



The euro hits the big time

International role of the euro

June 26, 2008



The euro has strongly gained in importance as an international trade, investment and reserve currency. For instance, the euro's share as an international reserve currency rose from 18% in early 1999 to 26.5% at the end of 2007. The dollar remains, however, the dominant reserve currency (share: 64%).

The euro meets essential prerequisites for a key global currency.

There are four driving market forces for the euro to catch up as international reserve currency by 2010: the dollar exchange rate, changes in exchange rate policy worldwide, rising investment requirements of central banks and the increasing focus on yield.

Beyond 2010 the dollar is likely to benefit from a higher US growth dynamic and a lower current account deficit. In contrast, Europe will see a dampening impact of the demographic development on growth. Thus, the dollar will remain the most important reserve currency in the longer run whereas the euro will be the undisputed No. 2.

A bipolar international monetary system per se is not unstable. It is likely to stimulate economic and fiscal policy discipline on both sides of the Atlantic. Large and liquid euro financial markets are likely to cope smoothly with abrupt and massive capital flows.

The rising holdings of euro reserves do not explain the price hike in commodities, including gold. On the contrary, central banks have sold one-tenth of their gold stock since 2001 dampening the gold price rally. Commodity prices have been pushed by dynamic global growth, particularly in emerging Asia.

Being an international reserve currency has benefits such as a higher degree of freedom for economic policy and lower bond yields. But the risks should not be overlooked, e.g. the greater exchange rate volatility in day-to-day business and a substantial overshooting of the EUR/USD exchange rate.

The ECB is pursuing a neutral stance towards the euro's internationalisation. Yet, the ECB has fulfilled its international tasks concerning price stability and the role of lender of last liquidity both tacitly and professionally.

The Eurogroup should resolve the problem of speaking with one voice in order to strengthen the euro area's international clout.

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Authors

Norbert Walter
+49 69 910-31810
norbert.walter@db.com

Werner Becker
+49 69 910-31713
werner.becker@db.com

Editor

Barbara Böttcher

Technical Assistant

Angelika Greiner

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director

Norbert Walter

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Fierce debate on the euro's international role**1. Introduction**

The dollar has been the undisputed key international trade, investment and reserve currency for decades. Neither the D-mark nor the yen which gained some weight as international currencies in the 1970s and 1980s, called the dominance of the dollar into question. But the advent of the euro in 1999 has triggered a vigorous debate on whether the euro will have the potential to challenge and even to surpass the dollar as key international currency in the foreseeable future. This issue was discussed well before the start of EMU.¹ This debate intensified in 2005 in light of the huge US current account deficit and the massive accumulation of foreign exchange reserves, and has so again since August 2007 in the wake of the sub-prime crisis, the US slowdown and the decline in dollar interest and exchange rates.

The objective of this paper

This paper analyses recent trends and driving market forces for the euro's international use. Looking ahead the main focus will be on the determinants of its future role as a reserve currency next to the dollar. A key issue is the stability of a bipolar international reserve system. Furthermore, the question is raised whether the rising reserve function of the euro explains the surge in the price for commodities, in particular gold. The analysis also deals with the benefits and risks of the euro's internationalisation. Finally, the paper reviews the impact of the internationalisation of the euro on the ECB and economic governance of EMU.

Rising international role of the euro**2. Main trends in international use**

The international use of the euro can be illustrated on the basis of the standard summary of the international functions of a currency² (Table 1). The results are summarised in the box on page 4. The main message is that the euro has caught up in relation to the dollar in nearly all markets or areas with the exception of the euro's share in the foreign exchange market. In the latter field, the dollar has benefited from the rapid integration of the dynamic Asian emerging markets into the world economy. This also reflects the fact that the dollar is still profoundly anchoring economic thinking in Asia. Nevertheless, the rising international use of the euro has been particularly impressive regarding its role as an international investment and anchor currency. The euro has even surpassed the dollar in the field of currency in circulations (Table 3).

Functions of an international currency

Function	Private sector	Public sector
Medium of exchange	Payments and vehicle currency in forex markets	Interventions
Unit of account	Trade invoicing	Anchor currency
Share of value	Financial assets	Foreign exchange reserves

1

¹ Fred Bergsten argued in 1997 that the dollar would have its first real competitor since it took over the pound sterling's international role. C. Fred Bergsten (1997). The Dollar and the Euro. Foreign Affairs. July/August 1997.

² Peter Kenen (1983). The Role of the Dollar as an International Currency. Occasional Paper 13. Group of Thirty. New York.

International role of the euro has gained momentum

Private international use comprises:

1. *The role as a medium of exchange in payment and foreign exchange transactions.* The (worldwide) volume of euro banknotes and coins in circulation surpassed that of dollar notes in 2006 for the first time. However, only about 10-20% of euro banknotes are used extraterritorially compared with 50-70% of dollar notes. In contrast, the role of the dollar/euro segment as the most frequently traded currency pair sank from 30% of global foreign exchange turnover in April 2001 to 27% in April 2007, while there has been a rise in dollar trading against many other currencies except the yen and pound sterling.
2. *Use as a unit of account in invoicing international trade.* Unfortunately, the data situation is unsatisfactory on this count. According to earlier analyses nearly 50% of world trade is invoiced in dollars. Oil and other commodities are billed in dollars (only Iran invoices oil exports in euros). Exports of the euro area have been increasingly invoiced in euros (on average: 60%, Germany: 80%). This also applies to non-EMU EU members.
3. *The store of value function.* This role is closely linked with the creation of large euro financial markets which are now comparable with dollar markets in terms of liquidity and availability of instruments. For initial offerings of international bonds in 2007, 49% were issued in euros and just 35% in dollars, whereas in the preceding years the euro had to settle for second place (with shares between 34% and 47%) behind the dollar (39%-49%). *In the circulation of international bonds* the euro achieved a share of 32% in 2007 compared with 19% in early 1999, while the dollar share fell from 50% to 44% and that of the yen halved to 5%.

