Will the Euro Rival the US Dollar?

Written by Silvia Caneva

This PDF is auto-generated for reference only. As such, it may contain some conversion errors and/or missing information. For all formal use please refer to the official version on the website, as linked below.

Will the Euro Rival the US Dollar?

https://www.e-ir.info/2012/06/08/will-the-euro-rival-the-us-dollar/

SILVIA CANEVA, JUN 8 2012

The launch of the Euro, Europe’s single currency, on 1 January 1999, marked an important step in the European integration process. Bergsten (2005, p.29) defined it as “the most successful episode in the entire history of the European integration movement”. Originally adopted by Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain, the Euro is today shared by seventeen EU countries. Besides the significant role played by the Euro in the EU integration process and in shaping a sense of collective identity among EU citizens, the introduction of a European single currency is of paramount importance in the financial and economic sector.

From the beginning of the negotiations for a European common single currency, predictions on the future of the Euro and on its international role have been made by experts all around the world. Particular interest was aroused by the question of whether the Euro would have rivaled the US Dollar. This essay revolves around this question.

This essay will provide a brief overview of the expectation concerning the birth of the Euro in reference to its possible role as challenger to the Dollar’s dominance as an international currency. It will then explain the criteria according to which a currency can achieve an international role and the determinants of the international status of a currency, with particular focus on the role of inertia. Particular attention will then be drawn to the weaknesses affecting the Euro and the EMU, which hamper the ascent of the European currency beyond the European region.

The introduction of the Euro was defined as “the most important development in the evolution of the international monetary system […] since the dollar succeeded sterling as the world’s top currency during the interwar period” (Bergsten 1997, cited in Bergsten 2005, p. 27). This event aroused great expectations in the financial world. Many experts considered the Euro a possible rival for the Dollar and a threat for its predominance as an international currency. Among others, Mundell (2000, p.57) claimed that the Euro would have altered the power configuration of the system by challenging the status of the Dollar. Unlike the Japanese Yen or the German Mark, the Euro was seen as “the first real competition to the US Dollar since the latter’s ascent to global currency dominance” (Bergsten 2005, p.2).

The reasons why the introduction of the Euro aroused such great expectations are not difficult to identify. The USA has been and is still being affected by international debt and deficit problems, which turned the USA from the world biggest creditor to the world’s biggest debtor (Bergsten 2005, p.34). As Bergsten (2005, p.35) reports, “in 2003 the US current account deficit reached $550 billion, or about 5 percent of GDP”. Moreover, the Eurozone, unlike Japan and Germany had (and still has) a size, a population and a GDP rivaling those of the USA. For these reasons, many observers considered the possibility that the Euro could rival or even surpass the Dollar. However, although the economic size is an important factor in determining the international status of a currency, it is not the only one.

In order to assess whether the Euro could rival the Dollar it is essential to define what an international currency is. An international currency has been defined as a currency that is extensively used outside the country of issuance as store of value, medium of exchange and unit of account (Avellaneda 2008, p.3). The use of an international currency as a store of value concerns its accumulation in international reserves by governments and its use as an investment currency by individual agents. As a medium of exchange, an international currency can be used as a vehicle currency for intervention in the foreign exchange market by governments and for the transactions of private agents. In the
function of being a unit of account, monetary authorities can use an international currency as an anchor for pegs, while private agents use it as a quotation currency for trade in goods and assets (Papaionnou and Portes 2008, cited in Avellaneda 2008, p.4). Cohen (2003, p.5) claimed that the Euro had made progress at the Dollar’s expense only in its function as a store of value, while it did not represent a serious challenge to the dominant use of the Dollar as a medium of exchange or as a unit of account. However, as stated by Szapary (2009, p.121), although the Euro has overtaken the European legacy currencies as a reserve currency, since 2003, when Cohen’s speech was made public, the shares of the Euro and the Dollar in international reserves have stabilized at approximately 27 and 64 percent, respectively.

