BANK FOR INTERNATIONAL SETTLEMENTS

The international role of the euro: down but not out[1]

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on "Strengthening the international role of the euro: European and international perspectives"

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Good morning.

It is a pleasure for me to testify before this Committee.

Much has been said about the role of the euro in the international monetary and financial system and about the currency's prospects. And much of it is not particularly encouraging.

Some of what has been said is about the future. Based on the lessons of history, there is a broad consensus on the financial and political preconditions for making that future a bright one.[2] One *can only* conclude from those lessons that the distance to travel is, to put it mildly, considerable. I can hardly add anything of value to that aspect of the debate.

Some of what has been said has been about the evolution to date. Take the IMF's tally of the share of official foreign exchange reserves denominated in euros. This shows a sizeable diminution, from about 25% in 2012 to some 20% recently.[3] Moreover, the ECB's composite index of the euro's international role paints a similarly unflattering picture.[4] One *might* conclude from all this that the euro has lost clout across the board.

Today, I would like briefly to question this verdict. My thesis is that the verdict is too categorical – a more nuanced assessment is in order.

I would like to argue that, in some important respects, the euro's heft has actually grown in recent years. I shall highlight three aspects: the euro's influence on global bond markets; its influence on exchange rates globally; and its influence on the "effective pricing" of commodities, regardless of the currency in which their prices are actually denominated.

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1 I would like to thank, for their input, Robert McCauley as well as Fernando Avalos, Giulio Cornelli, Boris Hofmann, Emanuel Kohlscheen, Marco Lombardi, Hyun Song Shin and Dora Xia.

2 See B Cœuré, "The euro's global role in a changing world: a monetary policy perspective", speech at the Council on Foreign Relations, New York, 15 February 2019.

3 See ECB, *The international role of the euro,* June 2018, p 8. Even if this decline is associated with the depreciation of the euro against the dollar, it may indicate that central banks chose not to rebalance their portfolios.

4 Ibid, p 4.

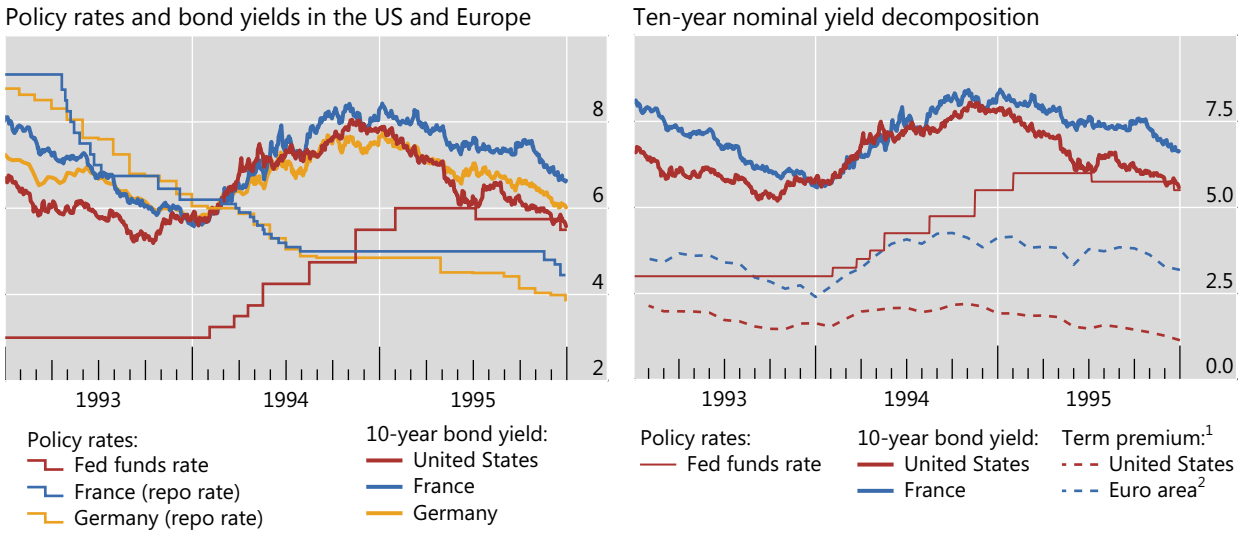
The euro in the global bond market

To appreciate the euro's impact on global bond markets, it is useful to recall the events of the 1994 bond market sell-off – a historical benchmark (Graph 1, left-hand panel). The global sell-off started with an unexpected hike in the US federal funds rate, which heralded the beginning of a tightening cycle, and was amplified by market dynamics, owing to investors' highly leveraged positions. This led to a transatlantic bond sell-off, notwithstanding monetary conditions in Europe had not changed: in fact, the Deutsche Bundesbank and the Bank of France were in an easing phase.[5]

We now have better evidence about what happened. The widening in the European bond term premium – the yield component in excess of expected short-term rates – drove European bond yields to track US yields (Graph 1, right-hand panel). And this despite the obvious divergence in the monetary policy stance.

