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The Euro and the Geopolitics of Post-COVID-19

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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The Euro and the Geopolitics of Post-COVID-19

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Abstract

This note provides a critical overview on the current status and recent trends related to the euro's international standing over the last decade and reflects on the opportunities and risks for the role of the euro going forward, including the post-COVID-19 international trade and political order.

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CONTENTS

LIST OF ABBREVIATIONS

APP	Asset Purchase Programme
CDS	Credit Default Swap
CLS	Continuous Linked Settlement
ECB	European Central Bank
EMU	Economic and Monetary Union
EP	European Parliament
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
SDR	Special Drawing Rights
TFEU	Treaty on the Function of the EU
TLTRO	Targeted Longer-Term Refinancing Operations
USD	US Dollar

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EXECUTIVE SUMMARY

- **Propping up the international role of the euro has long been discussed in both academic and policy circles**. This is an issue now at the core of the European policy debate as voiced recently by both the European Commission and the European Central Bank (ECB). At the centre stage of an internationally relevant and stable euro must be an independent central bank superseding strong economic and financial fundamentals and strong political governance.

- **Despite having a large economy, the euro area has not deep enough and integrated financial markets, particularly in some segments**. It does have, however, differently from China, more widespread confidence in its currency.

- **The classic three functions of money in an economy, i.e. store of value, medium of exchange and unit of account, can be understood at the international level as well**. Looking at the euro's use in denominating bond and loan contracts, its use in denominating international trade, the volume in foreign exchange trading and the euro share of central banks' reserves, the evidence does support the idea that the euro has made progress along those dimensions. Still, the euro and the USD have witnessed a relative decline in their role as foreign reserve currencies since the global financial crisis.

- **There are still specific factors which are likely to hinder the growth of the euro as a global currency**. The main problems are embodied not only in the need to enhance the euro's global geopolitical outreach (foreign policy and defence), but also in strengthening internal fiscal policies and cohesion.

- **The COVID-19 shock has revealed yet again the limits of the euro area fiscal and policy response, which has been synchronised in the response to the pandemic but largely uncoordinated**. Thus, there is a risk that the relative decline of the euro as a foreign reserve currency, observed since 2009, may accelerate with or after the COVID-19 shock.

- **To convince markets above all, the euro's role as an anchor currency will have to be pursued with the longer-term goal of achieving fiscal and political breadth**. For instance, the recent German Constitutional Court's ruling against the proportionality of the public sector purchase programme (PSPP) goes in the opposite direction and echoes a still strong North-South divide.

- **If left unaddressed, the lack of a credible European long-term response to the pandemic risks vanishing not only any attempts at internationalising the euro further but even jeopardising the European project as a whole**. International investors, on the margin, might prefer to avoid a currency whose values or even whose mere existence may be often at stake.

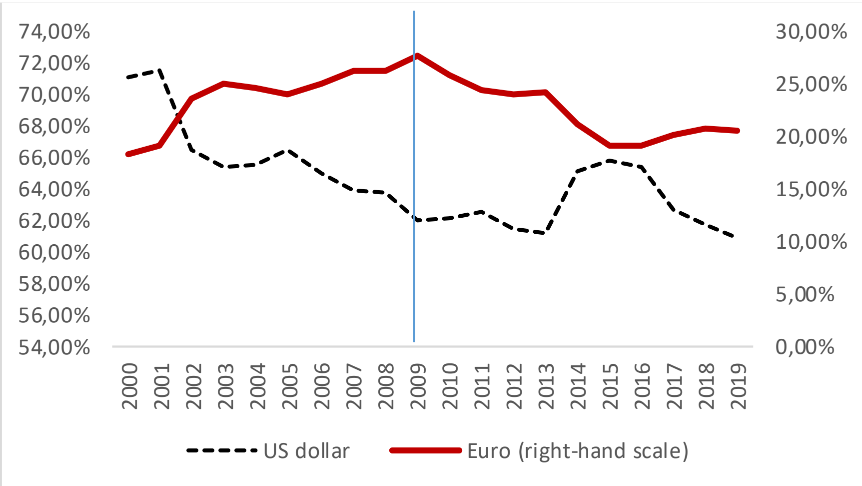
- **The hope is now that politics at the higher echelons of EU leaders' level would support the ECB President Lagarde's announcement that it is the time for Europe's Schuman moment towards greater solidarity**. If not, other countries such as China, Russia and Turkey will seek to capitalise on the increasing fragmentation of the global order, including in the European immediate neighbourhood such as in the Western Balkans region.

1. INTRODUCTION

Propping up the international role of the euro has long been discussed in both academic and policy circles. An international anchor status may seem less relevant for the real economy than the exchange rate itself. However, the latter two have always been causally interrelated (Chinn and Frenkel, 2006).[1]

On 5 December 2018, the European Commission officially communicated an initiative to improve the euro's international standing. This proposal rested on the possibility of achieving "a deeper and more complete EMU" (ECB, 2019). Last November, Commission President von der Leyen vowed to fulfil the European Commission's duties by pledging a more "geopolitical" approach, mainly through increasing the Commission appeal to multilateralism and international cooperation, while also preserving European sovereignty. ECB's Cœuré last year has fired up the claim that a strong currency "would not just be a symbol of European unity on the world stage, it would also be a tool to project global influence." At the core of the debate in Europe is indeed the potential to improve the euro's international position as a currency.

Figure 1: Official holdings of foreign exchange, end of year (in percent)



Source: Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics (IFS). Data extracted from http://data.imf.org/ on 11 May 2020.

