The Euro and the World Economy[*]

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The Euro and the International Financial Architecture

The dollar has been the dominant currency of the world economy for almost a century for a single overwhelming reason: It had no competition. No other economy came 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.[1] A similar situation for the United Kingdom explains sterling's dominance in the 19th century.

The clearest historical evidence for this conclusion is the fact that the dollar continued to reign supreme during 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, with productivity growth that was especially mediocre (at 1.5 percent or less per year).
- 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 30 years, including two periods when those deficits were rising at clearly unsustainable rates (1982–87 and 1998 to the present), and had become a debtor country by the late 1980s.

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[*] The first part of this paper is adapted from the author's "The Euro and the Dollar: Toward a 'Finance G-2'?" in Adam Posen, ed., *The Euro at Five: Ready for a Global Role?* (Washington: Institute for International Economics, April 2005).

[1] Helmut Schmidt frequently reminded us that West Germany was the size of Oregon. Hence the deutsche mark, the second key currency through most of the postwar period, never attained a global currency share more than one-fourth that of the dollar, in keeping with its GDP never exceeding about one quarter that of the United States.

Econometric evidence also 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 [PPP]) 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) 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. The central importance of size was clearly validated.

The creation and clear success of the euro over its first five years dramatically and fundamentally alters the global currency situation. The present Euroland is 20 percent smaller than the United States in terms of total output and 18 percent higher in its share of world trade. Expansion of the euro to include all 15 members of the current European Union would take the numbers modestly (3 percent) above the United States in output terms as well. Inclusion of the 10 new EU members would add another 5 percent to Euroland's output superiority (as well as bringing its population to about two-thirds greater than that of the United States). For all practical purposes, the two currency areas are already close enough on all key variables to be regarded as rough equivalents.

It is thus clear that the euro provides the first real competition for the dollar since the latter's ascent to global currency dominance. The key question is whether (and when) the euro will realize its potential sufficiently that a bipolar monetary system will replace the dollar hegemony of the past century. The outcome, and especially its timing, are likely to turn on four key variables (Bergsten 1996).

First, Euroland will need to further integrate its money and capital markets to realize the full international potential of the new currency (Portes and Rey 1998). The superiority of the American financial markets, and that of the United Kingdom during the period of sterling's dominance, was a key element in their global monetary leadership. The negative case of Japan is also instructive: Its failure to modernize its financial markets undercut any possibility that the yen, despite Japan's dynamic growth and huge international creditor position (before its lost decade of the 1990s), 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. Indeed, the euro's share already exceeds that of the dollar in the denomination of global financial assets excluding derivatives (chart 1) and approximates the dollar's share when derivatives are included (chart 2). However, national rivalries still impede 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 further rise in international asset allocation (Mann and Meade 2002).

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 four decades. Cooperation between this "trade G-2" was in fact a necessary condition for the successful launch and completion of each of the three major multilateral trade agreements of the postwar period (and again for the launch of the Doha Round in November 2001).

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 with the United States. The second, of crucial importance, was its early decision to centralize virtually all trade policy decisions and negotiations into a single entity (the European Commission in Brussels). But

Europe still speaks with a multiplicity, even a cacophony, of voices on the monetary and macroeconomic front. Hence it dissipates much of its potential for realizing a key international role for the euro.

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. Its growth has badly lagged that of the United States, however, and (along with Japan) has been one of the weakest components of the buoyant world economy of the recent past. International interest in the euro would surely rise if Euroland countries were able to overcome their continuing structural impediments and if the Eurozone would employ more expansionary macroeconomic (mainly monetary) policies.

Fourth, and perhaps most important, the United States will probably have to foul up for the euro to realize its potential to achieve comparable status 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, even in the presence of a fully qualified rival, unless the incumbent opens the door for that rival (Bergsten 1996). Sterling maintained a central international role for at least half a century after the United States had surpassed Britain's level of 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 had existed when US inflation hit double digits, interest rates rose to 15–20 percent, the economy suffered its worst recession since the 1930s, and the country started running external deficits that transformed it in short order from the world's largest creditor to largest debtor country. Even without such a competitor, the global market share of the dollar dropped substantially. The process of European monetary integration that eventually led to the creation of the euro was galvanized.

Are there any foreseeable developments that could represent such a repetition of recent history? As Robert Mundell (1998) indicated prophetically on the eve of the creation of the euro:

> 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.

The Quadruple Prospect for Euro Appreciation

There are four reasons, combining these structural systemic considerations with present market prospects, that should lead us to expect considerable further appreciation of the exchange rate of the euro against the dollar over the short to medium term. This appreciation may in turn hasten the expansion of the euro's systemic role.

