

The Euro's Rise to Global Leadership: A Market View of Reallocations

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Deutsche Bank





Factors influencing the emergence of an international reserve currency

- I. Issuing country's share in world output and trade
- II. Macroeconomic and price stability
- III. Size, state of development, depth, and regulatory framework of financial markets
- IV. Network externalities



Key economic characteristics of the euro area in 2007

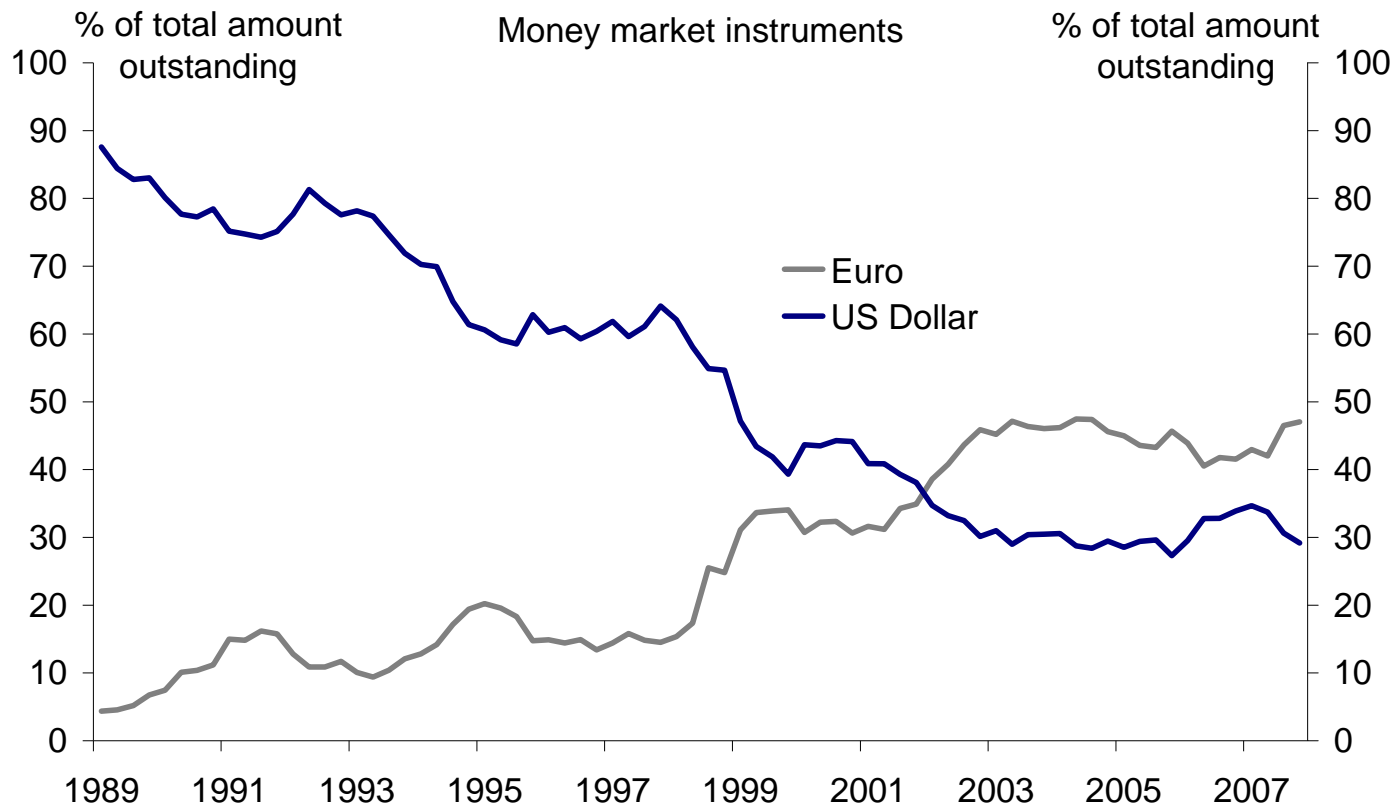
	Unit	Euro area	United States	Japan	
Population	millions	320.4	302.1	127.7	2 nd to US
GDP (share of world GDP, PPP)	%	16.1	21.4	6.6	
GDP per capita (PPP)	€ thousands	27.9	39.3	28.8	
Value added by economic activity					
Agriculture, fishing, forestry	% of GDP	1.9	1.1	1.4	
Industry (including constructions)	% of GDP	26.8	22.4	29.1	
Services	% of GDP	71.3	76.5	69.5	Internally stable
Unemployment rate	%	7.4	4.6	3.8	
Inflation	%	2.1	2.9	0.1	
Stock market capitalisation	% of GDP	77	142	94	
General government					
Surplus (+) or deficit (-)	% of GDP	-0.6	-3	-1.4	
Gross debt	% of GDP	66.3	49.2	159.5	
Revenue	% of GDP	45.6	30.4	33	
Expenditure	% of GDP	46.2	33.5	34.4	
External (excl. intra euro area trans.)					
Exports of goods and services	% of GDP	22.4	11.9	18.4	Biggest trader
Import of goods and services	% of GDP	21.2	17	16.5	
Exports (share of world exports)	%	17.5	9.9	6.1	
Current account balance	% of GDP	0.3	-5.3	4.8	