At the centre stage of an internationally relevant and stable euro must be an independent central bank superseding strong economic and financial fundamentals and strong political governance. For instance, historically, investors' willingness to hold US dollars above and beyond the United States current account position rested on the dollar's role as world's reserve currency, a title earned mainly on the back of (i) the development of the web of relations commenced with Bretton Woods and the Marshall Plan, (ii) the denomination of the USD as the main reference for the price of oil (petrodollars), as well as (iii) the constellation of countries having pegged to or adopted the USD as their currency (dollarization); see also Eichengreen (2008). Because of the role of the US, foreign investors' purchasing power historically relied on both the US core inflation and the value of the dollar as a currency.

[1] The ECB has typically maintained a rather neutral stance on outright exchange rate policies. Not only the latter are not part of the supranational central bank standard policy toolkit, but also direct exchange rate policies are recognised to be difficult owing to the well-known policy trilemma that makes independent monetary policy, capital control and exchange rate targeting pairwise exclusive (i.e. a *central bank cannot have it all*; see Burda and Wyplosz, 2005).

The trend of a general shift in global governance observed for over more than a decade has accelerated with the financial crisis and is bound to change (and possibly speed-up more) following the COVID-19 shock. Since the global financial crisis, both the euro and the dollar have fallen short in their role as foreign reserve currencies (**Figure 1**). What is special in the trend started more than a decade ago is that these changes go far beyond advanced economies (**Table 1**). Several nations are now trying to increase their currencies' international profile. In 2016, for example, the Chinese renminbi was included in the International Monetary Fund's Special Drawing Rights (SDR) basket alongside the US dollar, the euro, the yen and the pound sterling. In a recent move to raise the renminbi's grip on global energy markets, China also launched its first oil future contract denominated in renminbi, the so-called *petroyuan* (Cœuré, 2019).

Table 1: Official holdings of foreign exchange, end of year (in percent)

	US dollar	Euro	Japanese yen	Pound sterling	Chinese renminbi	Canadian dollar	Australian dollar	Swiss franc
2000-07	66.94%	23.23%	4.42%	3.48%				0.23%
2008-13	62.21%	25.37%	3.59%	4.04%		1.63%	1.64%	0.16%
2014-19	63.60%	20.14%	4.51%	4.39%	1.54%	1.87%	1.69%	0.19%

Source: Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics (IFS). Data extracted from http://data.imf.org/ on 11 May 2020.

While in the international financial and commodity system there are certainly high obstacles to the possibility of the dollar being displaced in favour of other currencies, it is becoming increasingly obvious that the COVID-19 pandemic is due to challenge the international geopolitical order. This is evident not only in the success stories of the quick rebound in East Asia and Pacific region – China, Singapore, Taiwan, Hong Kong and South Korea but also Australia and New Zealand, all in the process of swiftly moving in the direction of "business normality" after the pandemic (worth noticing is also the case of many Central Eastern European countries which have enforced early lockdowns) – but also in the relative inward look and the shaky response of the remaining BRICS (Brazil, Russia and India), as well as – perhaps, more surprisingly – the US and the UK.

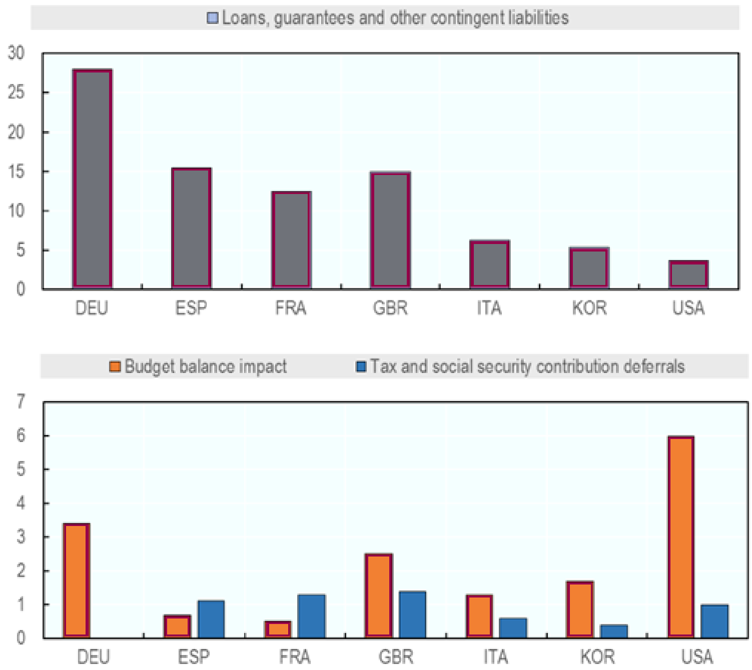
What about the EU itself?

During the first stage of this crisis, the European Central Bank is the EU institution that has taken on the risks. This has been the case in many other advanced economies, where central banks have greatly relaxed monetary policy, with these effects being reinforced through central banks' forward guidance and balance-sheet policies. The ECB announced "no limits" to its Pandemic Emergency Purchase Programme (PEPP) with large acquisitions of government and corporate debt. Such actions have started to contribute to alleviating potential liquidity pressures onto the euro area banking sector.

Nonetheless, the geopolitics within the EU will likely trail the outcome of the health-crisis' management.

The approach that has emerged thus far has enshrined, yet again, Germany as Europe 'most resilient country and most likely future growth locomotive in the recovery phase'. That approach has largely rested on the available fiscal space in each euro area country, i.e. the fiscal stimulus announced in Germany was five times as much the one in Italy (as a percentage of GDP). This has left countries which needed the demand stimulus the most to scramble for resources, ultimately forcing European leaders to opt for mutual support, agreed during the EU Summit on 23 April 2020 mainly on the back of fears of negative market and trade spillovers within the Union. In particular, EU leaders signed off the Eurogroup agreement for a collective safety net, worth EUR 540 billion, directed to 1) governments and public finances via the European Stability Mechanism, 2) companies through the European Investment Bank, and 3) workers via the European Commission's new instrument SURE. The ESM support for euro area Member States has already called into question the credibility of the European response, mainly through questioning the sustainability of a fiscal line which is limited *ex ante*.

