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1. Introduction

One proposition that commands universal agreement is that the euro deserves a greater international role, justified by the size of the European economy and the importance of its international trade and financial markets. And yet, as I will briefly summarize, the evidence is that nothing of the sort has been happening: after twenty years of existence, the euro's use as an international currency is more or less comparable, in its various dimensions of currency use, to the combined role of the French franc and Deutsche mark before the euro's inception. The relative weight of the dollar, on the other hand, has increased on many accounts.

Two questions arise in this context: the first one is whether and to what extent policy can change this state of affairs; the second is whether we Europeans really want this greater international role for our common currency, given its broader implications for internal macro-economic and regulatory policies. In this policy brief I will mainly dwell on the second question; however, some comments on the first one appear necessary to place the ensuing discussion in proper context.

Before addressing these issues, it is useful to quickly recall the benefits sought from an international reserve status. As long as the main currencies were linked to a fixed parity with gold, and financial markets were much less integrated than nowadays, the main advantage came from seignorage and from the possibility to use one's own currency to finance external deficits – which were easily identified in the overall balance of payments accounts by drawing a line between the official balance (the amount to be settled with official reserves), on one hand, and all remaining transactions, on the other. This world ceased to exist with the transition to a floating exchange rate regime between the main world economic areas and the gigantic growth of financial markets since the 1970s – which made the creation of means of payments in different currencies, especially the dollar, essentially endogenous (demand driven).

Following the demise of the Bretton Woods system, in the main currency areas the exchange rate by and large ceased to be a policy target, but most other countries moved to a regime of managed float. Moreover, many emerging countries learnt from painful experiences that a cushion of reserve currencies and credit lines from private and official sources is required to meet 'sudden stops' of external finance. Therefore, the demand for foreign currency reserves has increased substantially.

Within this context, the main benefit from the reserve currency status may mainly lie in moderating exchange rate oscillations and dampening speculative capital flows. Private companies from reserve currency countries also have the advantage of conducting their international transactions in their own national currency with the

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important attendant benefits of trading with a stable means of invoicing, payment, and financial risk hedging. A related benefit may reside in a lower cost of funding – at least relative to financial markets of currencies traded in thin markets – especially in times of heightened risk aversion and flight to safety by international investors. However, these benefits are not a free good and must be conquered. I will discuss some key requirements for obtaining the reserve currency status which depend upon consequent political choices at EU level. Beyond this, the main question that cannot be eluded is whether the reserve currency status requires a worldwide geo-political projection, something the European Union is struggling to achieve.

