



EUROPEAN CENTRAL BANK

# Discussion: The International Role of the Dollar and the Euro

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# Outline

- Major changes in the international financial system
- Some features of the international role of the euro
- Theory of reserve currencies
- [Developments in European capital markets – no time, perhaps in general discussion]

*Mixture of discussing Galati and Wooldridge's paper on "The euro as a reserve currency: A challenge to the pre-eminence of the US dollar?" and contributing other elements to this session*

# Major changes in the international financial system

- Financial globalisation/international financial integration
  - Economic activity in general cuts more and more across borders
  - Quantities: Capital flows and external investment positions become larger
  - Prices: Financial market returns become more correlated
- Introduction of the euro
  - **Major international currency** as of Day 1, already now exceeding the role of the German mark before EMU
  - Attractiveness of European financial instruments and domestic capital markets
- Emergence of two major (“new”) investor groups
  - Hedge funds: Dominate corporate control in many sectors
  - Asian central banks: Finance US current account deficit
  - (also in some regions mutual and pension funds as well as private equity groups)

# Major changes in the international financial system

- Securitisation and tradability of credit risk
  - Asset-backed securities, CDOs/CLOs, credit derivatives etc.
  - Origination of debt increasingly separated from monitoring and management of credit risk
- Comparative advantage of US (and a few other large) financial institutions in the provision of financial services
  - See e.g. Berger, DeYoung and others for cross-border banking
  - Underwriting in the European corporate bond market
  - Next targets: London Stock Exchange, Euronext, Chinese and Indian banks and corporates?
- Capital flows in significant amounts from some countries with high capital productivity to countries with lower capital productivity (part of “global imbalances” debate)

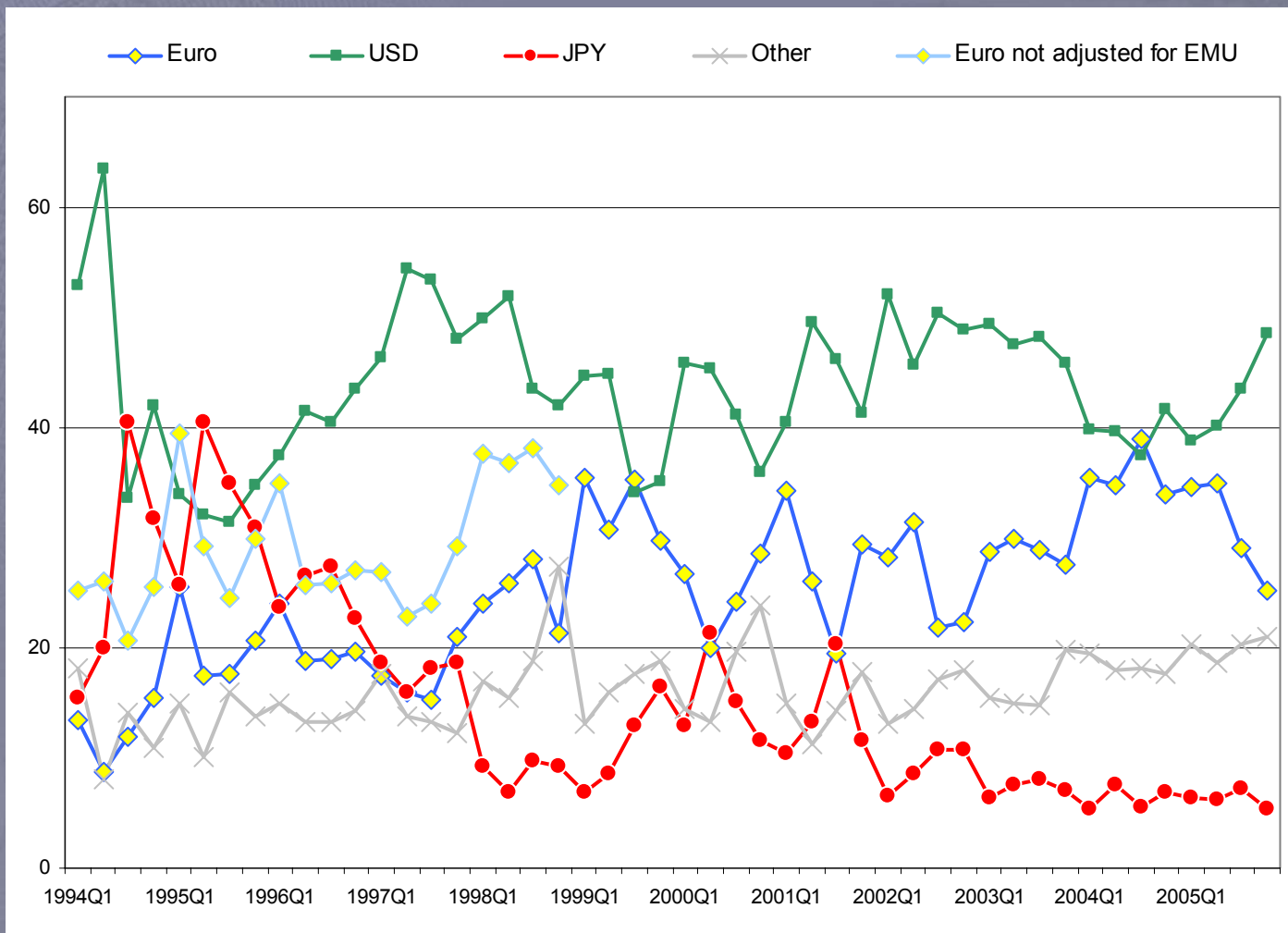
# Some implications for industrial economies