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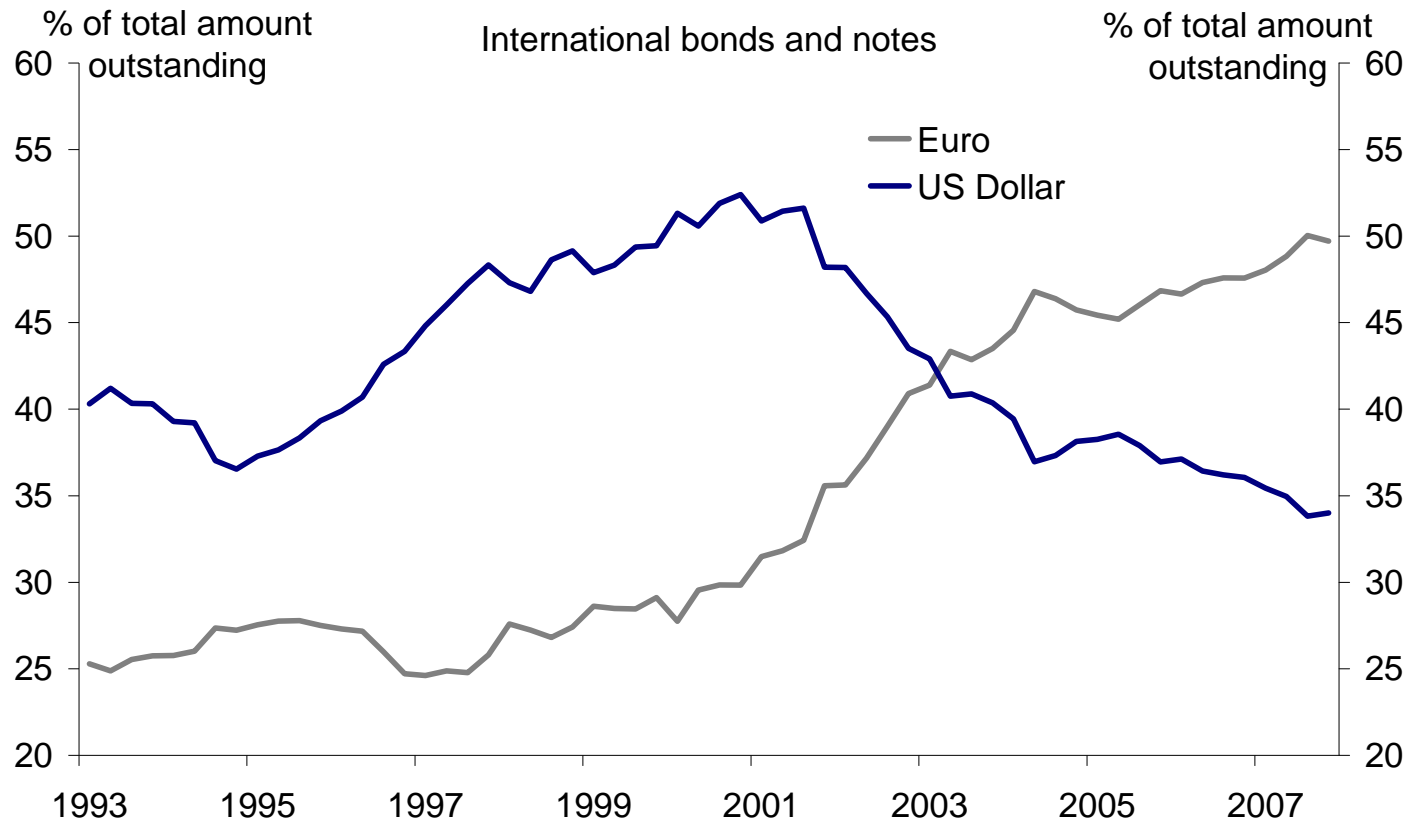
Depth of financial markets: Euro rates markets overtaking USD market



