Network of European Union
EUCE
Centers of Excellence

International Currency Competition: Euro vs US Dollar

The 1999 creation of the Economic and Monetary Union (EMU) within the EU was judged by many as the most important transformation of the international monetary system since the breakdown of "Bretton Woods" in the early 1970s. Nevertheless, the introduction of the euro as a single European currency did not create apprehension in the United States, and even less was American anxiety about how the euro would impact the US dollar. Now, ten years down the road, the US has slowly but surely become more aware of the possible challenges the European currency poses to the US dollar, particularly in a time of economic instability.

On paper, the euro shows almost all the prerequisites necessary to be a true competitor to the US dollar as the preferred international reserve currency and vehicle currency for international transactions. During the last decade, the euro has been able to mature and has earned its place as a first rate currency, typified by its stability and underpinned by a sound monetary policy. The question remained however on how successful the euro is – and can be – in translating this theoretical potential as a rival currency into practice.

This brief focuses on this euro-dollar international currency competition. It reflects upon the (European) expectations at the start of the EMU project, looks at its real performance across a decade of European and global growth, as well as during the current economic crisis. By analyzing this performance, it also touches upon the question of whether the European single currency has influenced transatlantic relations.

The conclusion is that the euro has performed well, as a new currency, but has not lived up to the expectations placed upon it. The euro has become an important international currency, but quite clearly still plays only a subsidiary role to the US dollar in terms of its influence and its usage as a worldwide vehicle currency. The euro can be judged as neither a failure for Europe, nor a huge threat to the US dollar. Rather than being a direct competitor, the euro forms an indirect challenge by creating an alternative to the US dollar for third parties (though, it is still seen as second-best). Thus, regardless of some concerns, for the near future, there seems to be little reason to expect a true currency confrontation between the eurozone and the United States.

Expectations at the Start of EMU

The European Union Member States formally agreed on establishing an Economic and Monetary Union when they signed the Maastricht Treaty in 1992. Seven years later, world financial markets were introduced to the euro as an accounting currency. In 2002,

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

European citizens received their currency as physical coins and banknotes entered circulation.

The Economic and Monetary Union got little attention in the United States. Within the academic world, views ranged from seeing EMU as an enormous benefit to the international community, to seeing it as possibly bringing civil war back to Europe, with all its negative implications for the transatlantic relationship. In US policy circles, there were no strong voices truly opposed to the idea of a single European currency, and the main concern was a possible deflationary bias of the future eurozone. In any case, these few existing critics were drowned out by the sheer weight of rhetoric in favor of the European project. One of the main rationales behind this US advocacy for the euro project was the idea that its introduction would contribute to the stabilization of the Central and Eastern European economies, which at that time were beginning their long journey from planned to market economies.

Soon it was clear that the euro had all the prerequisites needed to become an attractive currency at the international level – store of value, medium of exchange and unit of account. The currency zone was of substantial economic size, famous for its political stability and credible in having a sound monetary policy with low inflation rates. Its stock rose as the US did not seem to be able or willing to get its own economic house in order. But, despite having the economic weight to challenge the US dollar, the euro remained a novelty, an experiment and a stranger in the midst of the family of currencies: it was not backed by centralized policies and institutions in areas of vital interest to the well-functioning of the common currency. Next to not being guaranteed unconditional state support, the euro also never really enjoyed a positive emotional engagement of the European citizens. Even at the beginning then, the euro risked becoming the perfect scapegoat for all sorts of pre-existing and structural economic problems.

Performance, a Decade Later

The problem of dealing with a "weak" or unusual type of polity was compounded by a dynamic and complex system of global financial markets – with all its new forms of liquidity creation. Despite these unfavorable elements, the European Central Bank (ECB) succeeded in creating a quite stable and unproblematic childhood for the newly born currency. The governors of the euro had the wisdom to deliver price stability and were able to lock in expectations of low inflation. As a result, after a decade, the European currency has become appealing for many, both within and outside of the eurozone. But in spite of its appeal, and despite the fact that the introduction of the euro has had an overall positive influence on the economic performance of the eurozone itself, the currency has until now not lived up to expected wider effects on the international monetary system.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

Performance within the Eurozone

At the positive, domestic side of it – as captured in the European Commission's report *The Euro@10* – the euro is considered a "clear success". According to the Commission, the currency has brought the EMU member states many benefits. The most important benefits include: inflation in the last ten years has been around 2 percent on average; almost 16 million jobs have been created since 1999; long-term interest rates fell to less than 4 percent (half the level of the 90s); there is no need anymore to exchange currencies, facilitating holidays and shopping throughout the euro area; the stable exchange rates boosted trade among euro area countries; public budget deficits fell to a record low of 0.6 percent of GDP on average in 2007 (compared with around 4 percent of GDP in the 80s and 90s); and European markets became better integrated, meaning cheaper products and services. Putting these benefits in a comparative perspective, it can be argued that the eurozone has created comparative advantages over the US in the area of job creation, gross savings, the aggregate fiscal deficit, the current account balance and income distribution.

