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The international role of the Euro

Abstract

This paper analyses the main factors that determine the performance of the euro as an international currency. The economic elements are explained in terms of trade participation, the degree of openness, population, and the geographical scope of the EU compared to the United States. Also, the development of the European financial markets contributes to understanding the role of the euro in the International Financial System; how the euro has influenced the integration process of financial markets in Europe, and what remains to be done regarding financial integration to enhance the position of the euro. The political analysis is focused on the performance of the Eurosystem and the European Central Bank, as well as in the advantages that political integration could bring to the euro. Attention is paid to the process of decision-making in determining both monetary and fiscal policies inside and outside the EU, the institutions in charge, the external representation of the EMU, and how all those elements affect the euro as an international currency. Chapter three concludes with an analysis of the political power of the euro and the challenges that it represents for the EU members in the short term and the foreseeable future.

Key worlds

Euro, Eurosystem, ECB, EU Members Financial Marker, US Dollar

Introduction

After the U.S. dollar, the euro is considered the second most important international currency, followed by the Japanese yen. The creation of the EMU in the form of the Eurosystem and the launch of the euro in 1999, according to the established by the Maastricht Treaty, raised some questions about the performance of the common currency and its relation to the U.S dollar.

The expectations it raised led to speculations if the new currency could become a major rival to the US dollar's supremacy in the International Monetary System and, eventually, even replace the greenback as the top currency.

With the appearance of money as the main vehicle for transactions, several currencies have been considered international in their use in different historical periods. What determines the replacement of one currency for another has depended on the international conditions of a particular time, as well as, the internal situation of the issuing countries. The most recent case is that of the rise of the US dollar to replace the British pound in the 20th century when British power was reduced by two World Wars and the United States established itself as a superpower both in the political as well as in the economic fields.

The second part of the 20th century witnessed the creation and development of what is considered the most successful case of economic regionalization. Several European states decided to avoid more wars through economic means, which eventually led them to achieve both commercial and monetary integration in the form of a common currency, the euro. In the process, the EU has not only solved the inter-state conflicts that had characterized European history, but it has also helped to make the EU and its members major players in the global arena once again.

In the present study the focus is on the performance of the euro and the Eurosystem in the International Monetary System, the way European authorities face the challenge of having a single currency, the position the international financial actors adopt in respect to the euro, and the future of the euro as an international currency.

1. The euro as an international currency

There is no doubt that the euro had shown a rapid growth as an important currency in the International Monetary and Financial Systems even before its physical appearance in 2002. Although the euro has been in use for a short period, it has been set in the second place of the top currencies. But, what has made it possible for the European currency to become such an important player in monetary affairs? The use of the euro as an international currency is determined by three main factors: 1) the demographic and economic importance of the euro area and the degree of openness of the EU economy in relation to the rest of the world economy; 2) the rate of development and level of activity of the European financial markets and institutions; and, 3) the stability of the currency and the credibility of the ECB to guarantee the maintenance of the purchasing power of savings (Solana, 1999).

However, the euro is still far from replacing the US dollar as the first international currency. In the same way that the factors mentioned above have contributed to strengthen the position of the euro, it is important to note that there are also certain weaknesses within those factors which are provoking a slow adoption of the euro in particular areas. When the euro appeared, it generated great expectations about if it will replace the US dollar in a short period of time.

But those expectations have been replaced by more cautious analysis and arguments about the rise of the euro as the top global currency and the persistence of the US dollar in the privileged place. What are the conditions that have been determining the performance of the euro in the International Monetary System? We can analyze those factors from both an economic and a political perspective.

The demographic and economic importance of the Eurozone

According to Tavlas (1998), the larger the country's share of world trade, the more likely its currency is to be familiar to traders and the most useful is that currency as a unit of account and a medium of exchange. The size of a country's transactional network determines, in an important manner, the degree a currency is used in international transactions. A country's share of world trade is determined by two main quantitative factors: the demographic constitution of a country, particularly the number of inhabitants, and its economic position, that is its GDP participation and the degree of openness.

General data shows that:

• Population: In the case of population in the EU – 385 million inhabitants in 2010 for the 27 countries and 310 million for the euro area which represent the 7.2% of the world population– it exceeds the population of the United States – 295 million inhabitants in 2005 which represent the 4.6% of world population.