Figure 2: The scale of fiscal policy in selected countries post-COVID-19



Source: OECD (2020).

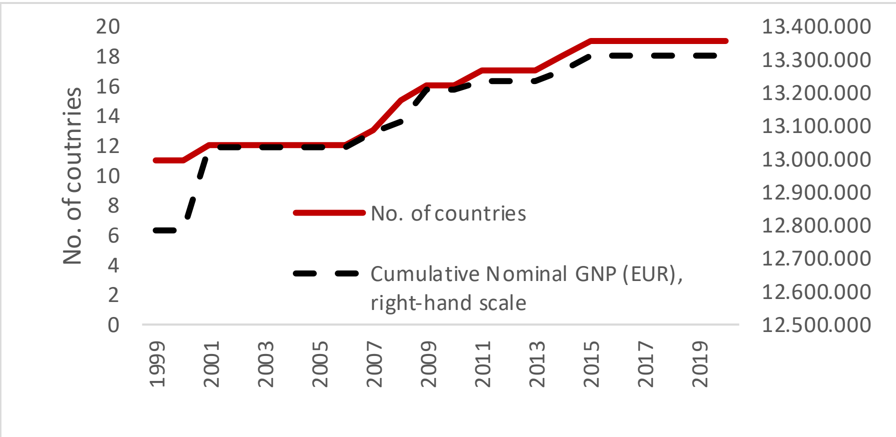
The European Commission has reiterated its call for a pan-European recovery strategy to supplement the existing national initiatives to compensate Member States' gaps in their national fiscal firepower. "The risk otherwise is that the crisis will lead to severe distortions within the Single Market and to entrenched economic, financial and social divergences between euro area Member States that could ultimately threaten the stability of the Economic and Monetary Union" (European Commission, 2020). If left unaddressed, the lack of a credible European long-term response risks vanishing not only any attempts at internationalising the euro further but even jeopardising the European project as a whole.

2. THE "POLITICS TRAP"

On 5 May 2020, in a shocking judgement, the German Constitutional Court ruled that the ECB's public sector purchase programme (PSPP) did not break the Union's 'no monetary financing rule. However, it claimed that for it to be continued, the ECB should be able to show that the buying system is proportionate. Within the next three months, the Bundesbank will thus not be able to participate in the PSPP "unless the ECB Governing Council adopts a new decision that demonstrates in a comprehensible and substantiated manner that the monetary policy objectives pursued by the ECB are not disproportionate." The Court's ruling does not apply to the new stimulus programme of the ECB's, the PEPP, but there is a great risk of another legislative challenge now that the ECB's role has been called into question; albeit this is not the first time (see also Macchiarelli *et al.*, 2020).

This ruling had an immediate effect on the euro, as the latter increased with the relief that no clear decision had been made about the bond-buying programme, but sentiment quickly deteriorated with the euro gliding on the day. This tells an important story: if the euro has to survive as a currency and build its stance as an international anchor, the political frictions which are intrinsic to the very issue of 'mutualisation' within the euro area should be resolved. This is for the simple reason that international investors, on the margin, might prefer to avoid a currency whose values or even whose mere existence may be often at stake (see Maggiori et al., 2015).

Figure 3: Enlargements of the euro area



Source: Authors' calculations.

As it stands, the euro area lacks the political unity needed to formulate common foreign policy objectives (De Grauwe, 2019; Cœuré, 2019). Thus, endowing the euro area of bigger firepower politically is undermined by the absence of a common voice on international foreign policy affairs. One example includes the handling of the European refugee crisis. Filling this gap would be only possible in the context of a Political Union which would entail the complete transfer of sovereignty from the nation-states to a supranational government embedded in a European parliamentary system which legitimates it (De Grauwe, 2020). Several years after the introduction of the euro, however, there seem to be yet no strong evidence that the euro has exerted a positive influence on the common sense of European identity (Buscha, 2017). That would make the case for the transition to a Political Union, albeit necessary and in many ways desirable, scantly feasible (see also De Grauwe, 2020; Macchiarelli *et al.*, 2020).

In a second-best scenario, a greater weight of the euro in international political clouts could be achieved through enlargements, particularly if all the remaining EU non-euro area countries, including – at the time – the UK, adopted the euro. This was the case, according to an early paper by Frankel and Chinn (2006), which predicted that the euro could have surpassed the dollar by 2020. Not only this did not happen, but the issue of enlargements somehow lost momentum under the impact of the 2010 sovereign debt crisis and with the UK decision to withdraw from the EU in 2016 (Brexit). As a result, the post-2012 enlargements have mainly seen the addition of smaller countries (in nominal GNP terms); **Figure 3**. For larger countries, such as Poland, the issue of relinquishing monetary and exchange rate competencies was and will remain contested. Brexit will further challenge this already frail equilibrium as countries such as Poland and Sweden may fear losing grip against the increasing role of countries such as Germany and France now that the UK's claims for slower integration have been dismissed.

According to Cœuré (2019), an important element of the euro being an international reserve currency is recognising that the euro is the currency of "the world's largest trading bloc." While the EU is already recognised as an international trade power, the question is whether it is feasible to convince Member States and national interest groups to pursue further political integration. In the case of trade policy, there was a strong sense for creating big welfare benefits through the transfer of trade competences (De Grauwe, 2019). This might not be the case with the transfer of political sovereignty mainly since political interests are yet to fully align.[2] Secondly, trade was seen as a technical – limited, as well as revocable – economic matter, not interfering with the concerns of the European nation-states. One additional aspect which is recognised to be missing is the euro's global geopolitical outreach, embodied in a common foreign or defence policy (Eichengreen, B., A. Mehl and L. Chițu., 2019; see also Bodea and Huemer, 2010, for a broader discussion).

