Advisory Council
on International Affairs

The euro on the world stage: the international role of the EU's currency from a geostrategic perspective

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The Advisory Council on International Affairs

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Summary

Current geopolitical developments, particularly the war in Ukraine, as well as the rise of China as a world power and the US response to it, are forcing the European Union to recalibrate its position on the world stage. Consequently, for the past several years a debate has been ongoing about how the EU can enhance its strategic autonomy in order to promote its economic and geopolitical interests and defend its values and security. In this context, strengthening the international position of the euro – in addition to other elements – may in turn help strengthen the position of the EU.[1]

Back in December 2018 the Juncker-led European Commission placed the debate on the euro's international role on the agenda.[2] Relations between the EU and the United States played a decisive role in this respect. After President Trump's administration unilaterally withdrew from the Iran nuclear deal in May 2018, the EU member states realised how little they could accomplish in opposition to the power of the dollar.[3] This experience – and with the prospect of a second Trump term starting in 2024 – have triggered a process of reflection on alternatives to the dollar-dominated system.

This process of reflection is also taking place outside the European Union. The Western sanctions imposed on the Russian financial system since Russia began its war of aggression in Ukraine in February 2022 have once again highlighted the extent to which currency power can be deployed geostrategically. However, due to strategic preparations and intervention by the Russian central bank, the deployment of currency power and Russia's exclusion from SWIFT have fallen a long way short of the 'ultimate measure' envisaged by the Western powers. Furthermore, the deployment of currency as a weapon has also encouraged other emerging countries to free themselves from the power of the dollar. Efforts to promote more widespread use of the renminbi in settlements between Russia, China and countries in Asia, Africa and Latin America were high on the agenda of the summits between Presidents Putin and Xi in Moscow, and between Presidents Lula and Xi in Beijing in early 2023. For the first time since the founding of the Bretton Woods system, the dollar's hegemony is no longer assured in the long term. European Central Bank (ECB) President Christine Lagarde remarked on this situation during the 2023 spring meeting of the IMF: 'These developments do not point to any imminent loss of dominance for the US dollar or the euro. So far, the data do not show substantial changes in the use of international currencies. But they do suggest that international currency status should no longer be taken for granted.'[4]

This advisory report explicitly considers the added value of strengthening our common currency's international role in the context of the world's shifting geopolitical tectonic plates. To what extent is the EU willing and able to respond with its currency to the possible fragmentation of the current dollar-dominated international monetary and financial system and to a potentially 'post-unipolar' monetary order?

In this advisory report the AIV examines the relationship between currency and power. It describes how currency power has been deployed over the course of history in positive and negative ways in pursuit of geostrategic goals. Take for instance the positive role played by the aid provided under the Marshall Plan after the Second World War in the reconstruction of Europe and – from the EU's perspective – the negative role played by US sanctions in relation to the Iran nuclear deal. Set against such offensive currency power is the desire for autonomy and resilience in the form of defensive currency power.

The political, geopolitical and strategic importance of currency has always been recognised in Europe and was one of the main driving forces behind the creation of the euro. However, this realisation has been insufficiently reflected in Dutch policy discourse, and as a result the Netherlands has in the past often found itself presented with a *fait accompli* – not uncommonly following a strategic agreement between France and Germany. The Dutch debate therefore needs to address the development of the euro more proactively, with a stronger focus on geopolitical aspects.

Building up currency power is a long-term process. Economic operators decide largely on the basis of confidence for themselves which currency they will use for international purposes. This confidence is determined by both economic and political factors. The economic factors concern the size, liquidity and stability of the financial markets. The political factors include a state's military, political and legal strength and stability. Building such confidence in a currency takes time. It would therefore be advisable to start investing without delay in the EU's currency power in order to facilitate the necessary scope for action in due course.

Various policy measures could strengthen the euro's international potential. With regard to the external positioning of the currency, the main options include systematically issuing invoices for new, green energy in euros; introducing a digital euro with the emphasis on large volumes of cross-border payments; and expanding the network of ECB swap lines. Measures to enhance the solidity of the eurozone would also boost confidence at the international level. This includes, for example, the further development of the capital markets union; the completion of the banking union; investment in the eurozone's sustainable growth capacity and resilience; and introducing more (individual and/or common) risk-free investment instruments.

At present there is insufficient political support for a number of these policy options, and they will not be introduced *solely* with a view to strengthening the international role of the euro. However, the political context and the underlying assessment of interests may shift over the course of time, under geopolitical pressure and given the changes in the international economic landscape. It is therefore important not to rule out any policy measures in advance. Taking appropriate steps now could bolster the power of the currency over the longer term. Finally, the eurozone could be strengthened collectively by striving to expand it to include EU member states that have not yet introduced the euro, such as Denmark, Sweden and Poland.

The key message of this advisory report is that the internationalisation of the euro will be a long-term investment in the resilience and autonomy of the eurozone and also of the European Union in a changing world. Irrespective of whether the world continues in the same vein as the current unipolar system or evolves into a bipolar or multipolar system, in each scenario a stronger role for the euro will benefit the resilience and effectiveness of the European Union. Outside the EU too, a stronger euro could in time have positive impacts by encouraging greater diversification, balance and cooperation in the design and development of the international monetary system. This is becoming all the more pressing given the increasing importance of this subject in international diplomacy in the G20 and beyond. The debate in the Netherlands regarding the future of the euro therefore merits an integrated approach, in which, besides the economic opportunities and risks, clearer consideration is given to current and future geopolitical developments.

Recommendations

Both as the second most commonly used international currency and as the currency of one of the world's top-three economies, the euro is inextricably part of a geopolitical balance of forces. The world is becoming more geopolitical, the rules-based multilateral order is under pressure and the importance of power relations is increasing. The European Union needs to find a response. The EU has more options for applying pressure than the single market alone; it also has currency power at its disposal. The AIV considers that there are convincing reasons to abandon the geostrategic neutrality of the euro and advises policymakers in the Netherlands and Europe to demonstrate greater urgency and commitment in developing the euro's geostrategic potential. To this end the AIV wishes to make the following recommendations.

► Recommendation 1

Build up the currency power of the euro so that it is possible to make a full and independent contribution to stability and cooperation within the international monetary and financial system.
The world order is changing and for now the outcome remains uncertain. A unipolar, bipolar or multipolar world are all possibilities in the long term. Euro power will offer added value in all of these scenarios, by giving the EU more scope for taking action. It will be an extra instrument in the EU's geopolitical toolkit. In a unipolar or bipolar system, a stronger euro will make the eurozone less vulnerable to the power of the dollar and/or the renminbi. Within a bipolar or multipolar system, a stronger position for the euro could enhance international stability, balance and cooperation. It would also create greater scope for effectively exerting influence on the design or reform of the international monetary system.

► Recommendation 2

When building up the currency power of the euro, maintain a focus on transatlantic relations and continue to strive for cooperation and coordination.
Given the dollar's current dominance, strengthening any other currency whatsoever, including the euro, will inevitably be detrimental to the hegemony of the dollar. Particularly in a future bipolar or multipolar world order, it will be in the interest of the US too for Europe to be a strong foreign-policy and monetary partner. Besides benefits, it will also be possible to share costs, risks and responsibilities for the international monetary and financial system.

► Recommendation 3

Demonstrate urgency and ambition in the further internationalisation of the euro in order to make it possible to operate more independently in the future if geopolitical circumstances so require.
Building up currency power is a long-term project, since the choice of currency is mainly determined by confidence, and building such confidence takes time. It is therefore necessary to start now: the long term, too, starts today. A bigger role for the euro will not be achieved overnight. Small steps will also help reach the long-term goal. Even when taking small steps, however, long-term ambition should be demonstrated. No policy options for strengthening the euro should be ruled out in advance. Options for which there is insufficient political support at present, such as common safe assets and aspects of the digital euro, may grow in utility and significance over the course of time and under geopolitical pressure.

► Recommendation 4

Take advantage of the opportunities for further digitalisation of the financial system: the e-€ merits a fully-fledged place alongside the e-CNY, e-₹ and e-$.

In the development of the digital euro, emphasis should be placed on cross-border payment transactions between large financial institutions and service providers (the wholesale segment). The threat of exclusion from SWIFT has in the past proved to be an effective weapon for motivating European financial institutions and companies – against the will of the European authorities – to comply voluntarily with geopolitical edicts issued by the US. Introducing a digital euro, among other things as a payment system operating in parallel with SWIFT, would lead to greater autonomy in relation to cross-border payments. The digital euro is currently under development. From the outset, its design should take the geopolitical dimension into account.

► Recommendation 5

Increase the role of the euro in invoicing and as a benchmark in strategic sectors such as (renewable) energy and in particular hydrogen; whereas the 20th century fossil fuel world revolved around 'petro-dollars', there is now a place for the 'hydro-euro'.

Use the opportunities presented by the green transition and the energy transition by making it more common to charge for new and local forms of energy in euros. This will require the European Union and the member states to step up their dialogue with the energy sector, which in Europe will also benefit from this strategic reorientation.

► Recommendation 6

Demonstrate solidarity with countries experiencing difficulties, take responsibility as lender of last resort in the international monetary system and contribute as an alternative safe haven to a more balanced international system.

Examine the expansion of the network of ECB swap lines beyond the EU and G7 countries in the context of the Global Gateway strategy, as a counterweight to the network of renminbi swap lines under the Belt and Road initiative. By doing so the EU can demonstrate monetary leadership, enabling countries in, say, Central Asia to rely on the euro for funding and liquidity in times of financial hardship. In this way the EU can demonstrate solidarity with countries experiencing difficulties and provide assistance to them.

► Recommendation 7

Get Europe's own house in order: strengthen the euro by means of internal reforms, such as ensuring that the European financial market operates more effectively and is more resilient to stress and laying down solid macroeconomic foundations.

- Efforts should be made to rapidly complete the capital markets and banking unions. A more effective European financial market will lead, through a more efficient allocation of financial resources and more private risk sharing, to greater growth potential and resilience for the eurozone.
- Strengthen the eurozone as a safe haven for international reserves through a larger offering of (individual and/or common) safe assets.
- Invest in the eurozone's sustainable growth capacity and resilience.

► Recommendation 8

In bilateral relations and at EU level, advocate that Denmark, Sweden and Poland join the euro area.

The strength of the eurozone, both internally and externally, is also the sum of its parts. It is important that the criteria for joining the euro area be enforced strictly. However, the Dutch agenda for the euro could be bolstered if like-minded countries such as Denmark, Sweden and Poland were to join. For these countries too, the geostrategic dimension of the euro weighs more heavily in 2023 than it has in the past and the considerations on whether or not to join the euro area are shifting in favour of membership.

Introduction

On 16 March 2022 the Advisory Council on International Affairs (AIV) was asked by the Minister of Foreign Affairs for its advice on the international role of the euro (see annexe 1).[5] The request for advice referred to two important developments: changes in the geopolitical orientation of the United States, and the rise of China. The questions on which the advice of the AIV was sought concern what response these geopolitical circumstances require in the international financial and monetary domain. What approach should the EU take in the financial and monetary domain to the new geopolitical reality?[6] What will be the role of the euro in this respect? To what extent and in what way is it possible from a policy perspective for Brussels and/or The Hague to exercise effective influence over developments?

Approach

Working on the basis of a literature review and interviews with experts from the worlds of academia and policy (e.g. the ECB, the European Commission, the European Stability Mechanism (ESM), the Dutch Ministries of Finance and of Economic Affairs and Climate Policy), this advisory report sets out eight recommendations regarding the international role of the euro. Annexe 2 presents a list of persons consulted. The AIV is very grateful to them for their assistance.

Geostrategic analysis

Although this report builds on elements of previous AIV advisory reports on the eurozone published in 2010, 2012 and 2017, this advisory report takes a different perspective.[7] It does not contain an economic analysis of the eurozone.[8] This report is aimed at clarifying the issue of currency and power and providing an integrated strategic view on the economic and geopolitical aspects of the euro. The report emphasises that the euro is in essence a political project. In Dutch policy discourse, the political and geopolitical dimensions of the euro receive relatively little attention in comparison with the discourse in other EU member states, such as Germany and France. The AIV aims to fill this gap. In that respect this advisory report follows on from the AIV's earlier advisory report on EU industrial policy.[9]

A new era

1.1 Introduction

For a long time there seemed to be no compelling reasons to reflect on the question of what contribution the euro could make to the European Union's position on the world stage. The question seemed, certainly from the Netherlands' perspective, to be purely theoretical. However, things have changed.

Extensive shifts in the global balance of power since 2000, which have been accelerating since 2015, are revealing the contours of a world in which the US dollar is losing the hegemony that it acquired in 1945. In due course, this could also have far-reaching political and economic consequences for the EU and therefore for the Netherlands.

The international use of the euro still may not seem a very pressing issue to policymakers today. Geostrategic shifts, such as the rise of China, occur over decades. The context of Russia's war of aggression against Ukraine, in which unified action by the US and the EU is paramount, also makes this a less expedient moment to question the position of the dollar.

Nevertheless, in 2023 it is indisputable that there is plenty at stake for the Netherlands and the EU when it comes to the euro's role in the world, whether in the near or longer-term future. The matter requires politicians to strategically look ahead and prepare.

1.2 Two significant shocks

Geostrategic developments are often compared to the slow shifting of tectonic plates. In this metaphor, certain events or brief crises – tremors or earthquakes caused by the collision or drifting of tectonic plates – suddenly make immense underground forces visible and palpable. In the area covered by this advisory report, there have been two such illuminating events since 2018. In the wording of the request for advice submitted to the AIV, both of them took place 'at the intersection of geopolitics, international trade, and financial, economic and monetary issues'.

The first shock arose from the decision by the administration of United States President Donald Trump, in May 2018, to unilaterally withdraw from the Iran nuclear deal (formally known as the 'Joint Comprehensive Plan of Action' or 'JCPOA'). This decision was taken against the wishes of the five other parties with which the Iranian government had concluded the deal, including the United Kingdom, France and Germany (the three European states or 'E3' representing the European Union).[10] The US also decided to impose sanctions on any entities continuing to do business with Iran that also operated in the US and/or traded in dollars. The latter 'extraterritorial' dimension enabled Washington to threaten to impose multi-billion-dollar fines on banks or energy companies in the EU with operations in Iran. Since most multinationals also operate in the US and that market is of much greater relative importance to them, virtually all parties involved decided that it was in their own best interests to withdraw from Iran and acted accordingly.[11] In the years that followed, the sanctions led to growing poverty and unemployment in Iran itself.[12]

The EU, which had invested a great deal of political capital in the Iran nuclear deal since 2003, pursued a number of initiatives to circumvent the US sanctions against Iran.[13] The most detailed plan implemented was INSTEX: a clearing house for imports and exports between participating EU countries and Iran. Its mandate encompassed food, medical supplies and other humanitarian goods, but ultimately INSTEX brought about only a single transaction.[14] Even the EU's own European Investment Bank (EIB) was unable to help EU businesses in Iran, among other reasons because the EIB is – and has to be – active on the US capital markets and would be in breach of US regulations by providing such help. Government leaders in the EU found it to be a humiliating episode. At least one EU government declined to host INSTEX in its territory for fear of reprisals by the Trump administration.[15]

The experience with sanctions against Iran raised important issues in two respects. First, it illustrated that EU member states were unable to defend their own geostrategic interests when their interests diverged from those of the US. One reason for this, besides the market strength of the US, was the weak international position of the euro (and of the British pound) in relation to the US dollar.[16]

It also became clear that Washington was willing to deploy heavy economic artillery, even against NATO Allies, in pursuit of its foreign policy goals. President Trump may have been an unpredictable leader, but what happened once could happen again in future. This vulnerability has not been forgotten, all the more so because situations in which the US could be tempted to deploy economic pressure against EU countries are becoming more common.

The case of Iran, in which the US and the EU diverged in terms of their geostrategic assessment of the situation and in terms of the economic impact of the sanctions, was just a foretaste in this respect. A much greater potential divergence of interests arises in relation to China. The Netherlands recently experienced these tensions itself in the case of ASML, with Washington exerting severe pressure on this producer of semiconductor manufacturing equipment, based in the Dutch town of Veldhoven, and on the government in The Hague to stop the export of certain semiconductor manufacturing equipment to China. The US regards China as its main strategic rival and wants to outperform it whatever the cost, whereas the EU (in language dating back to 2018) sees China not only as a 'systemic rival' but also an 'economic competitor' and a 'partner' for instance in relation to climate policy.[17]

A second recent event at the intersection of currency, trade and foreign policy that highlights slow strategic shifts has been less disruptive than the Iran situation but nevertheless significant. In December 2022 Chinese President Xi Jinping met with the leaders of Saudi Arabia and the Gulf Cooperation Council. After the summit ended, President Xi announced extensive cooperation in the field of energy, including the prospect of substantial increases in oil and gas imports as well as investment in exploration and production both in the Gulf Region and in the South China Sea. Beijing hopes that by 2025 all of these activities will be denominated and traded in Chinese renminbi, preferably on the Shanghai Petroleum and Natural Gas Exchange. With a nod to the 'petro-dollars' that symbolise the US dollar's dominance in the oil markets, one financial analyst spoke of 'the birth of the petro-yuan'.[18]

Viewed from a long-term perspective, the petro-yuan deal could be regarded as the beginning of the end of an era that started in 1945 with the famous agreement between the US and Saudi Arabia. In February 1945, only days after the Yalta Conference at which he had drawn up the European post-war order together with Stalin and Churchill, US President Franklin D. Roosevelt met with King Abdulaziz ibn Saud on a US aircraft carrier. The US offered the Saudis a security guarantee in exchange for oil paid for in US dollars. The agreement confirmed one of the key geopolitical alliances of the past 75 years.[19] In 2023, stronger ties between China and the Middle East are shaping a new world order in the field of energy.

This recent move by China is also part of a pattern. In time the country wants to end its dependence on the dollar and on the Western economies more broadly. China acknowledges that it is lagging far behind in the monetary field, even if only because the renminbi (or yuan) is not freely tradeable on international capital markets, but time is on its side. A closed capital market was one of the initial steps in the Chinese economic model. The progression to a global economy includes other relatively recent Chinese initiatives, such as the gradual deepening and opening up of its own financial market, the introduction of a Chinese cross-border interbank payment system, the opening of an offshore renminbi market ('dim sum bonds') and the opening of swap lines with other countries' central banks.

China's determination to pursue autonomy increased in 2022. After Russia's invasion of Ukraine, the West proved able to deliver a heavy blow to the aggressor in the form of financial sanctions (including by freezing the Russian central bank's accounts denominated in dollars, euros and pound sterling and excluding Russia from the interbank payment system SWIFT). Beijing wants to avoid what happened to Russia. China knows that the era of the dollar, which commenced in 1945, will not come to an end within two or three years. But in the awareness that currency and power are strongly connected for the rival of the US, the country is working towards becoming one of the poles in a world order that is multipolar in both a military and monetary sense. This goal will certainly not be achieved in 2025 but may be pursued with a view to for example 2049, the centenary of Mao's communist revolution.

Although the rise of the petro-yuan is taking place in the three-way relationship between the US, China and the Middle East, this development also raises important issues for EU policymakers to consider. What approach should be taken to the international energy markets? Should parties in the EU also request payment in euros more regularly, and do they have the power to do so? And what will a stronger position for the renminbi mean not only for the power of the US and the dollar, but also for the EU and the euro?

1.3 Strategic dilemma

Both examples mentioned above expose aspects of the geopolitical tensions facing the euro in 2023. The developments are not all necessarily moving in the same direction. They present the European Union with a strategic dilemma.