• Gross Domestic Product (GDP): in 2005 the EU's GDP was of $11 billion dollars while that of the United States was $10.9 billion dollars;

• Degree of openness: The degree of openness of an economic area is also a relevant factor as regards the international impact of its currency. In this respect the euro area is more open than the United States, with a percentage of external trade of around 14.6% of GDP, as compared with 8.8% for the United States. In 2005 the percentages of FDI for the EU and the United States were of 25.7 and 31.3 respectively; while the percentages of investment that European and American companies made overseas were of 46.1 and 24.8 respectively.

The considerable participation of the EU in world trade and the increasing population derived from the most recent enlargment have given a bigger projection of the euro in the international arena. The future adoption of the currency by the new members has already amplified the area of influence of the EU, since they have been linking their monetary activities around the euro even before they were fully accepted. The opposite case is that of Sweden, Denmark, and the United Kingdom, who have chosen to stay out of the EMU and whose future adoption of the euro still remains in doubt. The entrance of these three countries in the EMU could increase the weight of the euro in the international financial system, particularly with the participation of London, one of the most important financial centers.

The influence of the euro is not only constraint to the borders of the memberstates. The Euro-time zone integrates those countries and regions that could experience an influence of the euro in areas such as trade, finance, and development aid. In general, the Euro-time zone is formed by countries physically located in the periphery of the EU such as the Eastern European countries, many of which have applied for EU's membership, and Mediterranean and Middle East states; it also includes those regions with particular links to European states like countries that were part of the former European colonies in Africa, the Caribbeann, and the Pacific (ACP).

The importance of expanding the transactional network of a currency implies developments in different economic, demographic, and geographic factors as it has been seen. All those elements help to promote the use of a currency beyond the borders of the region and, consecuently, to enhance the position of the euro.

The progress achieved by the EU in the internal liberatization of trade due to the creation of a single market and the important presence it has gained in the international trade system, have made the EU a major player in trade negotiations and forums, equalizing the weight of the United States and acting sometimes as a partner and sometimes as a powerful challenger of American decisions.

The financial dimension: the European Financial Markets

The International Financial System has been considered one of the most important elements of the global economy. Susan Strange recognized this feature when she explained that finance was one of the four pillars of the world economy because of its fundamental function in the creation and allocation of credit and the international monetary order. The International Financial System has shown a rapid evolution both in the products and benefits it provides as well as in the volume of transactions that take place around the world, all of that derived from the changes in technology and the deregulation of financial markets.

The case of the European Financial System can be differentiated from other financial centers like the United States or Japan. The European Financial System – in particular the continental European model – is characterized by the dominant role of banks in channeling savings toward investment opportunities, engaging directly in the full range of securities activities, and establishing linkages between banks and insurance companies. In addition, in many European countries the widespread presence of central or regional governments in the ownership structure of banks has been seen as a way to alleviate the risk of systemic instability in the financial system (Padoa-Schioppa, 2004).

The creation of the euro has fostered the integration of the European financial markets. The transaction costs have shown an important decrease since the euro appeared, facilitating and expanding the transactional network of financial assets, especially because of the elimination of exchange-rate uncertainty. We have to remember that the establishment of well developed financial markets provides a fundamental ground for the international use of a currency.

Financial markets must have particular characteristics such as the freedom from controls, a wide variety of financial instruments, and the development of secondary markets.

However, the European financial markets are still far from achieving a total integration that could improve the performance of the euro. The Euro area financial markets remain far less liquid, less diverse and less integrated that the US markets, all of which have made investors reluctant to switch from dollar-into eurodenominated assets (Sapir, 2006). One of the reasons for the lack of total integration of the Euro-area financial markets is the considerable participation of banks in financial transactions, contrary to the case of the United States where most of them are conducted by individuals, corporations, pension funds, or other institutions.