In this sense, trade integration did not necessarily pave the way to achieving the necessary political power and prestige to acquire international anchor status.

[2] What De Grauwe (2020) calls the lack of a "deep variable".

3. THE EURO AS INTERNATIONAL ANCHOR CURRENCY

At its inception in 1999, the euro was the anchor currency in 53 economies, approximately half of the dollar's total. Two countries dropped out by 2015 although four more were included, i.e. Latvia, Lithuania, Romania and Serbia. By contrast, the dollar lost 5 countries (including Latvia and Lithuania) in 2015 compared to 1999, against 19 new countries choosing to adopt the USD as their anchor in 2015 (Maggiori et., 2015). Having said that, the euro area is for now not financially deep to constitute a global power (De Grauwe, 2019). Indeed, the fall in the global position of the euro in recent years is mainly the symptom of the well-known initial shortcomings of the Economic and Monetary Union (EMU).

To this taken, the politics which can enhance the global position of the euro as a reserve currency *and* the policies required to make the euro area more sustainable are – to a large degree – overlapping. The Capital Markets Union and Banking Union, themselves underscoring the risks of incompleteness, represent clear examples of this process (see also Macchiarelli, 2018). They do not represent the only problem, however; the recent decision of the German Constitutional Court to rule against the PSPP could potentially be far more dangerous to the euro than not creating common means for recovery and resolution.

According to Maggiori et al. (2015), there are four dimensions to summarise an international currency status, namely:

1. The use in denominating bond and loan contracts;
2. The use in denominating international trade;
3. The volume in foreign exchange trading;
4. The use as central bank reserves.

The aspects to consider are nevertheless broader and can be summarised in **Table 2**. The classic three functions of money in an economy, i.e. store of value, medium of exchange and unit of account, can be understood at the international level as well. Central bank international reserves are one example. There are, however, other possible uses of an international currency: currency substitution (e.g., the circulation of euros in some Central-Eastern EU countries), foreign goods' trade, as well as international financial flows denomination or invoicing, anchoring for smaller countries (i.e. pegs), and FOREX trading (Chinn and Frenkel, 2006).

Table 2: Roles of an international currency

Function of money	Governments	Private actors
Store of value	International reserves	Currency substitution (e.g., dollarization)
Medium of exchange	Vehicle currency for foreign exchange intervention	Invoicing trade and financial transactions
Unit of account	Anchor for pegging local currency	Denominating trade and financial transactions

Source: Chinn and Frenkel (2006).

Following the rubrics in Maggiori et al. (2015) and based on ECB (2019) estimates, we can document four main facts.

First, the share of the euro in the stock of international debt securities (at constant exchange rates) remained stable since 2014, following an upsurge until 2007 and a later decline during the financial and sovereign debt crises. In comparative terms, the share of the euro has decreased by some 8% since mid-2000 years, whereas the share of the U.S. dollar has risen by almost 20% (**Figure 4**). Based on data on new issuances, however, there has been a relative decline in the share of the US dollar mainly driven by borrowers in emerging markets (ECB, 2019). This can be attributed to a stronger US dollar exchange rate and an increasing interest of emerging economies to diversify their currency exposure (ECB, 2019).