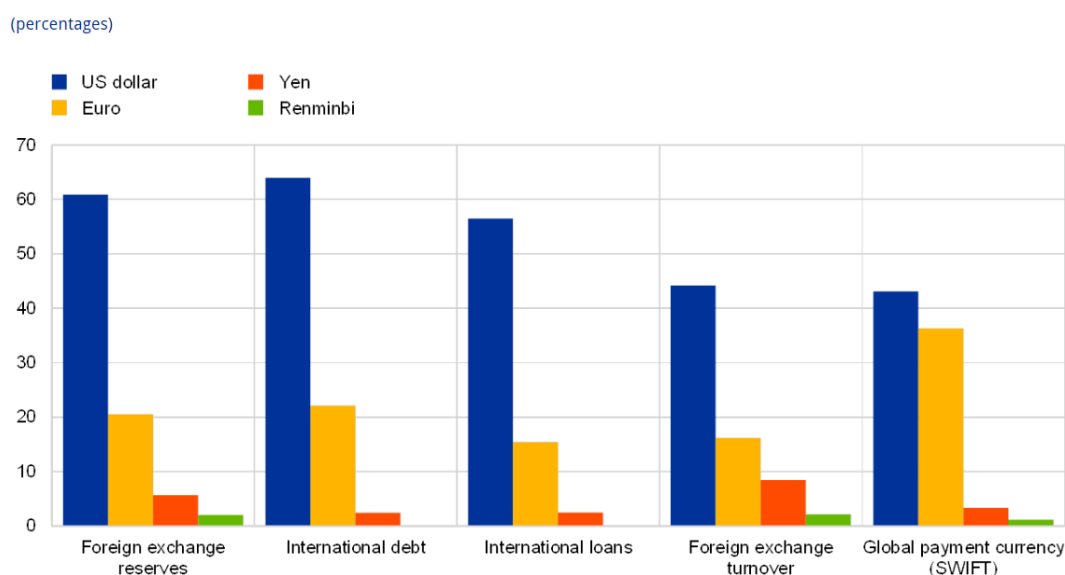
2. International currencies

Almost fifty years have passed since the demise of the Bretton Woods exchange rate arrangements, and the dollar remains the dominant world reserve currency, with the euro finishing as a distant second in terms of global importance, and the yen playing a limited role in the Pacific area. China clearly nurtures the ambition of making its currency, the renminbi, the third player worldwide, but it still has a long way to go to create the minimum market conditions for such a development.

The status of international currency has various dimensions, including its role in foreign currency reserves, trade invoicing and payment, debt and equity issues in financial markets, and the ‘safe’ store of value for international investors. Chart 1 summarizes the share of the main reserve currencies in the diverse functions they play. As can be seen, these shares are fairly stable across the different functions, with the US dollar hovering between 50 and 60 per cent and the euro between 15 and 20 per cent. The only exception to this stable pattern is in the euro share of global payments, around 37 per cent, which is a direct consequence of the weight of export and import transactions in the European economy.

Chart 1. Global Reserve Currencies

(latest data are for the fourth quarter of 2019)



Source: ECB

The world financial crisis has heightened the role of the dollar also due to the role played by Federal Reserve swap lines in providing liquidity to the world financial system under stress – including very large lines with the ECB and private financial institutions in Europe. –. Since all dollar liquidity transactions must be cleared through the US banking system, this has also given US regulators fresh leverage over world banking institutions, which have been obliged to comply with US rules in such areas as AML or respecting political embargoes.

These trends are to an important extent influenced by the advent into the world economy of Asian emerging countries, which by and large have chosen the dollar and do not do full justice to the role of the euro in international reserves. Indeed, the shares of the main foreign exchange reserves look rather stable over the past thirty years, around 60 per cent for the dollar and 20 per cent for the euro. Since the absolute volume of foreign exchange reserves has in the meantime increased ten-fold, to nearly 11 trillion dollars, the absolute volume of reserves held in euro has risen by a similar proportion – reaching about €2 trillion. An important observation is that some 50 per cent of the global foreign exchange turnover in euro was carried out in the United Kingdom, whose currency is not the euro, as against only 13 per cent in euro area financial markets, something that raises certain questions.

In a world in which political shocks play an increasing role in generating uncertainty, gold has also come back as a safe harbour for both official and private agents, as apparent from its high market price, but without any other reserve currency functions. According the ECB (2020), gold holdings now represent 12 per cent of total foreign exchange reserves.

It is also useful to look at the evidence provided by the indicator of international reserve status developed by Ilzetki et al. (2020), which assigns to each country an ‘anchor’ or ‘reference’ currency status and then aggregates the countries’ GDP by reference currency. The main finding is that the US dollar has massively increased its reach, from some 45 per cent of world GDP in the 1980s to around 70 per cent nowadays; its weight as a reserve currency always was and is even more now well beyond its weight in the world economy. The contrary has happened to the euro, which was used as a reference currency by 25 per cent of world GDP in 2000 and has now fallen to about 15 per cent. If eurozone countries are excluded from the calculation, this proportion falls to 3,5 per cent of world GDP. A closer look at the data indicates that the euro has been chosen by euro member countries and by European countries that have not joined the euro, but may do so in the future, and whose economies are closely integrated with those of the euro-countries.