Public international use comprises:

4. *The role as an intervention currency in foreign exchange markets.* Central banks have made only very limited use of euros for this purpose. This applies to the EUR/USD market, where a few coordinated interventions were carried out in 2000 in order to bolster the then weak euro, the European exchange rate mechanism II (ERM II) as well as those other currencies with a euro peg or a euro orientation. By contrast, several central banks in Asia and elsewhere have heavily intervened to support the dollar and accumulated huge foreign exchange reserves.
5. *Anchor role for other currencies.* About 40 countries in Europe, Africa and the Mediterranean align their exchange rate policy with the euro. The regimes range from a currency board (e.g. Bulgaria) and membership of ERM II to managed floating (e.g. Poland). In contrast, there are about 60 countries with a dollar peg. Furthermore, currency baskets are increasingly used as yardstick for exchange rate policy with the dollar and the euro as key components (e.g. China, Russia).
6. *The holdings of foreign exchange reserves.* The share of the euro has risen from about 18 % in early 1999 to 26.5% at the end of 2007, whereas the dollar share has declined from a peak of 71.5% in 2001 to about 64% (Table 4). The main reason for holding reserves are backing exchange rate policy via interventions, ensuring smooth development of international trade and capital transactions, and securing a face-saving way out of a currency crisis without having to comply with the conditionality of an IMF credit.

International comparison of key indicators 2007

	Unit	USA	Euroland*	Japan	China
Population	m	299.8	318.5	127.7	1,321
GDP	EUR trillion	10.1	8.9	3.2	2.2
GDP per capita	EUR thousand	33.7	27.9	25.1	1.7
Share of world GDP	%	21.4	14.7	6.6	10.9
Exports (goods and services)	% of GDP	11.9	21.6	17.7	41.9
Imports (goods and services)	% of GDP	17	20.9	15.9	33.8
General government debt	% of GDP	63.4	66.6	162.5	45
General government deficit	% of GDP	-1.2	-0.6	-0.8	-1.3
Current account balance	% of GDP	-4.9	0.1	5	9.2

* Euro area incl. Malta and Cyprus

Sources: ECB, IMF, Global Insight

2

Euro surpasses the dollar

Banknotes and coins in circulation, EUR bn

	euro	dollar
December 2004	517	564
December 2005	583	668
December 2006	647	619
December 2007	697	525
April 2008	690	521

Sources: ECB, FED **3**

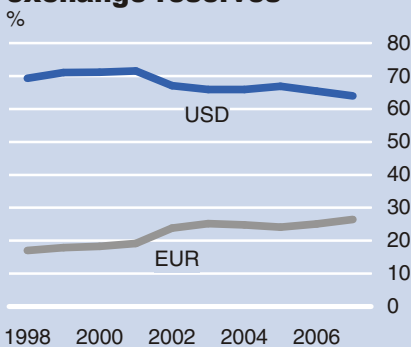
Euro share rising again

	99*	01	03	05	06	07
USD	71.2	71.5	66.0	66.9	65.5	63.9
JPY	6.0	5.0	3.9	3.6	3.1	2.9
EUR	18.2	19.2	25.2	24.1	25.1	26.5
GBP	2.7	2.7	2.8	3.7	4.4	4.7

* Q1

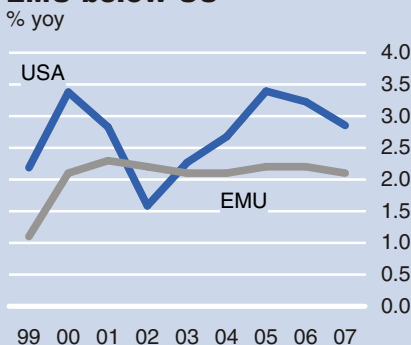
Source: IMF **4**

Shares in global foreign exchange reserves



Source: IMF **5**

Inflation rate: EMU below US



Source: Eurostat **6**

The euro is now firmly established as the second largest international currency next to the dollar. The euro has even topped the international role of the 11 legacy currencies including the D-mark. One feature is the regional concentration in Europe and nearby. While the international monetary system was characterised by the three poles dollar, D-mark and yen until 1998, the launch of the euro has led to a bipolar system with the dollar as key international currency – in particular with regard to the role as reserve currency – and the euro as the undisputed currency No. 2, whereas the yen has lost considerable weight and the pound sterling remained of minor importance.

3. What factors determine the euro’s international role?

The international role of a currency is not allocated by a political decision of governments but is the outcome of numerous decisions made not only by market participants but also by official authorities like the worldwide central banks. In history a currency’s international role used to exist over long periods and changes occurred only gradually. The dominant international role of the pound sterling lasted some centuries until the period between the two world wars when it was successively replaced by the dollar. There are mainly four factors that determine the international role of a currency³: (a) price stability, (b) economic size, growth dynamic and international openness, (c) large financial markets, (d) political stability and military power.