Figure 4: Currency composition of outstanding international debt securities

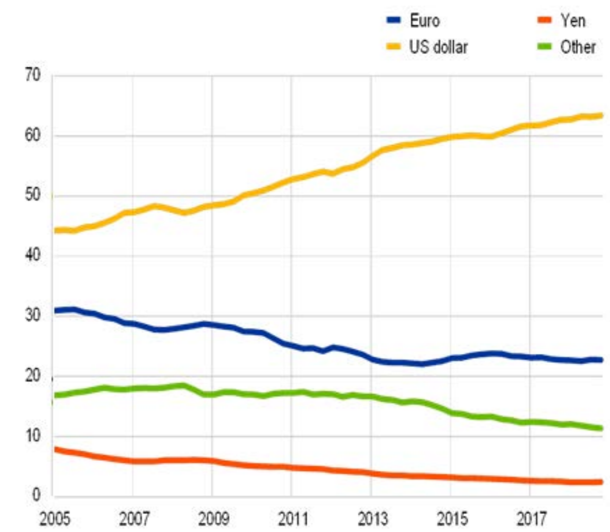


Figure 5: Currency composition of outstanding amounts of international loans

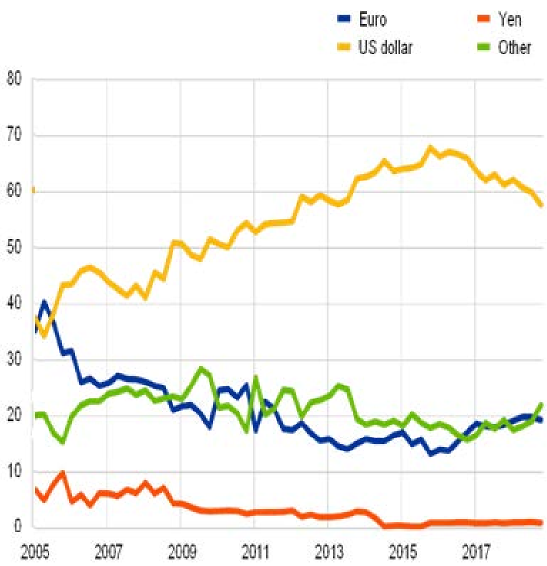
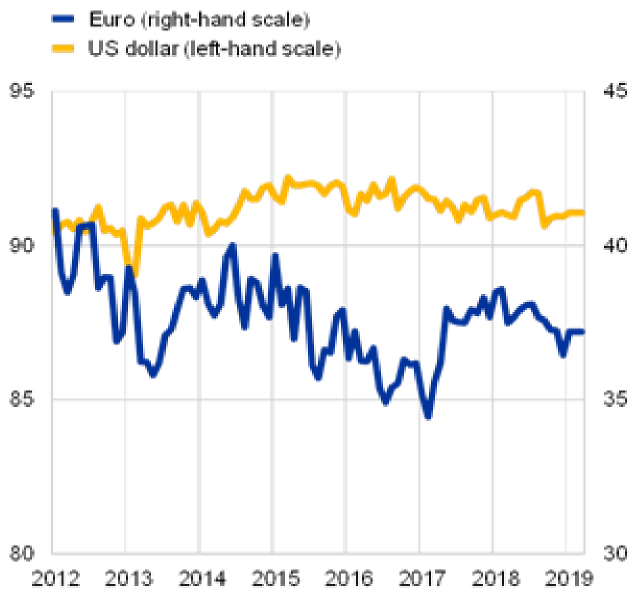


Figure 6: Share of foreign exchange transactions settled in CLS



Source: ECB (2019).

The share of the euro in international loan markets also continued to rise in recent years (**Figure 5**), following a decline over the period 2006-2014. The latter was mainly driven by deleveraging and regulatory efforts in the euro area banking sector. In recent years, this trend has stopped and partially reversed possibly as the result of the ECB's credit easing programmes (e.g., (T)LTROs) which have supported cross-border lending (ECB, 2019).

Secondly, the use of euros in invoicing/settling international trade remained broadly stable. More than 60% of exports and 50% of imports outside the euro area were invoiced in euro in 2018 (ECB, 2019). In comparison to the US dollar, however, there is limited use of the euro to invoicing international transactions between third countries that do not involve the euro area.

Third, looking at quantities/volumes in the foreign exchange market points to a slight decline in the use of the euro since 2018 (**Figure 6**).

Finally, the share of the euro in global foreign exchange reserves is increasing again (**Figure 1**), particularly as several emerging market economies have been selling foreign exchange reserves in the context of tight financial conditions and capital reversals. This has been the case either to stabilise their domestic currencies or simply to support a diversification of their reserve portfolios.[3]

All in all, these trends do support the idea that the euro has made progress in this respect. Thus, can the euro be regarded as international anchor currency?

3.1. The euro as an international anchor

From an economic viewpoint, the are a few advantages and disadvantages of having international currency status (Chinn and Frenkel, 2006): beyond *seignorage*, a global use of the euro would, for instance, reduce exchange rate risks for euro area exporters, importers, borrowers and lenders, and minimise exposure to sharp drops in other currency's liquidity (albeit the latter is admittedly less problematic since the introduction of outright USD-currency swap agreements with the Federal Reserve). In that sense, a stronger international role for the euro would result in spillovers and feedback through international trade and finance, the latter expected to affect monetary policy. On the flipside, there could be volatility stemming from an increase in the degree of capital mobility; an increase in the average demand for the currency which may disadvantage exports; and, international responsibility from the international anchor status itself. In the latter case, this would mean central banks in smaller and developing economies could turn to the Eurosystem for currency swap support, with the ECB becoming "an international lender of last resort" (Cœuré, 2019). However, any such extensions of the global network of currency swap lines may not be easy (also in the context of the already difficult political concertation within euro area Member States, and even less so if one thinks about future euro area enlargements) as they would need to be "based on sound monetary arguments" (*ibid.*).

Despite having a large economy, the euro area has not deep enough financial markets. It does have, differently from China more widespread confidence in its currency (**Table 3**). According to the last triennial report by the Bank of International Settlements, the dollar is still accounting for 88% of all foreign exchange trade, with the euro at 32% and the renminbi's share at just 4%.

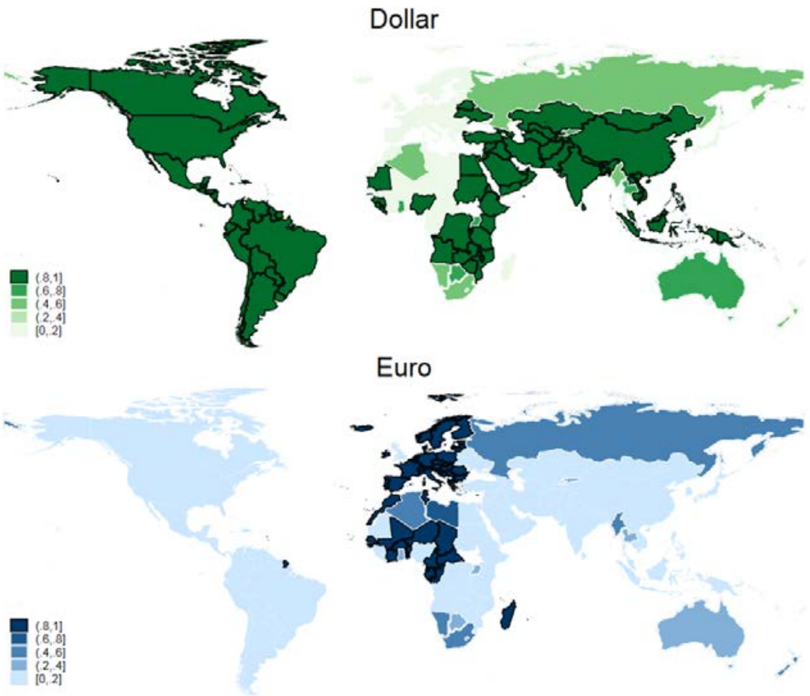
[3] According to the ECB's data (2019), much of these movements have been made in dollars, so promoting the euro's position in global foreign reserves.