The rise of China, succinctly encapsulated in the embryonic petro-yuan, the pursuit of market leadership in high tech and control over strategic commodities, signals an unfolding multipolar or bipolar world order, in which Beijing is challenging the leadership position of the US. In this constellation, it will undoubtedly to a certain extent be in the interests of EU member states to remain aligned with the US and to stand strong together as 'the West'. Views may differ among and within EU member states and the time horizon will also make a difference (since what significance will 'the West' even have by 2100 when the planet has a population of 11 billion people, 9 billion of them in Asia and Africa?) Nevertheless, the new battle of superpowers is apparently nudging Europeans in the direction of subordination to the power of the dollar.

In contrast, the example of the sanctions against Iran makes clear that, even between the US and the EU, strategic calculations can sometimes diverge. In certain situations it will therefore be in the interests of the EU to have more options for action through a stronger euro. The then Commission President Jean-Claude Juncker called this – upon publication in December 2018 of the Commission Communication on the international role for the euro, which took place not coincidentally in the aftermath of the Iran situation – a matter of 'sovereignty'.[20] Whether such a position is actually possible for the euro – as well as the economic advantages and disadvantages that may result from it – will be examined later in this advisory report.

In essence, this in itself illustrates the strategic dilemma that this new constellation presents to the EU. Is it important to keep buttressing the dollar so that the US can retain its dominance over China for as long as possible, or would it be wise for the EU to increase its capacity to act through a stronger euro? Or is this not such an acute dilemma after all?

This transatlantic currency debate has similarities to the debate in the military domain. There is a similar dispute over whether closer defence cooperation within the EU would necessarily be detrimental to NATO (and, *mutatis mutandis*, whether a stronger euro might be detrimental to the dollar) or whether European efforts would actually strengthen the West as a whole.

It is immediately striking how issues that on the surface seem technical – such as whether, within the EU, the Dutch government should advocate the international use of the euro in the oil or grain markets – have a bearing on essential strategic questions. Such questions often remain unexpressed but it would be better to articulate them. This will require a certain vision of the future, a framework within which specific policy options for the euro can be evaluated on their strategic merits.

A first set of questions concerns the type of world order that we expect. Will we see by 2050 a 'G2' world, divided into two power blocs, a Sino-US revival of the Cold War but with much greater economic and technological interdependency than ever existed between the West and the Soviet bloc? Or, given the economic and demographic weight of countries in Africa, Latin America and the rest of Asia, do we expect to see a multipolar world order take shape, in which, alongside Washington and Beijing, other geopolitical players demand a role on the world stage?

And which of the scenarios – the bipolar or the multipolar – would be the most favourable or least risky departure point for the EU? Can the EU itself influence the outcomes and, if so, how and to what extent? At first glance a multipolar world would offer more conceptual and diplomatic scope for a stronger euro, as one of the world's most widely used currencies. That would be less applicable in a bipolar world, split in economic terms into a dollar bloc and a renminbi bloc; but even then the importance of a stronger euro could remain substantial.

A second set of questions about the future concerns the urgency of the EU having its own currency power. Given the current hegemony of the dollar, these questions focus mainly on assessing how the US will deploy that power in future. As we have seen, Beijing considers it extremely likely that Washington will use the power of the dollar against Chinese interests and is therefore working in a targeted way on protective measures. But how great do we in the EU and the Netherlands estimate the risk of the US deploying its geoeconomic power in a way that is at odds with EU and Dutch interests? And within what timeframe do we expect China to deploy its accrued defensive currency power offensively, including against the European Union?

1.4 A new era

Without being willing or able to resolve these strategic questions here, the AIV underscores that it is nevertheless absolutely essential to examine them in light of the changing geopolitical situation. The answers of 1990 or 2000 will no longer suffice. The European Union, and therefore also the euro, are entering a new era.

Whether the end point is connected with the Russian invasion of Ukraine (the *Zeitenwende* of 2022), the egocentricity of the US under Trump (2017-2021), the rise of China since Xi Jinping assumed the presidency (2013) or with Erdoğan's migration policies, Modi's Indian nationalism or other recent forms of power politics – zooming out, it can be observed that the era in which the European single currency was introduced, a period of years coloured by progress for liberal democracy and belief in globalisation without domination that followed the fall of the Berlin Wall (1989), has ended. But we are not returning to the situation of the Cold War either. That makes a great difference when analysing the position of the euro. It is certainly true that in the period from 1947 to 1989 there were two blocs. And within the Western bloc back then, the US and the countries of the European Community were simultaneously geostrategic allies (in NATO) and economic competitors (in a rivalry channelled through the multilateral order that included e.g. GATT, WTO and the G7). The difference between then and now is that the military and economic/monetary domains were still somewhat separate at that time. This was possible because economic ties between the West and the communist Soviet bloc remained very limited, with the major exception of energy. Consequently, economic tensions between the US and Western Europe could be absorbed without repercussions for security policy. Nor did the question of the connection between military and monetary power come into focus in the quarter century of economic globalisation (1990-2015) that followed the Cold War, since at this time of geostrategic unipolarity the US was in a different league than all its potential rivals.

But in the new era of 'polarisation', 'deglobalisation' and 'derisking' – which, given the decisive role played by China's pursuit of power and the US response to it, can be said to have begun between the entry into office of President Xi (2013) and President Trump (2017) – all economic, financial, technological and other relations are deployed strategically. This is referred to as 'the weaponisation of economic interdependence'.[21] Again, the sanctions on Iran were a mere foretaste of this.

The European Union too must learn how to operate in this new context. Even if we prefer to avoid the subject sometimes, our partners and rivals will also be examining the strengths and weaknesses of the European currency.

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What is currency power?

2.1 Cause or consequence?

International use of a currency can be both a *consequence* of and a *source* of foreign policy power. It is not always possible to distinguish clearly between these two phenomena. The 'top power' in the world or a particular region, often also a large and dynamic economy, will generally provide the 'top currency' as well; but a strong international currency can also help a country remain the strongest power for longer. It clearly works in both directions. The details require further explanation.

2.2 Currency and state authority

Currencies are closely connected with state power. It is true that there have always been privately issued currencies and other means of exchange, from tobacco in the 18th century in the US to the cryptocurrencies of today. But only the central authority is permitted to issue currency as a 'lawful medium of exchange'. The currency is a prominent organ of state; the counterfeiting of currency, a violation of a privilege of the monarch, was subject to extremely stiff penalties, in some countries even the death penalty. Many currency names reflect the historic ties between the monarch and money (for example 'krona/krone/kroner', 'real', 'ducat' or 'Louis d'or').

For centuries, confidence in the value of coins was derived from the weight of silver or gold that they contained. Many currency names reflect this, including references to weighing ('gulden', 'pound', 'peseta', 'peso' and 'lira'). The words 'thaler', 'dollar' and the (old Dutch coin) the 'daalder' were derived from the name of the Joachimsthal silver mines in the Kingdom of Bohemia.

The ties between money and gold or silver were cut in the 20th century. Countries that are members of the International Monetary Fund (IMF) are permitted to let their currencies' exchange rate float, to peg it to one foreign currency or to a 'basket' of currencies, to belong to a currency union or to use another country's currency, but are *not* permitted to link their own currency to the price of gold. Nowadays, it is not possible to go to De Nederlandsche Bank (DNB, the Dutch central bank) and exchange a one hundred euro note for gold. This makes 'confidence' all the more important: users want to be certain that their money represents a particular value and is not merely a piece of metal or paper. Ultimately, confidence in a currency is rooted in state power, in the form of a central bank or government. And herein lies a unique feature of the euro: it is a currency without a state.

Given the close relationship between currency and state authority, the internationalisation of currencies has inherently become entangled with broader political rivalries between states. This is both because of the real advantages that such international use offers and because of the symbolic value that it gives a currency in relation to others. Who is the best in the world? Who is the strongest, the most popular? Which currency can you have confidence in?

On the world stage a currency therefore fulfils not only the economic functions of unit of account, means of payment and store of value but also a symbolic role as a concrete embodiment of a state or society. In this sense, a currency resembles a flag. Consequently, many countries experience a currency devaluation not merely as a pragmatic adjustment of the exchange rate, but as a political humiliation – an experience that in turn has an impact on economic policy. Likewise, a country can derive pride from having its own strong currency; for instance, the Deutsche mark was crucial to the recovery of West Germany's self-confidence after pre-war hyperinflation and the disgrace of Nazism. The euro also developed into a symbol of the EU as a whole, as a 'crowning' of European unification. As a consequence, the markets' loss of confidence in the euro during the financial crisis also led to a loss of confidence among the public and in the rest of the world in the EU as such, a dynamic from which politicians in turn drew unexpected resolve. (Chancellor Merkel said in 2010: 'If the euro fails, Europe fails,' [22] and therefore both Greece and the euro had to be saved.)

Balance of payments, exchange rates, foreign currency deposits, but also: prestige, confidence, and loss of face. Currency internationalisation is therefore not only the domain of economists, statisticians and financial experts, but equally that of politicians, diplomats, sociologists and historians.

▸ 2.3 From the Athenian drachma to the US dollar – a brief history of international currencies

As soon as goods started being traded across borders in a manner that went beyond bartering, the circulation of coins (mainly silver and gold) began. Generally, the currency of a strong economy in the region would develop into an 'international' currency. In antiquity, silver Athenian drachmas and Roman denarii were commonly used currencies of this nature. In more recent times, other currencies that played this role included the Florentine florin, the Venetian ducat and the Spanish/Mexican peso. The Dutch guilder had its international heyday in the 17th century, and continued to bask in the afterglow for a large part of the 18th century.

As of the 18th century the British pound became by far the widest used currency in international trade (accounting for more than 60% of settlements in 1900).[23] The pound retained this position until the period between the two World Wars. The French franc (accounting for around 30% of settlements) and the Deutsche mark (approximately 15%) also had moderate success in this field, followed at some distance by the Dutch guilder and the Swedish krona. The pound had a strong position as the means of payment of the British Empire, the global superpower of the 19th century. Another contributing factor was that London had developed into the world's biggest centre of business: the place where traders could go for foreign currency, loans, insurance etc. In today's parlance: London offered a liquid market. The Bank of England ensured a stable market environment.

The dollar, established in 1791, only started to become established internationally around the outbreak of the First World War. This was related to the founding of the Federal Reserve System (1913) – a lender of last resort along European lines – with which the US government created a more stable market environment. The US developed into a major lender to the warring parties, which they used to fund imports of weaponry and other goods. In the 1920s the US government actively promoted the international use of the US currency. Within a decade, these efforts had led to the dollar almost catching up with pound sterling.

The turnaround happened after the Second World War: after 150 years, the British pound finally ceded its dominant position to the dollar. The dollar remained the only currency fixed to gold; other currencies were fixed to the dollar. This gold-dollar standard, founded in 1944, was known as Bretton Woods, a system of fixed exchange rates centred on the dollar. All around the world, for central banks, investors, importers, exporters and even criminals, the dollar was and remains 'as good as gold'. Since then it has been the universal means of payment, the global monetary standard.

The abrupt decision in 1971 by the US administration led by President Nixon to 'temporarily' end the convertibility of the dollar to gold (the 'Nixon shock') brought an end to the Bretton Woods system of fixed exchange rates. The exchange rates of the major international currencies were allowed to float.

The background to this was major budget deficits (and rising inflation) in the US on account of the Vietnam War, as well as the realisation the country's outstanding dollar liabilities held abroad now far exceeded the US gold stock. This meant that if all of those foreign governments decided they wanted gold for their dollars, it could have caused the state equivalent of a bank run.[24]

The Nixon shock tested the budding economic interdependency of Western European economies and in this way gave a major boost to European monetary integration, which culminated in the euro (1999). However, to the surprise of many, the end of Bretton Woods did not for the time being change the dollar's central position in the global financial system. On the contrary, the financial capitalism in which the dollar played such a central role was only truly able to develop once the 'gold anchor' had been abandoned.

The end of the dollar's hegemony has been predicted many times since the crisis of the 1970s. The global financial panic of 2008 prompted by the collapse of the US investment bank Lehman Brothers once again caused the rest of the world to doubt the US's role as monetary beacon. As of 2017, the presidency of Donald Trump raised entirely different doubts about internal stability in the US. For a decade, China has been challenging the dominance of the US and has also pursued monetary initiatives of its own in this connection. Naturally, what happened in the past to the Athenian drachma and the British pound could happen to the US dollar too. But the US government attaches great importance to the hegemony of the dollar and will actively seek to resist the decline of its currency.

2.4 The 'exorbitant privilege'

In the first place, an internationally used currency has a practical advantage. Users save time and money in their international transactions. Tourists from the US do not need to exchange their dollars if for example they go on holiday to the Philippines. US companies are not exposed to an exchange rate risk when they conclude futures contracts. The currency's central position also delivers growth and employment in the financial markets. During the dominance of the British pound, London as a financial centre attracted not just banks but also financial services providers such as pension funds, asset managers and insurers. In the early 20th century, dissatisfaction about the fact that even insurance policies for the intracontinental transportation of coffee from São Paulo to New York had to be concluded in far away London was a factor in the US that contributed to efforts to establish a Federal Reserve System ('the Fed') and to promote international use of the dollar.[25]

Nevertheless, the key *economic* advantage of the international use of a currency is to be found elsewhere. Through their central banks, many countries hold reserves of foreign currencies so that they can stabilise their own currency in emergencies. It goes without saying that, since 1945, this mainly meant choosing the dollar (or securities denominated in dollars, such as US treasury bonds). Investors in the financial markets also like to invest in dollars or in dollar securities. The 'greenback' is a safe haven, offering financial security.

Valéry Giscard d'Estaing, French finance minister under President De Gaulle, noted in the 1960s that this popularity of the dollar as a store of value is a *privilège exorbitant* (exorbitant privilege) for the US. The fact that other countries hold enormous dollar deposits enables the US to systematically run a trade deficit with the rest of the world without this necessitating domestic economic adjustments. Consequently, each year the US is *de facto* able to consume and invest USD 90 billion more than its output.[26] This gives the US a major economic and strategic advantage.

How does the exorbitant privilege work? Normally, a balance of payments deficit would force a country to make economic adjustments, in order to restore balance in the next year. Such adjustments may take the form of devaluation, which stimulates exports and makes imports more expensive, or salary reductions or other reductions in public and private expenditure. But by whatever means: after the adjustments, less of the total economic output of deficit country A plus surplus country B will end up in country A; that country pays an economic price. Any country will want to avoid such an unwelcome outcome or delay it for as long as possible. The decisive factor is how long a country retains access to liquidity despite running a balance of payments deficit. Only in that way can the country continue to take out loans to delay having to make those painful adjustments. The consequence of the rest of the world's near inexhaustible demand for dollars – which is barely perceived as 'loans', although in macroeconomic sense that is exactly what it amounts to – is that the US need not worry about liquidity. The country can continue to run balance of payments deficits and postpone adjustments indefinitely. What is more, postponement is lucrative; every year of delay pays off. As Benjamin Cohen writes in *Currency Statecraft*, whereas other countries need to buy or earn dollars first before spending them abroad, things are simpler for the US: it can simply run the (proverbial) printing presses.[27]

Set against the exorbitant privilege is an 'exorbitant burden'. In times of global financial crisis, the country that provides the world's reserve currency (to a greater extent than states or currency unions whose currencies are held in smaller amounts by foreign central banks) has to shoulder responsibility. That means, for example, making liquidity available to economies in distress through other central banks, as the US did in 2007-2008. Furthermore, the flip side to foreign demand for dollars is often a higher exchange rate, which may boost purchasing power but also undermines the competitiveness of exporters. Nevertheless, on balance other states and powers regard with envy the economic and strategic advantages that the US in particular enjoys thanks to this privilege. Particularly now that it has proven in other ways to deliver gains in terms of power and capacity to act.

2.5 Currency as a weapon

The explicit *geostrategic* advantage to the US of its currency is a by-product of the omnipresence of the dollar in the international economy. Other parties with geopolitical ambitions would also want to capitalise on that advantage if they had it. Since the dollar occupies a unique position in the international currency system, which had never been occupied by any other currency prior to 1945, the following examples of using a currency as a weapon relate primarily to the US.

Thanks to the dollar's dominance and its essential role as an international means of payment, the US has acquired the role of the international economy's gatekeeper. Anyone wanting to acquire gas, oil or other goods and services abroad needs dollars and ultimately therefore the political blessing of the US. And in turn, where a country has an unstable currency: anyone wanting to sell goods or services abroad will prefer to receive payment for them in dollars. There is virtually no international transaction in which the US is not involved, via the dollar.

In recent decades the US has begun making strategic use of this gatekeeper role. Washington can indirectly deny countries of which it disapproves access to the greenback via SWIFT, thereby punishing them and isolating them economically. On the other hand, the US can also reward friendly states and support them with coveted dollar loans. Naturally there are practical and legal limits, but certainly at a time when the world economy and crucial value chains have become strongly interconnected at international level, this role as gatekeeper is extraordinarily powerful as a means of applying pressure and as a geopolitical weapon.

This also explains why many countries – for example Brazil led by President Lula, re-elected in late 2022 – are distrustful of the dollar's international role, which is enormous in Latin America. It fosters dependence and ultimately enables the US to interfere in domestic political affairs on the continent. Although it is not a goal for the short term, Brazilian politicians, particularly those in progressive circles around Lula, hope to boost their country's political sovereignty in relation to the dollar with a common South American currency, the 'sur', an idea already backed by Argentina. The proposed currency's name (which means 'south') expresses a strong geographical self-awareness, of South vs. North America (while at the same time reflecting the notion of the 'Global South' vs. the West), aligning with geography in the same way that the name 'euro' does.[28]

It is therefore highly understandable that the strategic rivals of the US are resisting the dominance of the dollar and want to reduce their vulnerability to US sanctions policies. China owes its prosperity in part to globalisation and an open international trading system. But Beijing also knows that the US will use its power as system gatekeeper to stay ahead of China economically and politically.

There are plenty of examples illustrating how the US has used its currency as a geopolitical weapon. In 1988 for example, under the Reagan administration, the US decided to prohibit all dollar transfers to Panama, a decision that proved disastrous for the local economy and population. For many years Washington had benefited from a secret deal with Panama's autocratic leader, the dictator and drugs criminal Manuel Noriega. In return for payment he ensured that Panama would assist the US in the political battle against progressive ideas and rebellions by popular movements in Central American countries like Nicaragua and El Salvador. But once the US discovered that Noriega had been double dealing with Fidel Castro, it attempted to force him to step down, using stringent financial and economic sanctions, including freezing dollar transfers. These sanctions did not deliver success quickly enough and Washington ultimately sent troops into the country, taking Noriega back to the US, where he was given a lengthy prison sentence.

Early this century the US began making broader use of its strong position in the global financial system, setting its sights on another party: SWIFT. This institution supplies banks and financial institutions with a communication system for initiating payments, verifying the parties involved and settling transactions. It handles more than 30 million transactions worldwide on a daily basis. More than 200 countries and territories are connected to the system. Although governments realised the importance of SWIFT for sanction enforcement at an early stage, the company resisted initial attempts to obtain access to its information. After the 9/11 terrorist attacks, that position became untenable. As part of antiterrorism efforts, the US authorities successfully prevailed upon SWIFT to make information available.[29] Despite some public opposition, the EU tacitly agreed to the use of SWIFT for these purposes.

In 2012 the US authorities used SWIFT for the first time in the context of sanction enforcement. Treating the communication system as a financial service meant that the company fell within the scope of sanctions legislation when it provided communication services to sanctioned banks. In response, SWIFT itself decided to exclude various Iranian institutions from the system (self-compliance). Consequently, Iranian financial institutions, including the central bank, were no longer able to make or receive international payments. The EU adopted similar legislation. This led to trade being stopped not only between Iran and the US and the EU, but also trade with other states. It proved to be an effective way of pressuring Iran to come to the negotiating table and helped bring about the Iran nuclear deal (JCPOA) in 2015.

