

**THE EURO VERSUS THE DOLLAR:
WILL THERE BE A STRUGGLE FOR DOMINANCE?**

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The Euro to Date

I am delighted to substitute for Robert Mundell on this panel since he and I are among the very few economists from this side of the Atlantic who have argued, from the outset of the debate over European monetary union, that the creation of the euro was a good idea, would happen on time, and would produce a strong currency that would challenge the dollar for global supremacy. Mundell in fact began making that case as early as 1969, when he called the currency the “europa.” On the eve of the launch of the virtual euro in 1998, he wrote:

The introduction of the euro will represent the most dramatic change in the international monetary system since President Nixon took the dollar off gold in 1971 [and when] the era of flexible exchange rates began...the euro is likely to challenge the position of the dollar [and hence] this may be the most important event in the history of the international monetary system since the dollar took over from the pound the role of dominant currency in World War I (Mundell 1998).

I made a similar argument, and in fact used very similar words, in analyzing the outlook for the international role of the euro a year earlier (Bergsten 1997a, 1997b). After three years of

experience with the virtual euro, and at the dawn of the creation of the physical euro, I see no reason to alter that assessment.

Indeed, the euro has already been a huge success internationally as well as within Europe (which I will not address in this paper, as success on that front is so widely agreed). It already became the most widely used currency for international bond flotations during its first year of existence (Mussa 2001). From the start of 1999 through September 2001, the latest date for which we have comprehensive statistics, euro-denominated bond issues exceeded dollar-denominated bond issues (de Larosi re 2001). During 1990-98, the predecessor currencies accounted for 10 percent of all corporate bonds issued by euro-area borrowers and only 2 percent of those issued by companies outside the area; those ratios have risen to 75 percent and 20 percent since EMU (Galati and Tsatsaronis 2001). The world already enjoys a bipolar international financial market if not yet a bipolar international monetary system. In addition, emulation is as usual the most sincere form of flattery: the early but deliberate progress toward an Asian Monetary Fund derives much of its inspiration from the euro (Bergsten 2000).

The Dominance of the Dollar

For all the complexities injected into the usual discussion of this topic, the potential “struggle for dominance” between the dollar and the euro, the fundamental issue is quite simple. The basic reason for the supremacy of the dollar over the past half-century or more is that it has had no competition. No other economy has even come close to the size of the United States. Hence no currency could acquire the network externalities, economies of scale and scope, and

public goods benefits necessary to rival the dollar at the global level. A largely similar situation during most of the nineteenth century explains sterling's dominance in that period.

The clearest evidence for this conclusion is the fact that the dollar has reigned supreme despite prolonged periods of very poor economic performance by the United States:

- Its economy grew very slowly for two full decades, from the early 1970s through the early 1990s, and productivity growth (which is now reportedly attributed great salience by the currency markets) was especially mediocre.
- It experienced high inflation for almost a decade, from 1973 through 1981, including three years of double-digit price increases.
- It has run large external deficits for most of the past 20 years, including two periods when those deficits were rising at clearly unsustainable rates (1982-87 and 1998-2000), and has become by far the world's largest debtor country (with a negative net international investment position of \$2 trillion at the end of 2000).

The dollar did experience significant erosion of its global market share in the late 1970s and early 1980s. Moreover, its weakness and instability provided crucial impetus to the first effective efforts to create a European alternative, culminating in the European Monetary System in 1979. However, the dollar's share of global finance stabilized again in the 1990s and has remained far above that of any other national money.

The overwhelming reason is that the United States has remained far larger, especially in terms of GDP and also trade and other size variables, than any other currency-issuing economy. Increasingly reinforced by its incumbency advantages (see below), the dollar has remained preponderant and generated a share of currency markets about four times as great as its share of

world output and trade. The deutsche mark was the world's second key currency for most of the postwar period but never attained a market share greater than one-fourth that of the dollar; this was quite logical since the economy of the former West Germany was about one-fourth the size of the United States (and, as Chancellor Helmut Schmidt constantly reminded us, its geographical size was approximately equal to the state of Oregon). Japan, whose economy at one point grew to be more than half as large as America's, never realized anything like that portion of world finance because of the underdevelopment of its financial markets (as amply demonstrated by the decade-long crisis that it is now experiencing and has yet to address effectively).

Econometric evidence verifies the central importance of size for international currency purposes. Eichengreen and Frankel (1996) concluded that a rise of 1 percentage point in a key currency country's share of world product (measured at purchasing power parities) is associated with a rise of 1.33 percentage points in that currency's share of central bank reserves. In a more sophisticated version of those estimates, which attempted to account for historical inertia (see below) as well as economic size, Eichengreen (1997, 51) found consistent if modestly smaller effects: the rise of a currency's share in global reserves that derived from a rise of 1 percentage point in its country's share of global output (at PPP) is 0.9 percentage points, about two-thirds as much as in the prior calculation. The central importance of size was clearly validated.

