Rising Euro, Falling Dollar

The Dynamic of a Global Monetary Shift

Hubert Zimmermann

Visiting Associate Professor, Cornell University

In the past weeks, print media and blogs are buzzing with renewed speculation about a possible replacement of the Dollar as the dominant global currency by the Euro. This intensification of the debate was sparked by the rise of the Euro above \$1.50 and a corresponding fall of the Dollar, also against other currencies. Even one Canadian Loonie is now worth more than one US Dollar. Numerous working papers and studies have been written since the late 1990s which present various arguments for either optimistic or pessimistic assessments of the Dollar's continued preeminence as a credible competitor to the Euro. Most of them focus on various economic indicators, while political scientists have tried to identify the political factors which might lead to a change of order in the global pyramid of currencies (Cohen 1998).¹ Relatively few of these studies deal with the likely consequences of such a shift, apart from wide-ranging and broad assertions which often reflect the predilections of the authors. What does it mean for international politics if the Dollar loses its preeminent position? What are the consequences for the domestic economies of either declining or rising currencies? This article will present some reflections on these questions, making use of recent advances in the study of international monetary policy and identifying some of the areas which necessitate more research.

Crouching Euro: Indications for the Leap Forward

It is generally accepted that a global currency needs some attributes to arrive at and stay in such a position. The first and foremost necessity is solid confidence by

market participants in its value. It has to be backed by an economy which guarantees political stability and low inflation (de Grauwe 2007: 253-4). Second, the currency has to provide deep, liquid, and efficient financial markets to guarantee easy access to capital and to allow market participants flexibility in the choice of instruments. Third, it must be internationally accepted almost everywhere. History suggests a fourth condition: the country issuing the currency should also be the dominant, or at least one of the dominant, political and military powers of the world. If these conditions are given, the currency might become the global leader in the core functions of international money as unit of account (vehicle currency), medium of exchange (transaction currency), and store of value (reserve currency).

Since 2001 the Euro has been on a slow but almost uninterrupted upward path against the dollar. From a low of about 0.82 \$/€ it is now well on its way to almost double its value against the dollar. This rise, however, is not necessarily an indication of a switch in the global currency balance: massive swings of exchange rates happened before, and the fluctuations of the Dollar against the German mark (DM) were just as extreme without the latter becoming a major reserve currency. Yet, it is clear that the Euro plays in a different league from the DM. This is not only due to the size of its market (15 countries with a population of 320 million), but also because the European Union, most of whose members will eventually adopt the Euro, has made no secret of its ambition to become a global actor, not only a regional one as Germany was. The rise of the Euro suggests to participants,

whether individuals, firms, or states, that holding Euros might be more profitable than holding Dollars. In fact, according to the latest IMF figures, the share of Dollars in total official reserves diminished from 71.5 % in 2001 to 64.7% in 2006, and the share of the Euro rose from 19.2% to 25.8% (IMF 2007). Clearly, this is also an indication that the Dollar still reigns supreme as reserve currency, but if that trend continues, the Euro will overtake the Dollar in about 15 years which would be quite rapid in terms of monetary history. Numerous countries have indicated they are contemplating a shift in their reliance on the Dollar as dominant reserve asset.² These developments make scholars speculate increasingly about an imminent reversal of the global roles of the Euro and the Dollar. Chinn and Frankel (2006) argue that either continued inflation in the US and the resulting Dollar depreciation, or an expansion of the Eurozone to most EU members, most crucially Britain, would signal the end for the preeminence of the Dollar.

Shifts are also on the way regarding the use of the Euro as vehicle currency. Recently, OPEC countries discussed openly whether they should switch from pricing oil in Dollars. Most members still reject such a step which could send the Dollar even lower and potentially make energy imports more expensive for the U.S. (Blas and Crooks 2007). As of yet, chances for such a drastic step seem low, and most international commodities are still invoiced in Dollars.

The amount of Euro notes in circulation has exceeded the value of Dollar notes since the end of 2006 (Atkins 2006). Despite that, the Dollar is still the world's leading transaction currency, being part of 86% (out of 200% because two currencies are involved) of global transactions. Overall, as the last report of the European Central Bank on the issue concludes, the international role of the Euro is still characterised by a strong institutional and regional pattern' (ECB 2007). What are the prospects for a change in the near future?