Other crucial determinants of the international status of a currency, besides economic size (mentioned above), are the maturity and sophistication of domestic financial markets, confidence in the currency value, and network externalities (Chinn and Frankel 2008, pp.56-59; Wong and Khan 2006, pp.2-5). According to Wong and Khan “broad, deep and open financial markets are necessary to satisfy the global needs of both private investors and central banks” (2006, p.6). They argue further that given the absence of fiscal harmonization in the Eurozone, this criterion ensures the dominance of the Dollar in international transaction. As far as the confidence in the value of a currency is concerned, Chinn and Frankel (2008, p.57) identify the fact that the USA as a large-scale debtor country is a negative for the Dollar, since it makes the Dollar unattractive.

Despite the latter factor, there is consensus in the literature on the fact that network externalities and the inertia associated with them favour the continued central role of the Dollar and hamper the rise of the Euro as a rival to the Dollar. This is due to the fact that network externalities lead to an increase in the value of a given currency as more people use it and seeing that one chooses a currency in the belief that it is the most used (Avellaneda 2008, p.6; Chinn and Frankel 2008, p.58). Chinn and Frankel (2008, p.59) identify economies of scope as one aspect of network externalities and they define it as the tendency of an individual to use a certain currency in his transaction if everyone else is doing so. As they explain:

If a currency is widely used to invoice trade, it is more likely to be used to invoice financial transaction as well. If it is more widely used in financial transactions, it is more likely to be a vehicle currency in foreign exchange trading. If it used as a vehicle currency, it is more likely to be used as a currency to which smaller countries peg (Ibid.).

In this perspective, the Dollar clearly has a historical advantage over the Euro. This advantage is also favoured by inertial bias. Cohen (2003, pp.6-7) identifies two sources of inertia: the first is the pre-existence of already well established transactional networks that generate “stickiness” in user preferences, given that switching currency is costly. The second source is the high degree of uncertainty connected to the choice between two alternative monies, which leads to a continuation in the use of a given currency in order to minimize risks connected with changing currency despite the emergence of a powerful competitor. Using Wong’s and Khan’s words, “agents tend to adopt a wait-and-see attitude when faced with a new and untested player” (2006, p.4). The role of inertia in preserving the supremacy of the Dollar over the Euro can be understood by looking back at the process through which the Dollar gained its dominance over the Pound. According to Chinn and Frankel (2008, p.50), the US economy surpassed the British economy in size in 1872, while US exports surpassed UK exports in the mid 1910s. During this period the UK passed from net creditor to net debtor, while the USA moved in the opposite direction. However, the Pound retained its dominant position as a key currency until the end of the Second World War, namely half a century after the United Kingdom’s GDP had been surpassed by that of the USA. Given the major shocks that were experienced by the UK before the Dollar emerged as the uncontested leader among international currency, such as the disruption of UK trade and investment due to the First World War, Bergsten (2005 p.34) stated that “US economy may have to foul up for the Euro to realize its potential to achieve rough parity with the dollar at the core of the international monetary system”.

Besides inertia, another non-financial factor that favours the dominance of the Dollar over the Euro is the USA’s political leadership in security affairs. As Posen observes, “longer-term choices of international currency commitments [...] are not solely driven by financial factors either, but also by foreign policy motivations and security ties” (2008, p.78). Evidence of this lies in the fact that “the CFA franc zone, where France still intervenes militarily, is the only group of countries outside of eurozone membership candidacy to peg to the euro” (Ibid.). As Posen argues
Will the Euro Rival the US Dollar?
Written by Silvia Caneva

further, the EU is unable to offer the security benefits provided by the USA beyond a very limited area and this constrains the attractiveness of the Euro outside Europe (2008, p. 80).

In addition to network externalities, inertia and security ties, Cohen identifies structural weaknesses, which represents a serious obstacle to the ascent of the Euro as a rival of the Dollar: an anti-growth bias built into the institutional structure of EMU, and the governance structure of EMU (2003, pp. 7-13; 2008 43-51).

The first flaw that undermines the internationalization of the Euro is to be found in the anti-growth bias built in the institutional structure of the EMU: as Cohen (2003, pp.8-11; 2008, pp.45-46) explains, on the monetary side the mandate of the ECB contained in the Maastricht Treaty attributes to the ECB the only objective to maintain price stability, and not that of promoting employment and output, as in the case of the Federal Reserve. Likewise, on the fiscal policy side, the Stability and Growth Pact, by mandating a cap on annual budget deficit of 3% of GDP, make it difficult to use fiscal policy to balance the anti-growth bias of monetary policy. The result is that the use of the Euro for investment purposes is discouraged.