3.1 Monetary policy and price stability

A high degree of price stability and monetary policy credibility are essential. The ECB has a clear mandate to attach priority to price stability. Only if this objective is achieved is the ECB permitted to pursue other EU policy goals. The ECB’s track record since 1999 has been even better than that of the US Federal Reserve System (Fed). The inflation rates in the euro area averaged at 2.1% from 1999 to 2007 compared with 2.7% in the US. The fact that the Fed has a “dual mandate” of fostering both price stability and growth increases the risk of stagflation, i.e. relatively high inflation rates associated with weak growth. Stagflation was a widespread problem in the 1970s that should be avoided. An inflationary bias is deemed to be detrimental to the international use of a currency over time. In this field the euro seems to have an advantage vis-à-vis the dollar.

3.2 Economic size, growth dynamic and international openness

Euroland or the euro area is the world’s second largest economy after the US, well ahead of Japan. Although Euroland has a larger population than the US it only produces the equivalent of 88% of US GDP at current exchange rates. The euro area is the most important global exporter, accounting for 20% of the world’s exports of goods⁴ in 2007 compared with a US share of only 12%. But it absorbs only about 19% of world imports, i.e. less than the US with a share of 21%, reflecting the role of US consumer demand as a global growth engine. Euroland produces about 15% of world GDP, compared with 21% in the US. With a ratio of goods and services exports (extra-EMU) to GDP of about 22%, Euroland’s degree of openness is

³ Chinn, Menzie David and Jeffrey A. Frankel (2005). Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency? G7 CURRENT ACCOUNT IMBALANCES: SUSTAINABILITY AND ADJUSTMENT. Clarida, Richard (ed.). University of Chicago Press,

⁴ World exports = total world exports minus intra-EU-trade.

higher than that of the US (12%) or Japan (18%). This implies that the euro area meets the prerequisites of economic size and openness. In contrast, the US growth rate has been higher than that of Euroland (3% on average from 1999-2007 compared with 2%).

Catalyst for financial market integration

3.3 Size and liquidity of financial markets

The euro has been the catalyst for pushing financial market integration in the EU and EMU with the Financial Services Action Plan (FSAP) of 1999 being a milestone. Substantial integration progress has been made in the money and (government) bond markets, which have provided the most important investment instruments for central banks. The high liquidity of government bonds – German and French bonds have benchmark status alongside the yield curve – is a means to overcome the disadvantage that there is not a central government borrower in the euro area like the US Treasury. Issuing activities have also flourished in the corporate and mortgage bond markets. A survey among central banks⁵ concluded that euro money and debt markets have reached the same quality as dollar markets as far as the liquidity and the availability of instruments are concerned. The euro's share in the stock of international debt securities (narrow definition of the ECB) amounted to 32% at the end of 2007 while the share of the dollar came to 44%.⁶ Thus, the size and the quality of euro financial markets are valid arguments for international investors to choose euro assets.

Differences in political structures

3.4 High degree of political stability and military power

While the US and Euroland have a similar high degree of political stability there are major differences in political structures and international clout. The US is a federal state and a military superpower while the euro area (and the EU) is an entity sui generis. The euro area is an economic powerhouse but a political dwarf in the global arena. Above all, the US has a more flexible monetary and fiscal policy enabling it to react faster to economic shocks. Given the dual mandate the US central bank has more room for manoeuvre in lowering interest rates than the ECB. The US has also a large central budget (27% of GDP) which allows substantial fiscal scope both in terms of automatic stabilisers and discretionary measures over the business cycle. In contrast, the EU has only a small central budget of 1% of GDP, but big budgets on the national level. Automatic stabilisers can only work smoothly via fiscal policy coordination and consistent consolidation policies in good times.

The euro has the potential to catch up further

4. What role will the euro play as a reserve currency?

Given these structural advantages of the US there are strong reasons to assume that the dollar will remain the international reserve currency No. 1 in the decades to come. Nevertheless, the euro has the potential to play a bigger role as a reserve currency, well beyond its last reported share of 26.5% at the end of 2007.

⁵ The survey was carried out between September and December 2004 among 65 asset managers of central banks. See Robert Pringle and Nick Carver (2005). Trends in reserve management – survey results. Central Banking Publications. London.

⁶ The narrow definition of the ECB includes only issuance in a currency other than the currency area in which the borrower resides. In the broad definition which also includes home-currency issuance the share of euro-denominated international debt securities even amounted to 48% surpassing the dollar share of 36%. See also European Commission EMU@10. Successes and challenges after 10 years of Economic and Monetary Union. European Economy 2/2008, p 117 f.

Looking ahead it is practical to differentiate between the period until 2010 and beyond 2010. There are several conceivable scenarios for the phase by 2010.⁷

Three scenarios

In a first extreme-case scenario the process of shifting into the euro could occur relatively quickly within a few months, assuming central banks utilised the current phase of dollar weakness to reduce their cluster risk by diversifying out of the dollar. Although a swift reserve shift in favour of the euro cannot be ruled out, the probability seems small because many Asian central banks are still dollar-oriented and will proceed cautiously to minimise the risk of their currencies depreciating against the dollar and avoid a decline in reserve value.