- Countries increasingly influenced by events abroad
- Possible tendency towards a multi-currency system (more diversified private and official portfolios, company accounting, currency baskets etc.)
- Financial risks increasingly distributed over households
  - E.g. through mutual funds and funds of funds
  - Banks become less of shock absorbers
- National governments increasingly powerless with regard to the functioning of their financial sectors
- Increasing importance of financing conditions and asset prices for monetary policy
- Financial system more efficient most of the time, but crises could be more severe (see e.g. Rajan, 2005)

# Features of the international role of the euro

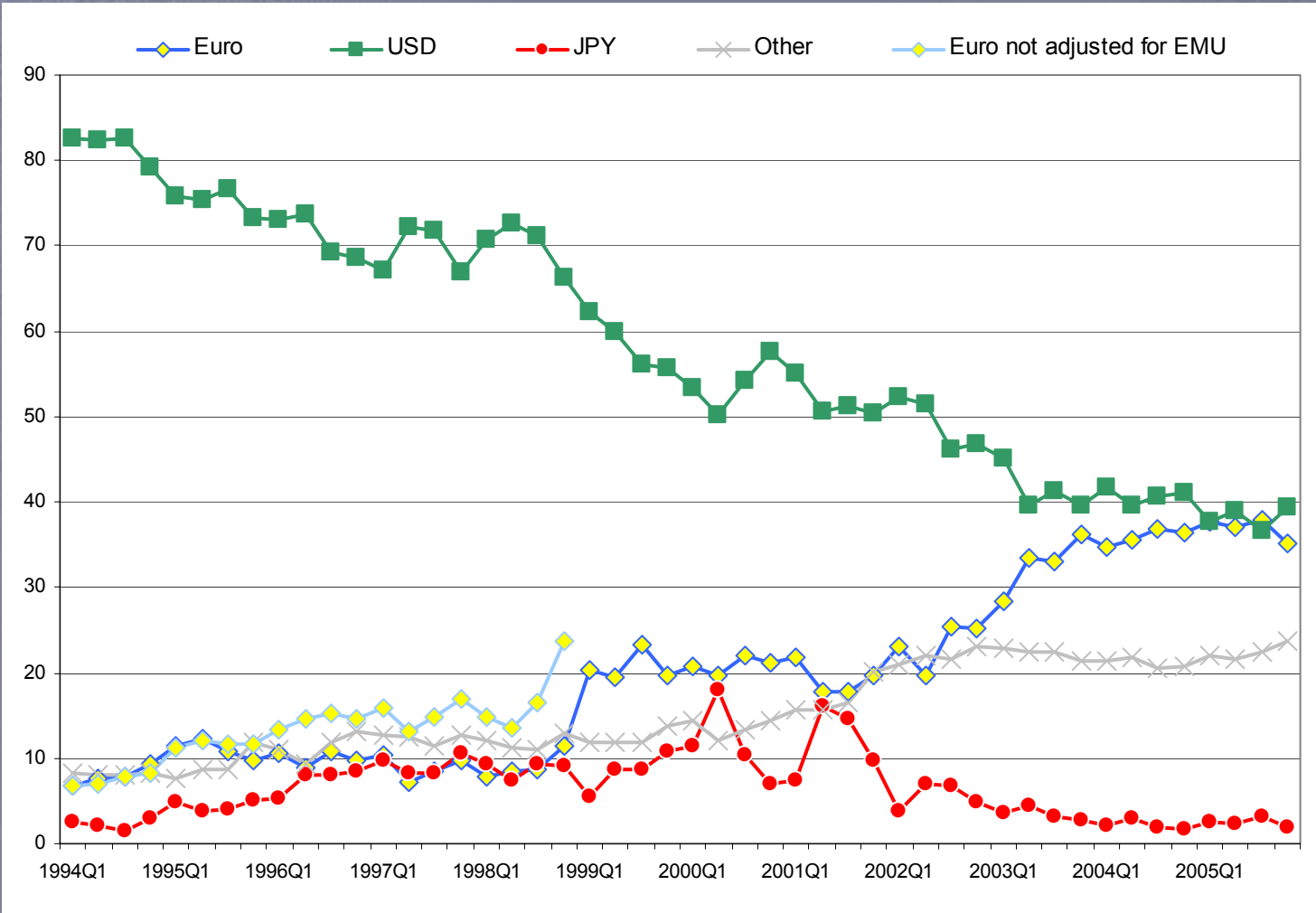
- Focus on some **salient features**
- They do **not** really include **official reserves**
- Most dynamic development as a **financing currency**: International debt securities markets (see Detken and Hartmann, *International Finance*, 2000)
- **Regional character** of the euro: Strongest role in neighbouring countries
  - Central and Eastern Europe, EMU “pre-ins”, some Northern European countries, Switzerland, Mediterranean region etc.
  - Forex vehicle currency (see Detken and Hartmann, *Economic Policy*, 2002)
  - Currency substitution (see ECB, 2005)
- Systematic source of data and analysis: ECB “Review of the international role of the euro”