Hidden Dollar: The Residual Strength of the Top Currency

Despite the indications for a rising role of the Euro, the majority of analysts remain skeptical that the Dollar will lose its top position. With reference to the decades it took the Dollar to replace the Pound, long after Britain had lost most of its political clout, the inertia of changes in the monetary system is often cited as a major reason why the fall of the Dollar is not imminent. The path-dependency of an established currency which market players are used to, creating what political scientists call 'network externalities' and 'functional synergies', serves as a strong pillar bolstering the Dollar. Economists Dooley, Folkerts-Landau and Garber (2003) have argued that the world is experiencing what they call a Bretton Woods II system. The original Bretton Woods system was stabilized by the willingness of key follower countries to hold Dollars and finance the American deficits because they had an overriding interest in the competitiveness of their exports. This role is now assumed by the big emerging market economies which depend on exports for economic growth. In an influential article, one of the leading IPE scholars, Benjamin Cohen, offered basically four reasons why the Euro will not surpass the Dollar in the foreseeable future (2003). First, the efficiency of Europe's financial markets is still way behind American markets, and the Eurozone has no instrument to rival the convenience of the US Treasury bill.³ Second, an alleged anti-growth bias is built into the Eurozone, given the focus on monetary stability. Third, the political structure of monetary decision-making in the Eurozone remains ambiguous. It is still unclear who represents the Euro in the international arena: the ECB, ECOFIN, or the newly appointed Mr. Euro, Prime Minister Juncker of Luxembourg? Even more serious, and this might be the most fundamental reason of all, is the fact that the Euro is not backed by a unified political structure. Doubts about its longevity are bound to linger. This leads directly into the question

of the sustainability of the Euro. What happens to the Eurozone if countries such as Italy would be forced to leave (Tilford 2006)? While this seems a far-fetched scenario at present, it might become more relevant as international investors weigh the consequences of a long-term shift to the Euro. In contrast, nobody seriously speculates about a break-up of the United States. The bottom line is that the Euro still has to overcome some serious obstacles before it achieves parity with the dollar.

Monetary Power: “Real Sharpness comes without Effort.”⁴

Does it matter if the Euro becomes a global currency and the Dollar gets a rival? This question ultimately hinges on the economic and political gains which the Eurozone countries and their citizens would derive from that change and, of course, also from the advantages the United States would have to forego. Again, estimates are diverging because there are no clear measures of the advantages and disadvantages of global reserve currencies for their issuing countries. The most obvious advantage of a global currency is the gain from so-called *seigniorage*. As other nations hold the global currency at no interest (for example, as Dollars kept under a mattress), they effectively extend a zero-interest loan to the issuing country. However, in terms of global financial power this effect is generally assumed to be relatively small (Kenen 2003: 265). Another advantage lies in the lower exchange rate risk for companies located in the core country. States owning a global currency can also, under certain conditions, use it to exert direct pressure on other states (Kirshner 1995). Finally, there is the ‘exorbitant privilege’ of financing deficits with liabilities denominated in the home currency, though this might well become a weakness over the long run (De Beaufort Wijnholds/McKay 2007: 61). The US all through the post-war was able to borrow short and lend long, continuously earning a higher income on its liabilities abroad than foreigners earned on their generally low-

yielding dollar assets. As Gourinchas and Rey (2005) demonstrate, even when US liabilities exceeded its assets by a considerable margin, the US recorded a substantial net income. In case of a Dollar devaluation, the US also profited from an exchange rate effect as Dollar-holders’ reserves shrank whereas US investments abroad rose in value.

It has to be stated, however, that there might be also drawbacks in a currency’s global dominance. More demand for a global currency can drive up the exchange rate, threatening exporters. Incontrollable currency holdings by foreigners can make the control of the money supply difficult, especially in the case of sudden swings in market sentiment. This was one of the major reasons why the German central bank, the *Bundesbank*, always looked with uneasiness at any indication of the DM becoming a major international currency. Its core mandate was to control domestic inflation and huge DM deposits abroad threatened to undermine it. The same is of course true for the Eurozone, and the European Central Bank (ECB) has maintained that it would neither promote nor hinder the development of the Euro as global currency. In fact, if the ECB had to tighten its policy in response to external influences, this might create enormous strains in some Eurozone countries (Tilford 2007). Thus, the question whether a global currency actually conveys tangible advantages to the issuing country (apart from the not unsubstantial factor of prestige) hinges on whether it actually serves the objectives of the country (and those of its firms and citizens) and whether it enhances the country’s power to pursue its objectives.