In a second extreme-case scenario it is assumed that no diversification is carried out for the time being, as the existing currency situation between the US and Asia suits all the countries concerned.⁸

A third scenario combines both the wish for diversification and the desire for value retention, namely a gradual increase in the euro share to 30-40% by 2010. Still, we consider this our baseline scenario.⁹

As things stand, there are probably four main drivers that will be essential in shaping the diversification of foreign exchange reserves into euros over the medium term: (1) the EUR/USD exchange rate (2) changes in exchange rate policies, (3) central banks' rising investment requirement and (4) the growing appetite for returns.

4.1 The euro may benefit from the dollar weakness

Dollar: the exchange rate counts

The dollar exchange rate has been an important determinant for the dollar's role as reserve currency. A period of a low dollar rate vis-à-vis the euro (or before 1999 vis-à-vis the D-mark and the yen) resulted – with a time lag of a few years – in a decline in the dollar's share in global foreign exchange reserves and vice versa¹⁰. Even in weak periods the dollar share remained dominant (i.e. over 50%).

The euro "behaves" differently

In contrast, there is no clear-cut relationship between the euro exchange rate and the international role as reserve currency. In the period 1999 to 2002 the euro exchange rate vis-à-vis the dollar tended to be weak while the euro's share in global foreign exchange reserves climbed from 18% to 25%. The euro share had stabilised at that level by 2006 even though the euro exchange rate rose considerably. Only in 2007 was the strong euro exchange rate associated with an increase in the euro's share to 26.5%. Looking ahead a further rise in the exchange rate – starting at a value of about USD 1.55 – cannot be ruled out given the uncertainty about the US economy in the wake of the sub-prime crisis. However, it should not be overlooked that the euro has already reached a very high level against the dollar. Thus, the risk of a dollar rebound against the euro is growing, making the euro less attractive to central banks wanting to diversify. The fact that the correction of the

⁷ Werner Becker (2007). Euro riding high as an international reserve currency. Deutsche Bank Research. EU Monitor 46. Frankfurt am Main.

⁸ In this scenario a de facto Bretton Woods II is assumed, in which the US benefits from Asian investments in the dollar while Asia can export to the large US market at a relatively low exchange rate.

⁹ In 2000 Deutsche Bank Research published a forecast that the euro share in global foreign exchange reserves would climb to 30-40% by 2010. Walter, Norbert (2000). The Euro Second to (N)one. The American Institute for Contemporary Studies. German Issues No. 23.

¹⁰ Werner Becker (2005). The euro: Well established as a reserve currency. Deutsche Bank Research. EU Monitor 28. Frankfurt am Main.

global current account imbalances is under way and the Chinese yuan has witnessed a tangible up-valuation against the dollar may be regarded as a signal that there is no need for a further major devaluation of the dollar against the euro. Thus, the exchange rate argument is likely to lose in importance in favour of the euro.

4.2 Changes in exchange rate policy may support euro use

Euro is anchor currency

The fact that countries use the euro as an orientation yardstick for their exchange rate policy implies that they have to hold reserves in euros in order to be able to intervene in the euro foreign exchange market of their currency. At present, about 40 countries align their exchange rate policy with the euro. Furthermore, currency baskets are increasingly being used as a yardstick for exchange rate policy, with the dollar and the euro as key components. Such changes in exchange rate policy demand that the respective central bank hold euro reserves. Recent examples have been China¹¹ and Russia¹².

At present, exchange rate policies are under review in many countries around the globe. Obviously, the trend towards the two corner regimes¹³ of either flexible exchange rates or a fixed exchange rate seems to be over as the number of middle-ground exchange rate models of pegged but adjustable exchange rates has recently risen. The exchange rate policy of many countries around the globe is currently challenged by two closely related problems.

Rising inflation rates

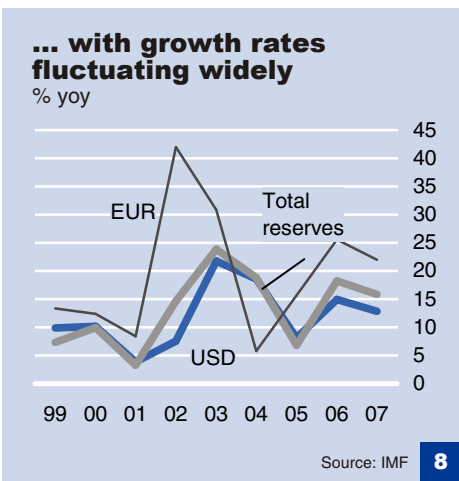
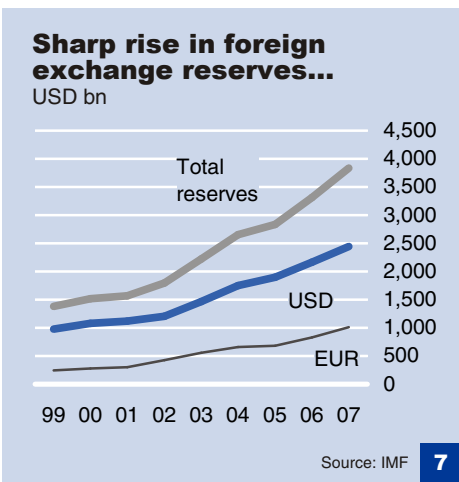
The first problem concerns rising inflation rates around the globe mainly due to increasing oil, other (energy) commodity and agricultural prices. The inflation rate has climbed to 8.3% in China (May 2008), to 7.4% in India, to 8.1% in the Asean countries and to even 11.6% in the six countries of the Gulf Cooperation Council. This provokes the question of how these countries can maintain economic growth in an inflationary environment, and which role the exchange rate should play with regard to fighting inflation.