Source: BIS



...and in debt securities markets



Source: BIS



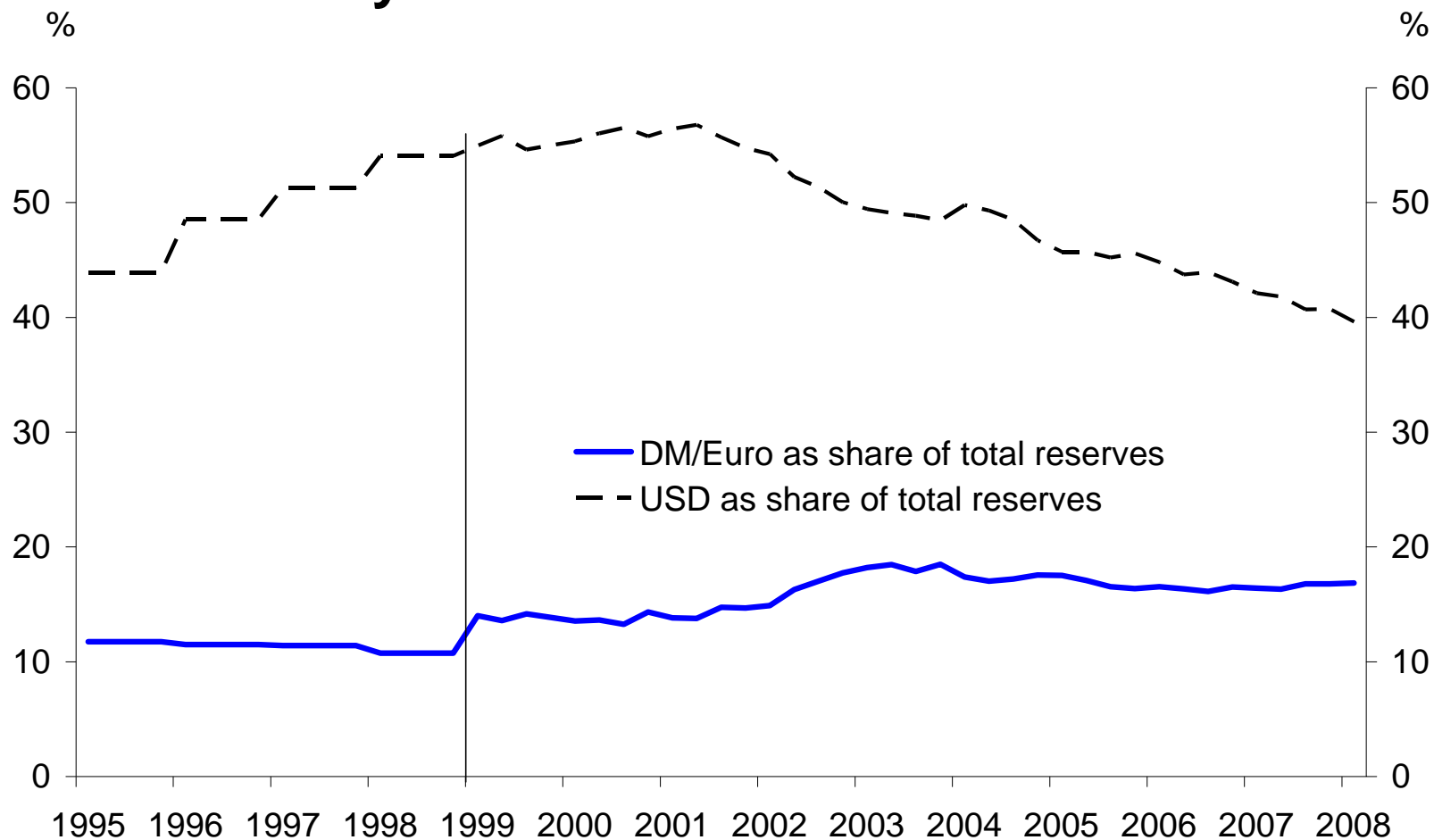
Euro area banks bigger in attracting international business