A final example of financial sanctions are those imposed on Russia after its invasion of Ukraine. In this case the US used the dominance of the greenback in a different way. Like many of the world's central banks and investors, Russia's central bank regarded the dollar as a safe haven and held substantial reserves of the currency (partly to 'defend' the Russian currency if needed). Many of these deposits are held in the US with the central bank or with private financial institutions. This meant that the US – and the EU, given Russia's substantial holdings of euros with central and commercial banks in the EU – could freeze these reserves. Consequently, Russia is unable to use its forex buffers to prop up its currency and economy.

In addition to these *direct* ways of wielding currency power, the dollar also increases the US's capacity to act *indirectly*: the 'exorbitant privilege' gives the country additional capacity to invest, for instance in gaining a military and technological lead over its rivals. In addition to using the power of the dollar as a 'stick', the US can also use it as a 'carrot'. In 1989, Poland's first democratically elected government, which was also pro-US, needed dollars fast. Without hesitation, the US did what was necessary, by providing a loan of USD 200 million. This was vitally important to the Polish government. But it also sent a clear signal to democratic forces elsewhere in Eastern Europe and in the Middle East. The dollar gave the US a powerful instrument to secure its strategic and geopolitical interests on the European continent, as it had done shortly after the Second World War by providing aid to Western Europe through the Marshall Plan.

2.6 Foreign exchange rate manipulation

A final way of exerting currency power beyond a country's own national borders is through currency manipulation. The accusations levelled by the US against the Chinese authorities that, in the interests of export-led growth, they are keeping the exchange rate of the renminbi against the dollar artificially low by buying dollars in large volumes, are well-known. Since 1988 the US has monitored the foreign exchange policies of other countries and may sanction them by designating them as 'currency manipulators', leading to the imposition of fines or exclusion from public procurement contracts in the US.[30] Besides China, likeminded countries are also being monitored under this legislation. According to the most recent report issued under the legislation, Switzerland is being subjected to enhanced analysis. Other countries on the monitoring list are Japan, South Korea, Germany, Malaysia, Singapore and Taiwan.[31]

During negotiations on the Transatlantic Trade and Investment Partnership (TTIP), a trade agreement between the US and the EU, Peter Navarro, head of the National Trade Council under President Trump, said: 'A big obstacle to viewing TTIP as a bilateral deal is Germany, which continues to exploit other countries in the EU as well as the US with an "implicit Deutsche Mark" that is grossly undervalued.'[32] It was a remarkable accusation. Since the start of the currency union, Germany has no longer been able to pursue its own monetary and exchange rate policies. The relatively high price of the dollar also stems partly from its role as international reserve currency; it is the flipside of the exorbitant privilege.

The US itself is also periodically accused by emerging economies of indirect foreign exchange manipulation as a result of loose monetary policy.[33] Under quantitative easing, a central bank purchases securities on the open market. As a result, the quantity of money in the market increases and interest rates fall, which stimulates domestic consumption. However, such a policy also has a dampening effect on the exchange rate. That is good news for exporters but not for their competitors abroad. The loose monetary policy of the 2010s was initiated by the Federal Reserve. Many other central banks followed suit.

2.7 To use or not to use?

Not every country whose currency has the potential to be used internationally is keen to let that happen. For example, until the 1980s the Deutsche Bundesbank resisted international use of the Deutsche mark. Scarred by the experience of hyperinflation in the years between the two World

Wars, the government maintained restrictions on the cross-border use of the Deutsche mark, for instance through restrictions on the issue of bonds.[34] Access to the domestic capital markets was also restricted. The use of the Deutsche mark as an 'anchor currency' was, however, permitted with a view to exchange rate stability (thereby having a positive effect on price stability).
In a similar vein, the Japanese authorities did not initially welcome the international rise of the yen after the Second World War. Japan's export-driven growth could have suffered under the higher exchange rate resulting from greater demand for the yen. Only in the 1980s – and partly under US pressure – did Japan begin to pursue currency liberalisation.[35] The push for internationalisation followed a major economic crisis in 1989 and the rise of China. It was hoped that internationalisation of the yen would protect Japan's economy against external shocks and strengthen its strategic position in the region. In 1996, the majority of the restrictions on cross-border capital transactions were abolished in a 'big bang'. Tokyo also put forward proposals for an Asian monetary fund in which the yen would be the dominant currency. Ultimately, attempts to pursue internationalisation of the yen were halted in the early 21st century owing to a lack of success. Since then Japan has taken a neutral position on internationalisation.

Both examples make clear that a distinction must be made between the *ability* to deploy currency power and the *will* to do so. The two do not always go hand in hand. The geopolitical ambitions of the country concerned are the decisive factor.[36]

The attitude of the UK to the international role of the pound illustrates the connection. After 1945 it quickly became clear that the pound was in decline internationally. That decline happened in parallel with the decolonisation of the British Empire, which resulted in the independence of India in 1947 and of countries in South East Asia and Africa in the 1960s. Whereas the early post-war UK governments actively resisted this colonial and monetary decline, later administrations more or less resigned themselves to it.[37] The turning point was the substantial devaluation of the pound against the dollar in November 1967. This step followed Israel's Six-Day War against its Arab neighbours and the resulting closure of the Suez Canal (once a proud British colonial project), which would drive up the price of oil imports for the UK. The more than 30 countries that still used sterling were dismayed by the decline in value of their currency reserves as a consequence of the devaluation. In cooperation with international partners and the Bank for International Settlements in Basel, London found a solution and thereby *de facto* changed course from resisting decline to managing decline.

As regards the relatively new euro, the European Central Bank initially showed itself to be the heir to the Deutsche Bundesbank of the 1980s. It took a neutral approach, neither hindering nor encouraging an international role for the currency.[38] Only in recent years has the ECB demonstrated a more positive attitude towards the internationalisation of the euro.[39] This has been primarily driven by a desire for greater monetary autonomy. The change of policy is of course tied in with the same international developments which in 2018 prompted the Juncker-led Commission to publish a communication on the international role of the euro (as well as prompting the Dutch government to request the present advisory report from the AIV).

China's change of course – from reticence to actively encouraging internationalisation – has been sharper than that of the EU. Only in the past 15 years has China gradually begun pursuing internationalisation of the renminbi. For a long time, a low exchange rate was more important to China's export-driven growth model than having an internationally prominent currency, as previously it had been to West Germany and Japan. Even in 2023 it is still not possible to conclude that China is making every effort to pursue internationalisation of the renminbi. But at the same time the country is taking steps to ensure that it will have currency power at its disposal in the future.

The last two examples illustrate a different distinction. It is not only about whether or not a currency should be used internationally, but also about offensive use as opposed to defensive use, in other words internationalisation in pursuit of *influence* and *autonomy*. Post-war West Germany, Japan, and the UK after 1968 no longer had geopolitical ambitions or the capacity to exercise influence abroad through their currency. This cleared the way for the US, which logically uses its currency power mainly for *offensive* purposes, to thwart its rivals or reward its allies. As a consequence, other currency blocs which are denied this tool are forced to consider a *defensive* strategy. Calculations about whether or not to pursue internationalisation are therefore changing for all monetary players, including the eurozone.

The process is in its early days. Nevertheless, the possibility cannot be excluded that the euro area members may take important steps in future to defend themselves against geopolitical shocks that make themselves felt through the currency, even steps that are currently still regarded as undesirable or unlikely in The Hague. The history of the euro and its predecessors since 1950 is after all not only a story of monetary integration for the sake of a single European market, but also illustrates the political will at key moments – in Bonn/Berlin, Paris, Brussels, Frankfurt and elsewhere – to work together to absorb setbacks and shocks and protect the EU's economic and political stability, where necessary through far-reaching monetary innovations.

▸ 2.8 Embedding of currency power within the multilateral order

Currency power has become institutionalised to a certain extent in international diplomatic relations, particularly in the form of the International Monetary Fund, established as part of the Bretton Woods agreement. In 1969 the IMF introduced 'special drawing rights' as an alternative store of value alongside the dollar and gold. The drawing rights are not a currency themselves, but consist of a basket of the world's major currencies, currently composed as follows: dollar (43%), euro (29%), renminbi (12%), yen (8%) and pound (7%). The weighting given to each individual currency in the basket is based on that currency's role in the international trade and financial system. Inclusion in the IMF currency basket is therefore confirmation of a currency's status in the international system: more prominent currencies weigh more heavily in the currency basket.

China spent a long time pushing to be included in the currency basket for the IMF's special drawing rights and these efforts bore success in 2016. Taken together with the increase in the renminbi's weighting in the currency basket in 2022, this reveals the renminbi's rise in terms of economic importance but also influence. The same applies to the absence of all of those countries whose currencies are not included in the basket.

The United States is the only party in the IMF with a *de facto* veto on important decisions. Consequently, it is not uncommon for IMF proposals to cause friction because they are viewed as 'American diktats'. Japan's proposal in the 1990s to establish an Asian Monetary Fund was a direct response to the liberalisation of capital flows imposed by the IMF in the wake of the Asian debt crisis, an idea that had been tabled by US diplomats in the 1980s. The debate unleashed in the EU in 2010 concerning a monetary rescue fund is also in keeping with this context: the European Stability Mechanism can be regarded as a 'European Monetary Fund'. Something similar applies to the New Development Bank, established on the initiative of the BRICS, although the Chinese and Brazilian presidents have been much more emphatic in presenting it as emancipation from the dollar order.

A brief political history of the euro

Contents

3.1 An increasingly resilient currency

It is essential to consider some of the central political issues in the history of European Monetary Union when issuing an advisory report on the international role of the euro. After all, the geostrategic dimension has never been absent from the decisions made from 1945 onwards that led to a single European currency and which have protected it since then.

There were of course also *other* motives underpinning monetary integration, such as practical and financial benefits, or expectations that the currency would be a driving force for unification. But in the minds of French presidents, German chancellors, EU representatives in Brussels or Frankfurt and other political officeholders, the strategic situation has always played and continues to play a role. Take for example Europe's relationship with the US and the dollar, the response to decolonisation or the fall of the Soviet empire. In addition, it is not always possible to distinguish clearly between motives. Particularly when it comes to the major breakthroughs in monetary integration – such as the establishment of the euro itself after the fall of the Berlin Wall in 1989 – we often see a convergence of economic interests, ideals and geostrategic necessity at specific moments in time.

European monetary integration is not only a technical project of central bankers and policymakers, but also – and above all – a series of political and institutional answers by states and institutions to shocks, each one of which has been of a new kind.[40] The currency thus becoming increasingly resilient.

A subdivision into four time periods highlights this dynamic: the periods after the Second World War (1945-1971), after the collapse of Bretton Woods (1971-1989), after the fall of the Berlin Wall (1989-2007) and after the collapse of Lehman Brothers (2008 onwards).

Originally, financial instability arose from *exchange rate volatility*, which was cushioned by the Bretton Woods system and then by the European Monetary System (EMS). Then it was inflation or *price instability* that had to be tamed, using the same EMS and, after that, EMU. Since 2008 the EU has also experienced *financial instability*, which has been tackled using a range of instruments, such as the rescue funds of the European Stability Mechanism (ESM). The *geopolitical volatility* with which the EU has recently been confronted is therefore part of a pattern.

3.2 After the Second World War: Bretton Woods (1945-1971)

The earliest moves towards West European economic integration took shape in the shadow of the power of the dollar in the years immediately after the Second World War. Under the Bretton Woods system, all participating currencies were assigned a fixed exchange rate in relation to the dollar (see also Chapter 2). The dollar remained the only currency that was directly convertible into gold. This amounted to the introduction of an indirect gold standard, centred on the dollar. The reliability of the dollar was beyond dispute, which offered stability. This was good for the economy. In a geopolitical sense, Bretton Woods operated as the financial-economic axis around which Western economies rotated.

It quickly became clear that the power of the dollar was not unlimited and that it entailed responsibilities. Consequently, after a balance of payments crisis in the United Kingdom in 1949, the US had to step in and provide dollar guarantees to keep Bretton Woods in place and prevent fragmentation in the West. The rescue by the US also involved another innovation; it took shape within the European Payments Union (EPU), a system for settlements and credits that was set up by the Western Europeans themselves. The aim was to restore currency convertibility, in other words the possibility of trading in currencies.

The EPU was connected with a new European reality. The emergence of intra-European trade made continental Europe less vulnerable to external turbulence. Countries were able to focus more on one another and trade among themselves. The driving force behind these developments was the impressive recovery of the West German economy. The growth in German imports gave an enormous boost to neighbouring economies (at the expense of the British). This became clear during the UK recession of 1949: the continental Western European countries surrounding Germany were largely unscathed. That had a certain value.

The EPU was intended to free intra-European trade, through currency reform, from the shackles of 'bilateralism'. This challenge was therefore embarked on before the European Coal and Steel Community (ECSC), the earliest of the EU's predecessors, even existed. But it was a slow process. Ultimately convertibility was not achieved until 1958, which not coincidentally was the year in which the European Economic Community (EEC) came into being (in France, Germany, Italy and the Benelux).[41] Even in the subsequent decades, European market and currency initiatives were often interconnected.

From the signing of its founding treaty in 1957 onwards, the European Common Market was plagued by currency crises. Increasing trade surpluses and competitiveness in northern Europe generated centrifugal forces. Vulnerable prestige projects aimed at Franco-German reconciliation, such as the Common Agricultural Policy, were able to function only thanks to a certain level of price stability and exchange rate predictability. However, that stability and predictability was constantly jeopardised by currency crises. As early as the 1950s, the situation gave rise to the first blueprints for a European Central Bank. For many decades though, that was considered a step too far and all that happened was policy coordination. Although a more accurate description would be: *ad hoc* crisis management.

Nevertheless, these initiatives were increasingly at odds with the economic and geopolitical agenda of the US. At the start of the 1960s, with President Kennedy in the White House, the country's self-confidence had reached historic heights. The US government pursued its own plans in Cuba, Vietnam and Berlin. At the same time, Washington was also the driving force behind European negotiations with the UK regarding the accession of the latter to the EEC. During a *tête-à-tête* in July 1962 in Paris, West German Chancellor Konrad Adenauer asked French President Charles de Gaulle for his take on the situation. Essentially, De Gaulle's answer was: 'Europe is one world, the English-speaking countries are another.' For the French President, this was the main reason why France and Germany needed to forge closer ties, before the British got involved. Paris had plenty of plans for such a step – for instance a European Monetary Fund, or even a currency union, as a logical follow-up to the EPU and the common market. Such a project would send a powerful signal that Western Europe was standing more firmly on its own two feet.

3.3 After the collapse of Bretton Woods: the EMS (1971-1989)

In the 1960s the war in Vietnam and the major domestic investment programmes of President Johnson in the US led to a substantial budget deficit, rising national debt and further issuance of dollars. However, owing to the dollar's central role and its function as a reserve currency, the dollar's exchange rate remained as high as ever, which caused a balance of payments deficit for the US and a decrease in the gold reserves. The value of dollars in circulation worldwide was quadruple the value of the gold stock held by the Federal Reserve. The indirect gold standard was therefore no longer tenable.

In August 1971 President Nixon ended the dollar's convertibility to gold. Because the US had taken this decision completely unilaterally and without consulting its international partners, it is also referred to as the 'Nixon shock'. The unilateral nature of the decision was encapsulated in the remark made by US Treasury Secretary John Connally at the G-10 summit that year: 'The dollar is our currency, but it's your problem'. In 1973 the EEC member states and Japan ended the fixed exchange rates of their currencies against the dollar. The end of Bretton Woods was ratified in the Jamaica Accords of 1976.

European countries would now have to control the volatility of their exchange rates themselves, without the dollar standard. Floating, fluctuating exchange rates once again necessitated *ad hoc* crisis management. In essence this was a bilateral matter between France and Germany, with a fixed pattern of roles. During each currency crisis, Paris would ask for greater solidarity, in the form of funds. Bonn would reject the establishment of funds, but ultimately pay up once a crisis had escalated to such an extent that it put European cooperation in jeopardy. In other words, in this Europe, West Germany took on the role previously played by the US.

And that was not all. The lack of budgetary discipline led to the US exporting inevitable and worrying inflation to Europe through the financial markets. Helmut Schmidt, Germany's chancellor in the 1970s, regarded this instability forced on Europe by the US (through imported inflation) as unacceptable. Schmidt's call for the 'rebuilding of Bretton Woods in Europe' led to the European Monetary System (1979).

Like Bretton Woods, the EMS was based on fixed exchange rates. The aim was for the twelve participating countries in the EMS to allow their currencies to move within fixed ranges relative to a central rate in order to prevent large fluctuations.[42] The exchange rates were calculated in the European Exchange Rate Mechanism (ERM). None of the national currencies in the EMS officially had the role of anchor currency. However, unofficially the German mark proved to be dominant. The Bundesbank in Frankfurt had a strong mandate to limit inflation and maintain price stability. Given Germany's central position – and to the dissatisfaction of France – the other member states were also confined by these parameters. The EMS also brought with it the introduction of the European Currency Unit (ECU): a unit of account that represented the weighted average of the currencies of the participating countries. The EMS and its ECU would pave the way for the euro.

3.4 After the fall of the Berlin Wall: a single currency (1989-2007)

After the fall of the Berlin Wall, on 9 November 1989, the Cold War was consigned to history. An integrating Europe could no longer avoid taking independent responsibility for its position in the world. The market-centred European Community was transformed into a new, more political Union, in which issues of security and defence were given a role for the first time. The breakthrough towards a single currency also took shape.

Once again, a fixed pattern of roles became apparent. French President François Mitterrand was the strongest advocate of a single currency, while the European Commission under its president Jacques Delors – together with the 12 central bank presidents of the member states – laid the groundwork from 1988 onwards. Only shortly after the fall of the Berlin Wall did the Federal Republic of Germany, led by Chancellor Helmut Kohl, agree to this step, partly – at a time of suspicions about (rapid) German reunification – as a way of emphasising his country's attachment to the European project on the international stage.

The Treaty of Maastricht laid the basis for Economic and Monetary Union and therefore for the euro.[43] It provided for:

- a common financial market without internal borders;
- convergence policy to coordinate economic policy;
- a European Monetary Institute (EMI) as a forerunner to the independent European Central Bank (ECB) and European System of Central Banks (ESCB) that would be established in 1998;
- the creation of Monetary Union and a single European currency by no later than 1999.

Soon after this ambitious agreement had been reached, the existing, more modest European Monetary System fell apart. In the aftermath of German reunification (1990) economic developments in Europe diverged strongly and could no longer be covered by uniform monetary policy. The German Bundesbank kept interest rates relatively high, which – on account of the German mark's *de facto* role as anchor currency – impeded the economic growth of other countries. Following massive capital flight, the British pound and the Italian lira were decoupled from the central rate under the EMS in 1993.

This meant that reasons arose very quickly to supplement the currency-related agreements concluded in Maastricht. To this end, in 1996 the principles of the Stability and Growth Pact were agreed in Dublin in order to strengthen the budgetary discipline of the future eurozone countries.[44] A new Exchange Rate Mechanism was also established (ERM II), a successor to the defunct ERM, with the aim of keeping watch over price stability and exchange rates in countries that had not yet joined the eurozone.

The euro was introduced in 1999, initially in non-physical form for electronic payments, for the issue of government bonds and for accounting purposes. In 2002 the banknotes and coins came into circulation, entering into the daily lives and appearing in the wallets of residents of the Netherlands and eleven other member states.

3.5 After the collapse of Lehman Brothers: rescue activities (2008 to present day)

The mood of optimism in Europe and the world in general was short lived. The Cold War may have ended in 1989 but predictions of the 'end of history' proved to be premature. New financial crises ensued. The countries of the eurozone may no longer have had to put up with exchange rate shocks among themselves since 1999, but it was still possible for economic imbalances and weaknesses to emerge in other ways.