The second problem regards the Fed's policy of easy money. Therefore, those roughly 60 countries that use the dollar as anchor currency face the problem of whether a dollar peg is still compatible with the aim of combating inflation or whether a change in the exchange rate regime is necessary. Alternatives to a dollar peg are, for instance, a basket solution with the euro as a key component or even a pure euro orientation. Both cases would generate a need to hold euro reserves. It is, however, open whether a country that changes its exchange rate policy will provide detailed information about the role of the euro, e.g. its weight in a currency basket.

¹¹ In July 2005 China switched over to managing its exchange rate policy via a currency basket that apart from the dollar also contains the euro, the yen, the pound sterling, the Korean won, the Thai baht and the Russian rouble. But there has been no announcement on the details of the currency weights in the basket.

¹² Russia completed the changeover from pegging its currency to the dollar to an exchange rate regime based on a currency basket made up of just the dollar and the euro in 2005. Interventions in the euro/rouble foreign exchange market made it necessary to hold a corresponding quantity of foreign reserves in euros.

¹³ Corner solutions were the mainstream in the exchange rate landscape of globalisation since 2000. Summers, Lawrence H. (2000). International Financial Crises: Causes, Prevention, and Cures. American Economic Review. Papers and Proceedings, 90, 2 (May), 1-16.



4.3 Central banks' rising investment requirement

Global foreign exchange reserves held by central banks more than tripled to around USD 6,400 bn between the end of 2001 and the end of 2007 – compared with cumulative increases in world trade of two-thirds and in global nominal GDP by two-fifths. The lion's share of the increase in foreign exchange reserves was accounted for by China, other emerging markets in Asia, and Japan. The main source for reserve accumulation has been the buying of dollars in foreign exchange markets against local currency. Of all the international foreign exchange reserves at the end of 2007 about two thirds were held in Asia (excluding Middle Eastern oil nations), with China and Japan combined accounting for nearly 50%. The accumulation of such huge reserves went far beyond the level necessary for exchange rate management. Thus, Asia's central banks are under increasing pressure to reduce their dollar-denominated cluster risk¹⁴ and diversify into other currencies. China is a special case as it has the largest stock of reserves. According to unofficial sources¹⁵ some 80% of its foreign exchange reserves are invested in dollars, i.e. more than the global average share of 64%. China is also a major player with regard to sovereign wealth funds (SWF).¹⁶ This special type of institutional investors has gained major importance in holding, managing and/or administering public funds mainly stemming from official reserves at central banks. This is also a vehicle giving the euro a major opportunity to grab a bigger share of global foreign exchange reserves.

4.4 Focus on yield of foreign exchange reserve investments

Given the huge volume of foreign exchange reserves eligible for investment purposes there is a growing pressure on central banks to sharpen their focus on yields. This is not only true for central banks in Asia but also in the industrial and oil-exporting countries. The watchword is diversification and from a yield standpoint in both senses: firstly, by instrument within the dollar segment and, secondly, by currency. Diversification moves within dollar segment – from US treasury paper into other securities – before July 2007 are likely to have been negatively affected by the sub-prime crisis. At present, diversification within the dollar segment might still be difficult due to a lack of liquidity in many securities markets except US treasuries. This also offers opportunities for diversification out of the dollar into the euro.

However, the desire for currency diversification and a higher yield on the one hand and the desire to maintain the value of foreign exchange reserves on the other can be conflicting objectives. A central bank must thus take into consideration what impact diversification out of the dollar into the euro could have on its country's exchange rate against the dollar. A strategy of massive currency diversification could prompt an appreciation of this central bank's currency against the dollar and this would in turn lead to write-downs of the dollar reserves in national currency. There are two alternatives: either it decides against currency diversification or it pursues a clandestine strategy of currency diversification, for

¹⁴ About 64% of global foreign exchange reserves were invested in USD at the end of 2007 according to the COFER statistics of the IMF. The currency breakdown of global reserves is, however, incomplete as it exists for only USD 4,064 bn out of a total of USD 6,400 bn. In particular, China does not officially report its currency breakdown.

¹⁵ Hui Feng (2007). China's new reserve strategy. Central Banking, Vol. XVII. 3.

¹⁶ Steffen Kern (2007). Sovereign Wealth Funds – state investments on the rise. Deutsche Bank Research. Current Issues. Frankfurt am Main.

instance by transferring part of its reserves into a separate unit (e.g. a SWF) or to a professional asset manager. However, it is doubtful whether a central bank's investment strategy can prevent a fundamentally driven appreciation of its own currency against the dollar in the medium run.

5. What will happen to the euro's role as a reserve currency after 2010?

Due to structural factors...

Whether the euro will still be on the rise as reserve currency or even outstrip the dollar after 2010 is closely linked with structural changes that can be expected in Europe, in the US and the rest of the world. One factor that will remain key for the euro/dollar exchange rate is longer-term US development particularly with regard to growth and interest rates. US growth is expected to pick up as of 2010 once the structural problems of the sub-prime crisis are overcome and the huge US current account deficit has been convincingly reduced to a manageable level. Then, US growth is likely to be more dynamic than in the euro area.

