DOLLAR DOMINANCE, EURO ASPIRATIONS: RECIPE FOR DISCORD?

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SUMMARY

- Question 1: Has the dollar met its match in the euro?
  - Answer: The euro is fated to remain a distant second to the dollar – unless Europe actively promotes its global role.

- Question 2: What would happen if Europe engages in an overt leadership struggle?
  - Answer: US-European tensions would rise – but the risk of outright geopolitical conflict seems low.

THE EURO @ TEN

- Trajectory: Following a quick start, global use of the euro has stabilized.
- Scope: Use is uneven across functional categories.
- Domain: Use is mainly confined to EMU's "natural hinterland."
- Implication: The euro will dominate only in its own region; the dollar will remain the only truly global currency.

EXPLANATION

- The euro is at a distinct structural disadvantage because it is a “currency without a country.”
  - An ambiguous governance structure.
  - Dependence on underlying political agreement.
- Conclusion: Market forces alone cannot guarantee success for the euro; a determined effort will be needed to promote a global role.

FOREIGN-EXCHANGE TRADING

- The euro's share (c. 37 %) has been essentially flat.
- Concentrated in the European region.
- Explanation: The dollar benefits from a natural advantage of incumbency.

TRADE INVOICING AND SETTLEMENT

- Significant increase of euro use for EMU imports and exports. But –
  - Leveling off after a fast start.
  - Mainly concentrated in trade with neighbors.

- The dollar continues to dominate in global trade because of its incumbency advantage in energy and commodity markets.

FINANCIAL MARKETS

- Bond markets: The euro has surpassed the dollar. But –
  - Leveling off after a fast start.
  - Most new issues are from neighbors.
  - Most are purchased by EMU investors (thus effectively “domestic”).

- Banking: Euro share of international loans and deposits has been flat; concentrated mainly within Europe.

CURRENCY SUBSTITUTION

- Rapid increase in foreign circulation of euro banknotes (already c. 10-20 % of total stock). But –
  - Concentrated in European region
  - Some will eventually become “domestic.”

ANCHOR CURRENCY

- Formal: Some 40 countries are formally aligned with the euro. But-
  - Little change after fast start.
  - Most are in Europe (mini-states, newer EU members, EU candidates) or CFA Franc Zone, confirming regional role.
- Informal: Many more countries “relatively more aligned” with the dollar, including more large countries.

RESERVE CURRENCY

- The past: Dollar share (64 %) has declined since 1999, while euro share (26 %) has increased. But -
  - The dollar was at an artificial high in '99.
  - Euro share has been flat since 2002.
  - Little evidence of *active* diversification.

- The future: Still many predictions that the euro will "surpass" the dollar (ex: Chinn and Frankel 2007, 2008). But this discounts the role of politics -
  - Is the issuer capable of effective governance?
  - Can the issuer project power abroad?
  - Does the issuer enjoy strong foreign-policy ties?

LEADERSHIP STRUGGLE?

- Repeat: Market forces alone cannot guarantee success for the euro; a determined effort will be needed to promote a global role.
- Will Europe become more pro-active?
  - Official policy is neutral.
  - But temptation is considerable.
  - Therefore, risk of discord is real.

SHOULD WE WORRY?

- Depends on Europe's aspirations:
  - Informal leadership (targeting market actors).
  - Formal leadership (targeting states).
- Informal leadership struggle: largely benign; natural in a market system.
- Formal leadership struggle: more politicized, hence more risk of conflict.

MAIN DANGER: THE MIDDLE EAST

- Basis for possible conflict:
  - Dollar presently dominates in the region.
  - But the region's commercial ties are more oriented toward Europe.
  - Thus, a temptation for Europe.
- Likely outcome:
  - US resistance will be strong.
  - Europe will avoid direct confrontation.
- Conclusion: risk of geopolitical conflict is low. The dollar will remain dominant.