The present Euroland is 20 to 30 percent smaller than the United States in terms of total output and about 25 percent higher in its share of world trade. For all practical purposes, the two are close enough to be regarded as rough equivalents. Expansion of the euro to include all 15 members of the current European Union would take the numbers modestly (10 to 20 percent) above the United States in output terms. Eventual inclusion of the additional dozen applicants for

EU membership would add another 10 percent or so to Euroland's output superiority (as well as bringing its population to about two-thirds greater than that of the United States).

In short, it is clear that the euro will provide the first real competition for the dollar since the latter's ascent to global currency dominance. The interesting questions in fact relate to the time period and adjustment path over which that competition will play out, and to what its systemic consequences will be. I turn now to those topics.

How Will the "Struggle" Play Out?

Mundell, others, and I who believed that the euro would move quickly to challenge the dollar would seem, at this point, to have had too much confidence that forward-looking markets would incorporate our analysis of longer-term trends. We presumably underestimated the incumbency advantages of the dollar—though we both noted that inertia is a powerful force in monetary matters and that historical transitions in this arena have not been smooth and linear.

Nevertheless, it will be interesting to see what happens to the euro's international role as it now becomes a physical as well as a virtual currency. It will also be interesting to observe the impact of the passing of such transitional effects, that have weighed negatively on the international role (and price) of the euro, as the movement into dollars (1) as investors sought to rebalance their portfolios to offset the loss of the diversification benefits of multiple national currencies in Europe and (2) as Eastern European and black money balances sought to avoid an unfamiliar new asset and the risk of registering large conversions into it (Sinn and Westermann 2001).

But even if it turns out that these transitional considerations explained a considerable part of the lag in the euro's acquiring its inevitably large international role, four additional factors are likely to loom large in determining the ultimate timing thereof. Three are within the control of the European entities themselves and one is wholly exogenous.

First, Euroland will need to further integrate its money and capital markets to realize the full international potential of its new currency (Portes and Rey 1998). The superiority of the American financial markets, and those of the United Kingdom during the period of sterling's dominance, were key elements in those monetary regimes. The negative case of Japan is also instructive: its failure to modernize its financial markets, despite repeated calls for such reform and even announcements of programs to do so (such as Prime Minister Hashimoto's "big bang" in 1996), undercut any possibility that the yen might have come to play a major international role.

The European financial markets, galvanized both directly and indirectly by the euro itself, have already made impressive strides (Danthine, Giavazzi, and von Thadden 2000). However, national rivalries have impeded cross-border mergers of both banks and equity markets. No single benchmark security, or yield curve, has developed to rival the US Treasury bill and other US government assets. The pace at which Euroland overcomes these shortcomings will play a major role in the timing of the euro's ascendance in international asset allocation. Early entry of the United Kingdom to Euroland would presumably accelerate the process.

Second, Europe will need to get its act together institutionally. The European Union has been a fully equal partner to the United States in the management of the global trading system for many years. Cooperation between this "G-2" was a necessary condition for the successful

launch and completion of each of the major multilateral trade agreements of the postwar period (as seen again with the launch of the latest round at Doha in November).

Europe was able to successfully challenge the previous dominance of the United States in the trading system for two reasons. One, as with finance, was the rough equivalence of its trade volume (and, though less important here, of its total output) with the United States. Second, and of crucial importance, was its early decision to centralize virtually all trade policy decisions and negotiations in a single entity (in this case, the Commission in Brussels).

A somewhat parallel situation exists on the monetary and macroeconomic front. On most of the relevant objective criteria, as noted above, Europe already equals the United States or, as in the case of integrating its financial markets, is on its way to doing so. But Europe still speaks with a multiplicity, even a cacophony, of voices on these issues. Hence it dissipates much of the potential for realizing a key international role for the euro.

Macroeconomic and monetary issues are qualitatively different from trade policy issues because markets dominate most outcomes on the former whereas intergovernmental activities by definition dominate the latter. Hence European institutional cohesiveness will not assure a rapid rise in the international position of the euro. But organizational reforms that enable Euroland to act together and speak with a single voice will probably be an essential prerequisite of full European equivalence with the United States *à la* trade. It could even turn out to be necessary for Europe to achieve full political integration, and become a single nation *à la* United States, to assure this outcome (Köhler 2001).

Third, the international role of the euro would obviously be strengthened if Europe would improve its economic performance. Euroland has already achieved convincing price stability but achievement of dynamic growth may also be necessary for the euro to effectively challenge the

dollar (Kawai 1997). Whether or not that is true, international interest in the euro will surely rise—and set in motion a self-reinforcing cycle of euro appreciation and increased portfolio diversification into euros—if Euroland countries are able to both overcome their continuing structural impediments and find a way to employ more expansionary macroeconomic policies, e.g., by recognizing that the European Central Bank ought to attach at least secondary importance to output goals and/or relaxing the arbitrary ceilings for government budget deficits in the present Growth and Stability Pact.