... the dollar will remain the key global currency

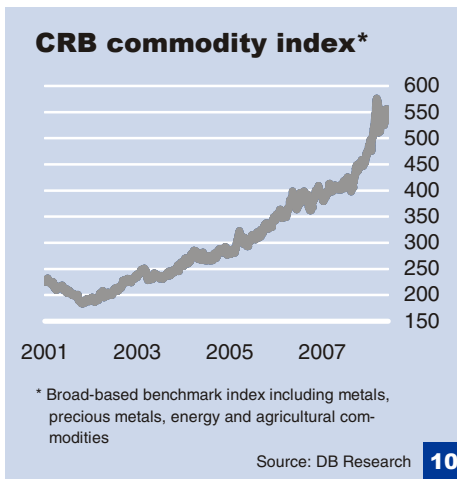
A longer-term problem of relevance to the euro area is the reduction of growth potential linked with the demographic developments. Trend growth in the euro area at nearly 2% is around one percentage point lower than in the US. The contribution of the factor labour will play a key role in this regard, as determined by the development of working hours per employee, participation rates and the population. Although working hours and the participation rates in the euro area have risen in recent years, they are well behind US levels. The euro area is, however, clearly at a disadvantage in terms of population growth. As the birth rate has been much lower than in the US in recent decades, population growth will continue to slow in the EMU states. Despite immigration the population in EMU countries will actually decline in the next ten years. Reduced future growth potential should, however, dampen the appeal of the euro especially among central banks focusing heavily on returns and constitute a risk factor for the euro as a reserve currency. Therefore, the dollar will also remain the most important reserve currency in the longer run.

6. Is a bipolar reserve system per se unstable?

Concerns that a bipolar system is unstable

There is no simple answer to this question. So far the answer has been that market participants and monetary authorities have established a bipolar international monetary system, which is working smoothly. The coexistence of two globally important currencies is based on the fact that both fulfil the prerequisites for an international role. The dollar has remained the No. 1 currency while the euro has the capacity to catch up further. Nevertheless, there are concerns that such a bipolar system may not be stable¹⁷ in the medium term. One argument stresses the risk that there will be large and abrupt capital flows in and out of the currency. In particular, it is argued that the US economy is much more flexible and dynamic than Euroland and that there is ample latitude for sudden massive capital movements from euro to the dollar, for instance once the US economy returns on a strong growth path with rising interest and dollar exchange rates. Moreover, it is argued that, in history, there have never been two major international currencies in parallel over a longer period of time.

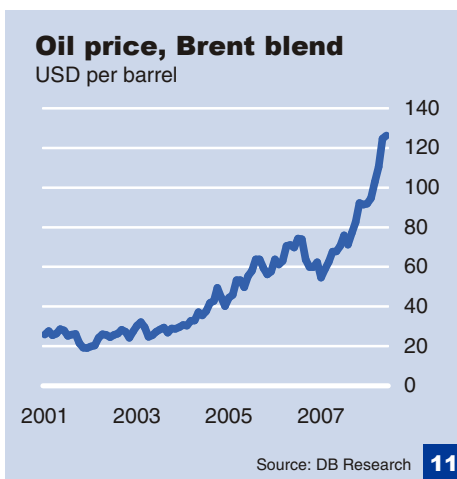
¹⁷ For instance, George Soros argues along these lines.



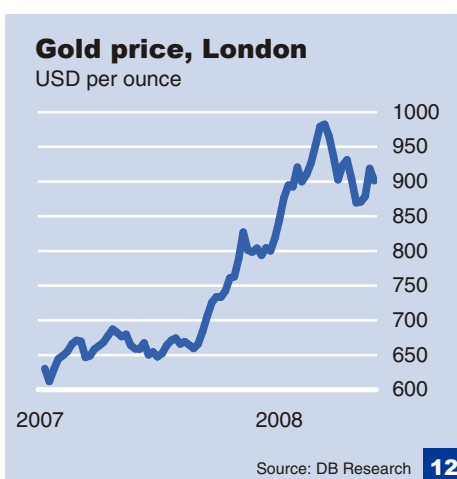
However, a bipolar system is not per se unstable. The risk of abrupt capital movements will exist in open and global markets anyway, irrespective of the euro being a reserve currency or not. More importantly, euro financial markets are liquid enough to cope with large capital flows. History also provides evidence that changes in the international role of a currency occur gradually. The new reserve currency used to crowd out the old one. In the past, we had the pound sterling then the dollar. Furthermore, competition between the dollar and the euro regarding the international role is basically a good thing. Such a permanent beauty parade is expected to provide a big incentive for policy makers on both sides of the Atlantic to pursue sound economic and fiscal policies. Last but not least, there is a close network of international policy cooperation, e.g. within the G7 and the IMF in order to deal with global monetary and economic problems such as exchange rate distortions or current account disequilibria.