It must be said that this positive view of what the euro has accounted for, is not universally held. Some well-founded dissatisfaction with the euro does exist. At the negative side, critics point to a higher price level (compared to the pre-euro era), to an anemic overall real GDP growth in historic terms as well as when compared to the US (over the period 1996-2005), to persisting inflation differentials between states, and to a relatively slow adjustment of prices within them.

Regarding both these positive and negative arguments of economic performance, as often is the case with these economic factors, it is difficult to conclude which developments have been caused by the creation of the common currency, and which are the result of other factors. Nonetheless and in sum, the Euro has been undoubtedly positive from the perspective of the European citizenry, and has boosted economic performance *within* the eurozone.

Performance Outside of the Eurozone

What about the influence of the euro outside of the currency zone, in the role of an international currency? The European Commission listed the rising international profile of the euro as one of its major benefits, stating that it is "second only to the US dollar and thus providing a shield against turbulences in the global economy". However, some elucidation on the external record for the euro might make it to be not all that astonishing.

As previously mentioned, in theory, the euro enjoys the necessary attributes to form a rival to the US dollar in becoming the international currency of first preference. Regarding its role in the international financial system, the impressive statistic is that 320 million Europeans in 16 countries now use the same currency – more than the population of the US. However, the euro has had much less influence on the international monetary system than some would have hoped. True, the euro quickly became the international currency of second preference and a widespread acceptable means of payments, thereby improving its international liquidity position substantially. The share of Euros in global Central Bank reserves stood at 25.5 percent in 2009, while the sum of all the individual European currencies before the introduction of the euro made up for only 18 percent of these global reserves. Also, the euro quickly became the most popular currency for issuing international bonds, which helped to underpin its stability.

However, this advance of the euro did not seem to occur at the expense of the US dollar, which at the start of 2009 still accounted for 65.4% of global foreign exchange reserves. The US dollar did not lose out in its status as the main vehicle currency, as outside of the EU, the bulk of international transactions are still pursued in US dollars, and, according to some, even within the Eurozone one third of all trade is denominated in US dollars.

More than the Euro causing its advance due to its own strengths, the choice for the Euro by third parties was primarily based on policy failures at the US side. The existence of the Euro has changed the dynamics in the international monetary system only until the point of offering as a second-best alternative to the Dollar. Within this dynamic, the emergence of an alternative to the Dollar could work as a check on monetary policies in the US. It could also empower third countries' bargaining position towards the US. For example, it has given OPEC and others the possibility of threatening the US by alluding to changing their invoices away from US dollars, possibly into Euros. On a similar note, the Chinese can threaten to slow down the pace of buying US debt, by moving their reserves into Euro-denominated assets, which could be credible, especially when the US continues to expose itself to higher levels of economic vulnerability. Nevertheless, the decision to do so depends more on US policies than on ECB policies, making the Euro more of a bystander than an active player in the international monetary system.

Explaining the Divergence between Expectations and Real Performance

What then are the obstacles that prevent the euro from becoming a true rival to the US dollar? Broadly, the barriers for better performance are to be found in the EU governance structure, its fragmented representation in international forums, and the ability to create a financial market based on the euro that could challenge the US dollar-based markets.

With regards to the EU governance structure of the Economic and Monetary Union, a main problem is caused by the differing domains between the "monetary" and the "economic at large" governance within the eurozone. Of importance for a well-functioning approach are the policy areas of monetary policy, fiscal policy, market structures and exchange rate policies. But the respective institutions that have authority in these fields hardly speak at the same level or within a similar composition. The ECB speaks and decides for the monetary side of the 16 members of the eurozone. The Ecofin group brings together all the 27 EU member states, which still individually decide on their respective fiscal policies, banking regulations, insurance systems and bankruptcy regulations. Next to that, there is the informal Eurogroup of euro area finance ministers, who try to coordinate their economic policies, but also are not bound by any obligations.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

The crisis might bring some elements of these policies to the community level. Unfortunately, the crisis hits in a period of time in which the member states show not all too much appetite in giving up further parts of their sovereignty. Nevertheless, some awareness of the need for coordination seems to be present, and at least exchange rate policy has by now become central to EMU discussions. But still, EMU lacks an independent authority associated with the management of money, and it lacks a clear identity, which cannot be said of the United States.

Also, and as a consequence of these differences in decision-making institutions, the EU does not speak with a common voice in international economic forums, while the US does. From the onset, in the Maastricht Treaty, there is no body formally appointed to represent the eurozone in international forums. For example, in the case of the IMF, the eurozone in the aggregate would be able to control almost a quarter of the votes, but proves unable to do so because of its political fragmentation. This lack of coherence obviously undermines the autonomy gained by joining a cooperative arrangement.