Fourth, and perhaps most important, the United States 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. Inertia is so strong in financial affairs that it may be impossible to dislodge an incumbent unless that incumbent essentially abdicates (Bergsten 1996). Sterling maintained a central international role for at least half a century after the United States had surpassed its GDP and faded only due to the shock of World War I (during which its trade and investment were disrupted and it had to sell off many of its foreign assets) and its own major economic mismanagement in the 1920s (a persistent macroeconomic slump, sterling overvaluation, creeping protectionism, and a variety of capital controls) (Eichengreen 1997).

An interesting thought experiment is to ask what would have happened to the international role of the dollar in the late 1970s and early 1980s, if the euro (or any realistic competitor to the dollar) had existed at that time, when US inflation hit double digits; when its economic growth was mediocre; and when the country started running huge external deficits and shifted from being the world's largest creditor country to its largest debtor. Even without such a competitor, the global market share of the dollar dropped substantially. European monetary integration was galvanized. Replication of such a period of poor US economic performance,

which is certainly possible if not inevitable, might be a necessary condition for the euro to realize its underlying potential—whatever the Europeans do themselves to ensure, or even accelerate, the process.

Are there any foreseeable developments that could represent such a repetition of recent history? Here I would again join Robert Mundell and quote from his writings on the eve of euro creation in 1998:

It would be a mistake to ignore [the fact that] in the last 15 years US current account deficits have turned the US from the world's biggest creditor to its biggest debtor... The low-saving high-debt problems will one day come home to roost... There will come a time when the pileup of international indebtedness makes reliance on the dollar as the world's only main currency untenable... The fact that the bulk of international reserves is held in dollars makes the currency a sitting duck in a currency crisis... Sole reliance on the dollar as the main reserve, invoice and intervention currency presents risks that are no longer necessary (Mundell 1998).

The US international debt and deficit problems have of course become much greater over the past four years since Mundell wrote those words. The current account deficit jumped by about \$100 billion annually during the three-year period 1998-2000, nearing \$450 billion or about 4.5 percent of GDP in 2000. This took it well into the traditional “danger zone” in which OECD countries, including the United States on three previous occasions in the postwar period, were forced to adjust (Mann 1999, Freund 2001).

The net international investment position of the United States reached a negative \$2 trillion at the end of 2000 and is projected to reach about 40-50 percent of GDP in the next two or three years (Mann 1999, updated 2001). Chairman Greenspan has referred to the US external deficit as “unsustainable” as recently as a month ago (Greenspan 2001). The International Monetary Fund has suggested that the dollar is overvalued by at least 20 percent (IMF 2001).

Hence it is quite possible, indeed probable, that the dollar will experience a sharp depreciation at some fairly early point. Major dollar depreciations are nothing new: they have occurred about once per decade since the advent of generalized currency convertibility in the postwar period: in 1971-73, 1978-79, 1985-87 and 1994-95 (to the dollar's all-time lows against the DM and yen).

Any substantial future depreciation would take place in a very different world, however: one which included the euro, the first potential competitor for global status that the dollar has faced throughout its period of currency hegemony. Such a future fall of the dollar could thus trigger important, indeed historic, systemic as well as market and macroeconomic effects. This is particularly true since any particular trade-weighted decline of the dollar would produce a much greater rise in the euro, because many of America's major trading partners (such as Mexico and perhaps Canada) simply could not accept substantial appreciation of their currencies against the dollar. Japan, another major trading partner, might also be too weak to accept (or attract) any significant appreciation if the dollar adjustment were to transpire in the near future. Hence a fall of even 20 percent in the average exchange rate of the dollar could produce a rise of perhaps twice that much in the euro. Such a substantial and prolonged strengthening of the euro would in turn almost surely induce a large part of the structural portfolio diversification into euros, which I earlier estimated at \$500 billion-\$1 trillion (Bergsten 1997a), that would mark the arrival of the euro as a major competitor to the dollar.

Such a scenario might indeed trigger the farreaching systemic implications hypothesized by Mundell and cited at the outset of this paper. Mundell himself concluded that the euro "...could present problems in the transition ...magnified by the likelihood of a massive

diversification into euro-denominated deposits. Both the EU and the US would need to take strong defensive action to ease the transition [but] it is unlikely that bilateral handling of the problem would be amicable” (see also Bergsten 2001).

The next big problem facing the “international financial architecture” may thus center on the countries and currencies at its core, the United States and the European Union, rather than the emerging market economies and their currencies, as in the last two decades. I look forward to participating in a panel on those topics at these meetings in future years if the world unfolds along the lines suggested and new systemic defenses do indeed turn out to be required.

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