The banking crisis that began in the US in 2007 and culminated in the bankruptcy of the investment bank Lehman Brothers (in September 2008) caused considerable turbulence for Europe's economies and credit systems. In the years that followed the markets lost confidence in the solvency of several EU member states, including Greece, Ireland and Portugal and in that of a number of major banks. Financial instability was the new threat and it even jeopardised the continuity of European Monetary Union itself.

While from 1999 onwards the newly established euro had been proof to the world of the success of European integration, conversely the currency's fight to survive now had an impact on the international reputation of the EU and its member states. The currency had to be saved.

To do so, Europe's political leaders, and in turn the ECB, took far-reaching decisions between 2010 and 2012. The foundations of the euro were reinforced. A noteworthy development was the establishment of rescue funds to stave off national bankruptcies. After a few *ad hoc* operations, these funds evolved into the European Stability Mechanism (ESM). Politicians in Berlin, Paris, Brussels and Frankfurt regarded the prospect of an EU member state like Greece having to turn to the IMF for financial support as a humiliation.

During the eurozone crisis of 2010-2012, other steps that could have enabled the eurozone to increase confidence were regarded as unnecessary by Berlin and The Hague. The issuance of common debt instruments or 'eurobonds', which France and Southern Europe had previously advocated, remained a red line. The same applied to transfers between member states. During the COVID-19 pandemic of 2020-2022, which caused major political tensions between Northern and Southern Europe and briefly threated to cause a new eurozone crisis, this changed. Germany's Chancellor Angela Merkel offered scope for both taboos to be breached on a one-off basis. In 2020 the European Council unanimously decided to establish the NextGenerationEU support funds, funded by the issuance of common debt ('corona bonds'), with part of the support being paid out as grants.

The 2008 financial crisis in the EU and Europe not only brought with it internal turbulence, but it also accelerated the political rise of China and the emergence of a multipolar order. In institutional terms this was reflected in the establishment of the G20 at the level of heads of state/government in 2008: for the first time the G7/G8 of major industrial nations would no longer suffice for a proper discussion of the world's financial and economic relations; China, India, Brazil and other major economies were also given a seat at the table. The panic and chaos on the other side of the Atlantic during the Lehman crisis also caused China to lose its respect for Western financial ingenuity. Since then China has been building its own financial and monetary order, including multilateral financial institutions (such as the Asian Infrastructure Investment Bank, founded in 2015).

In summary, the unipolar years (1989-2007) of globalisation under US leadership, in which the newly established euro flourished, were brought to an end by the banking crisis of 2008. Although this did not really cause trouble for the dollar, the crisis did pose a test to the euro (which armed itself against new shocks) and encouraged the further development of the Chinese renminbi.

The evolution of global currencies in figures: the dollar, the euro and the renminbi

4.1 The functions of an international currency

An international currency is one that is used beyond the borders of the country of issue. An international currency fulfils three functions that are used by both private- and public-sector actors as summarised in table 1.

	unit of account	medium of exchange	store of value
private	pricing	settlement of (foreign exchange) transactions	investment
public	anchor	intervention (in foreign exchange market)	reserve

Table 1 - Functions of international currencies. Source: Krugman (1991)

Currencies are used by businesses or financial institutions as a *unit of account* to price goods or financial instruments. A familiar example is the pricing of oil in dollars. Governments can use a currency as a reference point or anchor if they tie the value of their own currency to an anchor currency.

A currency is used as a *medium of exchange* when it is used by businesses to pay for imports or exports of goods and services. This function is closely connected with its function as a unit of account, but there is a distinction. For example, while the price of oil and other commodities is often denominated in dollars (the dollar is the unit of account), exporters and importers may agree that payment will be made in euros or yen (in which case the euro or the yen is the medium of exchange). The same applies to the use of the currency as a means of exchange by public-sector actors: a country that has pegged its currency to an anchor currency must buy and sell that foreign currency in order to hold the peg (*medium of exchange*). To this end, a country must maintain foreign currency reserves, which brings us to the final function of an international currency, namely that as a store of value. In this respect the different functions of the currency reinforce each other in the process of internationalisation. The more a currency is used as a medium of exchange, the greater the chance that it will also be used as a unit of account or store of value.

Currencies are used by both private- and public-sector parties as a *store of value* through holdings of savings deposits. Savings deposits are held in different countries and currencies with a view to optimising the risk/return ratio. Besides the motivation to save, governments need foreign currency deposits to carry out currency interventions if they wish to pursue a particular exchange rate policy.

In cross-border transactions settled using an international currency, it is logical for a private or public party from the country of issue to be involved, for example a Dutch exporter who is paid in euros by their Turkish importer. But currencies can also be used in international dealings without the involvement of a party from the country of issue. For instance, the Turkish importer could also pay in dollars, either directly or indirectly, in the latter case with Turkish lira first being converted into dollars and then dollars into euros. In this example the dollar is referred to as a 'vehicle currency'. The more frequently this occurs, the greater the currency's international role.[45]

All three functions are relevant to the exercise of currency power. Thus, the fact that oil and important commodities are priced in dollars contributes to the international use and the international reputation of the dollar. The dollar's role as a medium of exchange, notably as a vehicle currency, combined with the US's large and efficient financial system, is a decisive factor in the ability of the United States to deploy financial sanctions. That said, the dollar's function as reserve currency, which is described in chapter 2 and forms the basis for the country's 'exorbitant privilege', is the primary source of currency power.

4.2 The degree of use by function

Figure 1 shows that the international use of a currency is not an immutable fact. The most striking development is the turnaround that saw the US dollar replace the British pound sterling as the dominant reserve currency in the period following the Second World War. But there are also other noticeable trends, such as the emergence of the Deutsche mark and the Japanese yen from the 1960s onwards and, in 1999, the introduction of the euro, which inherited the status of the national currencies of the euro area members, especially the D-mark.

Figure 1 also shows that no one currency enjoys an absolute monopoly. While the dollar has been dominant since the Second World War, there has also been room for other currencies such as the D-mark, the yen and the euro.

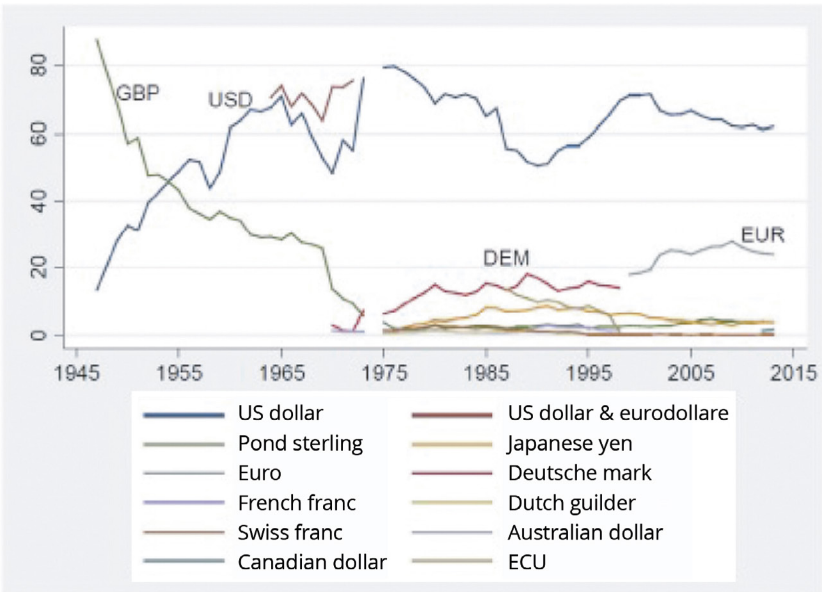


Figure 1 - Currency composition of foreign exchange reserves (store of value) Source: Eichengreen, Chitu and Mehl (2014)

The degree to which a currency assumes an international role (and by extension its ability to confer currency power) can be measured along two dimensions: the functions that it performs in the international system and its geographical reach.

Figure 2 shows the current international position of four international currencies (the dollar, the euro, the yen and the renminbi) as stores of value and mediums of exchange. It highlights the pre-eminent role played by the dollar in the international financial system and the fact that it vastly outperforms the other international currencies on almost all counts. The three panels on the left show that, as a public and private store of value, measured as a share of holdings of foreign exchange reserves, international debt issuance and outstanding international loans, the dollar is eclipsing the other currencies. The euro takes a good second place, comfortably ahead of the yen and the renminbi. The two panels on the right indicate that the differences between the currencies as mediums of exchange are smaller. The foreign exchange market (second panel from the right) is dominated by the dollar. Here the dollar's role as a vehicle currency is clear. Thus, while the US and the eurozone have an almost equal share of global trade (around 15%), the dollar is used nearly three times as much as the euro in foreign exchange transactions. The figure for the renminbi was around 7% in 2022, although China's share of global trade is considerably greater. As a means of payment however, measured as the currency's share of payments recorded in the SWIFT interbank payment system, the euro is vying with the dollar for first place.[46] The yen and the renminbi remain far behind on this score.

Note: The latest data for foreign exchange reserves, international debt and international loans are for the fourth quarter of 2021. Foreign exchange turnover data as of April 2019. SWIFT data as of December 2021.

Figure 2 - Different currencies as stores of value and mediums of exchange in 2021. Source: ECB (2022)

4.3 Geographical reach

Besides being the most-used currency worldwide, the dollar also has the greatest geographical reach and clout. Figure 3 (left panel) shows that the dollar, as a private unit of account (expressed as a percentage of exports invoiced in the currency), is used in all regions of the world.

By contrast, the euro is used for invoicing mainly in and around the EU or in countries that have historical ties with EU member states (particularly countries in Africa). The dollar has a far greater share in Asia and Latin America, despite the fact that the EU is an important trading partner of Asia. The renminbi and the yen also lack global reach, their relevance being limited primarily to their own region. The respective roles fulfilled by the currencies as a public unit of account or anchor currency confirms this picture (figure 3, right panel). The countries that peg their currency to the euro lie mainly in the EU's periphery or have historical connections with EU countries. The dollar on the other hand has a more global reach. The Japanese yen is barely used as an anchor currency and the value of the renminbi has been tied to the dollar since 1994.

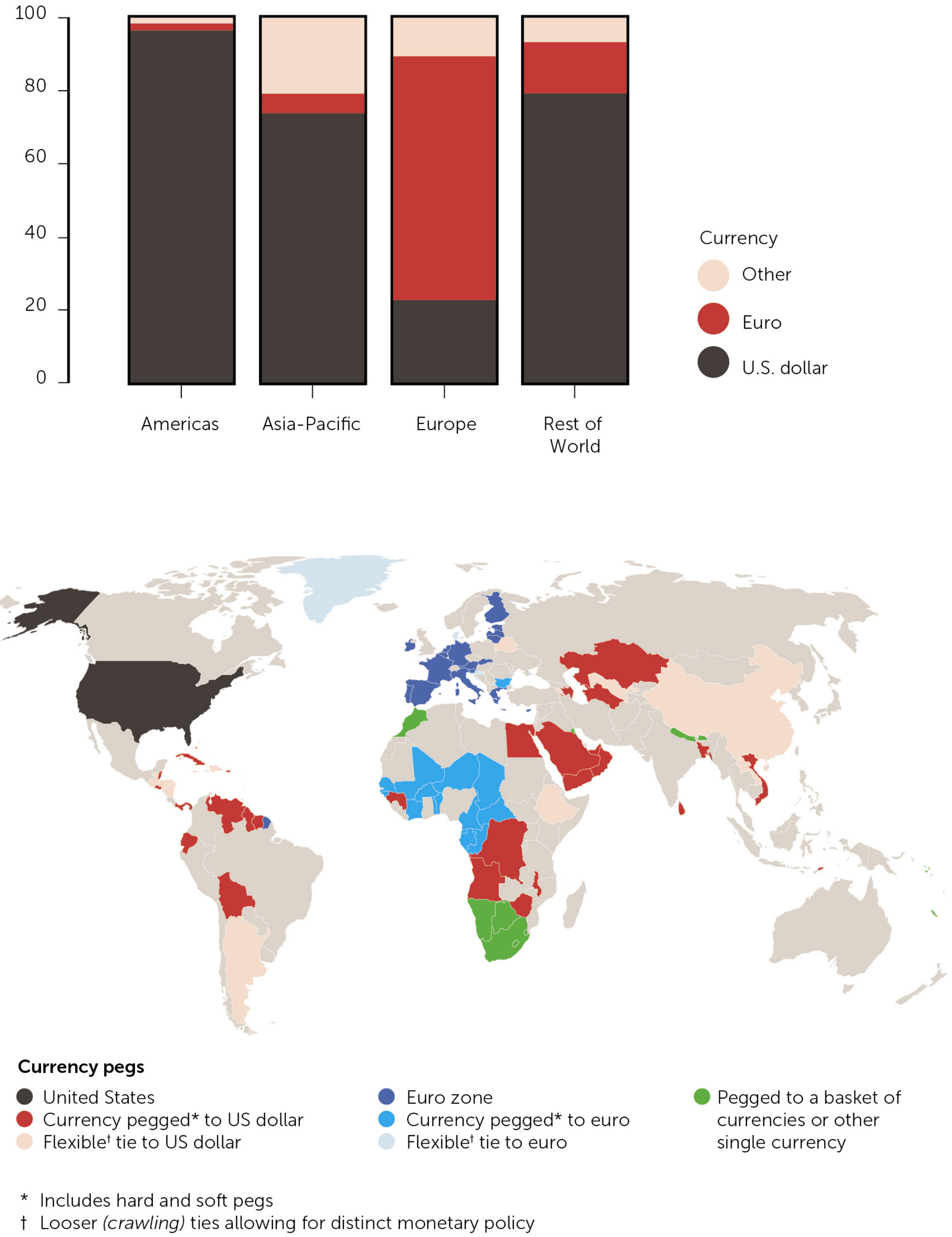


Figure 3 - The importance of international currencies as units of account. Source: Bertaut, Von Beschwitz and Curcuru (2021) and The Economist

What determines currency internationalisation?

5.1 Confidence

Adam Smith, the founder of economics as an academic discipline, asserted that 'All money is a matter of belief'. The use of a currency ultimately depends on whether there is confidence that it will be usable both now and in the future and that it will retain its value. This confidence is rooted not only in economic factors but also in a belief in a country's strategic and diplomatic might.

5.2 Economy: a stable, large and liquid market

A policy context that inspires confidence

In the economic arena, pertinent factors include a country's current account balance, its debt position and its fiscal policy. Monetary policy is also important: it can instil confidence if, for example, it is characterised by a consistent and apolitical focus on low inflation and a stable exchange rate, but it can also undermine confidence if it is erratic. In general, transparency and predictability in national and international policy and action tend to bolster confidence in a currency.

The ECB has a strong mandate to ensure price stability and is safeguarded against political interference in formulating monetary policy. In part the ECB inherited the reputation and the confidence enjoyed by the Bundesbank in this area. This inspires confidence, as does the firm entrenchment of the rule of law and stable institutions in the eurozone countries.

On the other hand, the euro is still very much a newcomer compared with the dollar, the British pound sterling or the Swiss franc, and so does not yet command the kind of authority that is established over time. And since the European Union is not a federal state like the United States, the eurozone lacks a central government that can take decisive action in a crisis and make a political decision to prop up the credit system. In the European debt crisis of 2010-2012, the lack of such a lender of last resort triggered a crisis of confidence that put the currency union under severe strain. Since then the ECB has *de facto* assumed this role and the eurozone's architecture has been manifestly reinforced by, among other things, stricter requirements for banks, the introduction of central banking supervision with a single resolution mechanism, and a permanent rescue fund, the European Stability Mechanism (ESM). Nevertheless, the euro has not yet been able to win back the standing as a reserve currency that it enjoyed prior to the crisis.

Nor does the track record of the Chinese renminbi compare to that of the dollar. Among other things, a lack of transparency with regard to decision-making and policy limits the confidence of market participants in the renminbi. Conversely, the long tradition and strict enforcement of banking secrecy in Switzerland underpin confidence in and the international use of the Swiss franc as a reserve currency.

Volume

The international use of a currency is primarily dictated by convenience, of which the main determinants are volume and liquidity.

As the volume of transactions rises, their costs fall. A comparison with language use may be instructive. The more people speak the same language, the easier and quicker the conversation will flow. Interpreters, interruptions and explanations are not required. When the participants meet again, it is highly likely that they will employ the same language and that new people who join the conversation will follow suit.

These kinds of network effects and dynamic benefits of scale are also observable in in economic interactions as they make it easier to find a counterparty for a transaction in a particular currency, and systems will be geared to that currency's use. As departing from this norm costs time, money and effort, parties are more reluctant to switch to a different currency. This inertia bestows an inherent advantage on the biggest currency over other currencies, and means the transition to a different dominant currency tends to proceed in fits and starts.

That being said, it is clear from the relative differences in the use of the dollar, the euro and the renminbi (see chapter 4) that volume is not the sole determinant. The EU is the smallest of the three economic blocs, but in terms of international use it clearly occupies second place. In other words, the renminbi is performing below its potential.

Liquidity

Furthermore, a currency benefits from a liquid, well-developed financial market. The broader and deeper a financial market is, the more likely it is that a company will find forms of financing that satisfy its credit requirements in terms of costs, maturity and other conditions.[47] For investors and creditors, the availability of a wider variety of investment instruments makes it simpler to achieve the desired risk-return ratio in their investment portfolio.

The international accessibility of the financial market depends on openness: the extent to which the market is unfettered by capital restrictions. For the reserve function of a currency, it is essential that quick and unlimited access to reserves is guaranteed in times of adversity.

With its deep, open and well-developed capital markets, the US enjoys a clear lead in terms of liquidity over all its competitors. The main factor undermining the status of the US as a safe haven is the weaponisation of the dollar system itself. It is prompting not only its rivals, Russia and China, but also countries like Brazil, Saudi Arabia, India and South Africa to pursue de-dollarisation.[48] Saudi Arabia is experimenting with the petro-yuan as an alternative to the petro-dollar. India is seeking to participate in the Russian and Chinese versions of SWIFT and CHIPS. In response to extraterritorial sanctions, China, Panama, South Africa and Singapore have adopted legislation comparable to the EU Blocking Statute. India also has a variant of INSTEX, the mechanism set up in the aftermath of the imposition of sanctions on Iran. In early 2023, Brazil and China concluded an agreement to facilitate the settlement of bilateral trade in renminbi.[49] China has concluded a similar agreement with Pakistan. Brazil and Argentina have their sights set on their own regional currency in order to reduce dollar dependence in the region. Following the sanctions imposed on the Maduro regime, Venezuela launched a cryptocurrency, the 'petro'. Finally, the African continent appears to offer fertile ground for the rollout of alternative electronic payment systems such as the digital renminbi.[50] South Africa is already testing a digital currency that can be used for cross-border payments as an alternative to SWIFT.

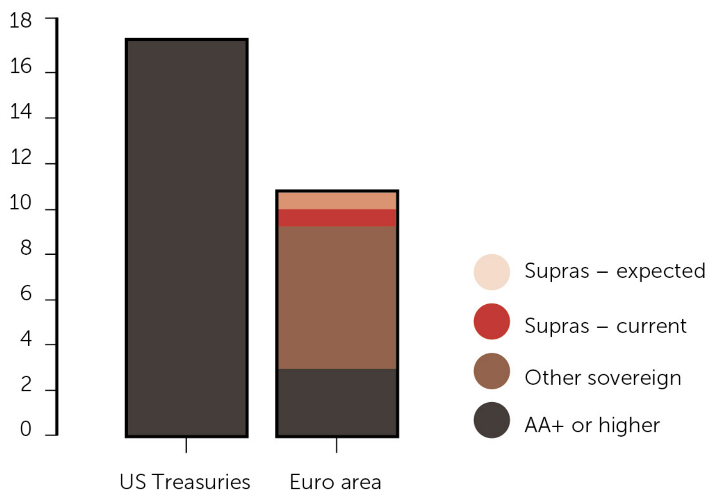
Despite recent moves towards limited liberalisation, the Chinese capital market places considerable restrictions on international capital flows, limits on the convertibility of the renminbi and has a lower degree of development and innovation. The renminbi is limited as an international reserve currency by, in particular, the restrictions on international capital flows and convertibility. Deposits held in renminbi are, after all, not withdrawable on demand in all circumstances.