The remarkable element in the process of integration of the European financial markets is that it has not been the same for the different market segments, nor for all the countries:

- The **foreign exchange markets** saw the most tremendous changes, but also the least spectacular ones, because it is evident that the introduction of the euro stopped all trading between the Euro-area currencies (Lederer, 2003)
- Another market that shows an almost complete integration is that of the **money markets** characterized by their high liquidity and the creation of the Euribor – the deposit rate used in European interbank market and which forms a common form of pricing within the Euro area (Lederer, 2003). However, the Repo-market segment has shown a slower development due to differences in the regulatory, legal, and tax environment as well as to differing markets practices (Galati and Tsatsaronis, 2003)

- The opposite case is that of the **loan markets** where – as it was already mentioned – most of the loans are acquired through banks and not through wholesale markets. These markets are furthermore still domestically dominated, because in the Euro-area banks give still 90 per cent of their loans to domestic customers and receive 91 per cent of their deposits from the same nationals where they headquarter is located (Lederer, 2003)
- The bond market has been the financial market segment where the influence of the single currency has been the quickest and most pronounced. In part this reflects the fact that the European bond market, in both its government and private components, had a fairly international character even before introduction of the euro (Galati and Tsatsaronis, 2003). The case of the **bond market** integration is due to the decision of market actors in diversifying their portfolios by investing on sectors instead of a country's preference. Among all the capital markets, the **equity and derivative markets** are considered to be the less integrated, partly because they started to integrate recently.

Although financial exchange has been extensively deregulated, the process of financial integration has also been considered one of the most important issues on the policy agenda of the EU. In 1998, the European Commission proposed a Financial Services Action Plan (FSAP) to establish deep and liquid markets in Europe and to broaden consumer choice (Freixas *et al.*, 2004). These policy actions are particularly relevant if we consider that by making European financial markets more efficient and transactions costs cheaper, the emergence of the euro as an international currency will be strengthened. So far, the euro is being more used as a store of value than as unit of account and medium of exchange. The dollar remains the first choice for commercial transactions and as a vehicle for other currencies' trade.

The inertia in monetary practices is one of the key factors that keep the US dollar as the main top currency. This inertia is caused by the uncertainty a change in a new currency can bring. So far, the European currency has had a relatively good performance, but, because of its short age, many doubts still remain about its improvement as unit of account and medium of exchange. The clearest indicator of a money's international status is the amplitude of its use as a medium of exchange in the foreign exchange market; top currencies are bought and sold not only for direct use in trade and investment, but also as a low-cost intermediary – a "vehicle" for the trading of other currencies (Cohen, 2003).

In conclusion, a deeper and wider development of the European financial markets is needed to strengthen the international status of the euro which, at the same time, will bring the benefits of certainty for investors when trading with assets denominated in a strong currency backed by well-established financial markets.

The Eurosystem, the ECB, and the euro: who makes policy?

The Maastricht Treaty established the Eurosystem as the central institution in charge of conducting the single monetary policy in the EU. The Eurosystem consists of the European Central Bank (ECB) as the head of the system, and the European System of Central Banks (ESCB). The ECB Executive Board is in charge of the day-to-day business of the ECB and the execution of the decisions taken by the ECB Governing Council; the Executive Board is composed of the President of the ECB, the Vice-President, and other four members designated by the European Council. The ECB Governing Council is the body in charge of decision-making in monetary affairs and it is integrated by the Executive Board and the governors of the Central Banks that participate in the EMU. In total, the Governing Council is formed by eighteen members that decide the guidelines for the Eurosystem and the single monetary policy.

The primary objective of the Eurosystem is maintaining price stability, while economic growth and employment are second objectives. In order to achieve this goal, the ECB has been granted a high degree of independence from political interference by national governments. The Eurosystem combines a federal with a national role in the working process of policy-making: decisions are taken by the Governing Council of the ECB; implementation of decisions is made by the Executive Board; while the execution is done by the NCBs and the ECB (Padoa-Schioppa, 2004). However, it is not as clear as it may sound. Certain tasks are assigned to national central banks, while others are exclusive matter of the supranational institution. Besides, the Maastricht Treaty establishes the participation of the Council of Economics and Finance (ECOFIN) in the determination of the exchange rate policy. This situation make us think about the specific functions that each actor has to play in the determination of the EU monetary policy, where the only clear point is that functions are particularly unclear about who is in charge of conducting and representing that single monetary policy.