7. Could the rising reserve function of the euro explain the surge in the price for commodities, in particular gold?

The surge in commodities (including oil and gold) has mainly been caused by the dynamic growth of the world economy between 2003 and 2007, in particular by continuously buoyant demand in Asian emerging markets. Obviously, there is no direct connection between the rising reserve function of the euro and the increase in commodity prices. However, the massive rise in foreign exchange reserves in recent years has led to a substantial increase in the liquidity of local currency in emerging markets irrespective of whether the reserves were invested in dollar or euro-denominated assets. This provision of local liquidity has contributed to the smooth financing of the dynamic growth in emerging markets such as China, India or Russia. Thus, it is fair to say that rising foreign exchange reserves have an indirect impact on commodity prices via growth financing.¹⁸



The gold price, which peaked at USD 1,011 per fine troy ounce in March 2008, has recently fallen to about USD 862. There has been a strong gold demand on the part of emerging Asia. The dynamic growth process in these countries has produced a burgeoning group of wealthy private individuals being in the position and willing to buy gold jewellery – in no inconsiderable quantities – and invest in gold instruments such as bullion or coins. Moreover, rising inflation rates around the globe have reinforced the demand for gold, which is obviously still deemed to provide effective protection against inflation. This is, however, a widespread misunderstanding as gold instruments involve costs (e.g. for storage and insurance) but do not bring a yield unless the gold price rises and gold instruments are sold with a profit.¹⁹



The central banks worldwide still hold a substantial stock of gold in their coffers. The gold holders have seen rising book values in recent years. However, a number of OECD central banks (including the Bank of England and the Swiss national bank) have sold part of

¹⁸ An interesting question is whether the provision of local liquidity through dollar interventions has been excessive and fuelled inflation. But there is no simple answer.

¹⁹ According to IMF statistics the gold stock has decreased from 944 m fine troy ounces at the end of 2001 to 853 m ounces at the end of 2007.



Exchange rate risks come to the fore

Several benefits

their gold stock.²⁰ In total, central banks have sold about one tenth of their gold stock since 2001 and thus enhanced global gold supply which has dampened – all other things being equal – the gold price. The receipts from gold sales were mainly distributed to the shareholders, i.e. mostly governments. The conclusion is that the increase in the gold price is driven by private-sector demand and cannot be explained by central banks' actions to rise their foreign exchange reserves in euro.

8. Cost and benefits of running an international currency

There is no single model to assess the costs and benefits for the country that issues an international currency, but several factors must be taken into account.²¹

On the cost or risk side it is argued that there is an impact on monetary policy as the international role of the euro may alter the statistical measurement and behaviour of monetary aggregates²², which are essential for the monetary pillar of the ECB strategy. However, the ECB can take international factors into account when analysing monetary aggregates and explain them to the markets. There may also be the risk of greater day-to-day volatility in the euro foreign exchange markets. While hedging instruments are available, they cause costs for the firms involved. Eventually, the internationalisation of the euro may trigger substantial changes in the exchange rate level. We would like to differentiate between two extreme cases. Firstly, the "strong euro case" featuring large capital inflows, when the international role as a reserve and investment currency has been established, that leads to an overshooting of the EUR/USD rate. The high exchange rate has a restrictive effect on the economy which may provide scope for the ECB to lower its key rates. Secondly, the "weak euro case", in which a strong capital outflow causes an undershooting of the EUR/USD rate and the ECB is confronted with the problem of imported inflation. In this case the ECB might increase key rates if necessary. So far it is good to see that the ECB has followed a medium-term monetary strategy that anchors inflationary expectations and minimises the risk of destabilising capital flows.

The benefits also concern a variety of aspects. The international role provides a high degree of freedom in economic policy compared with constraints of small or medium-sized economies with "national" currencies. Thanks to the international role of the dollar the US has, for instance, the ability to avoid a policy-driven adjustment of a large current account deficit by financing in its own currency. The Federal Reserve has ample scope for the conduct of monetary policy as it can focus on domestic issues and leave the exchange rate as a "residual". By the same token, the ECB has been in the position to pursue a monetary policy that is largely independent of the development of US policies and also able to focus on domestic stability requirements. This is illustrated by how differently the Fed and the

²⁰ Most sales were based on two central bank agreements on gold concluded in 1999 and 2004 between several OECD countries. The Deutsche Bundesbank also participated in the 2004 talks, but has so far not used the option to sell parts of its gold stock.

²¹ Elias Papaioannou and Richard Portes (2007). The euro as an international currency vis-à-vis the dollar. Paper presented to the Euro 50 Group Roundtable: July 2-3. 50 Years After the Rome Treaty. Strengthening the Economic Leg of EMU. Rome.

²² Hartmann, P. and O. Issing (2002). The International Role of the Euro. Journal of Policy Modeling 24. North-Holland, pp. 315-345.

ECB are dealing with the consequences of the US sub-prime crisis. The ECB is sticking to its mandate of price stability whereas the Fed has substantially lowered the key interest rate, taking into account its “dual mandate” of fostering price stability and growth. To our mind, the internationalisation of the euro will even increase the scope for an independent ECB policy but this will also require responsible action not only by the ECB but also by other policy makers in EMU.

Seigniorate income

A second aspect is that the international use of notes and coins produces net income from seigniorage²³. One major difficulty is, however, to estimate the share of currency in circulation held outside the euro area. There is one rough estimate suggesting that the seigniorage income in Euroland is unlikely to exceed 0.1% of GDP²⁴. Estimates for the US differ widely, one estimate being close to the Euroland figure. This indicates that the advantage of seigniorage income should not be overestimated.

Downward effect in bonds yields

Greater effects than from seigniorage are very likely to be realised in form of lower transaction costs in financial markets. Moreover, government, corporate and bank bond issuers are expected to benefit from the “liquidity premium effect” in the bond markets. For the US, estimates point to a sizeable downward effect in bond yields of between 65 to 150 basis points.²⁵ A rising role of the euro as reserve currency also implies rising investments in euro bond markets on the part of worldwide central banks. This promises a rising liquidity premium effect for Euroland provided international private-sector investors and central banks will continue to increase their euro bond portfolios.

