The euro challenges the dollar in international finance

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Road map

- Network externalities
- Key role of *financial markets*: interplay between vehicle currency and asset currency functions (for both private sector and central banks)
- Reserve holding and anchor currency role
- Invoicing/quotation: trade and assets
- Investment currency
- Vehicle currency
- Costs and benefits
- ‘World banker’ role

Markets choose international currencies, network externalities important

- But models with network externalities have multiple equilibria (Portes and Rey 1998)
- Might shift if expectations and transactions costs change, with high elasticities of substitution between assets denominated in alternative major currencies

Financial globalisation and international currencies

- Cross-border financial flows up much faster than trade
- Asset trade (including with emerging markets) dominated by major international currencies
- Resulting customer-dealer transactions in FX markets → large volumes of intra-dealer transactions
- FX markets have expanded dramatically, also international use of derivatives etc.
- Hence ***international role of a currency today much more related to financial than trade flows*** (relative to 1990)

International currency roles are linked

- Choice of reserve currency depends on currency stability (store of value, unit of account), size of economy, role in world trade
- Financial market determinants of vehicle currency
- Vehicle currency influences composition of reserves (maybe less so now, with more inflation targeting and floating)
- Size, depth and liquidity of financial markets also key in choice of investment currency

Dollar dominance in reserve holding

- Confirmed by Bretton Woods
- Maintained/explained by ‘network externalities’
- But does that make sense for central banks?
- And diversification motive works the other way – especially if there are alternative assets tradeable in large, liquid and deep financial markets
- And increasing use of euro as pegging or ‘anchor’ currency may change incentives for reserve holders

Central bank diversification

- Across assets – including activities of SWFs
- Across currencies
- Factors relevant to the currencies: inflation, ER volatility
- Inertia (persistence)
- Regionalism – distance matters

Anchor currency role

- Switch from $ to basket pegs (Russia, Libya, China, maybe GCC)
- De facto anchoring – some switch towards €, comparing 2005-6 with 1994-8

Private use: invoicing

- Data scant, but € gradually rising,especially when one party is an EU country
- Attractiveness of currency for invoicing affected by ER risk, volatility of inflation, capital market development, absence of capital controls – so € now attractive alternative
- Network externalities surely relevant here
- $ used for reference-priced and exchange-traded goods – won't change unless transaction costs change a lot
- Still, natural gas market worth watching, and OPEC becoming unhappy about $ pricing

Investment currency

- Transaction costs now lower for €-denominated than for $-denominated corporate bonds, close for government bonds
- Bid-ask spreads in FX markets now similar (very close to zero)
- €-area financial development now comparable to US and UK, superior to Japan
- Bund is world's most important hedging instrument
- But euro-area government bond market still has separate issuers, and corporate bond and equity markets much smaller than US

Issuing (quotation) currency

- € issuance exceeds $ in international markets since 2001, and € ahead of $ in outstanding stocks since
- € has brought significant increase in liquidity of international debt markets (Bobba et al. 2007)
- Is $ still ‘safe haven’? Not in August 2007, but apparently yes, since Lehman – although flow into dollars might be explained by unwinding of carry trade and deleveraging

Other private-sector use

- Optimal *hedging* strategies (Campbell et al. 2007): bondholders should be in $ (which appreciates when global bond prices fall), equity holders in € as well as $ (both negatively correlated with global equity returns)
- And volume of cross-border equity transactions growing faster than for bonds
- Physical currency use: $ still dominant, usage outside US 3 times greater than € outside EMU
- But €-denominated deposits from non-€-area residents) growing rapidly

Vehicle currency in FX markets

- BIS (2007) shows $ still dominant (appears in 86.3% of transactions, down from 88.7% in 2004)
- € at 37.0% (37.2% in 2004)
- $ also dominates OTC FX derivatives
- But € exceeds $ in market for OTC interest rate derivatives (cf. government bond markets, where cash market dominates futures for US Treasuries, the reverse for € government bonds)

Still, is € area capable of managing an international currency?

- Financial stability and regulation – fragmentation of regulatory authority
- Institutional factors (taxation, legal systems, ...) may impede further progress of financial integration and modernisation
- Unclear LLR authority
- But ECB has handled market liquidity problems at least as well as Fed
- And € area (with UK) led on bank recapitalisation and market reliquification

ECB cool to international role

- Internationalisation of the currency may complicate monetary policy – but no evidence
- And there are clear benefits
  - seigniorage could come to almost 0.5% of GDP
  - liquidity premium a further 0.5% of GDP
- Euro exchange-rate volatility has risen since 1999 – a cost

US is still ‘world banker’ with ‘exorbitant privilege’

- US borrows short, lends long, and earns excess returns on all asset classes (Gourinchas-Rey)
- Since 1999, euro zone investors have not earned consistent excess returns
- Like the US, the euro zone obtains a positive valuation effect when euro depreciates and suffers a valuation loss when it appreciates (assets in foreign currencies, most liabilities in euro)
- Euro area assets and liabilities are a higher percentage of GDP than for US – more highly leveraged
- But US does more maturity transformation

But global imbalances threaten dollar's dominance

- Unprecedented that main international currency is issued by country in substantial, continuing CA deficit, with NIIP << 0
- UK pre-1914 also borrowed short and lent long, but it ran a large CA surplus and was big net creditor

Summing up

- Network externalities are important but not decisive, except in vehicle currency role
- Euro clearly gaining ground, except in vehicle currency role
- There are significant economic benefits, possible small costs
- The supposed ‘structural weaknesses’ of the euro area are overstated as impediments to international currency role
- US is still the ‘world banker’, but on an increasingly precarious base