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# Europe cannot be strong if fragmentation risks linger in the euro area

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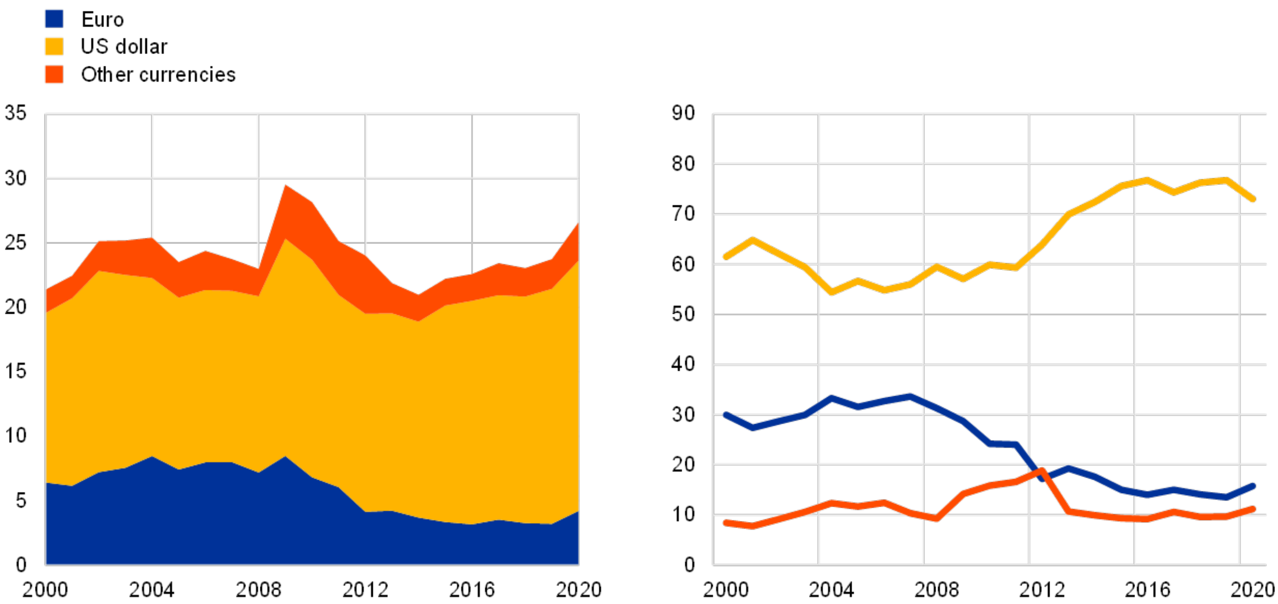
Officially, the fragmentation risks of the euro area – or the extreme divergence of financial conditions in member states belonging to the euro area - are tackled by the European Central Bank only if they have an impact on the transmission mechanism of the monetary policy. However, the risks of fragmentation affecting the euro area should be considered also for their negative effects on the global role of the euro and for the impact on the euro-dollar exchange rate.

Since the beginning of the European Monetary Union, wider global use of the euro has been considered one of the goals of the European economy. According to the latest European Commission report on the global role of the euro, the benefits can be described as follows: a) removing the exchange risk and other currency-related costs can lower the cost and risk of trading internationally for European businesses; b) the euro can represent an additional choice for market operators across the globe; c) a more attractive euro as a store of value lowers interest rates paid by European households, firms and states; d) a more widely used currency can make the economy less vulnerable to exchange rate shocks. A further factor is that the wide use of the currency supports the policy choices of the issuing area, as proven by the fact that almost half of the global green bonds supporting the EU environmental agenda are euro-denominated.

However, one of the most critical advantages of a more widespread use and a stronger global role of the euro is that the monetary policy of the ECB – and the underlying economy - would be less influenced by the external conditions produced by the dollar. This consideration has grown in importance in the last months when the U.S. monetary policy has driven financial markets across the world toward more tight credit conditions. American inflation was driven by excessive demand in the past years and thus fully justified the tightening of monetary policy. For Europe, according to the ECB, the acceleration of inflation was mostly caused by supply factors, bottlenecks, or special temporary conditions caused, first, by the Covid crisis and by the war in Ukraine at a later stage. Although the current conditions may differ, the conventional understanding of how monetary policy works dictates that in the case of supply shocks monetary tightening is not the most suitable instrument. The ECB was convinced that changes in the price level induced by supply conditions could not be constrained by reducing the demand for those goods or services.

Wider use of the euro, making it a stronger reserve currency, may thus have tangible consequences for the conduct of ECB monetary policy, making it best tailored for the needs of the European economy. The lack of independence of monetary policy was one of the major factors that motivated the completion of the European Monetary Union. A well-known event in the 1990s played a special role in convincing European national central bankers not to delay the launch of the euro. During the 1994 bond market sell-off, an unexpected hike in American interest rates wrong-footed the European national central banks that were engaging in an easing phase. European bond yields followed the American bonds, completely offsetting the monetary policies of the Europeans. According to analyses by the BIS, the US-euro relationship worked in the opposite direction in 2014 when the ECB lowered the euro bond yields, drawing also lower term premia in the US Treasury market. High-frequency analyses find that a much more symmetrical relationship has emerged across the Atlantic, although mostly between the German bund yields and the US equivalent assets.

The fragmentation risk has had important implications for the role of the euro and the conduct of monetary policy. Although the euro stopped gaining weight in terms of global reserves around 2005, it has been declining since the global financial crisis and the euro crisis, dropping from 25% of global reserves to lower than 20%. At around 19%, the euro's share in international currencies is markedly lower than the approximately 50% share of the US dollar.




Although several considerations have been advanced concerning a possible future decline in the global role of the US dollar, the American currency has remained the favorite global reserve currency. At the outbreak of the Covid-crisis investors rushed to the safety and liquidity of the US dollar. Similar behavior occurred during the Ukraine crisis this year with consequences for the ECB's monetary policy as the relative appreciation of the American currency made imported inflation more severe for Europe.

What happened this year is unusual because in the past when commodity prices – like oil or gas, normally denominated in dollar – rose, their prices in euro rose less. The war in Ukraine coincided with the stern tightening cycle announced by the Federal Reserve and with concerns about global safety that have made the dollar more attractive. The strength of the dollar is also related to US geopolitical strength. Analogously, the dependency of the euro on the dollar is a consequence of the political fragility of the euro area. This fragility becomes acute when fragmentation risks emerge.

As shown by simple co-variance analyses of sovereign spread movements and the euro-dollar exchange rate, accommodative ECB monetary policy intended to reduce the euro-area fragmentation risks, rather than lead to a depreciation of the euro-dollar exchange rate, can strengthen the euro. This factor is relevant for inflation containment, which is the primary objective of European monetary policy.

Interestingly, there seems to be a connection between the political and institutional strength of the euro area and the efficacy of the ECB's monetary policy, and this connection depends also on countering the euro-area fragmentation risks.