The conclusion is straightforward. Over the past decades the dollar’s reach has become truly global, with currencies from all over the world using the dollar as the anchor or reference currency in their exchange rate management, securities issuance, invoicing and means of payment, while the euro remains confined to a regional role for its members, its neighbouring countries and some former African colonies. Its limited role is compounded by the limited development of capital markets in Continental Europe – whereby the capital market transactions are concentrated in the City of London, which belongs to a country that is leaving the EU.

Why this is the case is well explained by Ilzetki et al. (2020), who also provide an overview on the literature on the subject. Their main conclusion is that many mutually-reinforcing factors combine in giving a global means of exchange, store of value and unit of account the nature of a natural monopoly – including the convenience of yield, of invoicing trade in a single currency (which the rise of global supply chains must have increased) and holding wealth in instruments easily exchanged in deep and liquid financial markets. The

currency denomination of goods and services, on one hand, and financial assets, on the other, may be closely complementary.

History seems to confirm the persistence of the global anchor currency. The Spanish silver dollar persisted as a global currency well after the decline of the Spanish empire. The pound sterling acquired its reserve status after the Napoleonic wars and surrendered it to the dollar well after the US economy had surpassed the UK economy in size; and, similarly, today's share of the dollar in international reserve transactions is much larger than its economic weight in the world economy. This development underlines the importance, in explaining the reserve currency status, of geo-political factors such as a dominating economic, trading and financial strength in the world economy, underpinned also by military might, which allows the issuing country to project its political influence globally.

Moreover, a global currency must be widely and easily available on demand. When this is the case, powerful network economies contribute to strengthening its attractiveness. Two ingredients are important in this regard: the first one is that the domestic markets for good and services and for capital must be open to foreign supply and foreign investment; the second one is that the reserve currency must be underpinned by a large and liquid market for a safe asset guaranteed by the issuing country.

On these grounds, it is clear that the euro still has a long way to go before being able to aspire to a reserve currency status in the world economy. However, its international use may be enhanced by specific steps that can make the euro more attractive for international traders and investors. They involve the creation of a true capital markets union and the establishment of a European safe asset guaranteed by the European budget and thus, ultimately, by its Member States.

3. Capital Markets Union

The capital markets union (CMU) is a complex project entailing a host of markets, financial instruments, and legal and institutional dimensions (European Commission 2020). While Article 63 of the Treaty on the Functioning of the European Union (TFEU) provides for the full freedom of capital movements between Member States, and between Member States and third countries, in practice this freedom is ensured more for portfolio investments and much less for real direct investment. In addition, regulatory standards for the implementation of European legislation differ considerably, due to the insufficient coordination of national regulatory agencies, with undesirable effects of market segmentation.

Indeed, the rationale underlying the company law harmonization directives was the fear that freedom of establishment could unleash an undesirable race to the bottom in corporate law and business arrangements. In this regard, most Member States hang on to a “real seat” legal doctrine implying that the applicable corporate law would be that of the main center of the company's commercial and financial operations. Under this doctrine, the legal seat and the main operations of a company must coincide, potentially limiting company mobility and freedom of establishment.

Over time the Court of Justice of the European Union (ECJ) has opened ever-broader breaches into the closed walls of the real seat doctrine, de facto turning the European company law system into an “incorporation” system whereby the applicable company law is determined by the place of legal incorporation. However, the

tension between the two legal systems has not abated, reflecting continuing Member States' resistance to the real integration of capital markets. As a result, key capital market institutions continue to hinder effective integration of "real" capital markets, notably as regards the cross-border flows of direct investments. They include such aspects as the freedom to choose the market where to issue shares; the market for corporate control and the takeover directive; golden shares, or public powers to limit private autonomy in the public interest; the rules for cross-border company mobility.