Table 3: Percentages of daily currency trades (April 2019)

Ranking	Currency	% (bought or sold)
1	USD	88.30%
2	Euro	32.30%
3	Japanese yen	16.80%
4	Pound sterling	12.80%
5	Australian dollar	6.80%
6	Canadian dollar	5.00%
7	Swiss franc	5.00%
8	Renminbi	4.30%

Source: Bank of International Settlements.

Figure 7: Estimated co-movement of national currencies with the dollar (upper panel) and the euro (lower panel) in Dec 2018



Source: Ferrari (2019). Data refer to Dec. 2018.

A crude measure of the international role of the euro is the measurement of its spillovers on other currencies or the extent to which euro-currency shocks propagate to other currencies. While the results suggest that the role of the euro as an anchor currency remained broadly stable, there is a strong regional dimension to it, compared to the role of the dollar (Ferrari, 2019; see **Figure 7**).[4]

[4] In that sense, "efforts to improve the stability of our currency union could be expected to lead to a more even distribution of reserve demand effects within the euro area" (Cœuré, 2019).

Many countries use the dollars in international trade because a dollar-based global payment system can achieve an efficient and large financial domain. The euro, by contrast, is not used as a major medium of exchange outside the euro area mainly because there is no outer euro-denominated payment system (see Macchiarelli and Monti, 2018). This is the case for China as well. The central bank of China, however, pushed ahead to establish a Hong Kong-centred offshore renminbi debt market, with the offshore exchange rate being independent of the central bank's onshore rate.

3.2. Implications for monetary policy

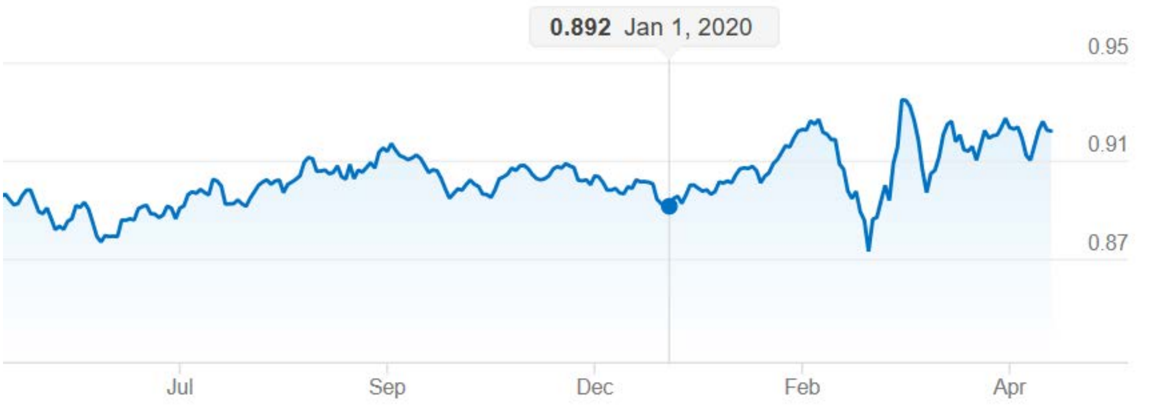
Pushing the role of the euro as an international anchor would have several implications for monetary policy.

First, there would trade feedbacks and financial spillovers to consider (Cœuré, 2019). In case the euro would be used for trade amongst third countries, a depreciation of the euro would make all euro-denominated exports cheaper, increasing global trade overall. Secondly, looking at the US example, financial spillovers could result into higher international risk-taking, whereby, following an interest rate cut, as the dollar depreciates, the provision of dollar-denominated credit might increase simply because such depreciation would boost foreign borrowers' balance sheets.

The second way in which an international currency can influence domestic monetary policy is through interest rates. In periods of uncertainty, such as the current one, or during financial stress, investors rush into safe-heavens or specific -denominated assets for protection and liquidity (US dollar, Swedish krona, Swiss Franc etc). This can have both short-run effects, such as volatility, or longer-term ones. Cœuré (2019), for instance, highlights how during the run-up to the financial crisis, the high demand for US securities from other international central banks helped explain the decline of long-term US interest rates, something akin to *quantitative easing*, thereby partially offsetting the policy tightening by the Fed. This highlights an important channel for the US as a world reserve currency. The sustainability of the US current account deficit depends on the foreign central banks' (as well as foreign private investors') preparedness to accumulate ever-greater quantities of dollar-denominated assets. This rests on (i) the availability of foreign central banks to intervene on the FOREX market to keep their currencies on check *vis-à-vis* the dollar. Secondly, (ii) these foreign central banks would need to retain their main share in dollars rather than in any other competing currency, such as euros (Chinn and Frenkel, 2006).

These effects are not present for the euro area today both because the euro area has a current account surplus, and because the holding of euro-denominated assets is globally lower than the US-denominated ones. However, due to its rock-bottom interest rates, the euro is becoming an increasingly common currency to sell against high yields. Hence, the demand for euros and euro-denominated assets has increased intermittently more recently (since Jan 2020). While the euro has typically fallen during times of market stress, since the COVID-19 outbreak its behaviour has been quite volatile (**Figure 8**). One explanation could come from the global interest-rate outlook. Several key central banks have enacted interest-rate cuts to ease the monetary stimulus further. Investors are pricing in the fact that the ECB may not be cutting its reference rate (on the deposit facility) further into negative territory, and this shift in interest rate expectations may make the euro relatively more attractive because the gap in interest rates between the euro area and other key central banks' interest rates, such as the Fed, is narrowing; **Table 4**.