The eurozone is likewise not comparable to the US in this regard. While the EU's banking and capital markets are open, they are still strongly fragmented, with national legislation and national supervisory authorities. This gives rise to uncertainties, information asymmetry, and home bias, that is to say a preference for investment and financing within the national system. Since the credit crisis, there has if anything been a fall in the number of cross-border banks.[51] Moreover, the absence of a genuine European financial market increases the risk of eurozone fragmentation. In the United States, the capital markets absorb 39% of state-specific shocks, as against 8% of country-specific shocks in the eurozone.[52]

In addition, the financial market in the EU is heavily oriented towards bank lending, whereas financing is raised in the US mainly by issuing shares or bonds on the capital markets (see figure 4, right panel).[53] Bank debts cannot be traded as easily as bonds and shares. This makes for a narrower market. And bank lending also confers a strong home-country advantage, as it is necessarily based on relationships between banks and customers.

Euro area and US sovereign and supranational dept

(in $ trillion, as of 2020)



Corporate debt

(in % of GDP, as of 2020)

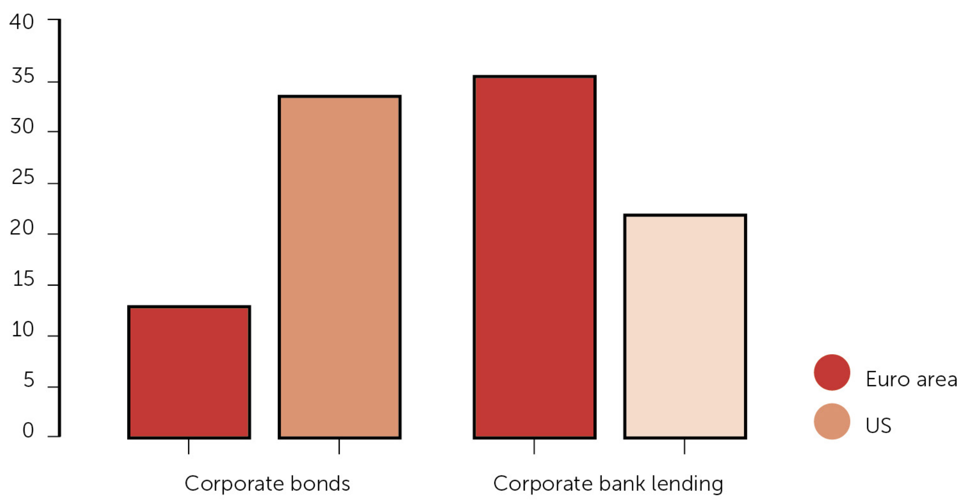


Figure 4 - Characteristics of the capital markets in the eurozone and the United States. Source: ESM (2021)

Finally, risk-free or low-risk investments are in relatively short supply in the eurozone. US Treasury bonds account for 60% of global government debt rated AA+ or higher.[54] Only a limited number of EU member states have an AA+ rating (see figure 4, left panel). This number has fallen further over the past decade, partly as a consequence of the sovereign debt crisis. Nor is there an EU-wide risk-free investment instrument. This means that the EU does not yet have enough to offer the rest of the world in order to challenge the supremacy of the US as the safe haven for investments.

5.3 Politics: a stable and resilient state

A country's strategic, diplomatic and military strength partly determines the extent to which actors in other countries are willing to hold its currency as part of their reserves or to use it to make payments. If a state is liable at any moment to be overrun by a dangerous neighbour, its currency will enjoy little confidence internationally regardless of the solidity of its monetary policy or debt position. In the last instance, confidence in the currency demands confidence in the state. Chapter 2 showed that major shifts in the international position of a currency are often linked to major geopolitical events, such as war, decolonisation or financial aid programmes.

By reason of its political, military and economic supremacy after 1945, the US was able to take the lead in the design of the new international monetary and financial landscape, with a pivotal role for the dollar and a *de facto* veto for the US in the IMF. In exchange for security guarantees, strategic partners such as Saudi Arabia accepted the dollar's pre-eminence in the international oil market and trade in general. Germany and Japan opted for the same reason not to call the dollar's power into question in the second half of the twentieth century.

China is also using economic partnerships, through its 'Belt and Road Initiative', as a means to strengthen the international position of the renminbi. But these partnerships are asymmetrical. The resolution of legal disputes falls largely under Chinese jurisdiction. In this way, Beijing's political and legal sphere of influence is being expanded. Figure 5 below illustrates the considerable extent of China's financial sphere of influence, which even reaches as far as the EU and its neighbourhood.

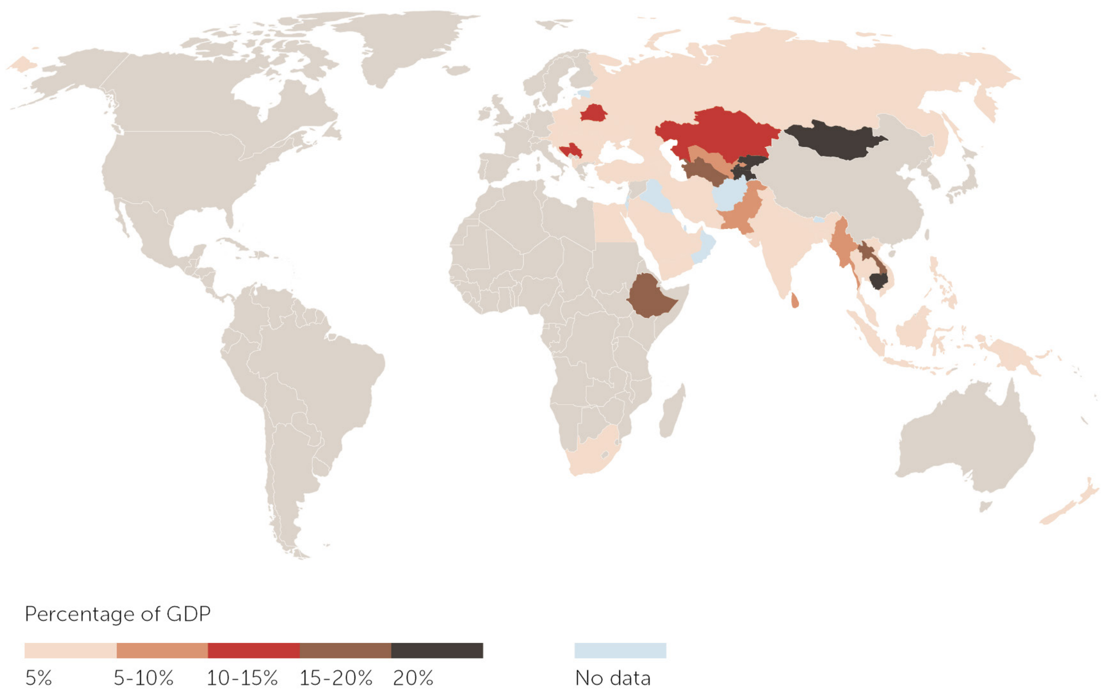


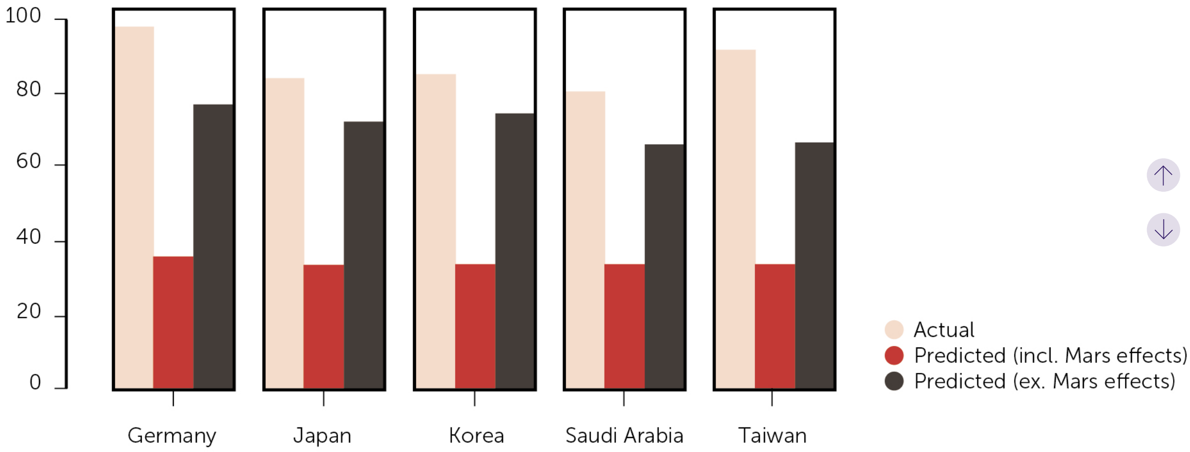
Figure 5 - External debt to China as a percentage of GDP. Source: https://www.cfr.org/article/belt-and-road-tracker

5.4 Who holds greater sway: Mars or Mercury?

Recently three researchers dissected the interplay of economic and geostrategic factors that explain why countries choose a particular international currency over another. They did so using terminology referring to Mars (the Roman god of war) and Mercury (the Roman god of commerce). Their research shows that 'Mercury' factors such as economic costs and benefits, liquidity, trade relations etc. cannot entirely explain choices of reserve currencies.

Strategic or diplomatic considerations ('Mars') are also relevant, and are part of the reason why an oil exporter like Saudi Arabia holds far larger dollar reserves than its fellow exporter Russia, and why Japan holds far greater dollar reserves than China, and why the Federal Republic of Germany – unlike France – holds practically all its reserves in dollars. Since while Saudi Arabia, Japan and Germany are strategically dependent on the United States' nuclear arsenal, Russia, China and France have nuclear weapons of their own to deter potential adversaries. Washington has on occasion not hesitated to put pressure on Bonn or Tokyo to support the dollar.[55]

The researchers conclude that the dollar reserves of countries that rely on the US for their security are 30 percentage points higher than those of nuclear powers. Conversely, for the US this represents a 'geopolitical premium' in the currency choices of other states, strengthening its 'exorbitant privilege'.



Note: The figure shows the predicted shares of the US dollar in the foreign reserve holdings of five countries which depend on the US for their security now. Predicted shares are computed under two scenarios: (i) using the model estimates reported in Table 8, column (6), i.e. including the effects of defence pacts (shown as dark brown bars); (ii) excluding the effects of defence pacts (shown as red bars). Actual currency shares are shown as salmon coloredbars. Credibility effects are measured using sovereign debt ratings.

Figure 6 - Importance of geopolitical versus economic factors in reserve currency choice. Source: Eichengreen *et al.* (2019)

This figure shows that economic factors (light grey bars) only explain part of the dollar's actual share in official reserves (black bars). A combination of the Mercury and the Mars hypotheses (dark grey bars) explains a considerably greater share of the whole.

Having analysed the currency composition of reserves held in the period 1890-1913, the authors found a similar correlation: a defence pact boosted the share of a currency in the partner country's reserves by an average of 33%. In this way the share of the French franc in international currency transactions rose from 17% in 1899 to 31% in 1913 while that of sterling fell from 65% to 48%. This was directly linked to a Franco-Russian military alliance that, in line with the Mars hypothesis, prompted Russia to use Paris as a financial centre for government loans.

A combination of Mars and Mercury factors cannot entirely explain the motives involved in a currency choice. Inertia and network effects also play an important role. Once a currency is being used, it costs time, money and effort to change systems and relationships. Sterling – with London as an important financial centre – still plays a major role in foreign currency trading that is out of proportion to the strength of the British economy.

5.5 Conclusion

Both economic (Mercury) and strategic (Mars) factors underpin international currency choices. Confidence in the currency and in the state is the deciding factor from both perspectives. In the case of Mars, there can be an element of hard or soft coercion in favour of a reserve currency, exercised for example by a colonial power in respect of colony or a military protector in respect of the country it protects.

What does this analysis mean for the international role of the euro? As far as economic factors are concerned, the picture is clear: the two main tracks leading to the broader use of the euro are an EMU institutional framework that inspires greater confidence and a financial market with higher volumes and higher liquidity.

As for strategic factors, the situation is also straightforward on paper: a more unified EU foreign policy, as has emerged recently in response to Russia's invasion of Ukraine, presents a path to increased confidence in the euro and the currency union.[56] However, it is likely that steps in this direction will in the first instance be made on the basis of 'Mars' factors, motivated squarely by security considerations, and not by the position of the euro as such. The big question as to how a strategically and militarily stronger European Union can be forged falls outside the scope of this advisory report.

This report adopts the reverse perspective, focusing on how the EU, through greater international use of the euro, motivated for the time being primarily by 'Mercury' factors, can strengthen its role on the world stage and/or reduce strategic vulnerabilities.

Policy options for euro-internationalisation

The government cannot compel market participants – whether they be private individuals, businesses, financial intermediaries or other governments – to use a particular currency. However, governments can create the necessary conditions to stimulate the international use of their currencies. Here, the various policy options are outlined on the basis of the three main functions of international currencies, as described in chapter 4 and reproduced below. A fourth category of options for action touches upon the institutional architecture of the eurozone.

	unit of account	**medium of exchange**	**store of value**
private	pricing	settlement of (foreign exchange) transactions	investment
public	anchor	intervention (in foreign exchange market)	reserve

Table 1 - Functions of international currencies. Source: Krugman (1991)

6.1 As a unit of account

As set out in chapter 4, use as a unit of account is not the most important function for accruing currency power, but it would be a prelude to the use of the euro as a medium of exchange or store of value. This role also contributes to a currency's international reputation. Consider, for example, the use of petro-dollars, which stimulates the use of the dollar as a reserve currency owing to the pricing of commodities, in particular oil, in dollars.

In this regard, the energy transition and the green transition are sources of opportunity. As yet there is no global benchmark currency for trading new forms of energy. This is recognised by the EU, the European Commissioner for energy having noted that: 'We have an opportunity to develop the EU hydrogen economy into a reference market and establish a reliable benchmark for euro-denominated transactions.'[57] While fossil fuels are traded on global markets, the shift to greener and more local sources of energy offers opportunities to price energy in local currencies such as the euro. Also in contracts with third countries outside the EU there is scope for invoicing in euros because dollar use is less entrenched in these markets. This would represent a shift from the petro-dollar to the 'hydro-euro'.[58] It is also possible to encourage the use of the euro for the invoicing and payment of traditional energy sources. China for instance is pursuing greater use of the renminbi (the petro-yuan) in oil deals. Besides the deal recently struck with Saudi Arabia mentioned in chapter 2, China had already concluded energy contracts with Qatar in renminbi in 2014. In 2016, India and Iran signed oil contracts in rupees. A recent contract between Bangladesh and Russia to build a nuclear power plant in Rooppur was concluded in renminbi.[59]

A Commission communication from 2018 called on member states to conclude bilateral energy contracts in euros, and for the EIB and EBRD to make a greater commitment to euro-based contracts.[60] The euro's share in natural gas contracts concluded between 2018 and 2020 rose from 38% to 64%. On the other hand, a large LNG contract in November 2022 between Qatar and the German LNG terminal in Brunsbüttel was probably concluded not in euros but in dollars. And the French company TotalEnergies recently agreed a sale of LNG with the Chinese oil company CNOOC in renminbi. Convincing private-sector market operators in Europe to incur additional costs and make extra efforts for the sake of strengthening the international role of the euro requires greater political pressure and powers of persuasion.

The euro's anchor function – the public counterpart of the private unit of account – does not contribute significantly to the currency's international use. Member states of the Union, except those like Denmark that have negotiated an opt-out, are expected to adopt the euro in due course. But before they can do so, they must tie their national currency to the euro for at least two years under the EU's Exchange Rate Mechanism (ERM II). This is a condition for joining the euro area in order to demonstrate that mutual economic differences do not present fragmentation risks that, with flexible exchange rates, necessitate currency devaluation. A second group of countries outside the EU, such as the Republic of Kosovo, Montenegro and a large number of countries in West and Central Africa, tie their currencies voluntarily to the euro to benefit from the stability of a fixed exchange rate with an important trading partner. The ECB's monetary policy has a direct impact on these countries, which entails a certain responsibility.

6.2 As a private medium of exchange

The sanctions imposed by the US on Iran after the former's unilateral withdrawal from the JCPOA, and its more recent sanctions against Russia, demonstrate the currency power it is able to wield thanks to the dollar's role as a medium of exchange in international payment transactions. Although the EU attempted to resist the Iran sanctions after 2018, all countermeasures proved ineffective (see text box below).

Central to the impact of the Iran sanctions on the EU were the system for interbank communication (SWIFT) and the US's large and efficient financial system. There are two ways for the EU to resist the power exerted by the dollar through its function as a medium of exchange: setting up alternative payment systems and strengthening the role of its own currency as a medium of exchange within the existing payment system.

Following the US's withdrawal from the JCPOA in 2018 and the subsequent extraterritorial sanctions, the EU took four measures:

1. The 'Blocking Statute' (Council Regulation (EC) No. 2271/96) prohibits EU natural and legal persons from complying with the US's sanctions and provides for the recovery of damages resulting from non-compliance with the sanctions. The scope of this regulation was extended to include US sanctions against Iran.
2. The mandate of the European Investment Bank was broadened to include the facilitation of loans for private investment in Iran.
3. The European Commission adopted a €50 million aid package for economic cooperation and support to the Iranian private sector.
4. The payment system INSTEX was set up to establish trade exchanges independently of the US dollar by enabling the exchange of Iranian goods for European goods, technology or services without underlying financial transactions (and hence avoiding use of the SWIFT system).

None of these measures proved effective. The sanctions under the Blocking Statute are not in proportion to the economic consequences of non-compliance with the sanctions in the US. There was also a lack of clarity about enforcement, which is configured at national level.

In addition, the regulation gave European companies considerable scope to decide for themselves to comply with American sanctions after all. INSTEX and loans via the EIB also proved ineffective.

The high level of financial and economic interconnectedness between the eurozone and the US, both in the market for goods and services, the capital markets, and via the interbank payment system, guarantees that the costs of compliance with the sanctions are far lower for eurozone companies and financial institutions than the costs of non-compliance. This was true even of the European Investment Bank (EIB), which depends on US capital markets to raise capital and make payments, both of which are essential if it is to perform its core tasks. INSTEX proved unable to attract sufficient interest among private parties and resulted in only a single transaction. In early 2023 the decision was made to liquidate INSTEX.

Alternative payment systems: 'SWIFT 2' and the digital euro

Establishing an alternative to SWIFT would not be a logical course of action for the EU. After all, SWIFT is already European; its headquarters are in Belgium and it falls under Belgian law. Moreover, alternatives – as the experience of Russian, Chinese and Indian pilot schemes shows – need a certain critical mass in order to be economically viable.

A central bank digital euro would also offer a way to disentangle payments in the EU from the current interbank payment system. Central bank digital money can best be compared to cash. Like cash, a digital currency is a liability of the central bank. Central bank digital money differs from deposit money (such as the money in a person's bank account) since a deposit is 'only' a liability of an ordinary commercial bank. It can be issued by the ECB directly to private individuals and businesses. This means that in principle a cross-border payment can be made using central bank digital money without the intermediation of a bank, just like a cash payment. It simply requires the amount to be debited from the central bank account of one party and credited to the central bank account of another party. Consequently, payments made in and from the EU are also insulated from the supervision and sanctions of third countries, provided the central bank in the 'receiving' country accepts the digital euro. This is of course dependent on the precise design of the digital currency. There is also a risk that the digital euro will impair the international competitiveness of commercial banks. The emphasis when introducing a digital euro should therefore be on large cross-border transactions between large financial institutions and service providers (wholesale segment). The current focus however actually seems to be on payments by private individuals (retail segment).