Another point in which the eurozone falls short in comparison to the US is the strength and diversity of its financial markets. The decision for a preferred international currency depends greatly on the extent of broadening and deepening of financial markets. The fact that the relevant European markets remain smaller and less diversified than others counts for a structural disadvantage in the geopolitics of finance.

The Economic Crisis as a Revelation

Volatile financial markets already made the euro's childhood a tough one, but international economic conditions kept deteriorating while the euro strengthened. Lately, the context has worsened in an unexpected and dramatic way. The first of these challenges faced by the ECB has been inflationary pressure due to credit-induced property-booms (most visibly in Ireland, Spain and the UK), and due to opaque credit-creation in general. Increasing demands at the global stage as a result of steeply rising economies also put pressure on prices. A second problem in the current international monetary system involves the major imbalances present, with a persistently high US deficit, financed mostly by a Chinese surplus. Thirdly, the combination of floating exchange rates and the peerless dynamics of financial markets has made exchange rates extremely volatile. A steeply falling dollar then meant a steeply appreciating euro, not least vis-à-vis the Chinese Yuan, and other currencies that were tied to the dollar. As a result of the volatility, trade relations have been severely disrupted and will stay disrupted until a solid solution to this volatility is found.

In sum, the current international economic environment is characterized by turmoil, and crisis and recession are forming a real test for the landscape of currencies. At least for the sake of analysis, the turmoil does reveal several strengths and weaknesses that are less clear in “good times”. Obviously, to assess with confidence whether this will bring about fundamental changes in the international monetary system, more dust will have to settle.

As economic conditions have deteriorated, the problems associated with having a single currency without a united political authority have become more apparent. Though the European government bond market is large, there is not a single issuer such as the US Treasury for dollar denominated bonds. The euro still has sixteen different issuers, of which the Italian, German and French governments are the largest. As the crisis has shown, investors perceive these markets still as non-integrated, and individual bonds are therefore rated differently. Despite the fact that the common currency has taken away the devaluation risk for individual countries, the differentiation of default risks shows that eurozone financial markets are still perceived as fragmented. The Standard and Poor downgrading of Spain, Ireland and Portugal in January 2009 showed this in the most formal and visible way. It would be an exaggeration to see this as a threat to the eurozone, but it certainly does undermine the euro's appeal as an alternative international reserve currency.

The crisis has also revealed that US dollar denominated bonds are still the most preferred safe-haven for international investors. Despite the extraordinary US deficit, despite the fact that the crisis had its roots in the United States and despite the Chinese and Russian utterances, for example at the 2009 World Economic Forum, that the blame for the turmoil lies with the "capitalist system", the US dollar still offers a level of trust to the international economy the euro cannot yet reach.

Thus, the current economic crisis has shown that the US dollar is still globally perceived as having important advantages over the European newcomer. Nonetheless, even though the euro might not compete with the dollar at the world level, the economic crisis has also shown that the common currency does offer distinct advantages in Europe. Thus, while not yet competing as a global currency, the euro does seem to have a strong regional base. This is especially true for some of the smaller countries outside the currency zone but geographically near it. Negative economic developments first in Iceland, Sweden and Denmark, second in the Baltics, Hungary and non-eurozone EU-members, have spurred a debate on accelerating acceptance in the European currency. Most likely, the euro will expand as an international reserve currency at the expense of smaller European currencies, and principally at the expense of the British Pound.

Conclusion

In a single decade, the euro has become the second international currency. It seems to have the capacity to prove a tough competitor to the US dollar, though faces several barriers that prevents it from translating this potential into practice. For now, too many obstacles remain for the euro to go truly global. The existence of the euro as a second-best alternative to the US dollar seems to have an influence on US relations with third parties, more so than on direct transatlantic relations.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

Sources:

Axel Bertuch-Samuels & Parmeshwar Ramiogan (2007) "The Euro: Ever More Global", *Finance and Development*, Vol 44 (1), pp 46-50.
Benjamin J. Cohen & Paola Subacchi (2008) "A One-and-a-half Currency System", *Journal of International Affairs*, Vol. 62 (1), pp 151-163.
Kenneth Dyson (ed) (2008) *The Euro at 10*, Oxford: Oxford University Press.
European Commission (2008) EMU@10, Successes and challenges after ten years of Economic and Monetary Union http://ec.europa.eu/economy_finance/publications/publication12682_en.pdf
Steven Everts (2000) *The Impact of the Euro on Transatlantic Relations*, London: Centre for European Reform.
C. Randall Henning & Pier Carlo Padoan (2000) *Transatlantic Perspectives on the Euro*, Washington: Brookings Institution Press.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.