9. Is the economic governance of the euro area appropriate to shoulder international responsibility?

ECB: neutral stance on the international role

As regards the policy stance of the ECB it is important to begin with a comment on its position towards internationalisation of the euro. For its part, the ECB does not actively promote the international role of the euro. Rather, the ECB has explicitly declared that it pursues a neutral policy, i.e. it refrains from hindering or promoting the international use of the euro. Yet, the ECB regularly monitors the international role of the euro and provides valuable information about its global use²⁶. It should, however, not be overlooked that the ECB has indirectly contributed to the international attractiveness of the euro by doing a good job on price stabilisation and – more recently – by temporarily assuming the role of “lender of last liquidity”. In the latter function the ECB has acted decisively, professionally and rapidly. Thus, the ECB has implicitly taken responsibility for the euro’s international role. Fulfilling this function tacitly and smoothly gets a warm welcome from market participants.

Eurogroup: move continuity in leadership and greater visibility

A second issue concerns the policy mix between monetary and fiscal policy. The ECB’s mandate of attaching priority to price stability and the principle of independence limit the room for

²³ In the case of coins, seigniorage arises from the difference between the face value and the cost of production and distribution. Seigniorage resulting from notes is the difference between the interest earned on government securities acquired in exchange for bank notes and the costs of producing and distributing those notes. In Euroland, income from seigniorage accrues to the central bank (in case of notes) and to the finance minister (in the case of coins).

²⁴ Elias Papaioannou and Richard Portes (2007),...

²⁵ F. Warnock and V. Warnock (2006). International capital flows and U.S. interest rates. NBER Working Paper No. 12560.

²⁶ European Central Bank (2007), Review of the international role of the euro.

manoeuvre for an ex ante coordination between the ECB and the Eurogroup of EMU finance ministers. It is positive that the Eurogroup has been led by President Jean-Claude Juncker since 2005. He has given the euro area more continuity in leadership, greater visibility in the general public and better representation in international fora. Three important issues should be on top of the agenda of the Euro group in order to strengthen the international responsibility of the euro area.

First, it is vital to make full use of the room for action in the reformed stability and growth pact. This implies in particular to push through consistent fiscal consolidation policies in good times in order to be able to let the automatic fiscal stabilisers work in recession without a violation of the 3% limit.

Second, globalisation has increased inequality and has led to an intense debate about the distribution of benefits, income and wealth. This threatens to deflect from the pressing problem of structural reforms which are badly needed to stimulate expansion in Europe in a global environment of slowing growth. Coordinating and pushing through structural reforms will be a major challenge for the Eurogroup.

More international clout requires speaking with one voice

Third, the euro area must be able to speak with one voice in order to increase its clout on the international stage in line with the rising international use of the euro. The current threefold international representation of the euro area by the ECB, the Eurogroup and the European Commission (as demonstrated by the visit in China last autumn) is neither transparent nor efficient. But there is some hope that the pending Lisbon Treaty will give the Eurogroup a somewhat greater say and contribute to strengthening the global voice. There are concerns that excessively high expectations might be pinned on designing and presenting a common voice. The designing requires the ability of the Eurogroup to agree on one voice, which is rather complicated given the different political and monetary views within the euro area. Moreover, an open debate about the complex representation structures in international fora (e.g. G7 and IMF)²⁷ is necessary. It is argued that a common voice is better than a common seat. Presumably, consistent changes in international representation are very complicated as they are associated with a reduction in the euro area's current number of seats in the IMF and in the G7. A consistent international representation with one seat in the IMF and one seat in the G7 (or better G3 with the US, the euro area and China) is only likely in the longer run.

²⁷ In the G7, the president of the ECB participates, alongside the president of the Eurogroup, in the Ministers and Governors meetings. At the IMF which is a country-based institution, the ECB has observer status.

10. Summary

Since 1999 the euro has gained in importance as an international trade, investment and reserve currency. The internationalisation has been a market-driven process. The euro meets essential prerequisites for an internationally key currency in terms of price stability, economic potential and international openness, size and liquidity of financial markets as well as political stability. There are four factors relevant for a rise in the international use of the euro as reserve currency by 2010: the dollar exchange rate, changes in exchange rate policy, rising investment requirements of central banks and increasing focus on yield. Beyond 2010 the dollar is likely to benefit from a higher US growth dynamic on the basis of a sustainable low current account deficit while Europe sees the restrictive impact of demographic developments on its growth potential. Therefore, the dollar will remain the most important reserve currency in the longer run whereas the euro will be the undisputed No. 2.

A bipolar international reserve system per se is not unstable as it is likely to stimulate economic and fiscal policy discipline on both sides of the Atlantic. The rising reserve function of the euro does not explain the surge in the price of commodities, in particular gold. There are benefits of being a reserve currency such as lower bond yields and income from seigniorage, but also risks e.g. in terms of greater volatility of the EUR/USD exchange rate. The ECB is pursuing a neutral stance towards the international role of the euro. The ECB is, however, fulfilling its international tasks tacitly and professionally both concerning price stability and the role of lender of last liquidity. Last but not least the euro area must solve the issue of speaking with one voice in order to increase its clout in the international arena.

Norbert Walter (+49 69 910-31810, norbert.walter@db.com)

Werner Becker (+49 69 910-31713, werner.becker@db.com)

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