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From Strategic Autonomy to the Internationalization of the Euro: Europe's Challenges and the Impact of the COVID-19 Crisis

by Nicola Bilotta and Alissa Siara

One of the key priorities of the new European Commission is to enhance the EU's geopolitical credentials and "learn to use the language of power", as stated by the incoming EU High Representative Josep Borrell.[1]

The EU's ambition is two-fold: to increase the Union's ability to project power and influence at the global level, including through increased integration and coordination among member states, and secondly to enhance the EU's strategic autonomy from the US in the political, military and economic domains.

Both objectives, ambitious in the best of circumstances, are today under severe strain by the COVID-19 crisis. Implications will be long-lasting and multidimensional, and for Europe, its impact will have a direct bearing on its ambition for strategic autonomy, touching each of the three pillars outlined above.

Clearly, the COVID-19 crisis will have severe economic implications for Europe. This will no doubt impact the financial and economic ambitions of the Union, including the goal of increasing the internationalization of the euro, a key dimension of the Union's ambitions for strategic autonomy, one which holds internal and external dimensions, spanning the economic and political domain.[2]

Due to the lack of a global currency, international trade and transnational investments require the intermediation of national currencies, thereby providing global political value to any

[1] European Parliament, *Hearing with High Representative/Vice President-designate Josep Borrell*, 7 October 2019, https://www.europarl.europa.eu/news/en/press-room/20190926IPR62260.

[2] European Commission, *Towards a Stronger International Role of the Euro* (COM/2018/796/4), 5 December 2018, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0796.

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international currency.[3] If a country relies on foreign currency to compose its national reserve holdings or to issue bonds, it will be indirectly influenced by the monetary policy of that foreign country. These spillover effects are transmitted by trade flows, currency exchanges and the increase of assets and liabilities held by foreign countries.

If the US dollar is depreciated, for example, this has a dramatic impact on natural resource-producing countries as these exports are mainly nominated in US dollars. Moreover, as demonstrated by US secondary sanctions on Iran, the US dollar's domination of the international financial system has prevented EU companies from doing business with Iran out of fear of being targeted or losing out on the lucrative US market. Beyond Iran, EU states fear that similar US sanctions could someday be imposed on other key trading partners, such as Russia and China, thus increasing the urgency to enhance Europe's independence in both political and financial terms.

It is largely for these reasons that the EU has sought to increase the internationalization of the euro. Yet, a stronger role for the euro does not only hold dividends at the international level, it is also indispensable to ensure stable economic growth and prosperity within Europe, making internationalization important for both the internal and external domains of European action.

Any un-coordinated financial response to the current COVID-19 crisis would have devastating effects on these objectives, however. This can be seen by analysing past trends in the euro's internationalization. Until 2008, the euro was consistently reducing its gap with the US dollar. In 2007, 40 per cent of the financing debt issued worldwide was nominated in euro, declining to 20 per cent after the 2008–9 financial meltdown and subsequent sovereign debt crisis. The composite index of the international role of the euro confirms this trend, showing a dramatic decrease after 2008.[4]

It is no coincidence that this sharp decline started after 2007–8. Even before the outbreak of COVID-19, EU economies were still struggling in their economic recovery whereas the US, after a GDP contraction in 2008 and 2009, has recorded an annual growth of more than 2 per cent. For the current crisis, the OECD predicts a fall in annual GDP growth of 0.8 per cent as consumers across the euro area have scaled back spending and strained companies' cash flows.[5]

Second, the EU has failed to integrate the area's financial systems. Despite having introduced a more coordinated framework with the European Stability Mechanism (ESM) for example, the EU's financial and capital market remains

[3] See: Jonathan Kirshner, *Currency and Coercion. The Political Economy of International Monetary Power*, Princeton, Princeton University Press, 1995.

[4] European Central Bank, *The International Role of the Euro*, June 2019, https://www.ecb.europa.eu/pub/ire/html/ecb.ire201906~f0da2b823e.en.html.

[5] OECD, *OECD Economic Outlook, Interim Report March 2020. Coronavirus: The World Economy at Risk*, 2 March 2020, p. 2, https://doi.org/10.1787/7969896b-en.

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fragmented, establishing remarkable asymmetries and weak centralized governance within the union, thus undermining the positive effects of a common currency.

To properly address its structural weaknesses, the European Commission had proposed key policy actions prior to COVID-19. The first step would be to complete the Banking Union[6] and the Capital Markets Union.[7] Such policies will need to form the basis on which to build a more resilient EU. The COVID-19 emergency, however, has added new complexities to this process and indeed the present crisis will likely represent the most significant test for the EU so far.

Unlike the 2007–8 crisis which affected countries unevenly and asymmetrically, the current shock is external and universal, requiring symmetric policy responses.[8] Furthermore, whereas the 2007 crisis started in financial markets and then spilled into the real economy, this time the shock has hit the real economy first, later impacting financial markets.

The EU has already activated the general escape clause of the Stability and Growth Pact, suspending the EU's strict rules on public deficits and lessening EU State Aid rules, allowing national governments to provide households and companies with emergency financial support. In addition, the EU has allocated 37 billion euro from the EU budget to the Coronavirus Response Investment Initiative to support healthcare systems, labour markets and small-sized enterprises and directed up to 800 million euro from the EU Solidarity Fund to the most hard hit countries. Also, the European Investment Bank has made up to 40 billion euro available to support small and medium-sized enterprises' financing needs.