The second necessary requirement for open and free capital markets is the establishment of a European single regulator with direct own regulatory powers. Here, progress has been remarkably slow; efforts have mostly been limited to ensuring the convergence of supervisory practices to achieve a gradual buildup of institutional procedures and cultural attitudes – under the constraints imposed by the EU Treaties on delegated powers. An improved convergence of regulatory standards was expected to come from the creation of the European Securities and Market Authority (ESMA), which was set up as an EU body with legal personality and was entrusted with binding powers to develop common implementing standards as the single rulebook for capital markets. Furthermore, ESMA was also identified as a single supervisor for a small set of market participants (credit rating agencies and trade repositories) – a potential harbinger of further transfers of powers. However, in practice these changes have not affected the very nature of ESMA as a network of national supervisory authorities due to the composition of its governing bodies and its decision-making procedures, which are still based on the principle of national representation.

A useful model for reform is provided by the European Central Bank, where a "management board" independent of national authorities and composed of independent and highly qualified individuals acts as an executive board, setting the agenda and preparing substantive decisions, while the representatives of national central banks only intervene in a broader "governing council" that is called upon to ratify the proposals of the management board.

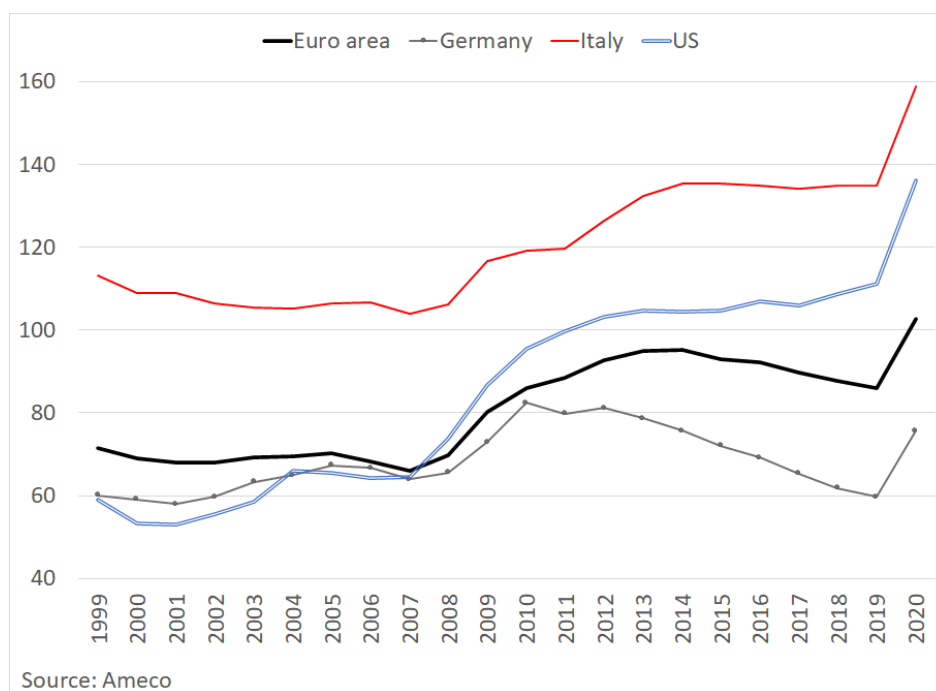
4. Market fragmentation

The main requirement for the development of a global currency status is the existence of a large and liquid 'safe' government bond market. Although the debt ratios of the US and the EU are not, in the aggregate, very different, and indeed the US debt ratio has increased more rapidly than the average debt ratio of the euro (Chart 2), investors see the US sovereign debt as not only a safe asset, but indeed the ultimate haven in case of instability in the world economy. This is not true for the euro area sovereign debts, which are of very different quality, as demonstrated by persistent financial fragmentation.

