The Euro and the Dollar as global Currencies

How important is the euro as a global currency compared with the dollar, and how will the relative importance of the two currencies, and the yen, develop? What are the economic and political advantages to the euro countries of having a world currency? What is the global role of the European Central Bank, and what are the implications for the structure of the international financial institutions? Can we differentiate the position of the euro as between different financial markets, and between its use as a financial currency and as a medium of exchange in international trade?

The euro represents an important structural change in the world economy. The euro countries account for 14 per cent of world GDP and 17 per cent of world trade. They are comparable with the United States, which accounts for 19 per cent of world GDP and 14 per cent of world trade. If the UK and the three other EU countries outside EMU were to join, the euro-15 share in GDP would rise by a quarter to 18 per cent of the world total, almost the same as the US.

The euro suddenly became the world's second currency, after the dollar and before the yen. The pace of development of the use of the euro from now on is unpredictable, and will vary as between different uses. The entry of the four "out" countries would mark a further step change in the development of the euro, in view of the part the pound sterling still plays in international finance.

There is still much uncertainty as to whether and over what time-scale the euro will challenge the dollar for first place, and whether the yen will expand its present minimal role in the system. A bilateral world system revolving round the dollar and the euro is envisaged as often as the idea of a triangular ¥€$ onfiguration. In effect, there appear to be two and a half key currencies at present.

At most times in history there has been a hierarchy of world currencies, with one dominant, one or two others subsidiary, and the rest nowhere. The case of sterling can be used to show how slowly the hierarchy changes. The dollar began to challenge the dominance of the pound only after the first world war, but it was not until about the end of the 1950s that the market share of the dollar overtook that of sterling. World currency and world power are also seen as going together, although Europe's world power role has lagged well behind its world currency role. Sterling's dominant world currency role in the 19th century was linked with the global pre-eminence of Great Britain - a fact which still lingers in the British folk memory when it comes to giving up the pound for the euro.

The advantages of a dominant world currency are well known. If the euro were to develop as the dollar has done, seignorage (financing debt with cash) would be worth 0.1 per cent a year of GDP, greater liquidity (smaller dealing spreads) another 0.1 per cent, and the gain in efficiency a further 0.2 per cent (see Portes, 1999). De Gaulle once called it an "exorbitant privilege" for the USA to have an international currency which allows near-

painless financing of their external deficit. It is easier to finance a large balance of payments deficit, as the US but not Europe is now doing.

3.1 The Euro in Financial Markets

"The euro did not bolt from the starting gate, but then it was not expected to", as one observer noted. Its progress has been most rapid in the euro-11 money market, where national currencies were phased out from the outset, and a single interest rate is set by the ECB. However, the money market is not yet fully integrated because of different national financial instruments and procedures. The ECB pointed out in its April Monthly Bulletin that bank mergers had been mainly within countries rather than across borders, thus limiting the scope for Europe-wide money market operations.

The dollar still accounts for 36 per cent of all international bank loans, compared with 20 per cent for the €-11, and 24 per cent for the €-15. The euro-11's share has fallen from about 24 per cent as international claims between euro countries in each other's currencies have become domestic claims in euro. Domestic bank loans in Europe are however, greater than those in the US, where securities markets play a much bigger part in corporate financing.

The euro has made good progress in the futures market. On a typical July day, 710,000 contracts in German euro government bunds were traded on the German Eurex exchange, compared with 200,000 US Treasury contracts on the Chicago Board of Trade. However, there is relatively little activity in other euro government bonds. It has been suggested that the market in euro government bonds should be divided into a northern and a southern section. German, French and Dutch bonds would be in the northern section, Italian, Spanish and Portuguese in the southern. This would give a bigger share of the market to the Mediterranean countries.

The bond market itself has been a success for the euro so far. The euro Government bond market is 23 per cent larger than its US equivalent. There are still more dollar than euro bonds outstanding in total, including corporate issues, and the dollar has 45 per cent of the total international bond market, compared with 24 per cent for the €-11, or 36 per cent for the euro-15, see table 1. There were $147bn gross new international bond and note issues in euros in the first quarter of 1999, compared with $200bn in US dollars. This was a net increase of $82bn, or 8 per cent, in outstandings. The comparable figures for dollar issues were a net increase of $131bn, or 7 per cent in outstandings. Figures showing a higher figure for euro than for dollar issues include some large German Pfandbrief housing bonds which are domestic rather than international instruments.