There is also the problem of a "crowded" Governing Council in the short term, when the new members of the EU become part of the EMU. The decision-making process will face a bigger challenge when this body grows from its 18 members to more than 30. A solution will have to be found in order to make the decision process more effective and to provide more credibility to the ECB.

The confusion that the policy-making process creates is not only restricted to Europe.

The lack of formal representation for the euro in the international forums creates an image of a multiplicity of positions in monetary affairs, particularly in the IMF where there is not a single body that represents the interests of the whole EU.

This case has been extensively criticized by scholars (Bergsten, 2005; Cohen, 2004; and Eichengreen, 1997), international organizations, and governments. The situation of the EU in the IMF has been attributed to the fact that the IMF "is a country-based institution that then will have to require an amendment of the Articles of the Agreement before other international entities such as the EU could become members" (Kiekens, 2002). To "solve" the case, the EU members have adopted common positions when it comes to their participation in the IMF, but this coordination has been entirely informal, which makes more evident the need for deeper integration on issues related to the external development of the EU.

A possible solution to the external representation of the EU is the formal establishment of the Euro Group – an informal body integrated by the eurozone finance ministers – as the institution in charge of this task. A single body that represents the EU's position on monetary and financial matters could provide a negotiating authority compared to that achieved in international trade negotiations.

The risk of maintaining separate representations for the EU members, as Benjamin Cohen has expressed, is a disincentive for market actors: "…fragmented decision making might fail to provide a clear indication of official intentions…" (Cohen, 2004)

The euro as a key element for political integration

The euro does not have behind it a political power as strong and as cohesive as that of the dollar or other currencies. The euro is issued by a union made up of multiple jurisdictions, not by a single political jurisdiction as in the case of the US dollar. The euro has given a tremendous impulse to the process of integration not only in the economic aspect, but also in the political one. The common currency has led to the convergence of policies in monetary and financial issues. It has proved that it is possible for a currency to perform as one of the most important international currencies without being backed by a single political power. So far, the credibility achieved by the ECB has been one of the key elements that support the euro in the international currencies market. The question is up to what point the lack of a strong political power will foster or diminish the international power of the euro?

The value of a currency is no longer determined by an intrinsic feature as it used to be in the times of the gold standard. Currently, the use and value of a currency depend on its purchasing power, based on the trust that like-minded transactors have in a currency's general use and acceptability (Cohen, 1998; Padoa-Schioppa, 2004). Public and market actors may be more confident in a currency which, in addition to the guarantee of an independent central bank, has the support of a strong political power. This is an assertion in favor of continuing with the decision to build a European political structure.

Monetary integration has been considered a fundamental piece in the search for political integration. However, it is also considered that political integration will follow quickly if monetary integration entails significant fiscal centralization, but slowly if it does not (Eichengreen, 1996). Fiscal policy remains at a national level; the power to tax and spend depends on the national governments wishes to distribute income and wealth. The importance of fiscal policy decentralization lies in the fact that large budget deficits – beyond those established in the Maastricht Treaty – can undermine the credibility of the euro (Tsoukalis, 2005). According to Eichengreen (1996), monetary integration would involve fiscal restrictions, and fiscal restrictions would lead to the centralization of fiscal functions, prompting the move to political union.

Also, the issue of accountability in monetary and fiscal matters remains a central factor that determines the political credibility of the euro and the ECB. Accountability is required to grant transparency in conducting monetary policy. Contrary to the US Congress ability to supervise monetary policy, the European Parliament lacks the authority to change the charter and mandate of the ECB (Padoa-Schioppa, 2004). This lack of accountability is a clear sign of the limited political integration of the EU.

The EU is a "polity in the making" (Padoa-Schioppa, 2004). The creation of a common currency is one step in the process of integration, not an ultimate goal.

However, reinforcing the euro and the monetary and fiscal policies may help to foster political integration in the EU which, at the same time, will strengthen the power of the euro.

2. The political power of the euro

The euro will make an attractive alternative to the dollar as a safe haven in the event of shocks to the world economy. It is very clear that the internationalization of a currency depends basically on the demand side of the market. Although the ECB has stated that it does not intentionally foster the euro as an international currency, it cannot be denied that the currency has been gaining more power in the international scene.