Source: BIS



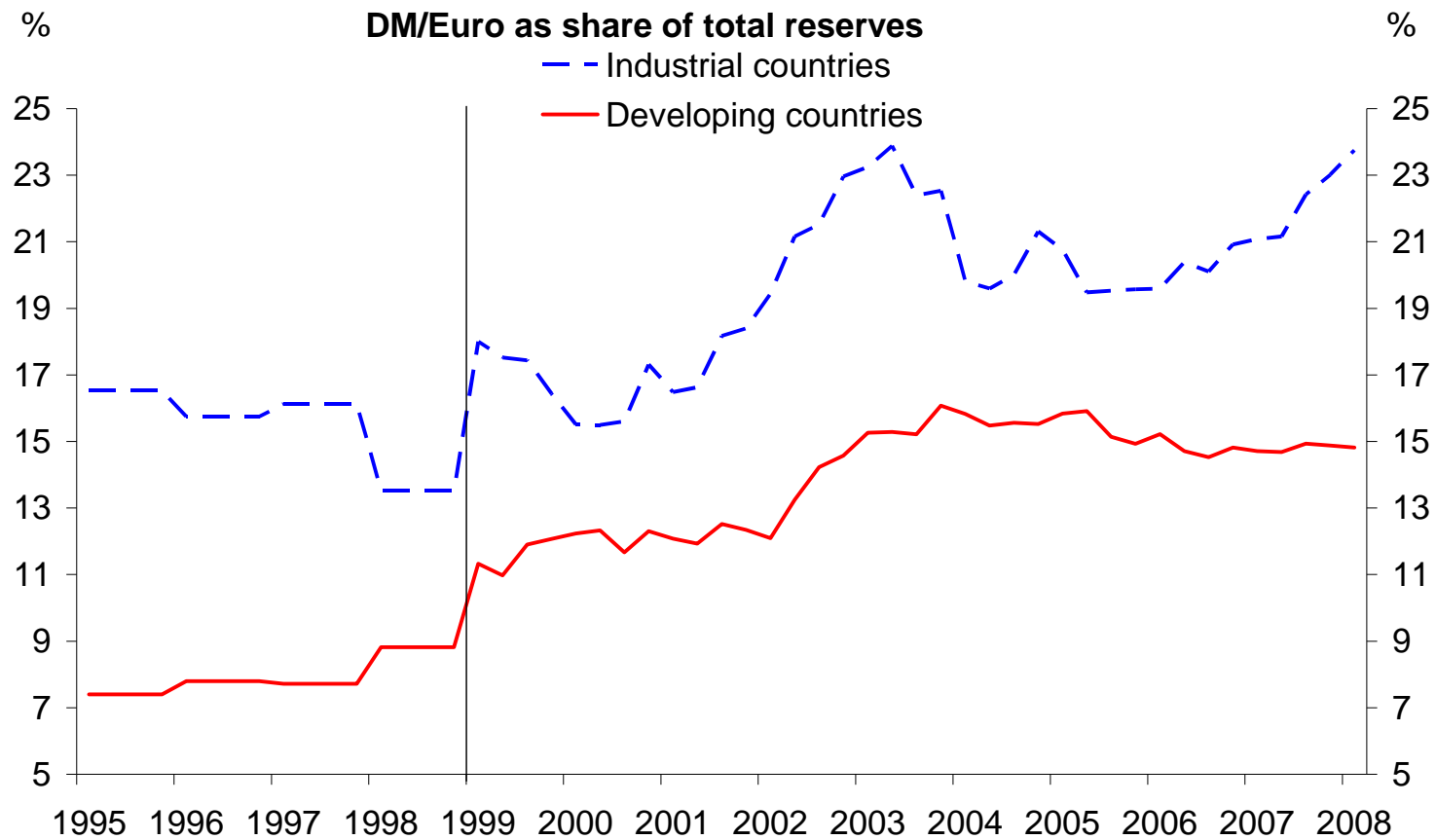
Store of value: Euro gaining moderately as official reserve currency



Source: IMF, Cover data base



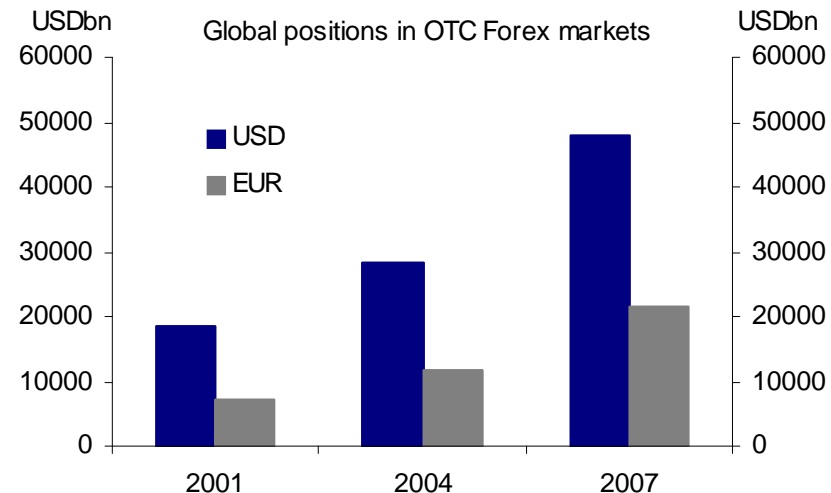
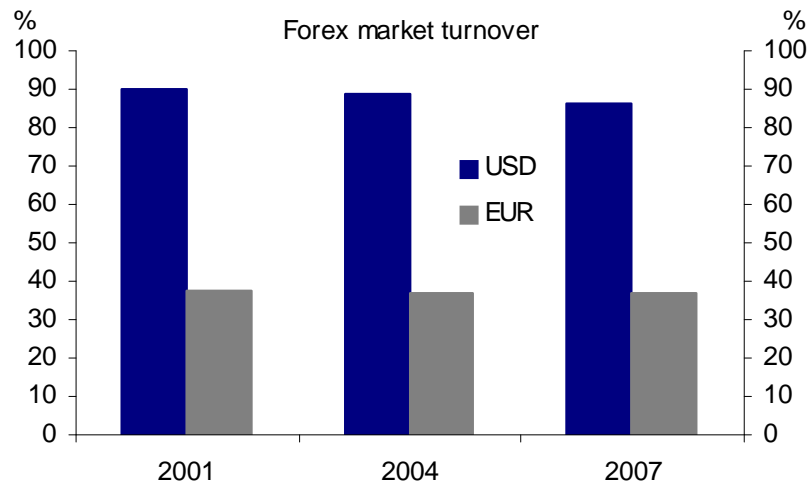
Euro gaining both in industrial and developing countries



Source: IMF, Cover data base



Medium of exchange: USD maintaining its lead in fx markets...

