

## The international role of the euro

Lunchtalk, 3 September 2012

### Speakers

Marcel Fratzscher, Head of the International Policy Analysis Division of the ECB

Maurizio Habib, Senior Economist, ECB

**Chair:** Guntram Wolff, Deputy Director of Bruegel

**Discussant:** Zsolt Darvas, Research Fellow at Bruegel

On 11 July 2012, the ECB published its 11<sup>th</sup> annual review of the international role of the euro. Its purpose is to present the development, determinants and implications of the use of the euro by non-euro area residents.

Following the structure of the report, the ECB presentation was divided into three sections. After depicting developments in 2011 (chapter 1), the second section was dedicated to the impact of the crisis on foreigners' appetite for euro area securities (chapter 2). The presentation was concluded with an overview of the changing landscape of global currencies and the international monetary system, with a particular focus on the renminbi (chapters 3 and 4 of the report).

The main findings of the report are that the international role of the euro remained relatively resilient in 2011. The euro also remained an important anchor of stability, especially for the neighbouring regions of the EU.

The euro preserved its share of around 25 per cent of disclosed global foreign exchange reserves in 2011. The drop in the share of the euro in the first quarter of 2012 is well in line with its standard volatility over the past decade. Foreign demand for euro-denominated debt securities was stable in the first half of 2011, and slightly decreased during the second half. The euro's share in foreign exchange deposits in CESEE declined somewhat as well towards the end of 2011, possibly due to an intensification of financial strains in some euro area countries. At the same time, the euro remained the most widely used foreign currency in the CESEE countries.

The appetite of foreign investors for euro area securities experienced a drop in euro area high-yield countries compared to the previous year. Overall, the impact on foreign demand was different compared with the Lehman crisis.

The Report also investigates the role of the Chinese renminbi in the international monetary system. The Chinese currency has been gaining ground in international trade transactions, particularly in Asia. The use of one international currency does not necessarily exclude another however. Multiple international currencies can prevail simultaneously (Chitu, Eichengreen and Mehl, 2012). During the following discussion, questions regarding China's future role in the international monetary system were raised, especially in the light of recent renminbi-trade settling agreements signed between China and other countries. Analytical work shows that financial market developments require capital account liberalisation and exchange rate flexibility. Despite a gradually growing role of the Chinese currency since the past few years, China's capital account remains relatively closed and capital cannot flow freely. This implies significant costs and hinders a full development of the country's financial markets as well as of the international profile of its currency.

In the following discussion, Zsolt Darvas pointed out to what he deemed as a possibly “surprising” result of the report, that despite the sovereign debt crisis and the signs of growing financial segmentation within the euro area, the euro had not been losing ground as an international currency. In his view, some possible explanations for this resilience include the following:

- The US also faces significant challenges, such as fiscal sustainability, notably should extraordinary low interest rates start to normalise.
- Markets may believe that the euro area will stay together, or if not, that at least a ‘core’ euro area would remain and therefore that the euro-denominated liabilities of these countries are presumably safe

Mr Darvas therefore wondered how to reconcile the growing segmentation observed in the euro area with the stability of the common currency. He wondered what the underlying explanations and interpretations of the stability of the euro are.

The open discussion with the participants entailed that part of the answer could be a change in the composition of capital flows within the euro area and increasing home bias in the preferences of investors. The resilience of the euro as an international currency could then be interpreted as a sign that investors still see the euro as the second most important international reserve currency (after the US dollar) .

Concerning the observed stability of the euro in various aggregates measuring its international role, notably as an investment currency, Mr Pisani-Ferry also enquired about potential shifts in the sectoral and country composition of capital flows to the euro area, which could be studied using more granular data. In addition, Mr Pisani-Ferry suggested that central banks issuing international currencies should stand ready to provide swap lines.

Last, as for the broader question regarding the medium term prospect of the euro as an international currency, one of the major issues is the impact of the declining share of European countries in global output, of the EU’s fragmented governance.

*Event notes by Li Savelin*