The dollar has a bigger lead over the euro in the domestic bond markets. Although the combined euro-11 government bond market is nearly one-quarter larger than the US Treasury bond market, government guaranteed mortgage issues and corporate bonds take total domestic US bonds outstanding to well over double the total in euro-11 currencies. The dollar accounts for 48 per cent of all domestic bond markets, the €-11 21 per cent, and the €-15 26 per cent. In view of the greater size of the US economy, and the fiscal restraint being exercised on both sides of the Atlantic, it will be a long time before domestic euro bond issues catch up with domestic dollar bond issues. The gap is not so large in international bond issues, where the currency of choice can change relatively rapidly, and international can be substituted for domestic bond issues.

Debt managers are reducing costs by increasing the size of issues, but the bid-ask spread on French or German Government bonds has fallen by only 4 basis points, not enough to attract a major inflow. There was a sharp increase in euro bonds issued by corporations in the first quarter of 1999. Since governments are constrained by the Growth and Stability Pact in their issues of new bonds, it must be to the corporate sector that the euro will look if it is gradually to catch up with the dollar sector in the international field. There are now 31 outstanding bond issues of over €10 billion in dollars, and 27 in euros; by the end of 1999, the numbers could be equal at 36 in each currency, according to estimates from Salomon Smith Barney.

Managers are setting up international syndicates, so that euro bonds are spread around the world, instead of being concentrated in the country of issue. Four "junk bonds" of less than investment grade were issued in euros in the first quarter of 1999, and single A bonds have been the best performers. Euro bonds are thus moving down the ratings scale, as their American counterparts have done. Analysts are consequently switching from foreign exchange research on bonds to credit research.

The euro may have seen a small increase in its share of the foreign exchange market compared with the DM. DM/$ trades using the dollar as a vehicle to move into other euro currencies have disappeared, while trades between other euro currencies and the dollar have been added to those between the DM and the dollar. The spread on €/$ trades has come down to 3 basis points from 4-5 on DM/$ trades. The euro is now used as a vehicle between non-euro European currencies, as the DM was, but the use of the Swiss franc for this purpose has surprisingly increased. In view of the Asian financial crisis, trading among euro currencies has not been replaced by the expansion of dealings between the euro and emerging market currencies. Trades with the dollar on one side of the transaction still dominate at 47 per cent of the total, double the share of the euro, which is itself double the share of the yen. The inclusion of the pound raises the euro share to 30 per cent, however.

The dollar still makes up 70 per cent of world foreign exchange reserves, compared with 11 per cent for the euro-11, or 14 per cent for the euro-15. The dollar's share has risen, because ECU reserves within the euro area drop out of the calculation. The euro share is essentially that of the D-mark, but D-marks held by the euro-11 countries come out of the reckoning, because they are no longer foreign currency. Greater use of the euro as a reserve currency will depend how rapidly its use as an invoicing and a pegging currency spreads.

3.2 The International Demand for Euros

While the use of the euro inside EMU is supply dominated, its use as an international currency is demand driven and therefore more competitive. The role of the euro depends therefore on international market preferences as well as on its ability to challenge the dollar in terms of liquidity and transaction costs.

The global currency system, it is argued, is an equilibrium between centripetal and centrifugal forces. The centripetal forces favour the main incumbent currency as the general medium of exchange benefiting from network externalities. The centrifugal forces depend

on the store of value function of currencies, and thus on the diversification of portfolios by means of a multiplicity of currencies. If it is true that major stock market movements have become more highly correlated across countries, then currency movements, notably between the euro and the dollar, may become more important in determining global security flows.

box 1

The centripetal view can be expressed as a virtuous circle. As the transactions costs of using a currency come down, so its use expands, and the two effects reinforce each other. The euro has not yet had time to demonstrate a virtuous circle. The speed with which it does so depends partly on how rapidly Europe's disparate financial markets become integrated. The internationalisation of the euro thus depends on its internal development, which has been delayed by conversion rates being known only on 31 December 1998, and by the time taken to agree on and implement official directives and private agreements to integrate European financial markets. It also depends to a significant extent on whether the pound and other currencies join.

3.3 Euro Invoicing Lags

The euro is not yet used much as an invoicing currency, even within Europe. Companies which stand ready to use euros are often not finding a demand for it. Most companies are concentrating on year 2000 problems, but will get over them one way or the other in early 2000. After that, matters are expected to change suddenly when companies start operating their own accounts in euros.

box 2

Invoicing in primary commodities is to a large extent priced in US dollars. Because the EU15 as a whole is a large importer in certain raw materials, the euro could replace the dollar for these goods. The US share of total raw materials in exports in 1995 was 17.6% and that of imports 15.8 per cent. In Japan it was 1.8% for exports and 41.7% for imports and in the EU 9% of exports versus 16% of imports. However, the most important commodity is oil.