Figure 8: USD-EUR bilateral nominal exchange rate



Source: Refinitiv https://www.refinitiv.com/en?ref=world-check.com. Accessed on 11 May 2020.

Table 4: Recent directions in monetary policy interest rates (April 2020)

	Jan. 2020	April 2020	Change	End 2009
USA	1.75	0.25	↓	0.25
Euro Area	−0.50	−0.50	–	0.25
Japan	−0.10	−0.10	–	0.10
Canada	1.75	0.25	↓	0.25
UK	0.75	0.10	↓	0.50
China	4.15	3.85	↓	5.25
India	5.15	4.40	↓	4.75
Brazil	4.50	3.75	↓	8.75
Russia	6.25	6.00	↓	6.00
Australia	0.75	0.25	↓	3.75
Turkey	11.25	8.75	↓	6.50

Source: Naisbitt et al. (2020).

3.3. The fiscal policy leverage

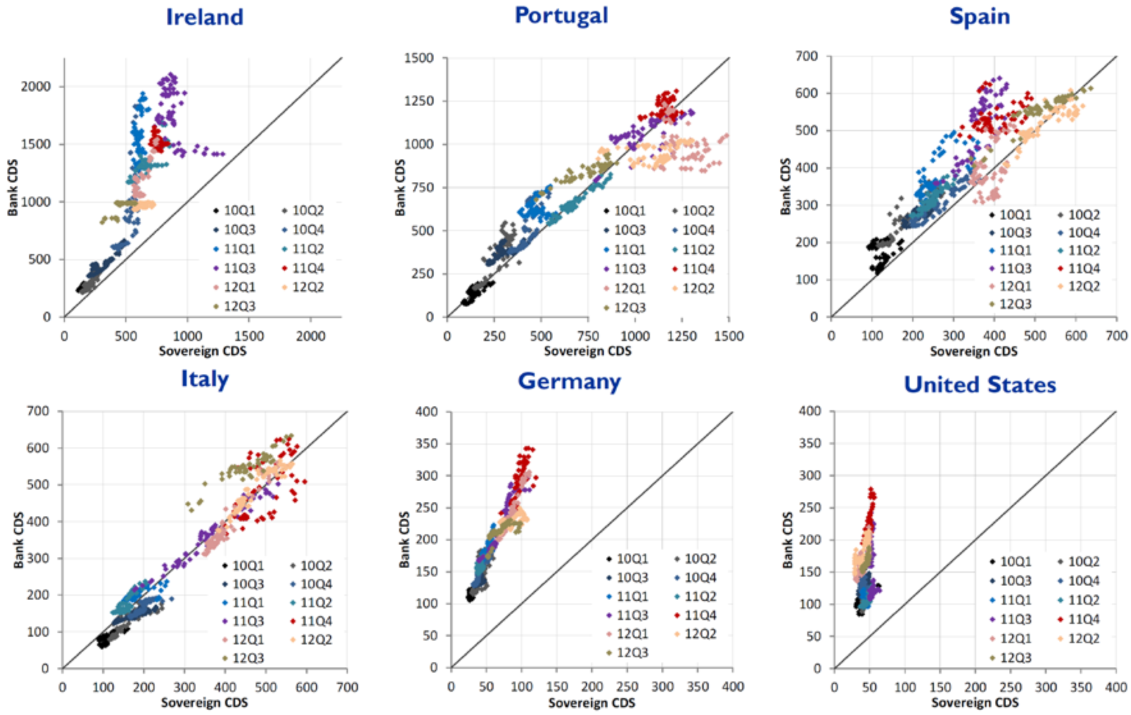
One important takeaway from the literature is that the euro area's financial markets remain still fairly small and heterogeneous compared to the US, and financial fragmentation persists particularly in some market segments, such as debt. At the intersection of financial integration and politics there are the issues of fiscal mutualisation and risk-sharing.

The original idea of the euro rested on a set of fiscal rules based on the principle that financial markets would be self-regulating and the 'no-bail out rule' (*ex* art. 125, TFEU) was credible. The idea was to use 'the advantage of tying one's hands' by guarding against government failure and letting markets find their equilibria (Fuest and Peichl, 2012).

The euro area sovereign debt crisis has exposed the shortcomings of such an incomplete approach. After 2010, the number of AAA-rated countries came to represent only 10% of the area GDP (*ibid.*). This now provides little space for risk-sharing or joint guarantees among Member States as any attempts of joint-debt issuance would be perceived as a free-meal attempt at the expenses of the investment-grade countries.

This could be partly circumvented with the creation of a common safe asset guaranteed from third institutions, such as e.g. the European Investment Bank (see Jones, 2017 for a summary of the literature) or the provision of contingent support to governments through the European Stability Mechanism. The problem with the latter is anyway that these initiatives are *ex-ante* limited, hence unlikely to be enough (see Diessner, Jones and Macchiarelli, 2020; De Grauwe, 2011).

Figure 9: Correlation between sovereign and bank CDS during the financial crisis



Source: ECB (2012). Note: Last observation: 12 September 2012.

If the euro is to serve as a genuine common shield in times of market stress and thus gain and sustain an international anchor status, the fiscal dimension of the euro area needs to be strengthened. This has to do with the idea of an international currency being able to deliver stability both domestically and internationally (Cœuré , 2019).