The second shortcoming jeopardizing the international role of the Euro is related to the governance structure of EMU. The ambiguity concerning how decisions are to be taken in the ECB along with the large size and the mixed representation of the Governing Council of the ECB not only undermine the efficiency of the body, but also discourage potential users of the Euro to abandon the Dollar (Cohen 2003, pp.11-13; 2008, pp.46-48). The absence of an authority designated to speak on behalf of the Eurozone, as the US Secretary of the Treasury does for the American greenback, is a part of a major problem of the EU: the lack of a single voice. This is an issue that affects most of the areas that the EU deals with and that undermines not only the possibility of the Euro in rivaling the Dollar, but also the stature of the EU in the international community. Concerning this point, it should not be forgotten that “the euro is a currency without a country – the product of an interstate agreement, not expression of a single sovereign power” (Cohen 2008, p.38).

Cohen (2003, pp.7-8; 2008, pp.43-44) also highlights the problem relating to transactions costs that “directly affects the currency’s attractiveness as a vehicle for foreign-exchange transactions or international trade” (Cohen 2003, p. 7). As Cohen (2003, p. 7-8; 2008, pp. 43-44) illustrates, the Dollar enjoys a natural advantage of incumbency; moreover Euro transaction costs have been higher than those of the Dollar. Therefore, unless the adoption of the Euro becomes really cost-effective, it is unlikely that the Euro will be adopted as a new international currency by countries whose foreign trade is not concentrated in the Euro-time zone. Conversely, countries trading heavily with the EU tend to use the Euro, even if there is not a distinct cost-advantage. This issue seems to be difficult to solve due to the absence of “a universal financial instrument that can match the US Treasury bill for international investor liquidity and convenience” (Cohen 2008, p.44).

Despite the evident presence of obstacles that hamper the Euro’s ascent as an international currency, there are elements that play in favour of the Euro and the Euro-area: political stability, a large economic base and a low rate of inflation. As Pisani-Ferry and Posen (2009, p.2) note, the strengths of the Euro contribute to making it a dominant regional currency. This view is supported by the analysis carried out by Szapari (2009, pp.121-138), who, on the basis of indicators such as the number of countries that have pegged to the Euro, the anchoring role of the Euro and the composition of foreign exchange reserves in the Eurozone neighbourhood, claims that the Euro plays a key role at a regional level. However, “beyond the European region, the Euro remains very much in the dollar’s shadow” (Cohen 2008, p.48). In the tenth year of usage of the Euro, Pisani-Ferry and Posen (2009, p.2) express the following consideration: “by all standards the euro is an overwhelming success in the EU and its neighbourhood, and by all standards it is junior to the US dollar in international monetary affairs”. In other words, the Euro, despite its dominance in the European region, is the number two international currency, behind the Dollar, which firmly maintains the role of the leading international currency.

Conclusion

At twelve years since the initial launch of the Euro, some observers consider the Euro and its performance a success, others a failure. Nowadays, despite being the dominant currency in the European region, the Euro does not represent
a challenge to the US Dollar at a global level. Moreover, given the structural deficiencies that weaken the EMU and consequently the international status of the Euro, it is unlikely that the Euro will rival the Dollar, at least in the short term. In order to enhance the possibilities of the Euro becoming equal to the Dollar, changes are crucial. If the achievement of dynamic growth is important, reforms that enable the Eurozone member-states to act together and speak with a single voice are essential. The objective to find a single voice for seventeen countries is, nevertheless, extremely difficult to achieve. Furthermore, despite this challenge, the changes needed may not be sufficient for the Euro to rival the Dollar given the role of network externalities and especially that of inertia in preserving the role of the Dollar as the main international currency. For these reasons, it is highly unlikely that the Euro will rival the Dollar as an international currency at a global level. Nevertheless, the overcoming of the flaws of the EMU and constant good performances of the Euro may contribute to increasing the influence of the Euro in the Euro-time zone.

Bibliography


Will the Euro Rival the US Dollar?
Written by Silvia Caneva