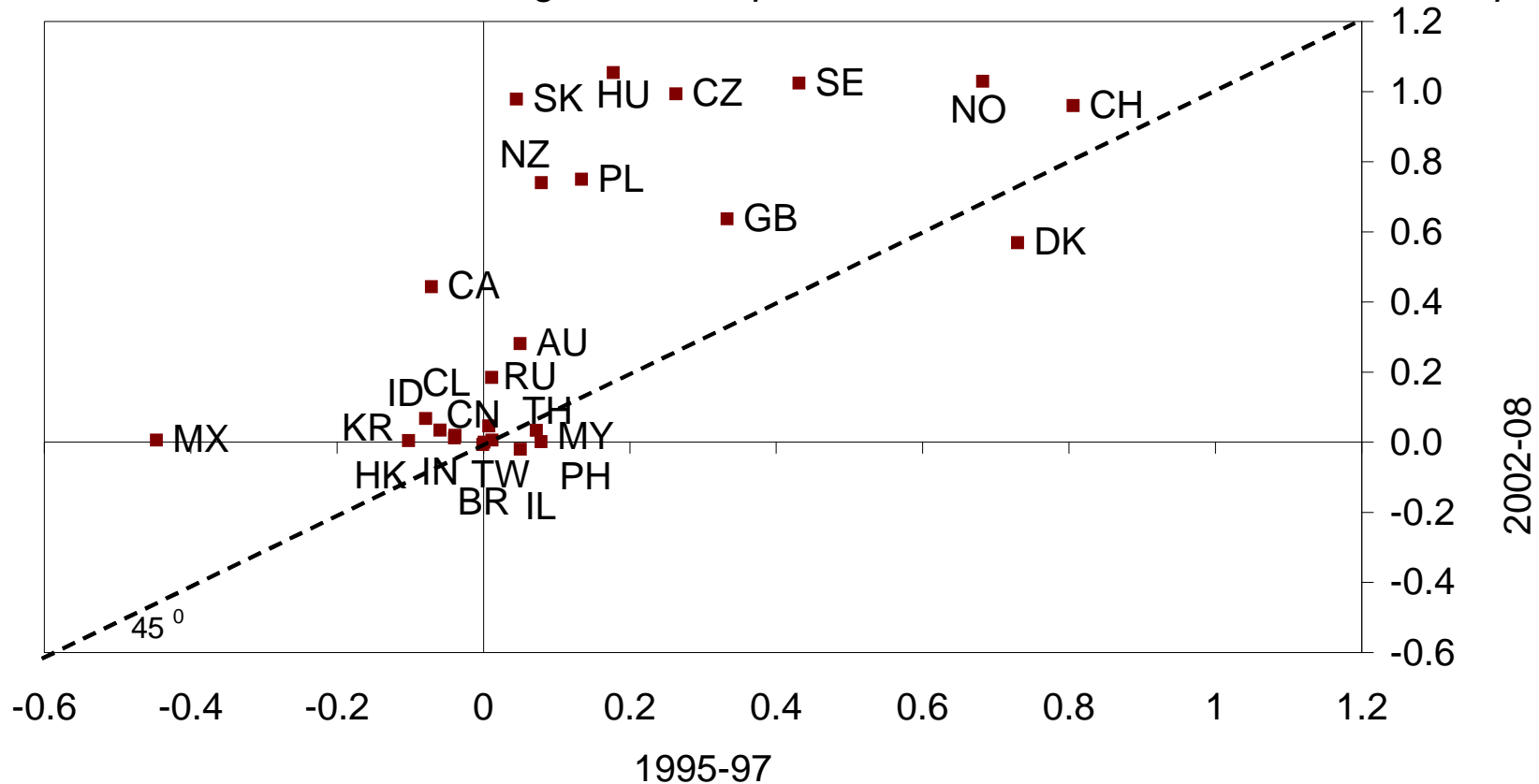


Source: BIS



...but Euro exerting a stronger influence on x-rates than DM

Currencies above the 45° degree line respond more to EUR now than to DM in the past



Notes: AU = Australia; BR = Brazil; CA = Canada; CH = Switzerland; CL = Chile; CN = China; CZ = Czech Republic; DK = Denmark; GB = United Kingdom; HK = Hong Kong; HU = Hungary; ID = Indonesia; IN = India; IL = Israel; KR = South Korea; MX = Mexico; MY = Malaysia; NO = Norway; NZ = New Zealand; PH = Philippines; PL = Poland; RU = Russia; SE = Sweden; SK = Slovak Republic; TH = Thailand; TW = Taiwan. Data points represent the coefficients in the regression of the dollar exchange rate of a currency on a constant, the dollar/mark (euro) and dollar/yen exchange rates, estimated with daily data over the periods shown.

Sources: Bloomberg.