# Announced issuance of international bonds



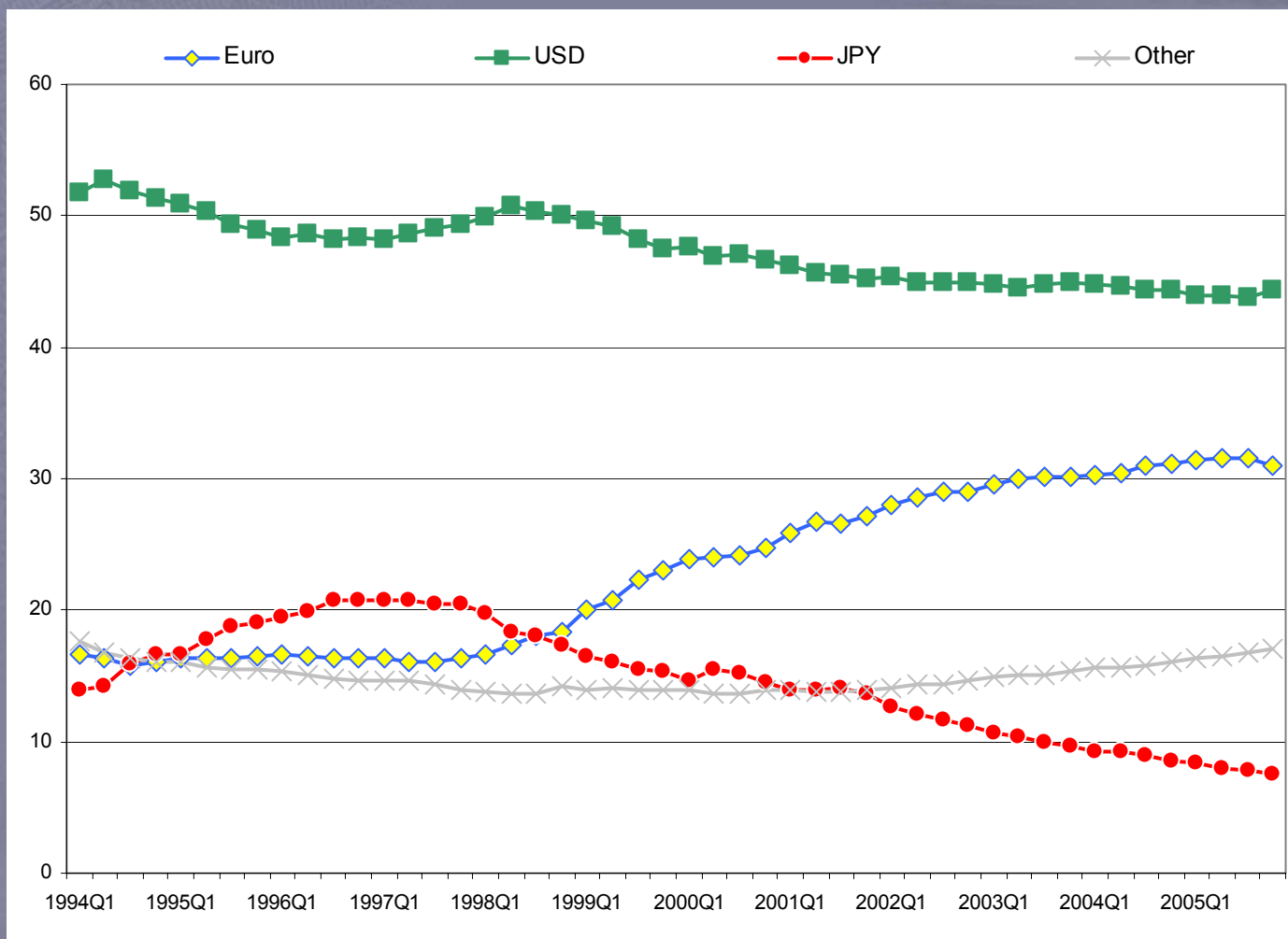
Source: BIS and ECB staff calculations

# Announced issuance of international MM instruments



Source: BIS and ECB staff calculations

# Stock of international debt securities



Source: BIS and ECB staff calculations

# In search of a theory of reserve currencies

- Reserve currency status is supposed to be the focus of the Galati and Wooldridge paper
- Problem: We cannot explain the currency decomposition of official reserves very well
  - The only thing that works for sure is lagged reserve holdings/currency shares
- Motives for the choice of reserve currencies
  - Exchange rate interventions
  - “War chest” more generally
  - Profit motive
- Constraints
  - Strong risk aversion
  - Very high liquidity requirements
  - Other central bank operations