With financial fragmentation, the risks of similar financial instruments and financial intermediaries in different euro-area members are priced differently by market investors, limiting cross-border interbank and capital flows, which in turn act as a major limitation on the capital markets union. The problem is aggravated by the incomplete architecture of the monetary union, which still lacks cross-border deposit insurance, a credible crisis resolution mechanism for banks, and a full public backstop in case of a systemic bank crisis, while banks continue to hold substantial amounts of national sovereigns. Consequently, the 'doom loop' between the bank crisis and the sovereign crisis has not been vanquished but may still reappear following, for example, a rating

downgrade of a highly indebted sovereign below investment grade.

Public debt in selected countries (% of GDP)



The key factor behind financial market fragmentation is the threat of sovereign debt restructuring and, ultimately, of the exit of a country from the euro. Chart 2 also shows sovereign-debt-to-GDP ratios for Germany and Italy, two euro-members that are widely divergent in this regard. In general, the average debt-ratio for the euro area corresponds to widely varying debt ratios among its members. Thus, interest rate spreads between euro sovereigns remain sizeable even under the present ECB ultra-expansive monetary policy. As a result, capital flows from international investors seeking safe havens concentrate on ‘core’ countries – Germany, the Netherlands, Luxembourg, even France and Belgium – while shunning Greece, Italy, Portugal, and Spain. Consequently, interest rates have fallen below zero in the former countries, while remaining well above in the latter.

As solid academic research has established, this happens because of a special externality created by the combination of a common currency managed by an independent central bank and fiscal and economic policies managed at national level. When the latter diverge, doubts are likely to arise on the sustainability of the sovereign debts of some countries, since the liquidity for their orderly roll-over depends on the willingness of the ECB to intervene as lender of last resort for distressed sovereigns – an intervention that persistent divergence in economic fundamentals makes highly controversial within the ECB Governing Council and official policy circles.

In sum, the creation of a large and liquid market in the euro area for sovereign debt requires the existence of a common debt seen by international investors as absolutely safe, which may only be possible if there was a joint and several guarantee against the risk of currency redenomination. Prima facie, this condition is not likely to be met without, if not a full fiscal union, at least credible governance mechanisms to ensure the convergence of fiscal policies in euro-countries.

As an intermediate step, one would also like to see a completion of the banking union, with the establishment of cross-border deposit insurance, a credible crisis management system (which present arrangements do not guarantee) and an adequate joint fiscal backstop for the resolution and deposit insurance funds (which are both under negotiation - the former almost ready to come into existence, though it is largely insufficient, the latter still in high waters together with the cross-border deposit insurance). Various other regulatory improvements to foster the international role of the euro are presented in Commission 2020.

5. A ready-made safe asset

Despite the difficulties generated by the incomplete monetary and fiscal union, various proposals have been advanced to build a European safe asset under existing circumstances. Brunnermeier et al. (2017) made an influential proposal for developing sovereign bond-backed securities (SBBS) with varying seniority tranches, with the most senior tranche (European Safe Bonds, or ESBies) being as safe as the German bund. Being based on private contracts, their SBBS would not entail any risk sharing.

A High-Level Task Force on Safe Assets was established by the ESRB to assess the feasibility and impact on financial stability of creating a market for SBBS. They concluded that the development of a demand-led market for SBBS might be feasible ‘under certain conditions’, but could not agree either on its desirability (for the feared impact on sovereign debt markets) or its viability without regulatory support (including the introduction of concentration charges to penalise banks’ holdings of national sovereigns, the usability of ESBies as collateral in ECB operations, and complex enabling product legislation). The Commission followed up in May 2018 with a proposal for a Regulation on SBBS (European Commission, 2018), which Parliament and Council failed to approve before the end of the past legislature. All these proposals aim to create safety by combining diversification of the underlying sovereign risk with seniority over national debts; this last feature is most problematic due to its likely adverse impact on sovereign markets’ spreads and liquidity.