Positive and negative factors influencing the euro's evolution as a global currency in the future

- + New member states should make euro area more dynamic**
- Growing internal economic divergence that could lead to higher inflation, or a break-up of EMU given the absence of a complimentary political union**

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- + ECB's status and single mandate for price stability (compared to Fed's dual mandate)**
- Lack of a unified regulatory framework for banking supervision in the euro area and limited involvement of the ECB in protecting financial stability**

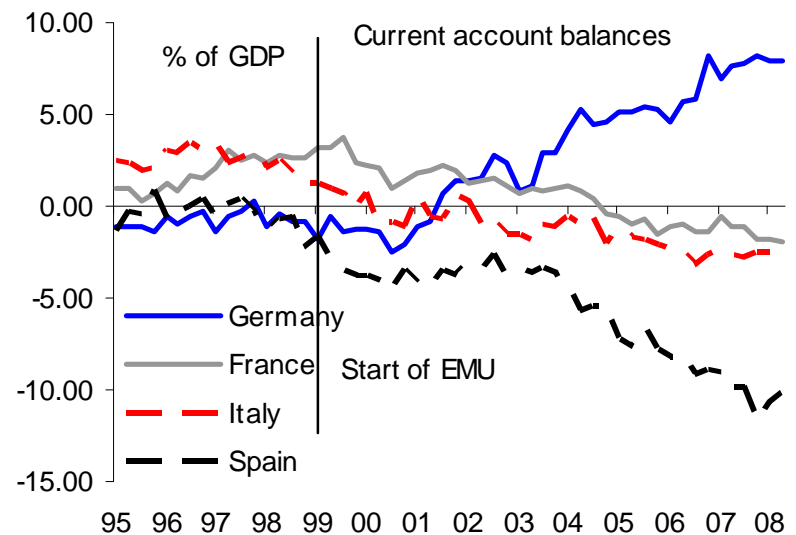
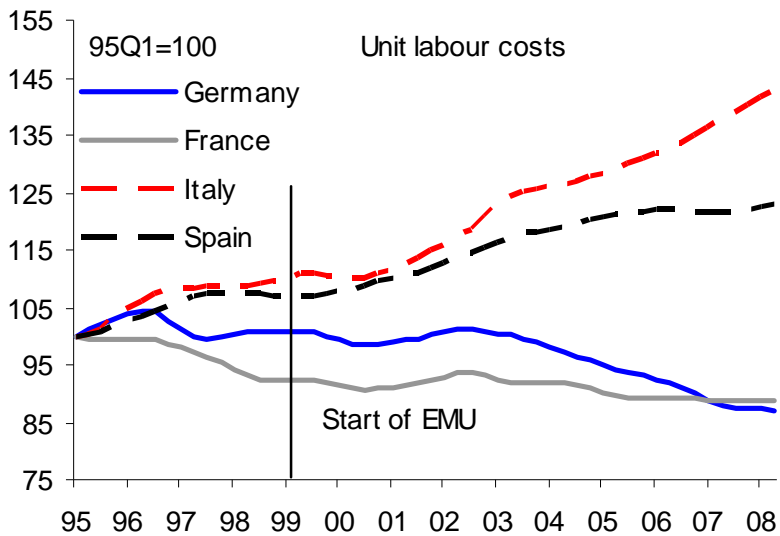
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- + Euro area's more sustainable aggregate savings-investment balance (which points to greater financial stability)**
- Government debt market remains national (no large issuer of "risk free" euro securities).**



1. The challenge of regional economic divergence

Can “club med” deflate its costs?



Source: Haver, GM Research



New EMU members a possible source of dilution and wider dispersion

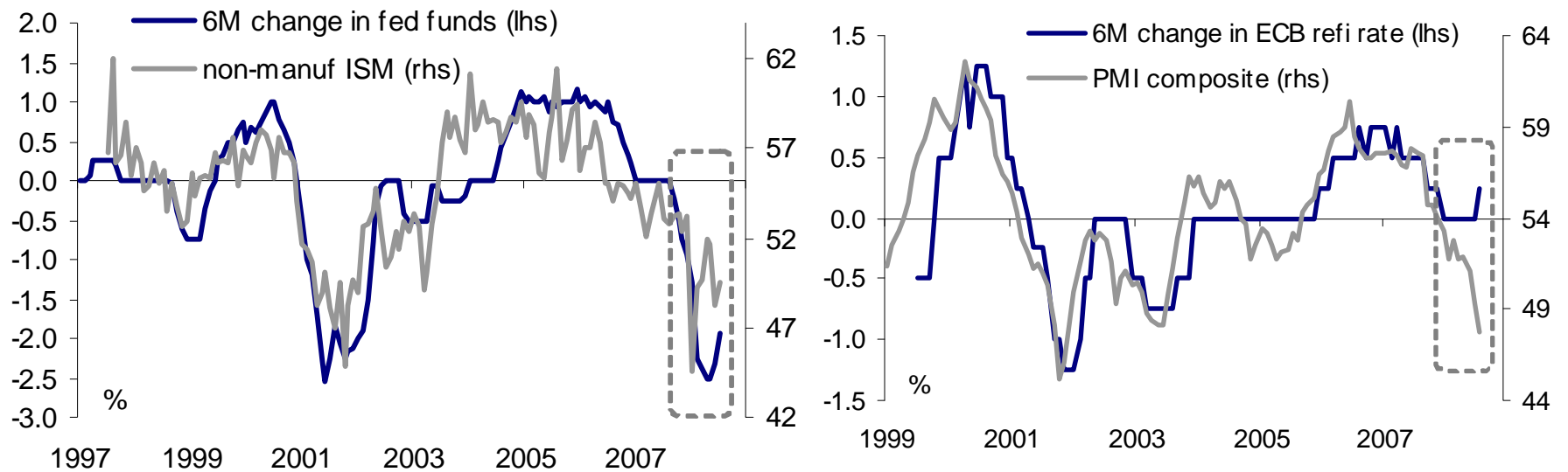
Year of entry	country	Inflation (July 08)
2001	Greece	4.9%
2007	Slovenia	6.9%
2008	Malta	5.6%
2008	Cyprus	5.3%