Digital currencies are on the rise. Some 100 countries are currently looking into the development of digital bank central currencies and this number is rising rapidly (see figure 7). China is ahead of both the US and the EU in this field. It has already launched a digital renminbi pilot which has also been hooked up to commercial payment platforms such as Alipay and WeChat Pay. Under the pilot, digital yuan in circulation amounts to 13.6 billion yuan (or €1.84 billion).[61] India is also piloting an 'e-rupee', while Russia recently decided to roll out the digital rouble in 2024, focusing on cross-border payments.[62]

In 2021 the ECB started researching the possibility of developing a digital euro. The Commission envisages presenting an initial legislative proposal in 2023. This is very much an area in which the government can exert influence. Keeping pace with innovation and developments in the monetary and financial system contributes to the euro's reputation as an international currency. In the light of the EU's ambition to achieve strategic autonomy, it could send the wrong signal if e-$ or e-CNY could be used for payments in the EU, but not the e-€.

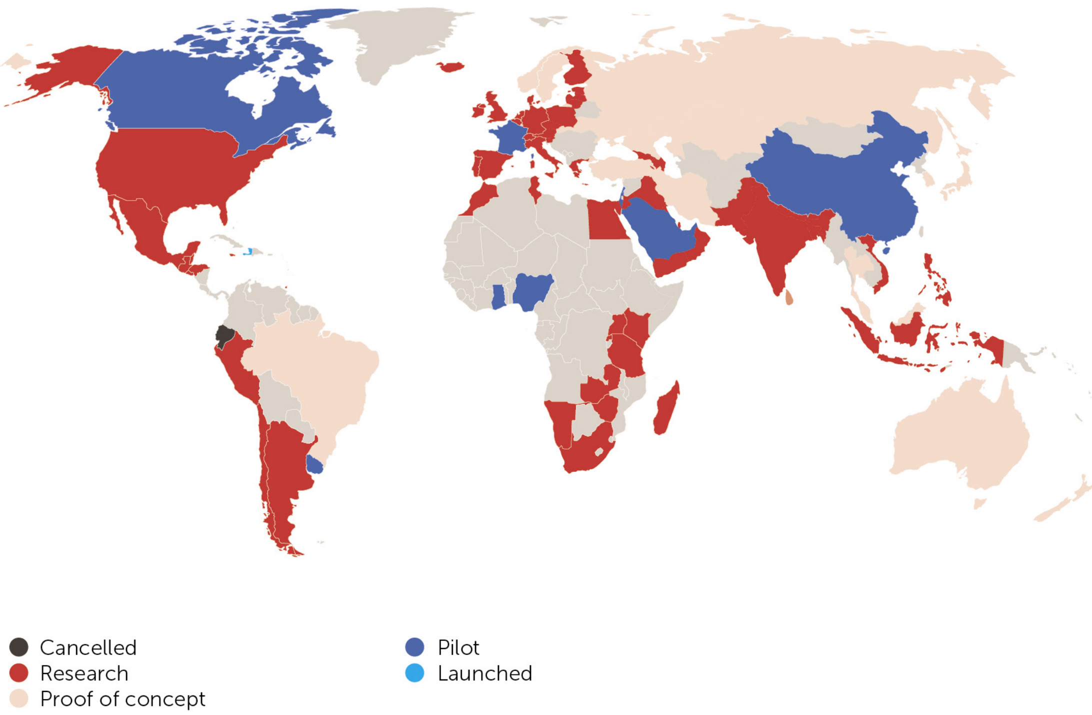


Figure 7 - Overview of central bank digital currencies status. Source: CBDCtracker.org

Strengthening the role of the euro within the current payment system via trade and aid channels

The international use of the euro within the current system can be strengthened via trade channels. This goes hand in hand with the increased use of the euro in international invoicing. Ultimately it is up to market participants to determine what currency they use for invoicing and payment. In the context of de-dollarisation, BRICS countries in particular are actively committed to paying in their own currencies in mutual trade relations, as is evident from the recent announcements made in the margins of the meetings between Presidents Putin and Xi, and Lula and Xi. In March 2023, India made the use of the rupee in international payments an explicit part of its new trade policy and granted 18 countries permission to settle bilateral trade in rupees, establishing special facilities – known as vostro accounts – for this purpose.[63] Countries in the eurozone do not need permission of this kind, since there are no restrictions on what currencies they may use for international transactions, but these examples clearly show that the BRICS countries intend to settle more international payments in their own currencies.

The European Commission is also seeking to bring about wider use of the euro, among other things by addressing, via EU representations in third countries, existing barriers and information gaps that inhibit the currency's use in cross-border payments.[64] The implementation of trade agreements, EU-financed projects and technical assistance provide a concrete basis for doing so. These initiatives could be taken up not only by the European Commission in Brussels, but also by euro area national governments in their bilateral contacts with the rest of the world.

6.3 As an intervention currency

The euro's role as an intervention currency – the public counterpart of the private unit of account – can be steered by policy. Article 219 of the Treaty on the Functioning of the European Union (TFEU) states that the Council, after consulting the ECB, may conclude formal agreements on an exchange rate system for the euro in relation to the currencies of third states. The Council may also formulate general orientations for exchange rate policy in relation to these currencies. Both should be consistent with the objective of price stability, which is safeguarded by the ECB. Although its mandate does not extend to exchange rates as such, the ECB does devote attention to exchange rates as a transmission channel of monetary policy and their impact on inflation.

6.4 As a store of value

Strengthening the international role of the euro ultimately depends on its role as a store of value, for which healthy financial markets are a precondition.

EU financial markets

As became clear in the previous chapter, euro area financial markets lag behind their US counterparts on certain points. The further development of the capital markets union and the banking union will increase the eurozone's growth potential by enhancing the allocation of finance across the eurozone, increase the spread of public and private risk within it, and hence increase the eurozone's resilience to shocks.

Reduced dependence on American financial markets can also have positive effects outside the EU. Currently, debts totalling some 65 trillion dollars are outstanding across the globe.[65] By way of comparison, global GDP is 104 trillion dollars. Because of its status as a safe haven, the dollar tends to increase in value against other currencies both in times of prosperity and economic adversity. This has been referred to as the 'dollar smile', as the dollar exchange rate rises at both ends of the economic cycle. While a currency's exchange rate usually falls when the economy falters, in the event of a global economic downturn (which usually also affects the US itself) investors nevertheless turn to the dollar as a safe haven, thereby pushing up its price. As a consequence, governments that hold dollar-denominated loans – for example because it is impossible to borrow in their own currency on account of a lack of confidence – get into difficulties when their dollar reserves are exhausted. Owing to the role played by the dollar in international trade, a higher dollar exchange rate hinders the import of food, energy and medicines. This caused Sri Lanka, for example, serious problems in 2022.[66] The diversification of the international system, with a viable alternative to debt issued in dollars, is therefore also important to the global financial system.

Banking union

The process of establishing the EU banking union was set in motion in 2012 in response to the financial crisis. The banking union is conceived as consisting of three pillars, of which the first two are already in place. The first pillar is the Single Supervisory Mechanism, a supranational bank supervisory body, for which the ECB is responsible, tasked with supervising the – over 100 – largest credit institutions in the EU. This pillar serves to underpin confidence in the banking system. The second pillar is the Single Resolution Mechanism, which ensures the resolution of failing credit institutions. Resolution is financed by the banking sector, so that national governments do not need to bear the costs.

For the time being, the banking union still lacks its third pillar, the European deposit insurance scheme, on which EU member states have yet to reach agreement. The protection of depositors is currently regulated nationally. Given that, in some eurozone countries, commercial banks hold substantial shares of government debt (15% and 10% in Italy and Spain respectively), the current arrangement increases the risk of entering a 'doom loop'.[67] An interest rate rise makes it more difficult for a government to service its debt. As important holders of government debt, national banks are directly affected. If the banks in turn get into difficulties, the national government's own debt position constrains its ability to guarantee the money that private individuals have deposited in the banks. This undermines confidence in the banking system. The introduction since 2010 of EU banking supervision under the auspices of the ECB and of the single resolution mechanism are important steps in preventing a doom loop and enabling bank failure without this entailing payment problems for a government. A European deposit insurance scheme would mitigate this risk even further, since the impact of problems at banks would be borne at EU level and not by a national government. This pillar would complete the banking union.

Greater confidence in the EU's banking system may also result in larger banks and banks with more cross-border operations. This could provide a stimulus to the international use of the euro and reduce dependence on correspondent banks in the US for the settlement of international transactions.

Capital markets union

Chapter 5 showed how the eurozone, compared with the US, still relies heavily on bank finance. Increasing the liquidity of its capital markets could facilitate a stronger international role for the euro. Further development of the capital markets union through the elimination of remaining internal barriers to the flow of capital, by means of further harmonisation of rules and market supervision in the EU's fragmented capital markets, harmonisation of the tax treatment of – and procedures for – investments, and greater convergence in insolvency frameworks, can help improve the functioning of capital markets, increase risk sharing and hence boost eurozone growth potential and economic resilience.[68]

Green investments

The EU is a frontrunner in green finance, that is to say the issuance of bonds to finance or refinance investments, projects, expenditure or assets that contribute to a better climate and environment. Some 42% of all green bonds are issued in euros, as against 32% in dollars and 8% in renminbi. As the leader in this field, the EU is able to make a substantial contribution to the formulation of international standards (through CertifHy for example, an EU-wide certification system for green hydrogen). Besides its intrinsic value in contributing to climate, environmental and social goals, green energy fosters the growth of EU capital markets by offering additional investment opportunities.

EU-wide risk-free investment instrument

The market for risk-free investment instruments is currently dominated by US Treasury bills. The euro will become more attractive as a safe haven if the supply of risk-free investment instruments grows. There are two routes by which this could come about. Currently, a great deal of debt securities issued by member states in the euro area have been assigned low credit ratings (below AA+; see also chapter 5) by the credit rating agencies. Economic reforms and restructuring will entail a slow improvement in the credit rating of this government debt and the supply of risk-free investment instruments will rise.

A second possible route is the introduction of a common risk-free investment instrument (or 'safe asset') that pools the debt of member states with high and low risk profiles. The issuance of an EU safe asset is a form of public risk sharing between member states. This is politically sensitive because of the risk of moral hazard. Member states with a high risk profile have fewer incentives to carry out national reforms and undertake debt restructuring because, in money and capital markets, they can profit from the risk profile of low-risk countries and are therefore less exposed to market discipline.[69]

During successive financial crises, notably the euro crisis of 2010-2012 and the pandemic of 2020, the political resistance to risk sharing proved not to be absolute. The establishment of the European Stability Mechanism (ESM) and the issuance of common debt through the Recovery and Resilience Facility (RRF) set up under the EU's 'NextGenerationEU' plan enhance the euro area's crisis architecture and its capacity to absorb shocks. However, the RRF and NextGenerationEU are temporary instruments. A possible way forward would be to introduce these or similar facilities on a permanent basis, as advocated by the Commission.

Swap lines

Fulfilling the role of a global reserve currency entails a certain responsibility, namely to provide world markets with the necessary liquidity in times of crisis. This can be achieved by means of swap lines. Via a swap line, the ECB provides a certain amount in euros to another central bank in exchange for collateral (often a certain quantity of the currency of the counterparty). This provides a stimulus to international use of the euro, given that it guarantees a certain measure of euro liquidity in the market and so safeguards access to the euro as a reserve currency and means of payment. Swap lines prevent problems in the financial markets from spilling over into the real economy when commercial banks have little or no access to a certain vehicle currency and are therefore no longer able to make any cross-border payments. They can then turn to the national central bank that has access to the foreign currency via swap lines (hence bypassing the market). By providing a route to obtaining foreign currency that bypasses the commercial interbank system, swap lines also strengthen resilience against financial sanctions that operate through international payment systems.

Swap lines also facilitate the exercise of positive currency power, that is to say the 'carrot' rather than the 'stick'. Just as Poland benefited from dollar loans after the democratic transition of 1989, the opening of swap lines by America's Federal Reserve at the time of the financial and COVID crises prevented considerable additional economic hardship by providing third countries, including Brazil and Mexico, with dollar liquidity. The euro can also offer this kind of much-appreciated assistance in difficult times.

Figure 8 gives an overview of the number of existing swap lines and their use. The ECB currently has swap lines with the central banks of a limited number of (exclusively European and G7) countries.[70] The Fed has around 15 temporary and permanent swap lines with both industrialised and emerging economies. China has bilateral swap lines with over 30 countries (including emerging economies) and is part of the regional Chiang Mai network of swap lines.[71]

Swap lines have often been employed to internationalise a currency. They were one of the means used by Japan in the 1990s in its attempts to further internationalise the yen. China is currently making active use of swap lines to increase the international role of the renminbi and ensure that countries and businesses remain liquid and can continue to meet their financial obligations to China. Nevertheless, renminbi swap lines are little used, in contrast to Fed swap lines, which are employed a great deal (see figure 8). This confirms the dollar's current status as global reserve currency and emphasises the fact that the renminbi has yet to attain that status. It also indicates that offering swap lines does not in itself decisively augment a currency's international role. But it can support such a development. Swap lines are not without risks, since there is always a chance that the counterparty may be unable to repay the ECB for the euros it has received.

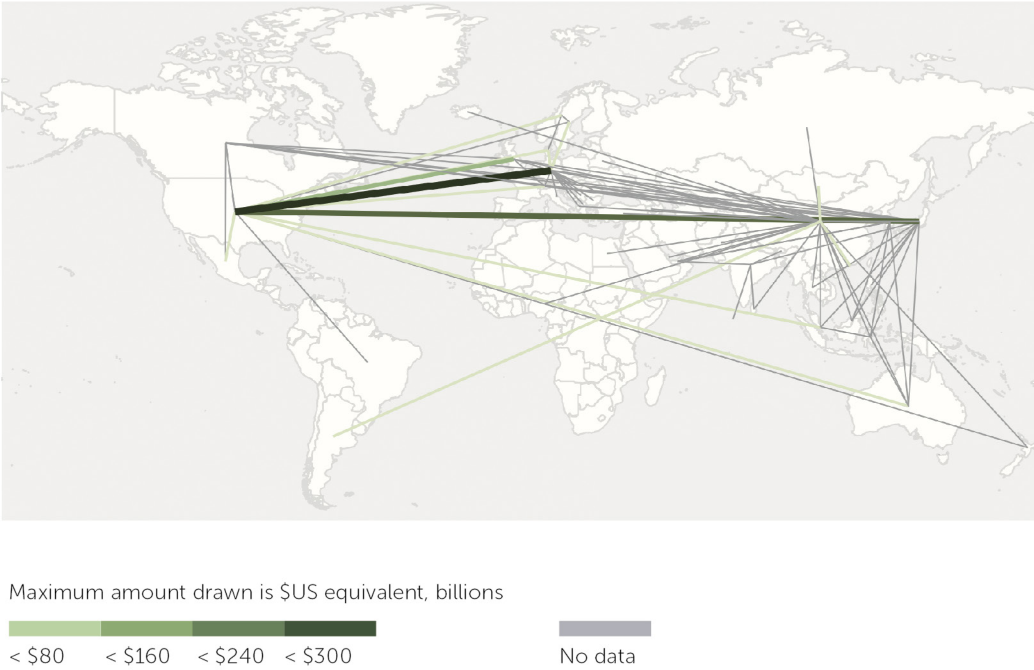


Figure 8 - Global swap lines in 2020. Source: https://www.cfr.org/article/central-bank-currency-swaps-tracker

6.5 Membership and institutions

Membership of the eurozone

The eurozone is economically as strong as its member states. It is therefore important to ensure that there are no substantial differences between member states that, in a monetary union, without the option of exchange rate adjustments, cannot be offset. This is why countries must satisfy convergence criteria prior to joining the euro area. Greece provides a case study in how enforcement of these criteria is fundamental to the economic and financial stability of the eurozone, which is a common objective. The euro crisis also demonstrated that, in addition to the debt and deficit criteria, the broader quality of public administration matters. Bulgaria recently decided to postpone its accession to the euro area because it could not satisfy all the applicable conditions.

The composition of the eurozone could also be made stronger by encouraging EU member states that are not yet members – such as Sweden, Denmark and Poland – to join. Denmark has negotiated an opt-out from the euro. Sweden and Poland have a legal obligation to join the euro area. The dialogue on accession to the euro area should therefore be conducted systematically with these countries as the weight they attribute to considerations for and against joining the euro may also change subject to the geopolitical situation following the Russian invasion of Ukraine.

International representation of the eurozone in the IMF

The eurozone is not independently and jointly represented in the international monetary system, even at the International Monetary Fund (IMF), although the eurozone enjoys exclusive competence in a number of areas that fall under the IMF's Articles of Agreement, such as monetary policy.[72] As a consequence, although there is a high degree of coordination between the countries of the eurozone, its voice at the IMF is fragmented.[73]

A common eurozone seat on international financial and monetary bodies like the IMF would convey unity and togetherness and so engender confidence in the euro area as an economic bloc. However, because of the practical and symbolic value of international representation, political resistance among member states to the idea of relinquishing their own seats remains as high as ever.

6.6 Old and new

Many of the above policy options have already been in circulation for some time. The joint representation of the eurozone at the IMF has been a topic of discussion since 1998.[74] Many of the proposals to promote economic confidence in the euro, such as the completion of the banking and capital markets unions, date from the time of the banking and euro crises (2008-2012). It is clear that policy on the international position of the euro must be informed by realism and that many options will initially encounter political resistance – including in the Netherlands – and are in any event long-term undertakings.

In view of the international developments described in chapters 1 and 2, the AIV expects that the issue of monetary strategic autonomy and the international role of the euro will gain in importance in the future. Given that most of the proposals, besides offering benefits, also have disadvantages and limitations, the overall assessment of interests underlying any decision on whether or not to adopt them may shift under geopolitical pressure.

Strategic considerations and conclusion

7.1 Towards a new monetary system: the end of dollar hegemony?

The position of the dollar, enshrined in the Bretton Woods system after the Second World War, has long been unassailable and unquestioned. That will remain the case in the immediate future. However, as chapter 2 showed, history teaches that currencies can lose their status. This is a fate that could also befall the dollar. The global monetary and financial system is in flux. This fluidity manifests itself in at least three different ways.

First, various pressures and threats – including economic and other forms of coercion, polarisation, resentment and the increasing leveraging of dollar power – are prompting ever more countries to seek alternatives to the dollar-dominated system. There are a rapidly increasing number of examples to illustrate this, as noted in this report. Currently, partly because of the dollar's considerable dominance, these alternatives are not having the effect sought by their initiators, but the fact remains that this trend has been set in motion.

Second, China is increasingly presenting itself as a global power that offers a real alternative to the United States. It is expanding its economic sphere of influence through its Belt and Road initiative, it has consciously adopted an independent policy on the war in Ukraine, and it has become a global player on the diplomatic stage by brokering a peace deal between Saudi Arabia and Iran. In the monetary domain, the People's Republic does not simply wish to defend itself against America's dollar power but aspires to the capacity to deploy the status and role of the renminbi offensively in the international monetary system in due course. China is already raising its monetary profile through the setting up of swap lines, the establishment of renminbi clearing outside China, the renminbi's addition in 2016 to the basket of currencies that make up the IMF's Special Drawing Rights, the renminbi's higher weighting in that basket in 2022, negotiations with central banks along the new Silk Road on the inclusion of the renminbi in official reserves, and the international rollout of the digital renminbi (e-CNY).