First, the international debt and deficit problems of the United States are accelerating at a rapid pace and are clearly unsustainable. The current account deficit reached annual rates in excess of $750 billion, more than 6 percent of GDP, in late 2004 and early 2005. It has risen by an annual average of about half a percent of GDP for the past decade and is likely to continue climbing rapidly (Mann 2004b, Cline 2005). As a result, the United States must import $5 billion of foreign capital every working day (to finance its own foreign investments along with the current account deficit). The net international investment position of the United States would hit 50 percent of GDP, on present trends, within the next few years and rise to 100 percent of GDP—totally uncharted terrain—in a decade or so (Mussa 2005). The dollar has experienced modest depreciation over the past three years but is thus likely to fall much farther.[2] The euro, as the main counterpart currency in the system, will undergo further appreciation against the dollar simply as a result thereof.[3]

Second, the major surplus countries in East Asia continue to resist significant—or, in the central case of China, any—appreciation to mirror the dollar decline. If China and the other Asians continue to block adjustment, and the rest of the world permits these practices to continue,[4] the euro (and the other truly floating currencies) will experience a further disproportionate share of the counterpart appreciation to further dollar decline.

Third, the current dollar depreciation is taking place in a very different world than the substantial dollar falls of 1971–73, 1978–79, 1985–87 and 1994–95: one that includes the euro, which as noted is the first competitor for global status that the dollar has faced throughout its entire period of currency hegemony. This fall of the dollar could thus trigger important—indeed historic—systemic, as well as market and macroeconomic, effects. The substantial and prolonged strengthening of the euro, arising from the global adjustment of the current account imbalances, is at some point likely to trigger structural portfolio diversification into euros by both private and official holders that is an inevitable result of the transition toward a bipolar monetary regime. This shift would reflect the failure of the United States to get its own house in order, thus jeopardizing the global role of the dollar and opening the door for the euro to accede to a major position in world finance. I and others estimated the magnitude of that shift at $500 billion–$1 trillion on the basis of the magnitude of global currency portfolios in the middle 1990s (Bergsten 1997a, Portes and Rey 1998), which would be at least twice as great today and would clearly mark the arrival of the euro as a major competitor to the dollar.

Fourth, and more conjecturally, the next few years could witness a substantial alteration in relative economic performance in the United States and Europe—due mainly to poorer results in the United States. A rapid fall of the dollar, combined with the precipitous rise of world energy prices that is likely to continue and indeed escalate further, could produce a series of major setbacks to a US economy that is now approaching full employment: much higher inflation and interest rates,[5] a renewed drop in both the equity and housing markets with large negative wealth effects, and a consequent sharp decline in economic growth. The economic attractiveness of Europe relative to the United States would then rise considerably and further accelerate the appreciation of the common currency. This effect would of course be multiplied if Europe were at some early point to enjoy the same unexpected jump in productivity growth that the United States experienced in the middle 1990s, perhaps related to enlargement or a serious new effort to implement the Lisbon Agenda.[6]

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[2] In addition to this international financial unsustainability, there is a domestic political unsustainability of the large and rapidly growing current account deficit (and continued large dollar overvaluation): trade protectionism. The current escalation of US trade controls and Congressional actions, mainly against China (apparel, textiles, color televisions, semiconductors, shrimp) and frequently linked directly to the currency misalignment, are the latest cases in point.

[3] However, the real effective exchange rate of the euro might not appreciate at all, or even depreciate, if the Asian countries (contrary to the next paragraphs) were to permit their currencies to appreciate significantly against the dollar, since the Asian currencies would probably rise more than the euro in the next phase of dollar correction.

[4] See Bergsten 2005 for an elaboration of the currency manipulation problem and what to do about it.

[5] Baily (2002) projects US interest rates rising to double digits under plausible combinations of these variables.

[6] As recommended in Baily and Kirkegaard (2004).

Policy Implications

Thus a series of three or four events—generalized further dollar depreciation, disproportionate euro appreciation due to continued Asian resistance to participation in the adjustment process, subsequent acceleration of the inevitable portfolio diversification from dollars to euros and perhaps a positive shift in the relative economic appeal of Euroland vis-à-vis the United States—could produce a very large further rise in the euro. Such a scenario would be extremely uncomfortable for Euroland and extremely destabilizing for the world economy, perhaps even triggering a global recession. Four steps are required to produce an orderly correction of the global payments imbalances and an orderly further depreciation of the dollar, rather than a hard landing, and hence to prevent realization of such events:

- The United States must launch a serious program to cut its budget deficit, the only policy available to substantially increase national saving in a deficit country, and thus reduce its dependence on foreign capital;

- The G-7 (especially Euroland) must insist that the International Monetary Fund implement its rules against currency manipulation and require China, in particular, to cease the competitive undervaluation of its currency that is blocking the participation of all of East Asia in the international adjustment process (Goldstein 2005);