Memorandum: Euro area inflation July 08 4.0%



2. The ECB is from Mars, the Fed from Venus...

In 2007-08 Fed took its policy cue from real economy, ECB from inflation



Source: Fed, ECB, NTC, GM Research



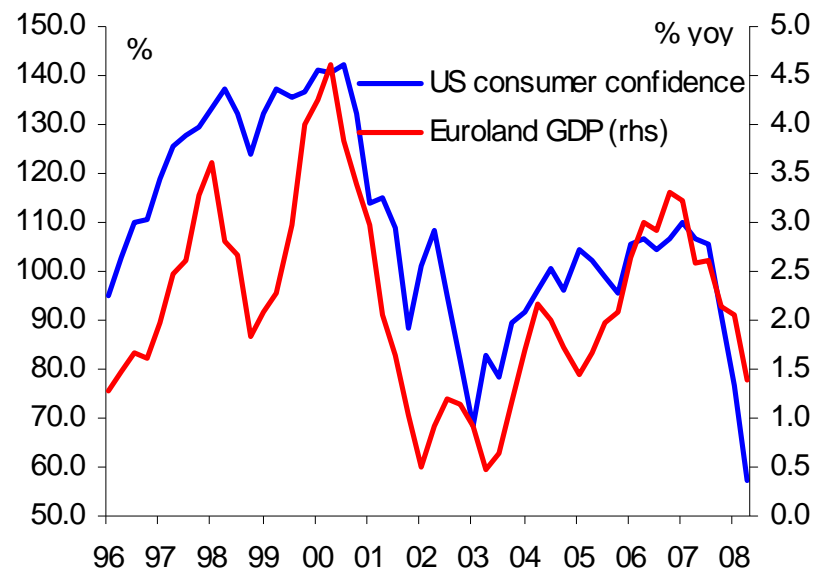
...but was this a good choice?

European and US banks both suffering... ...and euro area economy slowing sharply

Bank losses and capital raised since mid-2007
(in bn of USD)

	Loss (1)	Capital (2)	(2) in % of (1)
World	506.2	360.0	71.1
Americas	254.9	184.0	72.2
Europe	227.4	154.0	67.7
Asia	23.9	22.0	92.1

Source: Bloomberg (09/2008)

