Euro as a Global Reserve Currency

What is the issue?

- It was claimed that the euro would rival the US dollar as a second global reserve currency.
- But the hopes have failed to materialise, and euro's importance is about the same as it was two decades ago.

What is the recent move?

- The European Commission recently published a Communication entitled "Towards a stronger international role of the euro".
- The European Commission considers that the eurozone would benefit if the euro played a more global role.

How has the Euro's importance been?

- There is widespread use of euro banknotes outside the single-currency area.
- [Bank notes are similar to bonds; promissory note issued by a bank in large denominations, which is interest bearing and payable on demand.]
- On this measure at least, the euro has been a big success.
- Bank note issuance was a profitable business for central banks, because they could invest the proceeds in government bonds with a decent yield.
- With interest rates at 5%, and Euro 1.2 trillion of notes in circulation, the European Central Bank (ECB) could have generated revenue of about Euro 60 billion a year.
- Currency in circulation has more than doubled over the last 20 years, both in absolute terms and as a percentage of eurozone GDP.
- Furthermore, it is commonly estimated that a large fraction of euro cash is used outside the eurozone.

Why is the Euro dream unfeasible?

- **Bank notes** - The economics of banknote issuance have changed now, and at today's negative interest rates, currency issuance is no longer profitable.
- This might be another reason why the ECB decided to stop issuing the Euro 500 note.
- **Borrowing** - Another argument for having a global reserve currency is that

foreign borrowing becomes cheaper.

- It is a privilege the United States enjoyed owing to the dollar's status as the world's main reserve currency.
- But while issuing dollar-denominated debt is an important advantage for the US (the world's largest debtor), the eurozone is a net creditor.
- Also, with real interest rates tending to be higher in dollar terms, it would be better for the eurozone's external assets to be denominated in dollars than in euro.
- **Power** - The extra-territorial application of sanctions by the US makes it extremely difficult for European companies to maintain trade ties with Iran.
- This is because most of Iran's international trade is invoiced and settled in dollars.
- In this context, it is in Europe's interest for the euro to play a larger global role.
- However, the ability of the US to apply sanctions so widely is essentially due to its diplomatic and military power.
- So even if the euro played a much larger role in global finance, the US would remain dominant in terms of hard power.

What could be done?

- The eurozone currently is facing enough economic challenges without the additional burden of issuing a global reserve currency.
- So the euro could better increase its global role only by slowing the relative decline of the eurozone economy through rapid growth.

Source: Business Standard

SHANKAR IAS PARLIAMENT
Information is Empowering