As discussed, investors are normally reluctant to rebalance away from US-dollar denominated assets, despite the US large debt. For the euro area, though, Member States face a tougher budget constraint (De Grauwe, 2020): the lack of a common budget or a system of full-fledged risk-sharing expose the the euro area Member States to higher credit-risk premia compared to standalone countries, e.g., the US. Public debt is therefore not insulated from private debt (as observed over the period 2010-2012; **Figure 9**) and that makes investors demand higher premia in their euro-denominated asset holdings. The fact that the supply of euro-denominated safe assets is not large and sufficiently elastic (it decreases precisely when investors' demand for such assets increases) is one of the main factors preventing a greater international role for the euro (Cœuré, 2019).

This indicates that there are specific factors are likely to hinder the growth of the euro as global currency: to convince markets above all, this role will have to be pursued with the longer-term goal of achieving fiscal and political breadth within the euro area.

4. THE EURO AND THE GEOPOLITICS OF POST-COVID-19

The COVID-19 pandemic will certainly speed up a transition away from US-centric globalisation and there will inevitably be queries about the dependence on international supply chains. This poses several questions, mainly concerning the newly emerging international governance structure.

A concrete risk remains that some politicians might leverage concerns about keeping borders open, exacerbating the observed shift away from globalisation. Under the pretext of self-sufficiency and public health concerns, they might impose protectionist trade barriers and restriction to movement. Thus, global leaders now have the responsibility to safeguard the existing web of relations that has brought economies together post-Bretton Woods. Keeping international trade open will be crucial for the maximisation of resources for a rapid recovery globally. Even more importantly, countries will need to resist the impulse of stopping trade concerning healthcare and the exchange of scientific information. If this is not achieved, the result will likely be price wars on testing and medicines which will be not only inefficient in the global response to the virus but also more costly to the global economy *ex-post*. Globally, an area of potential collaboration, including between China and the US, will be that of producing a vaccine for the virus. Finding a vaccine could also serve as a pretext to determine different international equilibria.

Central banks will continue to be crucial in preserving the stability of global financial markets and steady credit flows to the economy. Especially in developed economies, countries have proven able to reduce spreads by buying whatever volume of debt that they need in order to sustain low rates at long maturities. In these economies, central banks have greatly relaxed monetary policy, with these effects reinforced through central banks' forward guidance and balance-sheet policies: for instance, the ECB announced "no limits" to its PEPP with large acquisitions of government and corporate debt.

Business continuity has called for active fiscal policy responses as well. The negative effect of fighting the pandemic on the economies may be long-lasting, as the extraordinary debt accumulation will be hard to reverse, all which will have consequences for the international order; particularly the extent and pace this new debt – and it future reduction – will be handled across countries. There is a wide spectrum of indebtedness among advanced economies with economies such as Germany starting with low levels of debt likely to face little difficulty with future debt servicing. At the other end of the spectrum is Italy which started with a debt to GDP ratio in excess of 130% and low potential economic growth. A low inflation environment will allow countries like Italy to persist with high levels of debt in much the same way as Japan has for the past two decades. Advanced economies which sit in the middle, such as UK and France, will face the prospect of tolerating higher debt levels or embarking on another fiscal consolidation plan at a time when the electorate is already suffering "austerity fatigue" (Kara, Macchiarelli and Giacon, 2020).

What about Europe?

Coming after the sovereign debt crisis, the migrant crisis and Brexit, the coronavirus crisis risks further damaging the EU's already weak reputation. On this occasion, Member States did not act in concert when the crisis erupted, but they chose to unilaterally close the borders and suspending free movement without coordination. When the support package announced by the ECB in March (EUR 750 billion asset purchase program of private and public sector securities through the PEPP) will be exhausted – which is likely to happen in October according to some projections – countries will be left with the question of how to roll the debt load further. As ever, wanting to share risks mainly through the ECB (as opposed to e.g., Eurobonds) represents a maigre consolation particularly for highly indebted countries, e.g., Italy, where the COVID-19 shock is set to challenge fiscal sustainability and financial stability.

The latest German Constitutional Court ruling against the proportionality rules of the ECB's PSPP risks hitting the PEPP as well, making more damage than the lack of any solidarity fund. Particularly now, with the US's and UK's being distracted away from the world stage in an attempt to deal internally with the pandemic, one should hope that the euro area could stand back on its feet and lead in the process of reconstruction post-COVID-19 without leaving a political void. In other words, the hope is that politics at the higher echelons of EU leaders' level would support the ECB President Lagarde's announcement that it is the time for Europe's *Schuman moment* (Lagarde, 2020) towards greater solidarity.

If not, other countries such as China, Russia and Turkey will seek to capitalise on the increasing fragmentation of the global order, including in the European immediate neighbourhood such as in the Western Balkans region; then, it might *really* be too late for Europe.

QUESTIONS FOR MEPS

- Many countries use the dollars in international trade because a dollar-based global payment system can achieve an efficient and large financial domain. The euro, by contrast, is not used as a major medium of exchange outside the euro area mainly because there is no external euro-denominated payment system. This also applies to the clearing of euro-denominated products which at the moment cannot occur anywhere outside of Europe. Is this something the Eurosystem will be willing to review going forward?
- There is a consensus that to fight the COVID-19 shock policymakers will have to 'break taboos'. This will be relevant not only during the pandemic but also for the recovery phase, to build resilience and mostly debt sustainability. Would the ECB be ready to revise its inflation target upwards, should the situation require, or resort to alternative strategies such as price-level targeting? Is the ECB concerned about imbalances among the Member States accumulating during this phase, including in the observed widening of TARGET2 balances (e.g., Italy and Germany)?

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This note provides a critical overview on the current status and recent trends related to the euro's international standing over the last decade and reflects on the opportunities and risks for the role of the euro going forward, including the post-COVID-19 international trade and political order.

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