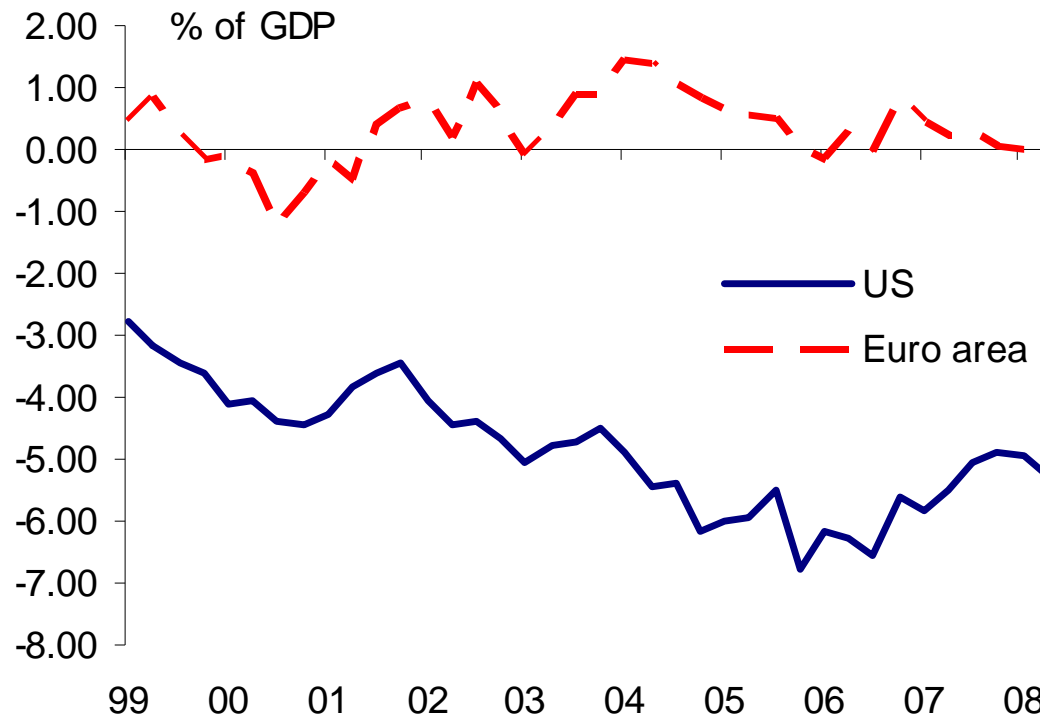


Source: Bloomberg, GM Research



3. Euro area not suffering from unsustainable external imbalances...

...but US current account beginning to adjust



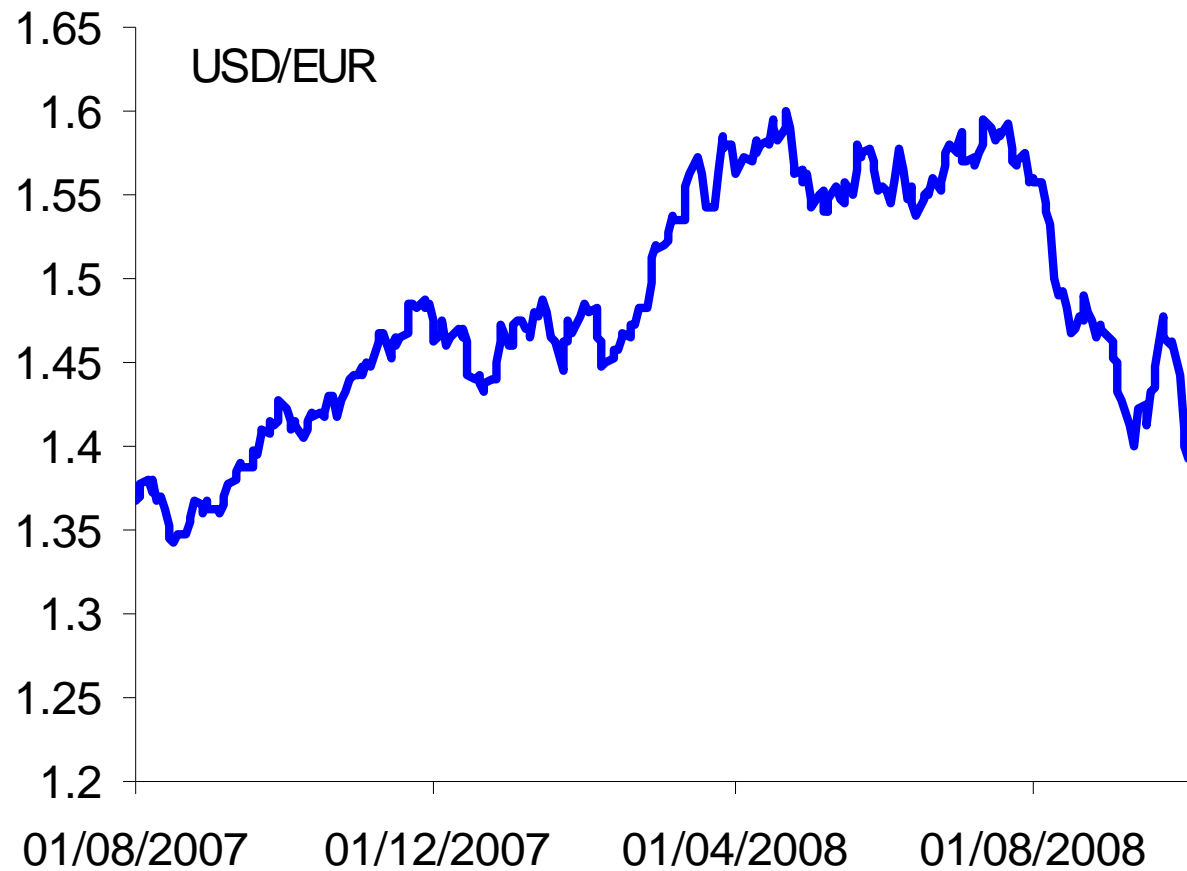
Source: Haver, GM Research

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...and USD may strengthen



Source: Bloomberg, GM Research



Implications from the financial crisis

- Confidence in the US financial system has been severely shaken
- Greater reliance on internal financing of investment likely to reduce US saving-investment deficit and slow growth in the medium-term future
- EUR can take advantage of reduced attractiveness of USD assets, provided that open questions on internal re-balancing among EMU countries and on the regulatory system are answered to the satisfaction of international investors



Conclusions

- Euro area has the economic weight to back a global reserve currency.
- Euro has overtaken USD in rates and debt markets.
- Euro has gained market shares in official fx reserves and fx markets.
- Financial crisis has shaken confidence in US financial system. This may well raise the attractiveness of the Euro. But investors are unconvinced that (i) economic adjustment within EMU works; and (ii) the regulatory system is fully up to crisis management.
- Next few years will test EUR's ability to be the key international reserve currency

Appendix



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The roles of an international currency

Role	Private use	Official use
<u>Medium of exchange</u>	Vehicle currency (in fx markets)	FX intervention
<u>Store of value</u>	Banking	Reserve accumulation
<u>Unit of account</u>	Invoicing	Monetary anchor

Source: BIS WP 216