The process towards the euro might be slow. For many countries commodity prices in dollars are currently less volatile than they would have been in D-Mark or Yen. Secondly, there are regional differences. Europe receives about the same quantities of fuels from Africa as North America receives from Latin America and gets most of the rest from the CEEC's. The main importer from the Middle East is Japan, which imports the rest from Asia.

table 2

Derivative markets for these products are in the UK and in the USA and they function mainly in dollars up to now, which further enhances the network advantages of the US currency. However, if the UK joins, preferences may change as well, leading to a switch

from dollars into euros for oil and other commodities. City of London institutions such as the London Metal Exchange and the International Petroleum Exchange might then start to use euros.

At the moment, the international use of the dollar still exceeds by more than three times the weight of its home country in world trade. That means that trade between two countries other than the USA is denominated in dollars. The use of the euro in international transactions is significantly smaller. The role of the euro is certainly greater than that of the euro countries in the world economy, which is similar to that of the United States. But it does not exceed the domestic role of the euro by as wide a margin. The rest of the world outside the US and Europe is a vast area in which competition between the two currencies should lead to greater efficiency in monetary and financial services, both internationally and within the two home territories.

In highly competitive markets such as the energy and metal market where demand is reactive to small price changes, pricing in an international currency is common practice. This reduces information costs for importers and exporters and transaction costs, due to high liquidity. The potential role of the euro in such markets depends therefore on its transaction costs.

The euro does not yet have the liquidity of the dollar. Dealing spreads and transaction charges are higher, because the costs of maintaining national financial markets, even in the same currency as each other, are higher than those of a single market such as the US, centred as it is in New York, or the international dollar markets. The average size and trading turnover of euro instruments are smaller than for their dollar equivalents. Since the willingness of market participants to hold dollar or euro instruments depends partly on the degree of liquidity, the euro area needs to develop greater liquidity by means of integration of national markets, greater size of issues, and higher turnover. The single European financial market and the euro depend on each other. They are both still in their early stages.

In differentiated product markets demand is less sensitive to small price variations in the importer's currency. Pricing in euro as a third currency will be chosen if the euro is more stable than is the exporter's against the importer's currency to ensure high profits. Trade between countries of the euro bloc can justifiably be assumed to be denominated in euro as exchange rate variations would be minimised. The larger the euro bloc the more likely is the use of the euro in intra-regional trade.

The European Union will remain one of the largest exporting zones in the world. This will boost the euro as an international invoicing currency and means of payment. However, the preference of the EU main trading partners might also shift to the euro when exchange rate variations are expected to be limited. For countries with relatively stable exchange rates against the euro and closed trade links with the euro area such as the ERM2 countries, Central and Eastern Europe and African countries, companies will have an incentive to invoice in euro because this will remove hedging costs.

3.4 Role for the Yen?

The evidence on the formation of a yen bloc is mixed. Most south-east Asian developing countries pegged their currencies to the dollar rather than the yen until the 1997 financial crisis, which was partly caused by the rise in the dollar causing excessive appreciation in these currencies, see page 32. When the yen fell against the dollar, the Asian countries started for the first time to peg to the yen, but when the yen rose again, they pegged once more to the dollar. The switch from dollar pegging to opportunistic yen or dollar pegging is a new departure, and it remains to be seen what role the euro will play in Asia. Japan still has 90 per cent of its reserves in dollars, and only 10 per cent in euros. (The intervention by the Bank of Japan in June 1999 to buy euros and sell yen, bypassing the dollar, was an interesting new departure, which may presage a more active role for the third member of the ¥€$ triumvirate.). Mr Larry Summers, US Treasury Secretary, condemned both pegging and target zones for exchange rates. This may be the true lesson of the Asian financial crisis.

The role of the euro is linked with that of the European Central Bank, which is still finding its feet. In American English: "We don't know what these guys are going to do from one day to the next." It is not known how or even whether the ECB would react to an international financial market disturbance. The institutional framework for the euro has not yet caught up with its importance as a global currency.

In statistical terms, the international use of the euro underwent a discontinuous fall, because the international claims of European countries against each other in the legacy currencies became domestic euro claims overnight. The extent of this effect cannot be precisely measured because of incomplete information about intra-European claims. Estimates centre around about 15-20 per cent of all European international items. This is a once-for-all statistical effect which should not obscure the expectation that the role of the euro will expand from its newly calculated base.

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