Third, technological developments such as digital currencies will generate their own momentum, opening up new possibilities but also creating uncertainty. The development of private cryptocurrencies is steadily continuing, despite evidence from recent price fluctuations and the collapse of the cryptocurrency exchange FTX that cryptocurrencies are not a secure store of value. Central bank digital currencies are being developed all over the world.

These developments suggest at least three possible scenarios for the international monetary system:

1. The monetary system remains unipolar. The dollar maintains its hegemony in the medium to long term in spite of the abovementioned factors. Just as now, the US is able – independently of its allies – to compel or impose certain developments in the international political arena. This may be acceptable to the EU to the extent that its interests are aligned with those of the US, but as the Iran sanctions showed, the EU is vulnerable where interests diverge.

2. The world is divided between the dollar and the renminbi in a bipolar system, with two competing spheres of influence. Depending on the character of this confrontation and the degree of competition it involves, the two great powers will make their currency power felt.
3. The monetary and financial system becomes multipolar. Various currencies coexist, separated for example along regional lines or according to their specialised function. In the latter case, for example, digital currencies might be used for international payments, the renminbi for commodity trading, and the dollar and the euro as private and public reserve currencies. Within their regional or functional spheres of influence, various countries are able, up to a point, to set the tone by wielding their currency power. The remaining countries have a wider choice and dependencies diminish.

Of course, other future scenarios could be imagined. The exact course that developments will take is impossible to predict. Experts disagree for example on the extent to which the renminbi can seriously challenge the dollar, as they do about the timescale for the renminbi's further internationalisation. Nor is there any agreement on whether the renminbi's rise will proceed smoothly or be accompanied by major shocks. At this time the renminbi still lags far behind, but the ambition fuelling its ascent and its potential for growth are both clearly apparent. The renminbi's rise is partly in the hands of the Chinese authorities themselves. Liberalising capital flows and making the currency freely convertible would enable clear progress to be achieved. It is certain that the degree to which the euro can fulfil its international potential will also depend on the attitudes and actions of other countries, notably China and the US.

Currency power delivers clear added value in all the future scenarios outlined. The EU and the eurozone are vulnerable to economic power politics due to their very open economy, their asymmetric relationship with the US, and their dependency on China for certain raw materials. A bipolar system or a unipolar system in which transatlantic interests diverge renders the eurozone particularly susceptible to monetary pressure. But in a multipolar system, too, power politics can play a prominent role in the monetary and financial system, and the EU and the eurozone would do well to prepare for this eventuality by ensuring that they themselves are one of the poles.

Despite all the uncertainty surrounding future developments and scenarios, three general observations can be made. First, changes in the global monetary system will almost certainly give rise to greater fragmentation in the light of the dollar's current hegemony. Second, changes will in any event entail considerable transitional costs and uncertainty, since existing systems will need to be adjusted and relationships will alter. Third, changes will occur more slowly than envisaged by some states. No government is in a position to unilaterally dictate the choice to use a currency in the international system. Market operators determine the international use of a currency largely on the basis of confidence. Building this confidence takes time and requires commitment over many years.

In the light of these uncertainties and observations, the EU would be well-advised to work out its position in good time, prepare for possible changes (and the costs and risks they entail), invest in currency power and also to evince and back up this commitment internationally.

7.2 Euro power: an anti-American project?

Given that major changes in the international monetary system will, by definition, come at the expense of the dollar and will, moreover, bring costs and uncertainties in their wake, the question arises as to whether the EU should oppose such developments by standing foursquare behind the US and the power of the dollar. Especially in the context of Russia's war on Ukraine, in which the transatlantic alliance and US leadership are of vital importance.

A decisive shift towards a bipolar or multipolar system

A shift towards a bipolar or multipolar system would result in the dollar losing power to the renminbi, possibly other (BRICS) currencies and/or the euro. In such an eventuality, the transatlantic alliance would become more important to the US, as would its interest in having a strong EU and eurozone as its partner. There is a parallel here with the defence debate surrounding NATO and the EU: in that context the US is in fact urging EU countries to invest more in their defence. There is no reason to assume that building up European currency power would automatically harm the transatlantic relationship. The reverse is equally likely. An internationally strong euro could boost the strategic partnership between the EU and the US. Moreover, if necessary, additional coordination mechanisms could be established to further coordinate positions and objectives.

Interregnum and regional interests

If the inroads made by alternatives such as the renminbi turn out to be relatively small or slow and dollar hegemony continues, the eurozone nevertheless has the right and the responsibility to strengthen the position of the euro where possible in order to boost its strategic clout in the monetary domain. There are clear signs that the US will continue to practise economic power politics for the foreseeable future. Domestic interests, including economic interests, currently carry great weight for both the Democratic and the Republican parties. The Iran decision was, for the EU, the most visible and tangible example to date of the use of extraterritorial sanctions and dollar power. The geostrategic interests of the US and the EU sometimes diverge on crucial points. Instability in the Middle East, Africa (Sudan for instance) or Central Asia (Afghanistan) is of immediate concern to the EU, being on its doorstep, because of its acute impact on migratory pressure and energy supplies; the situation is different for the US. This results in different assessments being made. Nor do the strategic and economic interests of the US and the EU always coincide in respect of China, despite the far-reaching convergence of the values and visions of the US and EU on the international order. There is a lot to be said for the EU taking anticipatory action – as far as it can – in preparation for the US possibly intensifying its use of currency power. In a general sense a larger international role for the euro will also give the EU more scope for action, including vis-à-vis other world powers.

Growing group of challengers

The EU is not alone in weighing up the possible advantages of greater monetary and financial autonomy, and is certainly not a frontrunner in this regard. As explained above, the trend towards de-dollarisation extends beyond America's strategic rivals Russia and China: India, South Africa, Brazil and Argentina, among others, are actively looking for alternatives to the dollar. Support for the international world order (including the monetary world order) which arose after 1945 is dwindling in the Global South. For instance, a large part of the world did not actively join the West in imposing sanctions on Russia after it launched its war of aggression in Ukraine. But even within the group of like-minded countries, Canada and Australia have introduced variants of the EU's blocking statute in order to increase their resilience to the extraterritorial effect of US sanctions.

Advantages of aspiring to internationalisation

The internationalisation of the euro also brings macroeconomic benefits. It leads to diversification in the monetary system and hence opens up possibilities to spread risks, reserves and investments compared with the current situation in which the dollar dominates the monetary cycle. For example, the dollar's dominance increases the likelihood of financial crises since many emerging countries hold their debt in dollars and exchange rate fluctuations can cause instability. Greater diversification could be beneficial in this regard. If the euro were to play a greater role as a reserve currency this would also provide more scope for the sharing of responsibility by the US and the EU to act as lender of last resort. At the moment this exorbitant burden rests almost entirely on the shoulders of the US, so that in times of crisis the Fed must provide liquidity to the entire global market.

All in all, growth in the euro's power will not threaten the dollar in any way in the near future, as the gap between the two currencies is too great. In the longer term, increased power for the euro could also be beneficial from an American perspective, since it would bring greater opportunities for diversification and a shared responsibility for the international system. The AIV is not an advocate of policy options aimed at decoupling, such as setting up a completely autonomous version of SWIFT. That would be economically and politically costly and not expedient. And there are sufficient policy options – as is apparent from the list given in chapter 6 – such as the green and digital transitions, and the development of the EU banking union and capital markets union, that contribute to the internationalisation of the euro without unnecessarily antagonising or thwarting the US.

7.3 Currency power: compelling circumstances and strategic costs

The internationalisation of the euro was put on the agenda by the European Commission in 2018 in the light of the EU's lack of resilience to the extraterritoriality of the US's sanctions against Iran. Its case was therefore founded on the *defensive* use of the euro's currency power. A case could be made along the same lines for long-term resilience to the power of the renminbi.

The situation is different when it comes to the offensive use of the euro's power. In response to the war of aggression being waged against Ukraine, the EU is working with the US and other partners in imposing financial sanctions on Russia. In this endeavour the EU is also using currency power offensively, for example by freezing assets held in euros in the EU and excluding a large number of Russian banks from SWIFT.[75]

According to some experts, the EU's sanctions against Russia themselves bear, for the first time, the hallmarks of extraterritoriality.[76] For example, parties are also sanctioned if they help circumvent sanctions against Russia, regardless of whether they are natural or legal persons from the EU and whether the activities take place within EU territory.[77] And vessels transporting oil purchased at a price above the price cap can in future be prohibited from receiving technical or financial services, even if they are sailing under a non-EU flag.[78]

Although these clauses had not yet been applied or elaborated in spring of 2023, these elements of extraterritoriality are indicative of a turning point in the EU's sanctions regime, especially as this extraterritorial effect is controversial the context of international law.[79] The EU sanctions manual, which presents the EU's own perspective, repeatedly denies that EU sanctions apply extraterritorially.[80] The Dutch government's coalition agreement in fact explicitly leaves open the possibility of extraterritorial sanctions: 'We will make strategic use of the EU's economic power, for example by imposing sanctions that can be extraterritorial.'[81] The authors of the coalition agreement (drafted in late 2021) in effect anticipated the abovementioned turning point.

It is clear that the EU – along with the US – is already becoming more assertive in its deployment of currency power. Without reaching a conclusion on matters of law, it is arguable that the EU is actively seeking out the limits of the offensive (extraterritorial) use of sanctions.

This seems at odds with the doctrine to which the EU traditionally subscribes, regarding itself as the guardian of international law. In the matter of the Iran sanctions, currency power and extraterritoriality were precisely the bone of contention. However, the sanctions against Russia can also be viewed as an exceptional reaction to an exceptional violation of international law. This exceptionality can also be seen in Switzerland's historic decision to abandon its traditional neutrality in response, and to align itself with EU sanctions.

This new assertiveness also has disadvantages. For instance, because of its coercive approach and instrumental interpretation of its pivotal role, it is more difficult for the US (and the EU) to present itself as a 'benign hegemon' that organises the international (monetary) system for the benefit of the entire international community. As has already been indicated, other countries and powers have taken defensive measures in response, accelerating the pressure under which dollar hegemony is being placed. The offensive use the dollar and the euro therefore carries clear costs that should be weighed up on a case-by-case basis against the benefits of exerting currency power.

7.4 How can the international role of the euro be strengthened?

Chapter 6 outlined a wide range of policy options to strengthen the euro's role in the international system. A selection may be made on the basis of the above considerations.

External dimension: the ambition to attain greater strategic autonomy

The euro's position can be strengthened vis-à-vis other currencies without impairing the relationship with the US by aligning with existing developments such as the green and digital transitions. EU institutions and member states should seek to strengthen the euro's role in renewable energy invoicing. In addition, the emphasis in the development of the digital euro should be placed on cross-border payments between commercial parties such as banks and other financial service providers. In this way the digital euro will offer an alternative payment system in parallel with SWIFT and thus contribute to greater autonomy in payment transactions.

Also, the eurozone could consider expanding the network of ECB swap lines in anticipation of a greater role as lender of last resort. That role entails economic risks, but also geostrategic advantages. It is no coincidence that the China's central bank offers such swap lines as part of its Belt and Road initiative. The EU envisages its 'Global Gateway' as an attractive alternative to that initiative for Central Asian countries, for example. By offering swap lines, the euro area exhibits its willingness to take responsibility for the international financial system by guaranteeing the availability of euros. It takes a step closer towards providing a credible alternative safe haven to the dollar and hence towards a more balanced system. A strong euro as a vehicle of European solidarity with countries in need.

Internal dimension: avoiding overreach

Confidence and the strong economic and political foundations on which it is based are important factors in determining the euro's international reach and stature. The euro's external role and its associated international status and responsibilities must be founded on internal strength that is capable of supporting them. Recent crises, such as the banking, euro and COVID-19 crises, made clear that the euro's international role and reputation depends heavily on the economic resilience and internal stability of the euro area. There can be no external projection without a solid home base.

As in the area of defence, the EU and the eurozone can gain considerably in strength by investing in their own capacity to act in the monetary domain. Remedies dating from the financial crisis of 2008 to 2012 such as the completion of the European banking and capital markets unions are therefore still highly relevant. The eurozone may have emerged from the crisis in more robust shape, but it is certainly not invulnerable. This was evident when unrest in financial markets following the collapse of Silicon Valley Bank in March 2023 spilled over into Europe and the German Chancellor was obliged to intervene in order to allay the fears Deutsche Bank's customers.[82] In this way, the completion of the banking and capital markets unions, which is necessary in any case, serves a dual purpose.

The EU can also continue to build on earlier initiatives such as the European Stability Mechanism (ESM) and the coronavirus pandemic recovery funds (NextGenerationEU). These instruments reduce fragmentation risks in the eurozone and contribute to investment in growth, stability and resilience. Additionally, the current review of the Stability and Growth Pact provides opportunities to strengthen the eurozone through more effective fiscal rules.

Timeframe

As explained above, the internationalisation of the euro is an investment in the eurozone's long-term resilience and autonomy. The policy options must therefore be placed in this longer temporal perspective.

At present there is insufficient political support in the Netherlands and a number of other EU countries for some of the options mentioned in chapter 6 to strengthen the eurozone's internal architecture, such as increasing the availability of risk-free investment instruments through common debt issuance or other forms of debt mutualisation. These measures will therefore certainly not be introduced solely with a view to strengthening the international role of the euro. In the short term the focus can be placed on policy measures that are highly beneficial for the EU internally, independently of the internationalisation of the euro, such as the completion of the capital markets and banking unions.

In March 2023, European Commission President Ursula von der Leyen and European Council President Charles Michel, supported by European Central Bank (ECB) President Christine Lagarde, Werner Hoyer of the European Investment Bank (EIB) and Eurogroup President Paschal Donohoe, called upon European heads of government to push ahead with the completion of the European capital markets union.[83] The Eurogroup meeting of 28 April 2023 attested in the light of the recent turmoil in the international banking sector to renewed momentum for the completion of the European banking union.[84]

Moving forward, it is important to keep the geopolitical aspect in view and not to rule out any options. Geopolitical pressure may prompt a reappraisal on the part of the Netherlands and/or its EU partners of their economic and strategic interests.

The Netherlands' position

The Dutch debate on the eurozone places a heavy emphasis on the financial risks of membership and possible transfers from the Netherlands to other euro area countries. This focus does not, however, give the full picture. For instance, as well as economic burdens or risks, there are economic benefits and opportunities. The lack of any exchange rate adjustments within the eurozone, for example, gives the Netherlands a competitive advantage over less productive euro area countries. Financial stability is also a boon to Dutch businesses and other economic actors.

Besides its economic dimension however, of more fundamental significance – certainly in the context of this report – is the fact that euro membership has an important strategic and political dimension for the Netherlands too. The historical survey in chapter 3 shows that, to its initiators, Economic and Monetary Union was always more than a bureaucratic and economic project. As the driving force behind the project, France initiated the steps taken towards a common currency, enlisting the ultimately vital yet pragmatic support of Germany at crucial moments (such as the end of the Cold War after 1989). Owing to its narrowly financial focus, the Netherlands repeatedly neglected this geostrategic dynamic and was taken by surprise, so that it subsequently had little alternative but to go along with the course that had been set out. For the Netherlands too, therefore, contributing proactively to the debate on the euro's global role has great political value, especially in the current international context.

With its open economy, the Netherlands is, also in comparison with other euro countries, especially vulnerable to the wielding of economic power. The Netherlands can easily get caught in a geopolitical vice between China and the US, both of which are crucial markets for its exports and links in its supply chains. As the case involving ASML and its semiconductors has made clear, it is not easy for the Netherlands to retain room to manoeuvre. As a bloc, the EU – provided it is sufficiently equipped – is better able to offer resistance than the Netherlands alone.

The Dutch government has demonstrated, through the non-paper on strategic autonomy which it drafted jointly with Spain, that it wishes to play a constructively critical role in the discussion on this subject.[85] Among other matters, the non-paper mentioned the international role of the euro. Currency power will be an extra instrument in the geopolitical toolkit. Given what is at stake for the Netherlands, economically and geopolitically, the government should continue to pursue a constructive and critical course within the EU, while remaining alert to geostrategic risks.

Finally, the Dutch agenda for the eurozone could be bolstered if like-minded countries were to join. The Netherlands should advocate, in bilateral contacts and at EU level, for the enlargement of the eurozone to include member states such as Denmark, Sweden and Poland that have not yet joined. For these countries too, the geostrategic dimension of the euro will weigh more heavily in 2023 than it did in the past and thereby modify the basis on which they decide whether or not to join the euro area. In parallel with Sweden's and Finland's accession to NATO, the euro area's north-eastward enlargement would dovetail with the Dutch agenda for the euro and open strategic autonomy.

Endnotes

1 For instance the non-paper on strategic autonomy submitted by the Netherlands and Spain for the General Affairs Council of 23 March 2021 also explored the international role of euro as a measure for enhancing the European Union's strategic autonomy: https://www.rijksoverheid.nl/documenten/publicaties/2021/03/25/spain-netherlands-non-paper-on-strategic-autonomy-while-preserving-an-open-economy.

2 COM(2018) 796: Communication from the Commission to the European Parliament, the European Council (Euro Summit), the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: *Towards a stronger international role of the euro*.

3 Official English title: the Joint Comprehensive Plan of Action (JCPOA).

4 Speech by Christine Lagarde, President of the ECB, at the Council on Foreign Relations' C. Peter McCologh Series on International Economics, New York, 17 April 2023: https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230417~9f8d34fbd6.en.html

5 Advisory Council on International Affairs, Request for advice on a stronger international role for the euro, 17 March 2022.

6 The terms EU and eurozone are used alongside one another to a certain extent in this advisory report. The European Union and the Eurogroup and eurozone are the relevant decision-making frameworks in relation to the geopolitical dimension of the euro. Joining the euro area is a condition for EU membership (except in the case of Denmark, which has negotiated an opt-out).

7 Advisory Council on International Affairs, *The EU and the Crisis: Lessons Learned*, Advisory Report 68, 29 January 2010. Advisory Council on International Affairs, *Towards Enhanced Economic and Financial Governance in the EU*, Advisory Letter 19, 3 February 2012. Advisory Council on International Affairs, *Is the Eurozone Stormproof? On Deepening and Strengthening the EMU*, Advisory Report 105, 7 July 2017.

8 For a more thorough economic analysis, please refer to the report of the European Economy Committee (2021) *Consistent paths towards a stable and resilient European economy*.

9 Advisory Council on International Affairs, *Designing Smart Industrial Policy: New Departures for the Netherlands within the EU*, Advisory Report 120, 18 March 2022.

10 The JCPOA was concluded on 14 July 2015 between Iran and the five permanent members of the UN Security Council plus Germany (P5+1). The EU also committed itself to the deal through a vote by its Foreign Affairs Council. The EU's High Representative was closely involved in coordinating diplomatic efforts to conclude the JCPOA. The High Representative also coordinates the work of the Joint Commission established under the JCPOA to supervise its implementation.

11 De Franse bank *BNP Paribas* kreeg in 2015 een boete van 8,9 mld dollar opgelegd vanwege overtreding van sanctiewetgeving in de VS ten aanzien van onder meer Iran.

12 See https://www.cnbc.com/2021/03/23/these-6-charts-show-how-sanctions-are-crushing-irans-economy.html en https://www.ohchr.org/sites/default/files/2022-05/Iran-country-visit-conclusions-SR-UCM-17May2022%20-EnglishPersian.docx

13 See https://www.files.ethz.ch/isn/168617/eunpc_no 27.pdf

14 INSTEX (Instrument iN Support of Trade EXchanges) was established to facilitate non-dollar trade by exchanging Iranian goods for goods, technology or services from the EU, without any underlying cross-border financial transactions. The rationale was that the EU exporter of particular goods is paid not by the Iranian importer but by an EU importer of other goods provided that the transactions have the same value. INSTEX brought the parties together. A similar mechanism was established in Iran: STFI. The arrangements would enable transactions to go ahead and all parties could be paid without cross-border payments having to be made. The operation of this barter system is explained here: https://www.forbes.com/sites/francescoppola/2019/06/30/europe-circumvents-u-s-sanctions-on-iran/?sh=a0f16782c8d3

[15] https://www.euractiv.com/section/global-europe/news/eu-plan-for-iran-trade-circumventing-us-sanctions-unravelling/. INSTEX was founded in 2019 under French jurisdiction, with its registered office in France. The participating countries were France, Germany, the United Kingdom, Belgium, Denmark, the Netherlands, Norway, Finland, Spain and Sweden.

