetary Instrument for Convergence and Competitiveness.

Second, *a robust institutional set-up is essential to increase the confidence of "suppliers" and "costumers"*. This also depends on the strength of the institutions, and the way their competences are organised across levels of government. A stronger EMU requires stronger legitimacy and governance and a fair and balanced political representation of interests of all Member States. Those are the guiding principles underlying the current reform discussions on the European Stability Mechanism.

Third, *deep and broad financial markets are necessary to increase the attractiveness of the euro both as a currency for payments and as a store of value*. Investors looking for safety and liquidity need a broad variety of euro-denominated financial assets and well-developed secondary markets. In this respect, the completion of the Banking Union and the Capital Markets Union – building on the proposals made by the Commission in recent years – remains crucial. These are central initiatives for the further integration of financial markets in the EMU and its overall resilience, which will increase the liquidity and credit quality of euro-denominated assets.

5 Capital

That takes us to the capital part, the alpha and omega for any inventor seeking to scale up. For the euro, we are talking about political capital and trust capital. How can we present a convincing pitch?

There are some very strong arguments in the euro's favour. Article 63 of the EU Treaty prohibits all restrictions on capital movements and payments, not only within the EU, but also between EU countries and countries outside the EU. This is a (quasi) constitutional guarantee. The rule of law provides assurance for businesses' autonomy and capital flows. I already mentioned the size and economic weight of the euro area. Reforms on banking union and deepening EMU are already underway.

Two non-euro member states, Bulgaria and Croatia, have signalled recently their intention to join the euro area and are actively getting ready, which confirms that political and trust buy-in remains strong.

I note furthermore that the role of the euro caught the attention of political actors far beyond finance ministries, namely foreign ministries and chancelleries. This also means more "political capital".

All of this will affect market participants and support the development of "trust capital".

The glass is half-full as we enter the new political cycle in Europe.

What are the next steps?

After several targeted consultations on energy, foreign exchange markets, aircraft, maritime and rail respectively, the Commission will pull results together in a report that is scheduled for June. The Commission teams are still in the midst of analysing the data, but below are some first conclusions.

The take up of the consultation was very good, with more than 60 respondents covering the key market actors with around half of the participants coming from the banking sector, followed by industry associations. Other types of financial institutions such as exchanges, trading platforms, investment funds, insurance companies and credit rating agencies also participated in the consultation.

Overall, there is broad support for increasing the global role of the euro. Not surprisingly, there is broad agreement on the importance of liquidity for the global role of the euro. It matters in terms of volumes traded in foreign exchange markets, listing of currency pairs available and promotion of euro currency pairs by market makers. A majority of respondents highlighted that the market liquidity of currency pairs involving the euro was lower in comparison to those involving with the US dollar.

Concerning the cost of hedging, views are more differentiated. While 45% of respondents judge hedging costs to be broadly the same in euro and US dollars, 37% consider hedging more expensive in euro.

A main conclusion stemming from the sectoral contributions, is that the prominence of the US dollar is strongly linked to long-established market habits. In the oil sector, oil benchmarks are almost exclusively denominated in US dollars and all oil derivative products depend on these benchmarks. In the aircraft industry, the US dollar is dominant across the whole value chain. Moreover, banks and other investors are very reluctant to provide credit and liquidity in currencies other than the US dollar.

When asked about factors that could support a greater role of the euro, the consultation found strong support for the package of measures proposed by the Commission in its December 2018 Communication. Respondents supported coordinated action at three levels, i.e. the EU level, the national level and market participants. Completing the Banking Union and the Capital Market Union was widely considered as an element to enhance trust and confidence in the euro.

Conclusion

We are in the middle of a next project around the euro. The first 20 years were about starting-up. Now we are gearing towards scaling-up. The debate around the euro echoes a wider European debate: what is the place of Europe in the world? To what extent will other global actors influence our decisions about citizens, data and governance? How do we protect and leverage our internal strength globally? In this debate, the euro is one of the crown jewels.