Transatlantic eastward waves: from US policy rates to bond yields in Europe

In per cent — Graph 1



[1] Defined as the yield component in excess of expected short rates; estimate based on a joint macroeconomic and term structure model; see P Hördahl and O Tristani, "Inflation risk premia in the euro area and the Unites States", *International Journal of Central Banking*, September 2014. Yields are expressed in zero coupon terms; for the euro area, French government bond data are used. [2] Last date: January 2019. [3] Difference between 10-year nominal zero coupon yield and 10-year estimated term premium.

Sources: National data; BIS calculations.

This was just another instance in an already long-established pattern. The relationship between European and US bond markets was highly asymmetrical. The US market was the unmoved mover. In fact, one of the hopes of those who dreamt up the euro was that the new currency would usher in an era of symmetry.

For a long time, those hopes were dashed by reality.

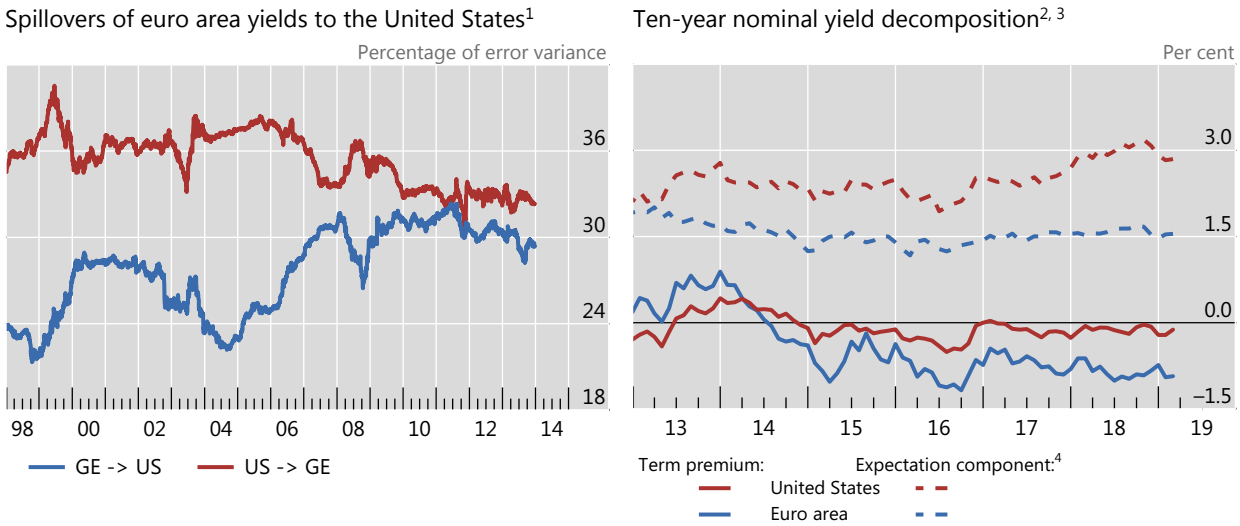
Fast forward to 2014. The prospect of the ECB's asset purchase programme depressed euro bond yields. On this occasion, however, lower term premia in Europe seemed to lead lower term premia in the

[5] See C Borio and R McCauley, "The economics of recent bond yield volatility", *BIS Economic Papers*, no 45, 1 July 1996.

US Treasury market (Graph 2, right-hand panel). The direction of influence across the Atlantic had now become east to west. Accordingly, high-frequency analysis finds that a much more symmetrical relationship has emerged.[6]

More generally, there is evidence that movements in German bund yields exert a more symmetrical effect on movements in Treasuries. Rolling estimates of spillovers across the two markets suggest that their strength has gradually increased since 2004 and, more importantly, that the strength of westward transatlantic ones – from the euro area to the United States – has intensified and pretty much closed the gap (Graph 2, left-hand panel).