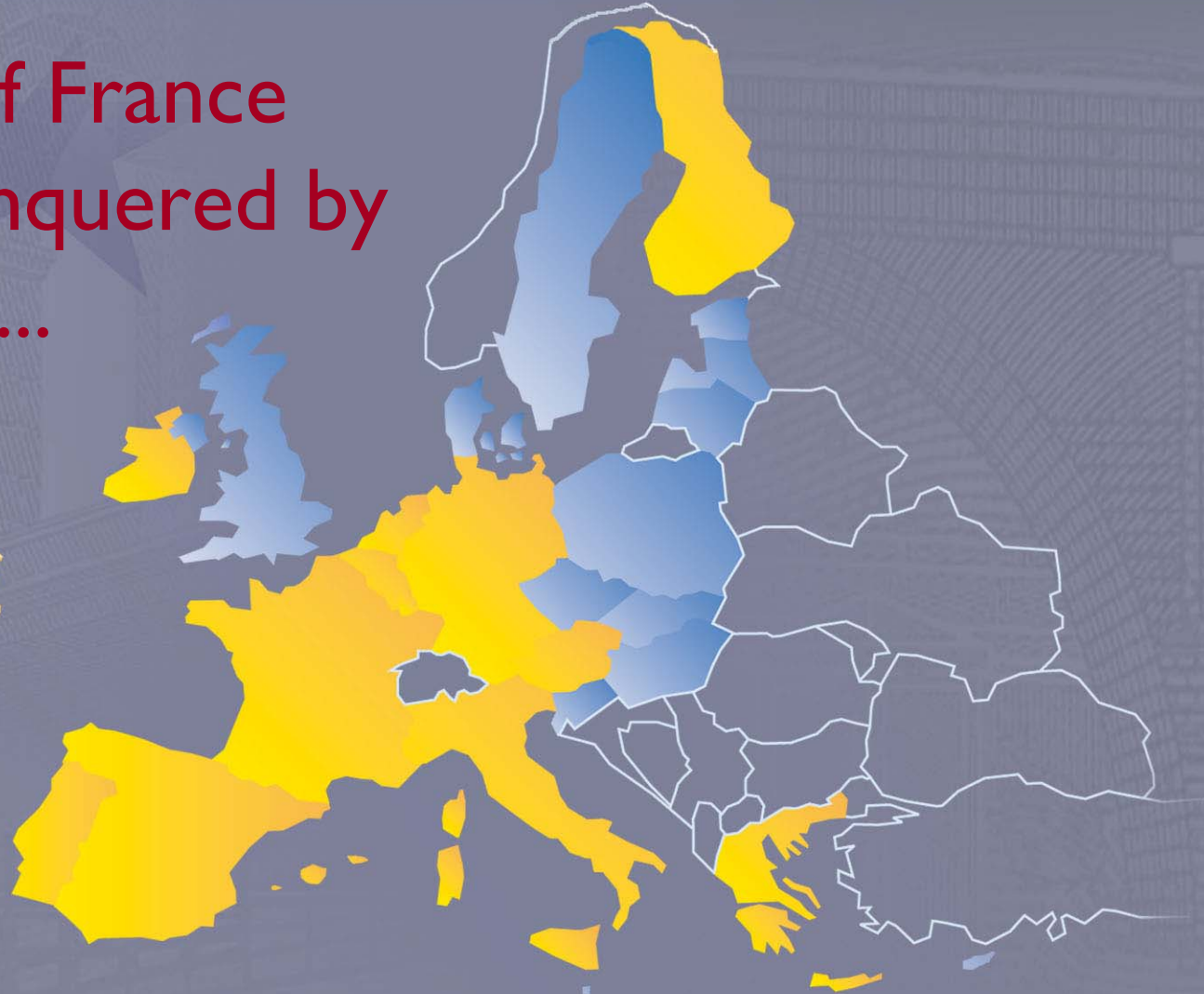
# In search of a theory of reserve currencies

- Academic research should come up with better approaches to explain reserve currency shares
- One angle: Start from profit maximisation under constraints
  - Central bank maximises portfolio returns subject to
  - Portfolio risk not exceeding a certain level
  - Overall reserves at least  $x$  times (twice?) the largest intervention of that country in history
  - Liquidity of each (most?) position(s) exceeds a certain high level
  - Other central bank constraints?
  - Less than this, but first steps, see Papaioannou et al. (2006)
- Another angle: Reserve holdings are a residual of non-portfolio policies
  - Systematic exchange rate or monetary policies



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The whole of France  
had been conquered by  
the Romans ...



... but one village did not cease to resist.

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