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Chapter Title: Comment on "Trade Invoicing in the Accession Countries: Are They Suited to the Euro?"

Chapter Author: Richard Portes

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Comment

Richard Portes, *London Business School, NBER, and CEPR*

1. Theory

The paper argues that the choice of a currency for invoicing will depend on: (1) hedging: macroeconomic volatility, in regard to differentiated products; and (2) herding: market structure, insofar as herding may be desirable in markets for "reference-prices" and "organized-exchange-traded" goods (collectively, "RW goods"). Note that despite the reference in the paper to network (thick-market) externalities, the model has no network externalities. Rather, the herding motive arises from strategic behavior with respect to competitors' pricing decisions, with the objective of limiting movements of the agent's relative price.

2. So Where Are Network Externalities?

There is no "vehicle" role in invoicing per se—invoicing refers to money as a unit of account, not medium of exchange. That is why I believe that in the international context, it is better to use "vehicle currency" for foreign exchange markets alone. And that is where we find network externalities, in the use of money as medium of exchange.

3. Role of Transaction Costs

In a wide range of asset markets, including foreign exchange, unit transaction costs fall with aggregate turnover. Thus a third currency, v, may be used as an intermediary in transaction between two others, e and d, because the volume of direct exchanges between e and d would be so low that transaction costs in that market would be higher than the sum of transaction costs in going from d to v and v to e. The direct d-e market disappears. Again, none of this has anything to do with invoicing.

4. Forex Market Vehicle Currency and Invoicing

Portes and Rey (1998) argued that network externalities in foreign exchange markets interact with transaction costs in securities markets (especially those for government bonds, which are used as short-term store of value for foreign currency holdings) to determine the choice of vehicle currency in the FX market and the choice of currency denomination of asset holdings. That suggests that choices in the financial (bond, foreign exchange) markets determine which is the vehicle currency; that this in turn strongly influences the choice of a peg (if any) for the domestic currency, hence the choice of intervention currency, and hence the currency of reserve holding (Papaioannou et al. 2006). Moreover, one of the key determinants of the choice of invoicing currency will be the role of the currency as a vehicle in foreign exchange markets and the currency peg (not the converse). The bottom line is that the invoicing decision is influenced by much broader considerations than the hedging and herding motives examined in the model and in the empirical work of the paper.

The dollar is still the dominant vehicle currency in the foreign exchange markets. It appeared on one side of 88.7 percent of all transactions in those markets in April 2004, whereas the euro appeared on one side of 37.2 percent of all transactions (Bank for International Settlements 2004). If the dollar were to give ground to the euro as a vehicle currency and an asset currency (the growing U.S. current account deficits and debt...), then European export invoicing would probably become almost entirely in euros.

5. Role of Exchange-rate Regimes

There is no direct role in the model for the exchange-rate regime—i.e., pegging, managed floating, etc. Of course this will affect cov (m_{ed} , s_{ed}) and cov (m_{ed} , s_{ev})—e.g., if s_{ed} or s_{ev} is constant. But surely the exchange-rate regime is more important than that—in the extreme, can we imagine Pemex invoicing any Mexican oil buyer in USD, or a Canadian producer of timber invoicing in USD to a buyer in another Canadian province? So we should expect the exchange-rate regime of accession countries to affect their invoicing choices. This point is discussed briefly in the paper, and some allowances are made for it in assessing whether countries invoice "excessively" in euros, but I believe it merits more extended treatment.

6. Empirics

Here we have extremely useful and informative work with the data, including the application of the Rauch framework to accession countries. Still, in Table 4, virtually all coefficients are insignificant, and I cannot even see the "preponderance of negative coefficients" that the author claims. Moreover, I am not convinced by the key Tables 5 and 6.

Going from the early 1990s through 2004 is necessary to get enough observations, but the exchange-rate regimes of several of the accession countries changed significantly during that period. The use of a post-1999 dummy variable cannot take account of these changes, which were spread out over the period (Poland 1996; Czech Republic 1997; Bulgaria 1997; Latvia, Lithuania, ...). Moreover, the euro came into existence in the middle of the period—as an accounting and asset currency at the beginning of 1999, as a physical currency (notes and coins) not until 2002.

7. Tables 5 and 6: Are They Suited to the Euro?

In Table 5, several countries are likely now to show the hedging consideration not favoring the dollar for Europe trade—e.g., Estonia, Latvia, and Lithuania (now have euro pegs), Slovenia, Slovakia, Hungary (all with managed floats with respect to the euro). That might leave only CR as "yes" in the last column. In Table 6, even as it stands, there are very few cases in which the euro share in invoicing is higher than predicted. Of these, Hungary is now in the euro band system, Estonia is pegged (currency board) to the euro, and Slovenia has a managed float with respect to the euro, with the prospect of adopting the euro at the beginning of 2007.

8. Conclusions

This is a very nice application of theory to the data. The empirical work is careful and detailed. The results are suggestive but by no means conclusive. And in my own view, the answer to the title's question is "yes," without doubt. Slovenia will in fact enter the euro zone in January 2007, and at least two others should have joined it under any reasonable criteria (those applied by the European Commission and the European Central Bank are decidedly unreasonable). They and the others will, I

expect, continue to show rising shares of euro invoicing for their trade both within the EU and outside it.

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Jeffrey A. Frankel is James W. Harpel Professor of Capital Formation and Economic Growth at Harvard University's John F. Kennedy School of Government. Christopher A. Pissarides is Professor of Economics at the London School of Economics. Both are Research Associates at the National Bureau of Economic Research.

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