Transatlantic westward waves have intensified since the mid-2000s — Graph 2



[1] Spillover estimates are based on F Diebold and K Yilmaz, "Measuring financial asset return and volatility spillovers, with application to global equity markets", *Economic Journal*, vol 119, no 534, January 2009. [2] Decomposition of the 10-year nominal yield according to an estimated joint macroeconomic and term structure model; see P Hördahl and O Tristani, "Inflation risk premia in the euro area and the Unites States", *International Journal of Central Banking*, September 2014. Yields are expressed in zero coupon terms; for the euro area, French government bond data are used. [3] Last date: February 2019. [4] Difference between 10-year nominal zero coupon yield and 10-year estimated term premium.

Sources: Bloomberg; national data; BIS calculations.

Shift now from changes to levels. It is remarkable how low euro area government bond yields are relative to US Treasury yields. To be sure, the gap of 2% (or thereabouts) – using bunds as an example – reflects in part the difference in monetary policy stance. But the record of 2014 suggests that the scale and heft of the euro area and the euro bond market play an important role too. Indeed, estimates indicate that the term premium in euro area sovereign markets is considerably lower than that in the US (Graph 2, right-hand panel).

The euro area bond market has gained ballast. Maybe not as much as those who established it had hoped for. But ballast nonetheless.

[6] See S Curcuru, M De Pooter and G Eckerd, "Measuring monetary policy spillovers between US and German bond yields", *International Finance Discussion Papers*, no 1226, 2018.

The euro as an anchor in the global foreign exchange market

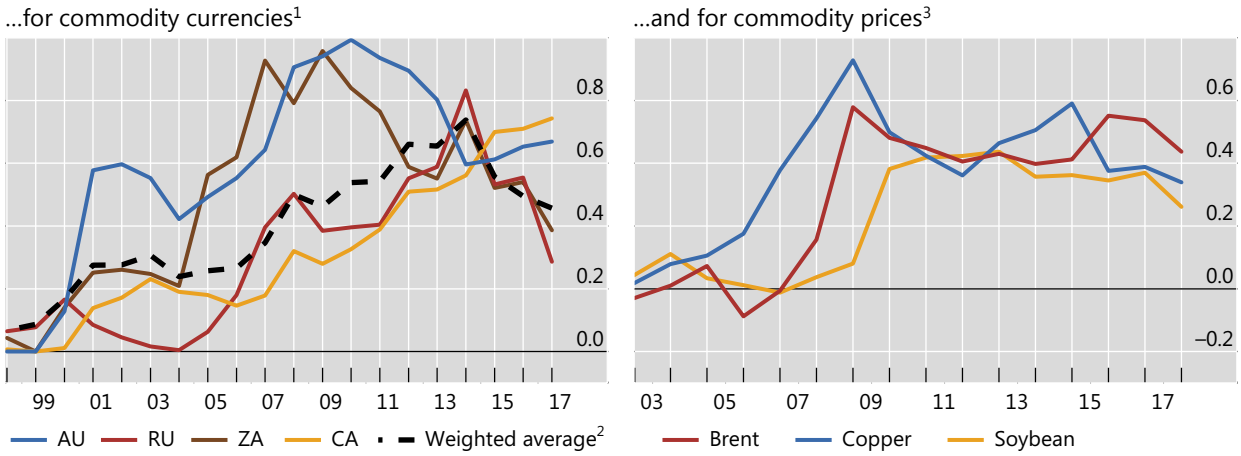
Another market in which the euro has gained clout is the foreign exchange market. Here, I am not referring so much to the volume of transactions. In this respect, its role barely exceeds that of its predecessor, the Deutsche mark.[7] But look at it as a magnet, or anchor, for other currencies, and it's a different story.

It is not just because, as we know, since the inception of the euro several countries to the east have joined. Or because various other currencies of countries to the east share most of the euro's movements against the dollar. Think, for instance, of the Czech Republic, Hungary and Poland.

The story is bigger. The euro's influence does not end in Europe. Notably, in late 2015 the People's Bank of China disclosed the currency basket that guides the management of the Chinese currency. This basket puts a weight of 16% on the euro, compared with 22% on the dollar. Given China's strong trade links, over time this could mean that the currencies of East Asia could move in sympathy with the euro against the dollar.

What's more, since the inception of the euro, commodity currencies have tended to move to a varying but significant degree with the euro against the dollar (Graph 3, left-hand panel). I am not referring to the dollar pegs of Middle East oil producers, but rather to the currencies of other commodity producers such as Australia, Brazil, Canada, Russia and South Africa.