The economic objective of creating a single currency is to complement the single market established long time ago in order to maintain price stability inside the euro area. The political objective is to promote political integration of the EU members. The question is, then, how will the EMU authorities deal with the internationalization of their currency even if it is not a goal? More important, why the EU authorities would not like to take advantage of the benefits that a powerful currency brings with it?

The economic size of the EU makes impossible to limit the use of the euro as a regional currency only. Its transactional network, the importance of its financial markets, and the evolving process of political integration strengthen the power of the euro as an international currency. However, the Eurosystem is, or at least it officially seems, focused on working on its main task of maintaining price stability.

It has been seen in that a powerful currency brings advantages to the issuing country –in this case the issuing bloc: a potent political symbol to promote a sense of national identity; a potentially powerful source of revenue to underwrite public expenditures – or seigniorage; a possible instrument to manage macroeconomic performance; and a practical means to insulate the nation against foreign influence or constraint. In the case of top currencies extra seigniorage is created, financial institutions provide earnings derived from loans and investments, and the vulnerability to changes in the value of the currency is lowered. But a powerful currency also comes with political advantages: adoption of independent positions to acquire political power, exercise influence, and achieve foreign objectives. For the particular case of monetary union, the common currency strengths the power of the entire group of member-states to act in the market, to avoid external dependence, to guide macroeconomic performance, and promote a sense on community.

It is clear that the EMU purpose is basically to insulate the Union against changes in the value of the currency. It was one of the driving forces in the creation of the euro. The multiplicity of national currencies inside the EEC members and their dependence on the US dollar under the Bretton Woods System, made it evident that the instability of the currency leader could provoke a serious damage to their economies, by raising inflation and transactions costs. With the euro that risk has almost disappeared.

Also, the euro has helped to promote the sense of European national identity that characterizes sovereign states. The political symbolism of the currency is creating a new vision of the European identity, while it reinforces the support for political integration.

But when it comes to the creation of extra seigniorage, the management of macroeconomic performance, and the exercising influence and political power to achieve foreign objectives the EU remains silent. In fact, it seems evident that in the case of macroeconomic performance and participation in the international forums, where it can actually exercise the power and influence such a union, the EU retreats to the national ground where a multiplicity of voices and interests reflects the lack of harmonization and agreement on crucial issues such as the improvement of the International Financial and Monetary Systems. The monetary union is supposed to pursue the power of a group of states, but the EU is still speaking separately at the international level.

The case of creating extra seigniorage to underwrite public expenditures is definitively not a purpose of the EMU. Fiscal policy is determined according to national guidelines; the ECB has been granted independence to avoid political pressures and avoid price instability derived from a wrong spending performance. However, sooner or later the decision-making of fiscal policy will have to be assumed by the European authorities in order to promote economic growth needed in the EU in the form of the creation of jobs to reduce the increasing rate of unemployment. More important, the centralization of fiscal policy at the European level will promote the creation of the political structure of the EU.

3. Conclusion

In its short time of life, the euro has been rapidly placed among the three most important international currencies along with the US dollar and the yen. Although it raised many expectations about the challenging role of the euro for the US dollar, it has been evident that the newly created currency is still far from replacing the greenback as the top currency, at least in the foreseeable future. So far, the most important factors that have helped to promote the euro's position are those related to the economic weight of the EU in trade, first, and in the financial markets, second. The potential of the euro to challenge the dollar as the top international currency will depend on several factors:

1. The growth of the EU's transactional network outside the Euro-time zone, to include those countries to which the EU does not have strong economic ties;
2. The implementation of mechanisms and policies to develop deeper and wider European financial markets in order to enhance the participation of the euro in international financial transactions;
3. The promotion of structural changes to improve the performance and accountability of the proper bodies required in the creation of the single monetary policy to assure the effective

implementation and supervision of the designated tasks, all of which will derive in the strengthening of the EMU credibility;

4. The centralization of fiscal policy in the European authorities to implement monetary policy and integrate all the central economic decision at the European level;

5. The creation of a formal institution that represents the EMU at the international level in forums and organizations, where it can exert the powerful influence obtained by achieving monetary union;

6. The building of a European political structure that could bring a strong support to the euro. The value of a currency does not exclusively depend on the performance of the central bank, but also on the social, economic, and political attributes of the issuing entity.

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