Furthermore, the European Central Bank has introduced an extraordinary bond-buying programme of private and public securities totaling 750 billion euro (of which 220 billion in Italian bonds, equivalent to 12 per cent of national GDP) to stabilize financial markets and mitigate risks of growing interest rates.[9]

While encouraging, such stimulus might not be enough. Despite these policy actions, the euro has continued to drop against a rising US dollar.[10]

The old EU crisis instruments are inadequate to counteract the current economic downturn as they were designed for asymmetric shocks.[11] As

[6] Jerome Jean Philippe Deslandes, Cristina Sofia Pacheco Dias and Marcel Magnus, "Banking Union. What Next?", in *In-Depth Analysis*, July 2019, https://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_IDA(2019)634374.

[7] Ashok Vir Bhatia, Srobona Mitra and Anke Weber, "A Capital Market Union for Europe: Why It's Needed and How to Get There", in *IMF Blog*, 10 September 2019, https://blogs.imf.org/?p=27091.

[8] Daniel Dombey, Guy Chazan and Jim Brunsden, "Nine Eurozone Countries Issue Call for 'Coronabonds'", in *Financial Times*, 25 March 2020, https://on.ft.com/2vN0LX6.

[9] Carlo Cottarelli, "Dalla Bce un aiuto da 220 miliardi all'Italia. Ecco perché non c'è soluzione fuori dall'Ue", in *La Stampa*, 28 March 2020.

[10] Saqib Iqbal Ahmed, "Dollar Soars, Boosted by Worries Over Coronavirus Impact", in *Reuters*, 19 March 2020, https://reut.rs/2vzjZzo.

[11] See: Paul Krugman, "The International Role of the Dollar: Theory and Prospect", in John F.O.

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of June 2019, the difference of shares between the US dollar and the euro as an international reserve and debt issuing was around 40 per cent. A failure to move towards new instruments will likely increase this difference and confine the euro to its current standing as the second international currency in the world.

Signs that would indicate a move towards more coherent financial policies are sparse. Member states are debating the extent to which the 410-billion-euro ESM fund could be used to provide credit line instruments and under which clauses of conditionality – if any. Governments also remain divided over the more ambitious issuance of the so-called coronabonds. As leaders clashed in a virtual summit on 26 March, European finance ministers have been given ten days to come up with proposals.

Paris, Rome and Madrid – the three biggest EU economies after Germany – face a backlash from Berlin and The Hague. Northern member states have repeatedly rejected the introduction of a common debt instrument in the form of eurobonds, also during the previous sovereign debt crisis. The moral hazard argument – that mutualized debt would encourage further bad behavior – has nevertheless become invalid, given that today's economic crisis is caused by a health pandemic.

Dutch opposition against common instruments is deeply problematic. The European Commission has extensively investigated the Dutch tax system for facilitating unfair profit sharing in a country that – according to Oxfam International – is the third most prominent corporate tax haven in the world.[12]

Coronabonds, even if temporarily issued to boost economic recovery, would constitute a major breakthrough for financial integration. EU member states can still find a compromise on how to develop this instrument, discussing technical features such as maturity length or issuer and the specific purposes of its use.

Today the EU is facing a historical challenge which will change – for better or for worse – its future forever. Under the current emergency, countries must demonstrate European solidarity and debunk nationalist or isolationist tendencies. A lack of collective responses will not only undermine EU credibility and strength internally but also diminish the EU's weight and leverage at the international level. This will further weaken the international role of the common currency, potentially even undermining efforts to keep the EU united and responsive to the needs of its citizens.

In addition to deeper financial integration, the EU also needs to improve its cooperation in defence and foreign affairs matters to back-up the internationalization of the euro. So far, the EU has been unable to act as a

Bilson and Richard C. Marston (eds), *Exchange Rate Theory and Practice*, Chicago, University of Chicago Press, 1984, p. 271-278, https://www.nber.org/chapters/c6838.

[12] Oxfam International, *Four EU Countries Among World's Worst Corporate Tax Havens, New Report Reveals*, 12 December 2016, https://www.oxfam.org/en/node/10616.

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cohesive actor in international forums as priorities still depend on national interests rather than on a united EU perspective.

A recent study suggests that while economic bases have been overlooked with regards to the international status of a currency, there are also essential geopolitical factors which influence the choice of an international currency. A comparison between nuclear-weapon states and states dependent on the US for their security shows they differ in the share of the US dollar in their foreign reserve by 35 per cent. The study also suggests that if the US was disengaging from its global leadership, the US dollar would have experienced a drastic reduction of its international role, increasing US long-term interest rates.[13]

The EU's strategic response plan cannot therefore ignore the internal political dimensions behind an international currency. The EU acknowledges that a stronger international role for the euro is necessary to improve its political autonomy and economic consolidation in the global arena. Whereas the EU has set out a roadmap towards a more efficient financial and economic framework for facilitating this process, the COVID-19 emergency shows that the process needs to accelerate drastically.

Without a stronger and united EU, the common currency will not be able to properly challenge the dominance of the US dollar in global markets. Without a stronger international euro, the EU will not reinforce its economic and political autonomy, hampering its independence and credibility as a "global actor" on the world stage.

1 April 2020

[13] Barry Eichengreen, Arnaud Mehl and Livia Chiţu, "Mars or Mercury? The Geopolitics of International Currency Choice", in *Vox*, 2 January 2018, https://voxeu.org/node/62433

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