The euro's pulling power has increased… Graph 3



[1] The figure plotted shows the co-movement as a percentage change in commodity currencies against the dollar associated with a 1% move in the euro/dollar exchange rate; a positive value indicates that the currency tends to appreciate as the euro appreciates against the dollar. Computed as the within-year averages of the regression coefficients of monthly percentage commodity currency returns on monthly percentage EUR/USD returns, in a rolling window of three years. [2] Weighted average for Australia (AU), Brazil (BR), Canada (CA), Norway (NO), Russia (RU) and South Africa (ZA). [3] The figure plotted shows the correlation of commodity prices expressed in dollars with the movement in the EUR/USD exchange rate; a positive value indicates that the commodity tends to become more expensive in dollar terms as the euro appreciates against the dollar. Computed as the within-year averages of the regression coefficients of monthly percentage commodity price returns on monthly percentage USD/EUR returns, in a rolling three-year window.

Sources: H Ito and R McCauley, "A key currency view of global imbalances", *BIS Working Papers*, no 762, December 2018; Bloomberg; national data; author's calculations.

[7] The euro was on one side of 31% of foreign exchange transactions in April 2016. In April 1998, the Deutsche mark's share was 30%, and that of the other currencies that became the euro was 11%. See https://www.bis.org/statistics/d11_3.pdf.

To be sure, the reasons for this correlation are not well understood.[8] But it may reflect the fact that commodity prices in dollars tend to weaken when the dollar appreciates against the euro; and to strengthen when the dollar depreciates, as in late 2014 (Graph 3, right-hand panel). As commodity prices respond to shifts in the dollar/euro rate, so do commodity currencies.

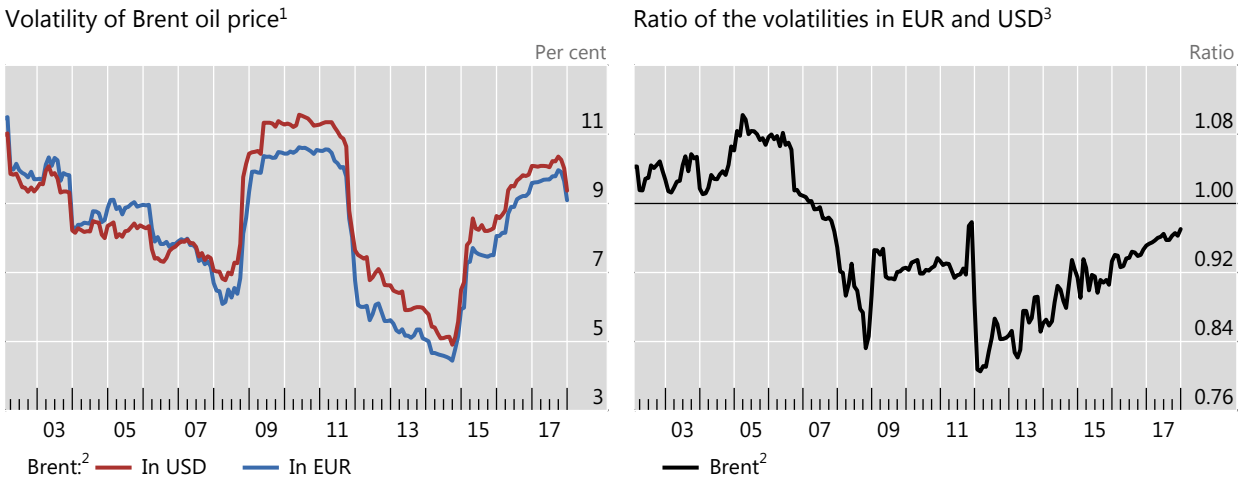
Trading commodities in euros?

This brings me to my last point: the implications of pricing commodities in euros rather than in dollars for the stability of those prices for euro area producers and consumers and for other policy dimensions. Here, the systematic relationship between commodity prices and the dollar is key.

If one reason for wishing that commodity prices, especially that of oil, be denominated in euros is to reduce their volatility when measured in euros, then we should pause to reflect. One ought to distinguish between the currency of denomination for trade in commodities and how the prices of those commodities co-move with exchange rates, which might be termed the "effective pricing" of commodities.

Commodity prices may not be denominated in euros. But, they move – at least to some extent – with the euro. As noted earlier, as commodity prices rise, the dollar – their currency of denomination – tends to weaken vis-à-vis the euro. As a result, commodity prices rise less in euros. In other words, paradoxical as it may sound, they are actually more stable measured in euros than in dollars. For instance, since 2008 the volatility of Brent oil prices expressed in euros has been lower than that in dollars (Graph 4). In effect, the systematic shift in the dollar vis-à-vis the euro as oil prices change means that the exchange rate acts as a shock absorber.