- Japan and (especially) Europe must stimulate domestic demand to affect the decline in their external surpluses, not only by adopting the needed structural re-forms (Baily and Kirkegaard 2004) but also through a lowering of interest rates by the European Central Bank (which the euro appreciation will help to permit); and

- Euroland and the United States, as the issuers of the world's two key currencies, must create a new "finance G-2" to manage both the sizable currency swings that have already come to dominate their bilateral monetary relationship and their joint responsibility for global financial instability (Bergsten 2005b). The next big problem facing the "international financial architecture" may otherwise center on the countries and currencies at its core, the United States and Euroland, as was the case in the 1960s and 1970s, rather than the emerging market economies and their currencies, as in the last two decades.

Tommaso Padoa-Schioppa has been the "Foreign Minister of the Euro" since (and indeed even before) the creation of the single currency. There could be no more fitting tribute to his historic contribution to the evolution of the international monetary system than if this conference in his honor would both recognize the advent of the euro as the world's second key currency and initiate a process to assure that its new role would be stabilizing rather than destabilizing for the global economy. I deeply appreciate the honor of addressing this esteemed group and hope that its members will do everything they can to initiate the actions necessary to realize both of these outcomes.

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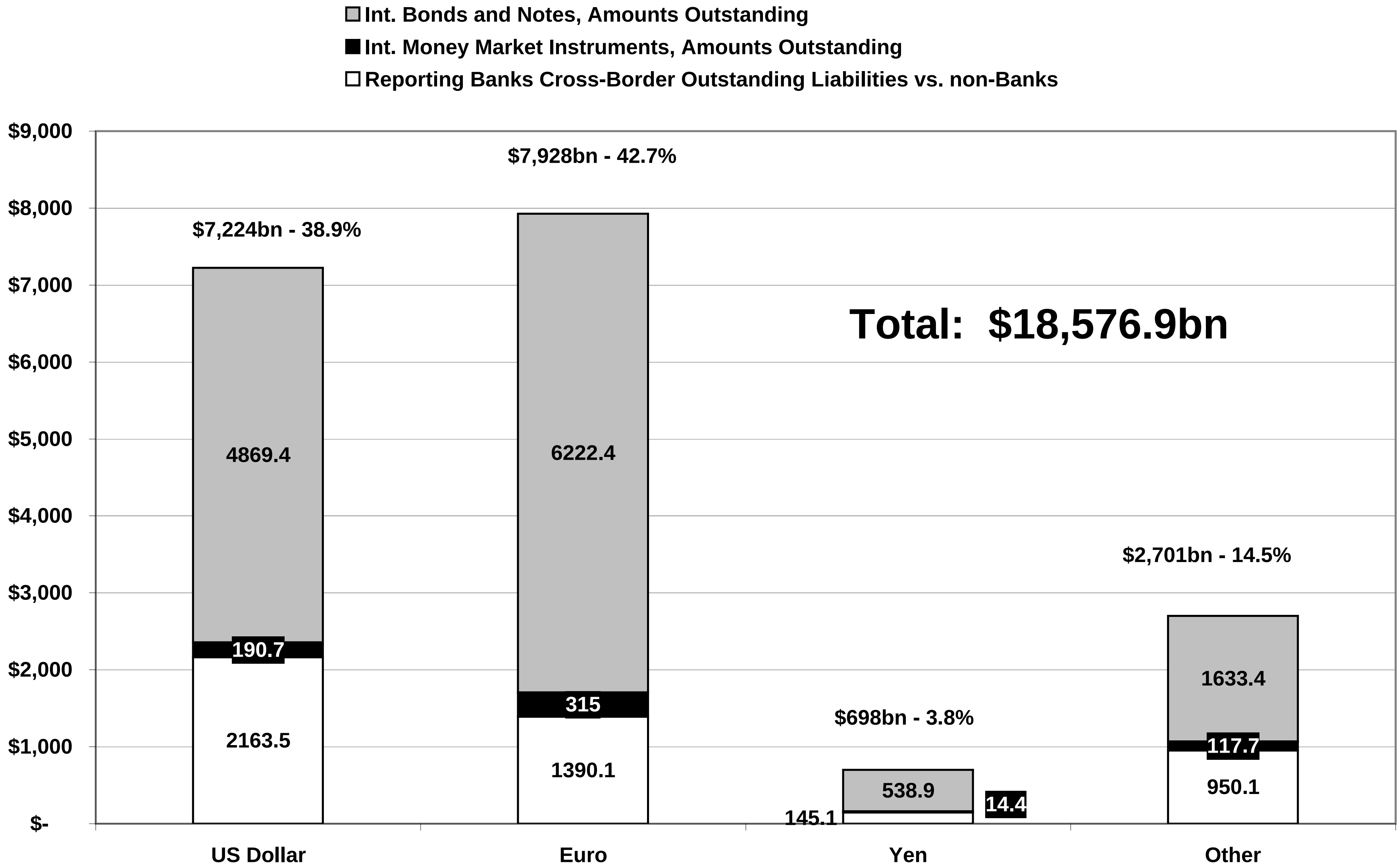
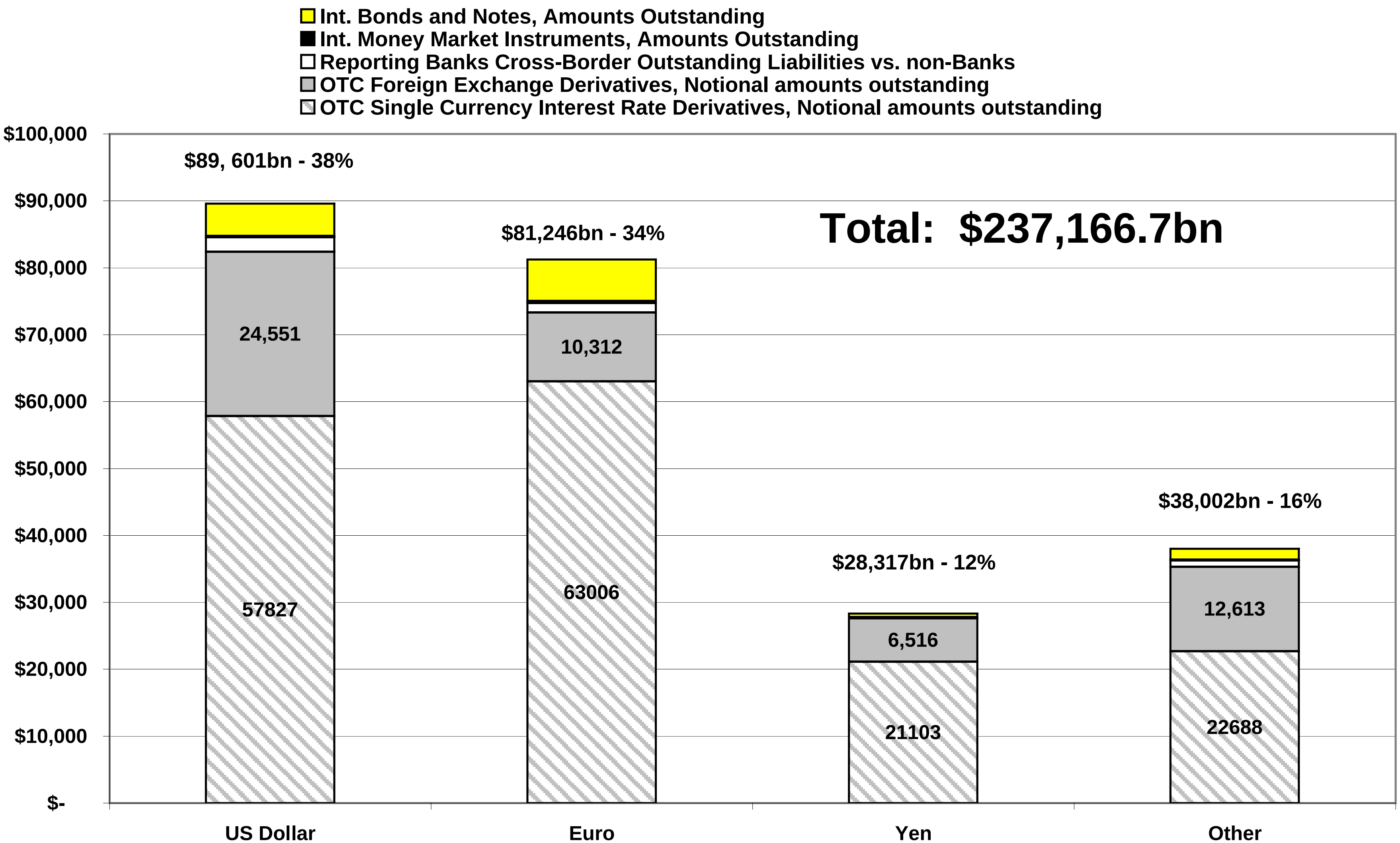
Global Financial Assets Q4 2004, By Currency



Source: BIS Quarterly Review March 2005, Table 5B, 13A and 13B

Global Financial Assets, incl. Derivatives Q4 2004, By Currency



Source: BIS Quarterly Review March 2005, Table 5B, 13A, 13B, 20B and 21B