



The Monetary Realist

It's Not Just About The Money

BY ADAM S. POSEN

Financial panics are indeed dramatic and, for many private individuals and economic policymakers, traumatic. They are rarely of lasting significance to the fate of nations or their currencies, however, as the prompt recovery of Korea, Mexico, and Russia from their travails a decade ago demonstrates—as indeed does the lack of any lasting impact from the United States' closing of the “gold window” on the dollar's standing or on U.S. economic performance. Though such calm is difficult to maintain while the United States experiences a panic in its many interlocking asset-backed securities markets, following years of large current account deficits and a concurrent

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sell-off of the dollar against the euro, it would be a mistake to read too much into recent developments. In fact, they obscure the reality that the euro is at a temporary peak of influence, and the dollar will continue to benefit from the

geopolitical sources of its global role which the euro cannot yet or soon, if ever, match.

Given the apparent readiness of the euro to provide an alternative for all these concerned individuals to accept in lieu of dollars, or even into which to switch their investments, the euro's ascent to at least comparable status with the dollar has a surface and popular plausibility. The fundamental drivers of reserve currency shares are usually thought to be relative economic size, financial depth, and commitment to low inflation of the relevant currency blocs, all of which could be expected to converge over time with the United States, if not favor the euro. The only offset to this projected trend of increasing euro usage usually admitted is the obvious inertia in dollar usage shown in the data, which is usually ascribed to incumbency advantages due to the network benefits from the already wide use of the dollar.

Some analysts have argued that the euro's attaining co-dominance simply awaited a significant series of policy mistakes or a balance of payments crisis on the part of the United States to overcome this inertia. Such a process is assumed in those analysts' interpretation to have been operative when sterling lost its role to the dollar in the 1930s, once the United Kingdom's balance of payments and

monetary discipline flagged, and the dollar was spared such a fate in turn during the 1970s only because neither the deutschemark nor the yen were a viable alternative at the time.

It is overdue and correct for American and other observers to shed any remnants of the excessive doubts about the euro that prevailed in too many quarters from the mid-1990s onward, and to recognize that the euro has been an ample success within the limits of the monetary realm. Yet, to go further and to argue that this is the turning point for



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euro to equal the dollar in, or to displace the dollar from, its global role, however, would be misguided:

- There will be no abrupt displacement of the dollar from a dominant role in official reserve portfolios as a result of short-term exchange rate movements, because official reserves either are accumulated for insurance purposes or are managed to rebalance allocations;
- Longer-term choices of international currency commitments—by private as well as public decision-makers—are not solely driven by financial factors, but also by political ones; and
- The eurozone's monetary strengths are insufficient to offset the European Union's structural weaknesses (economic and political) in the exertion of global leadership.

The source of all of these mistakes is too narrow and deterministic a focus on simple observable economic determinants of reserve currency holdings, and of global currency usage more broadly.

U.S. political leadership in security, commercial, and even cultural affairs

globally has a critical impact on the usage of the dollar in the monetary realm. Other governments' reserve currency holdings and exchange rate man-

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agement are importantly influenced by security ties, and decisions to peg (and thus to accumulate dollar reserves for intervention) from Taiwan to Saudi Arabia to Panama depend as much on foreign policy as economics. Private decisions to invest in the United States, both at the corporate level and by indi-

viduals, are supported by the desire to gain insider access to key decision-making processes and to membership in transnational elites. In fact, it is this desire for membership and access that is a major source of the return differential on U.S. investments abroad versus foreign investments in the United States—and thus constitutes much of the “dark matter” providing the United States with the exorbitant privilege to pay for its current account deficits in its own currency.

The European Union, let alone the eurozone itself, is unable or unwilling to offer these systemic or security benefits beyond a very local area, and thus is fundamentally limited in its ability to attract currency adherents, despite the success of the euro for its internal use. This significant dependence of the dollar's global role on political as well as economic factors, however, suggests that it is vulnerable to foreign policy failures—that in fact some of the decline in the dollar's global role of late is already due to the foreign policy failures of the Bush administration, not just to recent economic developments and policies. Therefore, the big risk were the dollar to be displaced from a dominant role is fragmentation of the global monetary system, not bipolarity with the euro (which would be a much happier prospect and at least a smoother transition). ◆