The exchange rate dampens oil price volatility in euros — Graph 4



[1] Measured as the rolling three-year standard deviation of monthly returns of the Brent oil price expressed in USD and EUR, respectively. [2] Brent Forties Oseberg (BFO) Month 1 Europe Free on Board. [3] Ratio of the two volatility measures shown in the left-hand panel; a value below one indicates that the Brent oil price expressed in EUR is less volatile than that in USD.

Sources: Datastream; author's calculations.

Of course, denominating energy prices in euros would yield other benefits.

[8] See BIS, *85th Annual Report*, June 2015, Box II.B, for a discussion.

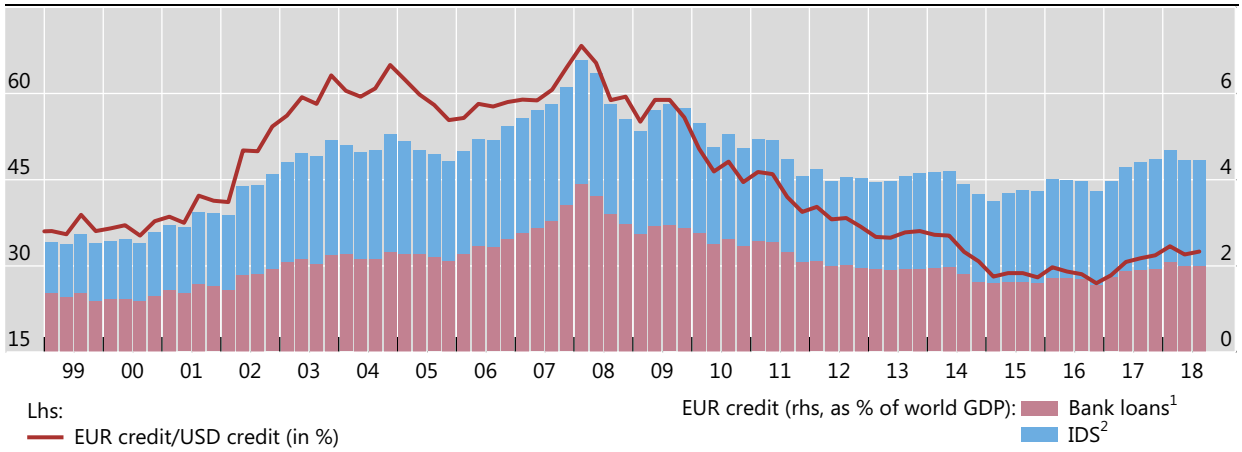
For one, trading and settling oil in the euro would move payments from dollars to euros and thereby shift ultimate settlement to the euro's TARGET2 system. This could limit the reach of US foreign policy insofar as it leverages dollar payments.

In addition, denominating energy prices in euros would have implications for those borrowers seeking to hedge foreign exchange risk. Euro area importers would do so automatically by borrowing in their home currency. And energy producers outside the euro area would be induced to borrow in euros to hedge cash flows. Likewise, users outside the euro area would have an incentive to borrow in euros to finance purchases. Importantly, all this would promote the use of the euro as an international funding currency – a role in which its importance has waxed and waned since its introduction (Graph 5).[9] For much the same reasons, it would also boost its role as a reserve currency.

These would be significant changes.

The ups and downs in the euro's role as an international funding currency

Euro-denominated credit to non-residents — Graph 5



[1] Cross-border loans and local loans in foreign currency to non-bank borrowers. [2] International debt securities, by residence and immediate sector of issuer; all instruments; all maturities; non-bank issuers. International debt securities are debt securities issued by non-banks in a market other than the local market of the country where the borrower resides.

Sources: IMF, *World Economic Outlook*; Dealogic; Euroclear; Thomson Reuters; Xtrakter Ltd; BIS locational banking statistics and global liquidity indicators; BIS calculations.

Conclusion

The euro has suffered well known setbacks as an international currency. But it has also made unacknowledged gains. These have occurred in the bond market, in the foreign exchange market and in the effective pricing of commodities.

[9] On this, see in particular S Avdjiev, C Koch and H S Shin, "Exchange rates and global liquidity", presented to the NBER conference on *Capital flows, currency wars and monetary policy*, Boston, 5–6 April 2018.