[16] The UK also wanted to maintain the Iran nuclear deal. In 2019 the UK was one of the founders of INSTEX, although the procedure for its withdrawal from the EU in response to the Brexit referendum had already commenced at that point.

[17] See also the Joint Communication of the European Commission and the High Representative of the Union for Foreign Affairs and Security Policy to the European Parliament, the European Council and the Council, 'EU-China – a strategic outlook', 12 March 2019, JOIN (2019) 5 final and Advisory Council on International Affairs, *China and the Strategic Tasks for the Netherlands in Europe*, advisory report no. 111, 2019.

[18] See R. Foroohar *A new world energy order is taking shape; Global oil trade is de-dollarising slowly but surely*, *Financial Times* 3 January 2023.

[19] See also H. Thompson, *Disorder: Hard Times in the 21st Century* (Oxford: Oxford University Press, 2022).

[20] See EU State of the Union 2018 *The Hour of European Sovereignty*: 'The euro must become the face and the instrument of a new, more sovereign Europe.'

[21] H. Farrell and A.L. Newman, *Weaponized Interdependence: How Global Economic Networks Shape State Coercion* in *International Security*, vol. 44, no. 1 (2019), pp. 42-79.

[22] Speech by Chancellor Angela Merkel to the German parliament on 7 September 2011: https://www.bundesregierung.de/breg-de/service/bulletin/rede-von-bundeskanzlerin-dr-angela-merkel-802338.

[23] B. Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford: Oxford University Press, 2011), p. 22.

[24] This problem was identified for the first time in the 1950s by Robert Triffin and became known as the 'Triffin dilemma'.

[25] B. Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford: Oxford University Press, 2011).

[26] Ibid. Estimates in the literature of the extent of the 'exorbitant privilege' vary.

[27] B. Cohen, *Currency Statecraft: Monetary Rivalry and Geopolitical Ambition* (Chicago: The University of Chicago Press, 2019).

[28] See also the name of the common market of Argentina, Brazil, Paraguay and Uruguay: Mercosur.

[29] This was possible because there is a 'mirror' data centre in the US where all of SWIFT's data is stored. SWIFT also has data centres in Belgium, the Netherlands and Hong Kong.

[30] This action is being taken under the Omnibus Foreign Trade and Competitiveness Act. Since 2015 it has also been possible to impose fines under the Trade Facilitation and Trade Enforcement Act.

[31] https://home.treasury.gov/news/press-releases/jy1094 .

[32] https://www.ft.com/content/57f104d2-e742-11e6-893c-082c54a7f539.

[33] https://www.wsj.com/articles/SB10001424052970204530504578076953350391848 and https://www.ft.com/content/05a18088-c0d2-11e3-bd6b-00144feabdc0#axzz2z09UqppN.

[34] M. Neumann, 'Internationalization of German Banking and Finance' in *Internationalization of Banking: Analysis and Prospects* (Seoul: Korea Federation of Banks, 1986), pp. 67-144.

[35] The Plaza Accord of 1985 was an agreement between the governments of the UK, France, Germany, Japan and the US aimed at reducing the value of the dollar. See UTLink: Plaza Accord, September 22, 1985 (utoronto.ca), art. 18.

[36] B. Cohen (2019) *Currency Statecraft: Monetary Rivalry and Geopolitical Ambition* (Chicago: The University of Chicago Press, 2019).

[37] B. Cohen, Currency Statecraft: *Understanding Monetary Rivalry* (Princeton: Princeton University Press, 2015), pp. 138-148.

[38] This was confirmed in the first speech by ECB President Wim Duisenberg, entitled 'The euro has arrived', in 1999 at De Nederlandsche Bank in Amsterdam.

39 J. Gräb and A. Mehl (2019) *The benefits and costs of the international role of the euro at 20*, https://www.ecb.europa.eu/pub/ire/html/ecb.ire201906~f0da2b823e.en.html#toc15 and speech by Fabio Panetta, member of the Executive Board of the ECB, to the European Parliament entitled 'Unleashing the euro's untapped potential at global level', 7 July 2020, Unleashing the euro's untapped potential at global level (europa.eu)

40 For more on this vision, see for example A. Szasz, *The Road to European Monetary Union A Political and Economic History*, (Palgrave Macmillan, 2000) and M. Segers, *Reis naar het continent: Nederland en de Europese integratie, 1950 tot heden*, [Journey to the continent: the Netherlands and European integration, 1950 until now] (Prometheus, 2019).

41 Until then, intra-European trade and payment transactions consisted mainly of a system of bilateral drawing rights. Countries with a surplus on their balance of payments, like Belgium, provided financial support on a bilateral basis to countries in debt, for instance by passing on Marshall Plan funds in the form of loans.

42 The fluctuation bands within the EMS ranged from 2.25% for 'strong' currencies to 6% for 'weak' currencies.

43 The Treaty of Maastricht (official title: Treaty on European Union) was agreed in Maastricht in 1991. It was signed in 1992 and entered into force on 1 November 1993.

44 The principles of the Stability and Growth Pact were agreed in Annex I of the Conclusions of the Dublin European Council of 13-14 December 1996 (https://www.europarl.europa.eu/summits/dub2_en.htm). These principles were later elaborated in a Resolution of the European Council on the Stability and Growth Pact, adopted on 17 June 1997 in Amsterdam https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A31997Y0802%2801%29, followed by two regulations concerning the practical details adopted on 7 July 1997.

45 The same principle applies more broadly to the payment system. A payment between a Turkish bank and a Dutch bank that do not have direct relations can be made via a third – foreign – bank with which they do. Banks that fulfil this role are known as correspondent banks.

46 SWIFT stands for Society for Worldwide Interbank Financial Telecommunication and is a messaging system that facilitates the processing of money transfer instructions between banks internationally.

47 The depth of the market is determined by factors including the presence of secondary markets (i.e. markets where previously issued securities are bought and sold), high turnover, and the presence of short-term government debt. A market's breadth is determined by the variety of financial instruments and assets – such as bonds, shares, options, futures contracts and other securities with different maturities and conditions – that are on offer.

48 Z. Zoe Liu and M. Papa, 'Can BRICS de-dollarize the global financial system' in *Elements in the Economics of Emerging Markets*, ed. B.S. Sergi (Cambridge University Press, 2022).

49 https://www.reuters.com/markets/currencies/china-says-it-will-set-up-yuan-clearing-arrangements-brazil-2023-02-07/.

50 https://www.lowyinstitute.org/the-interpreter/china-s-digital-currency-next-stop-africa and https://www.coindesk.com/policy/2021/02/03/china-leads-africas-digital-currency-race/.

51 European Economy Committee, *Consistent paths towards a stable and resilient European economy*, (2021) https://www.rijksoverheid.nl/documenten/rapporten/2021/06/30/consistent-paths-towards-a-stable-and-resilient-european-economy

52 European Economy Committee, *Consistent paths towards a stable and resilient European economy,* (2021) https://www.rijksoverheid.nl/documenten/rapporten/2021/06/30/consistent-paths-towards-a-stable-and-resilient-european-economy and D. Furceri and A. Zdzienicka, 2013, *The Euro Area Crisis: Need for a Supranational Fiscal Risk Sharing Mechanism?*, IMF Working Paper No. 198, https://www.imf.org/external/pubs/ft/wp/2013/wp13198.pdf.

53 The value of the US stock market is equivalent to some 200% of GDP, while that of the European stock market is approximately 66% of GDP.

54 The creditworthiness of debtors (public or private) is rated by international credit rating agencies like Moody's, Fitch Ratings and S&P Global.

[55] B.J. B. Cohen, *Currency Statecraft: Monetarey Rivalry and Geopolitical Ambition*, (The University of Chicago Press, 2019).

[56] This is why two Dutch authors, following in the footsteps of André Szasz, a former board member of De Nederlandsche Bank (DNB), recently argued that the Ukraine crisis improves the euro's prospects. T. Nijhuis and C. Ullersma (2022) *Oekraïnecrisis verbetert het toekomstperspectief van de euro* [Ukraine crisis improves euro's prospects, *available in Dutch only*], ESB 107(4812) (2022): pp. 362-364.

[57] EU Commissioner Kadri Simson in a speech at the European Hydrogen Forum on 26 November 2020: https://ec.europa.eu/commission/commissioners/2019-2024/simson/announcements/speech-commissioner-simson-european-hydrogen-forum_en.

[58] 'Hydro' refers here to hydrogen rather than hydropower.

[59] https://www.reuters.com/business/energy/bangladesh-pay-russia-yuan-nuclear-plant-2023-04-17/

[60] The Commission is also working to bring about greater international use of the euro in transport, commodity, agricultural and foreign exchange markets.

[61] https://www.reuters.com/markets/currencies/chinas-digital-yuan-stands-out-cross-border-pilot-show-global-ambition-2022-10-27/.

[62] https://www.centralbanking.com/fintech/cbdc/7954185/russia-developing-cross-border-cbdc-settlement#:~:text=Earlier%20last%20year%2C%20Russia%20announced,at%20the%20end%20of%202022.

[63] An example of a vostro account is a deposit in rupees held by a foreign exporter at an Indian bank. If the exporter sells goods to an Indian importer, the amount payable is settled in rupees through the Indian account. The same applies to goods sold by an Indian exporter to a foreign importer. The use of a vostro account does not involve any cross-border flow of money so conventional systems such as SWIFT need not be used. See https://content.dgft.gov.in/Website/dgftprod/4f665d2f-20cc-4887-ae6a-5ec912bc0d44/FTP2023_Chapter02.pdf.

[64] European Commission, 'Strengthening the International Role of the Euro: Results of the Consultations', Commission Staff Working Document SWD (2019)600 final, 12 June 2019.

[65] World Economic Forum, 'The global financial system is facing $65 trillion in hidden dollar debt' (2023) https://www.weforum.org/agenda/2023/01/65-trillion-debt-bank-financial-system-economic/.

[66] https://www.bbc.com/news/business-61505842.

[67] See P. Hasekamp and B. Soederhuizen, *CPB Position Paper Toekomst van de Euro:* [Netherlands Bureau for Economic Policy Analysis position paper on the future of the euro, *available in Dutch only*] (2023) https://www.tweedekamer.nl/kamerstukken/detail?id=2023Z02257&did=2023D05210.

[68] COM(2020)590 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Capital Markets Union for people and businesses – new action plan, https://eur-lex.europa.eu/legal-content/en/TXT/HTML/?uri=CELEX:52020DC0590&from=EN.

[69] In 2022 the House of Representatives adopted motions both against the issuance of eurobonds and other new forms of debt mutualisation (motion submitted by MPs Wybren van Haga and Olaf Ephraim, Parliamentary Paper 35 925, no. 167) and against common debt issuance for new European funds and projects (motion submitted by Pieter Omtzigt, Parliamentary Paper 35 925, no. 169).

[70] The ECB has swap lines with the US, UK, Canada, Japan, China, Denmark, Sweden, Switzerland and Poland.

[71] This regional swap network bringing together ASEAN countries, Japan, China and South Korea was formed in 2000 in response to the Asian financial crisis of 1997. Besides opening swap lines, the network provides loans for countries in financial difficulties that are granted independently of the IMF.

[72] On other subjects, such as advice on macroeconomic policy, the eurozone is competent together with its member states or member states have exclusive competence, as for example with regard to support for countries outside the euro area experiencing balance of payments difficulties.

[73] The euro area countries are represented individually, with eight of the 24 seats. Two – Germany

and France – have seats of their own on the Executive Board, while the remainder – including the Netherlands – belong to constituencies, each having one seat on the board, formed together with various other countries that act and vote jointly.

74 In addition, the ECOFIN Council agreed in 2006 that securing a seat for the euro area at the IMF should be a long-term objective. The European Commission announced in its work programme in 2014 that it wished to pursue a more streamlined external representation of the eurozone. The Five Presidents' Report of 2015 argued that a stronger international voice was required to enhance the eurozone's economic governance. Later in the same year, the Commission published a roadmap for moving towards a more consistent external representation of the euro area in international fora and a proposal for a Council Decision to establish a unified representation of the euro area in the IMF by 2025. The Commission's communication on the international role of the euro of 2018 also emphasises a the unified representation of the euro area, *inter alia* in the IMF.

75 It may be noted that the consequences of imposing sanctions via SWIFT, originally described as the nuclear option in the sanctions package, are not as severe for a large and less-isolated country like Russia than they are for Iran. Furthermore, in response to the Iran sanctions and the sanctions imposed after the invasion of Crimea, the Russian government and the Russian central bank armed themselves against sanctions that leverage the power of the dollar and the euro by, for example, increasing the share of reserves they hold in renminbi and gold.

76 I. Timofeev and D. Kiku (2022) https://valdaiclub.com/a/highlights/new-stage-of-eu-sanctions-policy-extraterritorial/.

77 Council Regulation (EU) 2022/1905 of 6 October 2022: https://eur-lex.europa.eu/legal-content/en/TXT/HTML/?uri=CELEX:32022R1905&qid=1679329271755&from=EN.

78 Council Regulation (EU) 2022/1904 of 6 October 2022: https://eur-lex.europa.eu/legal-content/en/TXT/HTML/?uri=CELEX:32022R1904&from=EN.

79 For example, the Commission notes in point 2 of the recitals of the regulation amending the EU Blocking Statute in response to the Iran sanctions: 'The Regulation acknowledges that by their extra-territorial application, such instruments violate international law.' Commission Delegated Regulation (EU) 2018/1100 of 6 June 2018: https://eur-lex.europa.eu/legal-content/en/TXT/HTML/?uri=CELEX:32018R1100&from=EN.

80 https://finance.ec.europa.eu/system/files/2023-03/faqs-sanctions-russia-consolidated_en_1.pdf.

81 People's Party for Freedom and Democracy (VVD), Democrats '66 (D66), Christian Democratic Alliance (CDA) and Christian Union, *Looking out for each other, looking ahead to the future, 2021-2025 coalition agreement*, 2021, p.38: https://www.government.nl/documents/publications/2022/01/10/2021-2025-coalition-agreement.

82 https://www.faz.net/aktuell/finanzen/wackeliges-vertrauen-in-die-deutsche-bank-18774288.html.

83 Charles Michel, Ursula von der Leyen, Paschal Donohue, Christine Lagarde and Werner Hoyer, *Het is tijd voor meer ambitie bij de financiele integratie van Europa* [Time to show greater ambition in Europe's financial integration], *Financieel Dagblad*, 9 March 2023: https://fd.nl/opinie/1469849/het-is-tijd-voor-meer-ambitie-bij-de-financiele-integratie-van-europa-lae3ca3vCK9s. *Available in Dutch only.*

84 See the statement made by Paschal Donohoe in the margins of the Eurogroup meeting of 28 April 2023: https://www.consilium.europa.eu/nl/press/press-releases/2023/04/28/remarks-by-paschal-donohoe-following-the-eurogroup-meeting-of-28-april-2023/.

85 https://www.rijksoverheid.nl/documenten/publicaties/2021/03/25/spain-netherlands-non-paper-on-strategic-autonomy-while-preserving-an-open-economy.

Request for advice

Koninkrijk der Nederlanden

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Date March 2022
Subject Request for advise on the international role of the euro

Dear chairman,

In recent years, there has been an increasing debate in the European context about the role and position of the European Union on the world stage and how it can best promote its interests and defend its values in the future.[1] This discussion is taking place against a background of shifting geopolitical relations, of which the United States' increased focus on Asia and the rise of China as a world power are the most striking.

The international role of the euro is discussed as one of the elements that can potentially contribute to strengthening the economic position of the European Union, with repercussions on the geopolitical position of the EU that are similar to the advantage that the United States derives from the dominant position of the dollar.

Since its introduction as a currency in 1999, and as a means of payment in 2002, initially the euro experienced clear growth as a means of payment in international transactions. From 2009 onwards, however, this growth reversed and the use of the euro declined. For some years now, it has been stable at around 19%.[2] Over this period as a whole, the euro has therefore remained the most widely used currency after the dollar by far.

Looking to the future, there seem to be several developments outside the EU that could have an impact on the use of the euro. Firstly, the rise of the Chinese economy could increase the role of the renminbi in international financial markets in the longer term. In addition, there is the emergence of so-called crypto-currencies and, by extension, the possible introduction of digital central bank money. These developments may put pressure on existing positions and structures in the international payment system. Here too, China, which has already introduced Chinese digital central bank money on a limited scale, plays a role.

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[1] Towards a stronger international role of the euro: Commission contribution to the European Council and the Euro Summit (13-14 December 2018) en BNC-fiche: Kamerstuk 22 112, nr. 2752
[2] ECB, International role of the Euro, June 2021.

Given the breadth of policy areas covered in European debates on the position of the euro and the possible geopolitical, economic and monetary implications of a greater international role for the euro, a more detailed analysis is desirable. To this end, a number of questions arise, which lie at the intersection of geopolitics, international trade and the financial-economic and monetary spheres.

Onze referentie

1. To what extent can the international role of the euro be enhanced as a result of European policy and to what extent does such an enhanced international role of the euro contribute concretely to the strengthening of the economic and geopolitical position of the EU? In relation to which international players? Would a stronger international role for the euro come at the expense of the dollar, and what would be the consequences?

2. Given that the role of the euro was stronger before 2009 than it is currently, what are the main determinants for maintaining or strengthening the role of the euro in the future?[3] How can confidence in and use of the euro be boosted, for instance in commodity or energy markets, or how can improving the architecture of the euro increase confidence?

3. If a stronger role for the euro can contribute to a stronger geopolitical role of the EU, what are effective measures to achieve this? What could be the role of the Dutch government in this?

4. It is often said that greater integration of financial markets in the EU contributes towards enhancing the international role of the euro. To what extent can current European plans in the capital markets and banking sector be helpful in this regard? And are there still obvious missing elements in that context?

5. To what extent is it to be expected that the renminbi will continue to emerge as an internationally used currency and what kind of interaction could arise if both the euro and the renminbi emerge as reserve currencies at the expense of the dollar? Would this have any significant implications for the global financial system and the geopolitical relations between the EU, the US and China?

Yours sincerely,

The Minister of Foreign Affairs,

W.B. Hoekstra

[3] See for example https://www.ecb.europa.eu/pub/ire/html/ecb.ire202106~a058f84c61.en.html

List of persons consulted

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List of figures

List of abbreviations

AIV	Advisory Council on International Affairs
Benelux	Belgium, the Netherlands and Luxembourg
BRICS	Brazil, Russia, India, China and South Africa
CIPS	Cross-border Interbank Payment System
DNB	De Nederlandsche Bank
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECSC	European Coal and Steel Community
ECU	European Currency Unit
EEC	European Economic Community
EIB	European Investment Bank
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
EPU	European Payments Union
ERM	European Exchange Rate Mechanism
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
Fed	Federal Reserve System
forex	foreign exchange
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IMF	International Monetary Fund
INSTEX	Instrument in Support of Trade Exchanges
JCPOA	Joint Comprehensive Plan of Action
NATO	North Atlantic Treaty Organization
STFI	Special Trade and Finance Instrument
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TTIP	Transatlantic Trade and Investment Partnership
UK	United Kingdom
US	United States
WTO	World Trade Organization