This brings us to the question of monetary power. In a recent path-breaking volume on monetary power, B. Cohen defined its essence as ‘the relative capacity to avoid the burden of payments adjustment, making others pay instead’ (Cohen 2006: 50). The ultimate measure of monetary power is the ability to pursue one’s goals without regard to the effects on others. Potential adjustment

costs will fall on other participants, since opting out of the monetary system is no option for practically all market participants. The one red thread running through any analysis of US monetary policy since the ascendancy of the Dollar is the American unwillingness to subject domestic economic strategies to movements on global currency markets. There have been exceptions, notably during the 1960s when, for reasons related to the cohesion of Cold War alliances, the US implemented various restrictions on its international monetary transactions, negotiated deals with allies, and participated in a series of international mechanisms, all designed to bolster the Dollar (Zimmermann 2002). But the essential fact is that the US didn't have to adjust. This autonomy for the most part was not based on a conscious strategy. Despite some conspiracy theories,⁵ there are few indications that the US actively tried to promote or preserve the status of the Dollar. The most frequently cited episode is described by David Spiro who maintains that US protection of the oil-rich gulf countries such as Saudi Arabia hinges on a quid-pro-quo of these countries to support the Dollar and American consumption (Spiro 1999). But that seems to be clearly an exception. It was much more important that other countries had to react to the effects created by various policy choices in the center country, whether that suited their preferences or not.

Europe with its integrating markets, which necessitate a high level of exchange rate stability, suffered particularly from these fluctuations (Zimmermann 2008). Doubtlessly, the introduction of the Euro has made the Eurozone much more autonomous in this sense. Exchange rate fluctuations such as the fall of the Dollar in the past years would have led to incessant asymmetric adjustment pressure on European currencies, whereas in the current situation Europe has suffered remarkably little impact, apart from exports to the Dollar area which have not yet reached the pain threshold. In that sense, the Eurozone has acquired the core attribute of monetary power.

Just as the US was able to pursue its major objective, that is, to ascertain a continuous inflow of capital without inflation or other adjustment pressures, the Eurozone has been able to pursue its objective of macroeconomic stability. Much more research is necessary to exactly clarify the links between the international role of the Euro and its possible effect on domestic economic (and therefore political!) conditions in the Eurozone. The contest about which is the real global currency will be decided once a major crisis forces the major cost of adjustment on either the US or Europe (almost certainly, innocent bystanders will suffer considerably more than the big players).

Green Destiny? Possible Consequences of Monetary Bipolarity

We might live already in a world of a monetary bipolarity. There are few historical parallels for such a situation. The most plausible comparison is the interwar period between World War I and II, when the British pound was in decline whereas the Dollar was ascendant. Obviously, this was a period of rampant international financial instability. Can this be attributed to the absence of a clear top currency? This was the claim of hegemonic stability theory: without a hegemon providing a minimum of public goods to overcome dilemmas of collective action, international cooperation would collapse (Kindleberger 1973). This much maligned theory was actually developed with monetary policy foremost in its mind but its opponents usually point to the 1970s and 1980s when the US lost its dominance in trade but kept its monetary leadership. Thus, it might finally face a real world test. However, even if the world descended into instability this would not necessarily rescue the theory, since the US in monetary policy rarely exerted leadership for the sake of systemic stability. Frequently, it has been the source of instability. The noted economist Barry Eichengreen, who has studied the interwar period extensively, attributes many

of the problems not to monetary bipolarity but rather to the absence of functioning institutions for international coordination and an unwillingness to cooperate among the major players, caused by domestic pressures (Eichengreen 1995: 8-12).

Currently, monetary relations are characterized by a very low level of formal cooperation. The G8 is ineffective in this area, the IMF is limited to a surveillance role, and Central Bank cooperation occurs mainly ad-hoc, such as during the recent credit crunch caused by the subprime mortgage crises. Such Central Bank cooperation, in the framework of

the Bank for International Settlements and the Financial Stability Forum, tends to be rather non-controversial in case the solutions involve benefits for all participants and negligible adjustment costs. Once a distributive dimension enters the game, political conflict is unavoidable. At this point, the destiny of the greenback could easily result in the often evoked battle between the Dollar and the Euro. There is a clear danger of all participants losing if a duopoly in monetary policy leads to instability without working mechanisms to address monetary crises.

Endnotes

¹ Since 'Money is Politics', as Jonathan Kirshner (2003) reminds us, it makes little sense to focus exclusively on economic determinants when dealing with international monetary issues.

² 'India seen cutting its dollar reserves', FT, May 4, 2005; 'Diversification Specter Unnerves the Dollar', International Herald Tribune, Mar. 17, 2005.

³ However, the adoption of the Financial Services Action Plan (FSAP) by the EU in March 2000 has been a big step in creating a single financial market. It aims to remove regulatory and market barriers to the cross-border provision of financial services in the EU. There are already some indications that European markets have made substantial progress in catching up with the US.

⁴ Quoted from: *Crouching Tiger, Hidden Dragon* (2000), directed by Ang Lee.

⁵ Among the most frequently cited on the internet is the wildly implausible theory that the US marched into Iraq to punish Saddam Hussein for switching to the euro.

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