Comments on "Why is the euro punching below its weight?"

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When the euro was introduced, it was amidst great hopes that it would rival the dollar as a reserve currency. Twenty years on, these expectations have failed to materialize. Ilzetzki, Reinhart, Rogoff (henceforth IRR) set out to achieve two goals in this interesting and timely paper. First, using various metrics, they document that the role of the euro in the world economy has indeed remained stagnant (or even declined!) over the last two decades, remaining substantially below the euro area's weight in world GDP or global trade. Second, they discuss some hypotheses for this disappointing performance.

The statistics compiled by IRR paint an unequivocal picture. Only 29% of the world's countries, representing 15% of global GDP, anchor their currency to the euro. In turn, 59% of countries anchor their currency to the dollar, and they collectively represent 69% of global GDP. Only 21% of the world's reserves are in euros, whereas 64% of them are in dollars. Of the total stock of external debt issued by developing countries, only 8% is denominated in euros against 74% in dollars. These differences are astounding, and far exceed what could be expected based on the relative sizes of the US and euro area economies. Moreover, there is no indication that they are getting smaller over time: if anything, the relative performance of the euro appears to be stagnant or even declining over the last decade. IRR show that the dollar even outperforms the euro in terms of trade invoicing, although the euro area makes up a substantially larger share of global trade!

But what explains this underwhelming performance of the euro? IRR discuss two major hypotheses. The first is based on asset supply. Namely, the euro area is incapable of supplying high-quality financial assets at a scale comparable to that of the US. This is true for public assets, because many euro area governments lost their "safe-asset" status after the European sovereign debt crisis, and for private assets, because both corporate access to bond markets and equity markets are less developed in the euro area than in the US. The second hypothesis is based on the fragmented nature of the euro area. Basically, the bloc lacks economic and political cohesion: it does not have a central authority with taxation powers or even a global financial center, and it often fails to speak and act as one military and diplomatic unit. All of this was of course made worse by the euro area crisis. And, perhaps, the paper suggests, by a European Central Bank (ECB) that throughout the first decade appeared to conduct what IRR call a "Bundesbank-plus" monetary policy, i.e., a policy that essentially mimicked the Bundesbank and appeared to be better tailored for Germany than for the euro area as a whole.

Everything you wanted to know about the euro's standing in the world economy…

For many readers, IRR's paper will rightly become the go-to reference of the euro's standing in the world economy. If only for the concise and well-documented presentation of facts, it should become mandatory reading for anyone interested in the past (and future?) of the euro and, more broadly, in the structure of the international monetary system. I have no major comments on this part of the paper, which I personally found extremely informative. My suggestions and questions for the authors thus focus on the second part, in which IRR interpret the facts in light of different hypotheses.

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…but were afraid to ask

My first question is very general. Throughout, the tone of the paper is one of disappointment or regret. IRR take it for granted that it would have been desirable for the euro to become a "reserve currency", and its failure to do so is a lost opportunity for the euro area. Yet, as I read the paper, I could not help but wonder whether the net gains of becoming a reserve currency are really that self-evident.

It is true that a reserve-currency status is believed to entail benefits, mostly in terms of seigniorage and lower borrowing costs for the government and private sector. But seigniorage revenues are likely to be small, and the effect on borrowing costs is not obvious: US entities, for instance, do not appear to face significantly lower costs than those of other creditworthy industrial economies like Germany. Moreover, a reserve-currency status may also entail costs. Reserve currencies provide safe havens for global investors, which may lead to appreciations in bad times (i.e., the exorbitant duty documented by Gourinchas et al. (2010) for the case of the US dollar). The design of monetary policy for reserve currencies may face tighter constraints, as it is likely to generate large cross-border spillovers and thus attract intense scrutiny from the international community.

Ultimately, it is unclear how these different effects add up. Bernanke (2016), for instance, has argued that the benefits of having reserve-currency status may not be substantial. Although IRR cannot be expected to provide an answer in this paper, a brief initial discussion along these lines would have been useful for a general reader like myself to frame their findings.

My second question has to do with the framing of the findings. IRR show beyond doubt that the role of the euro is low relative to the weight of the euro area in the global economy. But the same is probably true for other countries, such as Japan or China. It is thus not obvious whether the situation is best diagnosed as the euro punching below its weight, or as the dollar punching above its. As IRR acknowledge, there are strong complementarities that may lead to the natural monopoly of a single reserve currency. These complementarities are linked both to currency invoicing, as well as to the currency denomination of financial assets. In fact, recent theories of reserve currencies also emphasize complementarities between the trade and financial aspects of a currency's uses (e.g. Gopinath and Stein (2018)). If such complementarities are strong enough, there is no fundamental reason for the euro (or any other major currency) to threaten the dominance of the US dollar once the world has coordinated on the latter. This has little to do with the economic performance of the euro area, and it is not clear what – if anything – the bloc could have done to change the status quo.

More specifically, the paper points to the insufficient supply of safe, euro-denominated assets as one of the factors that held back the euro's role in the global economy. Indeed, IRR stress that in 2018 the supply of "safe" euro public debt was about a third of US public debt. But this raises a number of questions. The first is that the relative supply of euro-denominated safe assets was quite high before the global financial crisis. In 2003, for instance, the stock of euro public debt that could be considered safe was comparable to the stock of US public debt.[2] So

[2] According to Eurostat, the combined stock of public debt of Austria, Finland, France, Germany, and the Netherlands amounted to 3.0 trillion euros in 2003, and to 5.1 trillion euros if Belgium, Ireland, Italy, Portugal and Spain are also added to the mix. The stock of US public debt, in turn, amounted to approximately 4 trillion dollars.

what prevented the euro from gaining traction during these early years? One possibility is that it was the European sovereign debt crisis which, by undermining the safety of some of these assets, truncated the rise of the euro. But this narrative seems inconsistent with IRR's data, which does not show the euro gaining significant ground in the world stage even during its first decade. A second problem with this argument is that it can go both ways, i.e., it may well be that it is hard for some euro area members to issue safe assets precisely because the euro is not a reserve currency. Of course IRR cannot be expected to solve this issue here, but the reader should be aware of the problem of causality lurking in the background.

My final comment refers to the analysis of euro-area monetary policy over the last twenty years. In particular, IRR argue that the ECB appears to have followed a Taylor rule for Germany until 2012, after which the institution changed and began following something closer to a euro-wide Taylor rule. This part of the paper is a fascinating read, but it is not immediately obvious how it relates to the euro's standing in the global economy. Is the argument that the ECB's (initially) suboptimal monetary policy undermined the international role of the euro? Or that the institution's shift in the conduct of monetary policy has undermined its credibility? My reading is that this part is unrelated to the international role of the euro – and thus to the main point of the paper – and is instead intended to provide a thorough account of the currency's first two decades. In any case, and whatever mistakes the ECB may have made during this period, the fact is that the euro has held up well against the US dollar despite the euro area's economic woes (including a full-blown sovereign debt crisis). The euro may not have challenged the supremacy of the US dollar, but it could have done much worse.

Overall, IRR provide a timely and fascinating description of the evolution of the euro's role during its first two decades. They convincingly show that this role has remained basically stagnant, and that the currency has underperformed relative to the economic weight of the euro area. Their discussion of the underlying causes of this underperformance is more speculative, however. Even so, this paper is bound to become an essential reference for anyone seeking to understand the history – and the future – of the euro.

References

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