More importantly, the very idea of building a safe asset without risk-sharing by euro-area members seems to be an artefact founded on a wrong premise: that the monetary union can survive indefinitely without any element of fiscal union, i.e., at least, some joint sharing of sovereign risks. Some sovereign risk sharing in the EMU is unavoidable precisely to conquer the externalities generated by the common currency that I have described.

Thus, the inevitable conclusion is that a European safe asset must be issued by an EU public entity – arguably, the ESM – and must enjoy a public guarantee against sovereign default. The simple scheme that I would like to propose consists in the ESM purchasing the sovereigns held by the European System of Central Banks (ESCB) as a result of the asset purchase programme (APP) undertaken to enact its quantitative easing policies. The sovereigns would be purchased according to the proportions established in the APP, thus avoiding any undesirable differential impact on national sovereign markets. More importantly, the sovereigns purchased from the ESCB should continue to enjoy the full guarantee against default de facto offered today by national central banks, so that no sovereign risk would be transferred to the ESM.

As a counterpart, the ESM would offer its own securities, in suitable maturities. These securities would be guaranteed by its sizeable (callable) capital; in addition, they would enjoy the guarantee of its Member States

already in place for ESM liabilities, in proportions determined by the Member States shares in the ESM capital. This double guarantee, together with the guarantee maintained by national central banks on their sovereign paper, should be more than enough to ensure the Triple A rating for ESM securities without any special seniority privilege. The major drawback of the various proposals for a safe asset previously examined would thus be eliminated.

While of course these purchases by the ESM would develop gradually over time, they would eventually make available a total amount of over €2 trillion that would offer plenty of space for the diversification of banks' sovereign portfolios, as well as for large investments by international investors. A sizeable addition to these will be represented by the debt issued by the European Commission to fund its new programme, Next Generation EU. An adequate basis would thus be established for the development of a large, deep and liquid market for a European safe security, which would become the basis for a truly integrated capital markets union and underpin the international role of the euro as a reserve currency and investment instrument. Over time, it would become clear that there is no need to reimburse these liabilities, but simply to roll them over, so that they become a stable component of the international monetary system.

This scheme has several other attractive properties that are worth mentioning. First, over time it would free the ESCB from the encumbrance of sovereigns in their balance sheets, thus creating suitable conditions for unwinding the large increase in their balance sheets after quantitative easing policies come to an end. As ESM purchases proceed, the liquidity created by the asset purchase programme would be reabsorbed, but the ECB would receive cash from the ESM. It could then decide to purchase other sovereigns, to maintain an unchanged policy stance, or let its balance sheet shrink if it deemed that the existing degree of monetary stimulus was unwarranted. The time for such a decision will of course be determined well after the current coronavirus crisis ends.

Second, by bringing to the market a large supply of new high-quality assets, the scheme is likely to relieve the downward pressure on interest rates in the bond markets of 'safe' (low debt) euro-area countries, opening the way to interest rate increases in core countries even with present ECB policies. Moreover, these ESM securities would price counter-cyclically, as they would become a safe haven for investors fleeing instability; and they could become the principal instrument of monetary policy operations, as the ECB could purchase and sell them freely without effects on national budgetary policies.

6. A concluding remark

The foregoing analysis shows that creating the conditions for the euro to become an international reserve currency requires a complex policy set up that cannot bear fruit rapidly. However, if this is what is wanted, these policy requirements should be made explicit in the public debate before Parliaments and the public. They entail moving decisively to open capital markets by completing the banking union and the capital markets union. They require a willingness to issue and jointly guarantee a very large common debt instrument, something that could be done by building the joint debt instrument on the ECB's sovereign debt purchases and the securities issued to finance Next Generation EU.

The fundamental question that remains to be answered, however, is the following: is the euro area, or perhaps the EU itself, ready to take up such responsibility in the world? Is it ready to project its economic power and influence worldwide, which would in turn entail a common foreign and defence policy and a willingness to deploy these tools to assert larger political influence in the world?

My inability to answer this question justifies the question mark in the title of this paper.

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