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Thinking ahead for Europe

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The euro's global dreams and nightmares

Barry Eichengreen

One motive for founding the euro was to create a European unit that might provide an alternative to the dollar as an international and reserve currency.[1] The Werner Report, the first full-throated argument for a single European currency, was issued in a period of angst about the Bretton Woods System and the dollar (Zimmermann, 2002).[2] The Delors Report, which provided a detailed roadmap in 1989, was not unrelated to the preceding decade of wild dollar fluctuations.

After 1999, European authorities continued to pay lip service to the idea that the euro should become a fully-fledged alternative to the dollar.[3] Now, however, this notion has gained urgency as a result of the Trump Administration's enlistment of the greenback to advance its foreign policy goals.

The Administration proposes to track transactions cleared through the Society for Worldwide Interbank Financial Telecommunications (SWIFT) between European firms and their Iranian customers in violation of unilateral US sanctions. It insinuates that it will bar US banks from providing dollars to European entities engaged in this business. The threat matters, since the single largest share of transactions booked by SWIFT, nearly 50 per cent of the total, are denominated in dollars. They therefore require dollar credit.

More generally, there are reasons to doubt that the US will remain a reliable source of the dollar liquidity that greases the wheels of international commerce and finance. Trump's attacks on Jerome Powell raise troubling questions about the stability of the greenback and US financial

[1] An international currency is used widely as a unit of account, store of value and means of payment in cross-border transactions. A reserve currency, in contrast, provides these functions specifically to central banks and other official holders.

[2] In the event, European fears were validated when US President Nixon unilaterally suspended the dollar's convertibility into gold in 1971.

[3] It has done so most prominently in an annual report on *The International Role of the Euro* issued by the European Central Bank each June (more on this below).

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markets. The US president's belief that international trade and finance are zero-sum games casts a shadow over the prospects for international cooperation. In 2007, the Federal Reserve lent dollars to the American subsidiaries of European commercial banks such as Deutsche Bank and Crédit Agricole. It provided dollar swap lines to foreign central banks, ensuring the liquidity of global markets and preventing financial instability from spreading further (Sheets, Truman and Lowery, 2018). Its operations were criticised by the likes of Senator Rand Paul as a give-away of US taxpayer money. Now, with the Fed under attack by Trump, it is reasonable to ask whether the central bank will feel free to engage in such initiatives again.

This in turn points up the question of what Europe should do in response. As the European Commission (EC 2018a, p.4) cautiously puts it, without naming names, "recent extraterritorial unilateral actions by third country jurisdictions like in the case of re-imposed sanctions on Iran, together with recent challenges to the international rules-based governance and trade, are a wake-up call regarding Europe's economic and monetary sovereignty".

No one questions that the euro remains a considerable distance behind the dollar as a vehicle for international payments, a unit of denomination for international bonds, a source of international reserves, and a focal point for foreign exchange transactions. More contentious is the direction of travel. The European Central Bank, in its latest report on *The International Role of the Euro* (2018), highlights positive developments. The share of global foreign exchange reserves held in the form of euros, it observes, rose in 2017. The currency's share of global payments also rose in 2017, according to SWIFT. The share of the euro in global foreign exchange turnover, according to CLS, increased in the course of the year.

Maggiori, Neiman and Schreger (2018), by comparison, paint a bleaker picture. They show that the share of cross-border corporate bond holdings denominated in euros fell sharply since the global financial crisis. The currency's share of global foreign exchange transactions, as tracked by the Bank for International Settlements, similarly fell over the decade.

The timing of these movements sheds light on the nature of the problem. Most of the decline in the euro's share of cross-border bond holdings, for example, was centred in 2010-2012 – that is, between the eruption of the Greek crisis, which created existential doubts about the future of the euro, and Mario Draghi's "do whatever it takes" pledge which put those doubts to rest. This observation suggests a relatively positive take on the euro's prospects, since existential doubts about the currency have since receded.

But while the fall in the share of the euro in global foreign exchange transactions was similarly concentrated between 2010 and 2013, that share continued to decline between 2013 and 2016. This trend suggests a less positive spin. It indicates that more than just "do whatever it takes" is needed to enhance the euro's international role.

What does the Commission propose?[4] Much of what it recommends is a repackaging of proposals advanced previously on other grounds. On the financial side, the Commission

[4] Again, the proposals described here are advanced in European Commission (2018a).

emphasises finalising the Banking Union to enhance confidence in Europe's banking system. It advocates completing the Capital Markets Union in order to buttress economic and financial stability (by increasing private-sector diversification and risk sharing), and in order to enhance liquidity through greater integration (which will create a deeper market populated by more diverse participants). It reiterates an earlier proposal that the private sector should pool, securitise and tranche government bonds.[5] The senior tranche would receive an AAA rating, be traded Europe wide, and therefore enjoy relatively high liquidity, making it attractive to international investors. The Commission similarly recommends full implementation of the existing Benchmark Regulation mandating the creation of more transparent and reliable reference interest rates for use in financial markets.

At a more general level, the Commission reiterates its proposal for a dedicated fiscal fund to provide stabilisation in the event of asymmetric shocks affecting some members of the monetary union. By creating a more robust economic union, it argues, this fund will strengthen confidence in the eurozone economy and, thereby, its currency. Whether there is political appetite for meaningful action along these lines is another matter, of course.

That these initiatives are a repackaging of existing ideas does not make them inconsequential. But despite having been underway for some time, they have produced only incremental results. In turn, this suggests that they will at most incrementally enhance the international role of the euro.

One novel element in the Commission statement is "a targeted consultation with financial market actors" to identify obstacles to wider trading of the euro on foreign exchange markets. Were the euro traded more widely, it would be easier to hedge euro-denominated risk. The currency would then become more attractive as a vehicle for invoicing, payments and investment.

But the dominance of the dollar on global forex markets may in fact be a historical inheritance that cannot be overturned by consultation alone. It may reflect historical circumstances giving rise to a contemporary convention – trade currencies against the dollar – that is itself the source of liquidity of dollar currency pairs. This kind of convention can't be overcome by selective consultation, given the decentralisation of global forex markets and the large number of participants. The Commission can't consult with everyone. Nor can it force everyone with whom it consults to shift their business to euros. And absent a simultaneous shift, there will be little incentive for individual traders and institutions to alter established practice.

More concretely, the Commission notes a number of specific measures the official sector can take to boost activity in euro-denominated markets. Airbus can be encouraged to invoice more of its transactions in euros (the majority are still in dollars). Energy companies can be coaxed to invoice and pay for oil and gas imports in euros (the dollar continues to dominate this market). The European Investment Bank and other official entities can curtail their issuance of dollar denominated debt. Foreign aid disbursements by European governments can be

[5] See European Systemic Risk Board (2018).

denominated and transferred in euros. These concrete acts would generate a modest increase in the installed base of euro-denominated securities and the flow of euro-related transactions. They would thereby enhance the liquidity of the market and attract other participants.

But there has been chatter to this effect for years, with only marginal results. Geopolitical tensions might make for slightly faster movement in this direction, but it is hard to imagine them causing trading activity to tip sharply toward the euro.

The one thing that could tip the balance would be a stampede by investors out of the dollar and into the euro, the only existing alternative of any consequence.[6] This is not something that the European Commission could, or for that matter should, want to precipitate. It is, however, something that President Trump, were he to fire his Fed chair and treasury secretary and then mismanage the resulting crisis, could inadvertently provoke.

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[6] There is much talk of the Chinese renminbi as an alternative, but as of end-December it accounted for a mere 2 per cent of payments through SWIFT.