Euro-optimist hypothesis

Economics, Currency

Ones of the first economists to predict the euro's ascendancy as a strong international currency were Richard Portes ; Hine Rey (1998). Their analysis, based on econometric modelling, accurately established the integration of the European financial markets as the key, as it was, independent variable in determining whether the euro would topple the dollar. Inching towards the International Political Economy terrain, they acknowledged that this variable would only be optimised by an active policy of financial market integration and international currency promotion by the European authorities.

They assumed and justified this political activism on the grounds of the benefits that derive from issuing an international currency. While they briefly covered how an international currency translates into political power and prestige, their attention was more directed to the economic gains, which they consider more significant and less 'nebulous'. First of all, they highlighted the trade advantage of buying and selling products in one's own currency, thereby avoiding exchange rate risks for local companies and institutions.

Secondly, they pointed to the 'exorbitant privilege' of financing one's balance of payment deficits with liabilities denominated in one's own currency, which makes one less reliant on foreign reserves, offers better protection from external shocks (price volatility) and, most importantly, reduces financing costs due to the centrality and demand-pull that the currency has in the system. Overall, then, an international currency provides the issuing country with enormous international sovereignty, defined in simple words by Portes & Rey 'as the ability to obtain real resources (net imports) in exchange for almost costless notes' (1998, p. 309).

In the dollar's case, foreign residents hold approximately 60% of total outstanding US dollar stocks. In Portes ; Rey's calculations this means that annual revenues of international sovereignty for the US account for around 0. 1% of US GDP which, updated to 2010 GDP figures, would reach an actual sum of US$14. 6 billion. With the benefit of hindsight, it can confidently be said today that most of the assumptions presented by Portes & Rey in their 1998 calculations have not yet materialised.

While it is true that Europe's financial markets have been integrating further thanks to policy decisions like the Financial Services Action Plan (FSAP) set in motion by the European Commission in 1999 (Galati ; Wooldridge, 2006), transaction costs are still higher in Europe than in the US (Grant 2010) and, most importantly, the European Central Bank has not shown any signs of actively promoting the internationalisation of the euro.

This development has been left to market forces. 2. 2 The " Euro-Pessimist" Hypothesis Despite these optimistic views about the euro's rapid internationalisation, not all economists agree with these predictions. Around the same period, several authors highlighted the obstacles facing the single currency in its attempt to rival the dollar. Rudi Dornbush (1996), for instance, identified from an early stage some internal limitations that would hamper the EMU's global aspirations.

His analysis is of relevance today because it predicts with great accuracy some of the difficulties experienced by peripheral EZ countries as a result of the effects of the Great Recession. Drawing on the fact that the EZ is not an Optimum Currency Area (Mundell, 1961) and considering that the Maastricht

Treaty limits any transfer of funds from one country to another, Dornbush foresaw that potential asymmetric external shocks or growth disequilibria within the European Monetary Union would be extremely difficult to manage under a single monetary policy.

Historically, in Europe these asymmetries would be offset by moves in the exchange rate, but lacking this mechanism and a common fiscal policy to allow transfers between EZ member states (something Dornbush does not conceive to be feasible in the European context), the adjustment costs will have to come through the labour markets. It is certainly astonishing how this description written 15 years ago closely resembles the current situation in countries such as Portugal, Greece, Ireland, Italy and Spain (the PIIGS), which are all suffering high unemployment, massive public spending cuts and major labour reforms.

In the end, it must be mentioned that a vehicle currency is likely to function also as a reserve currency, but it is also true that a reserve currency might gradually become a vehicle currency. This can be explained by an example. If the European debt markets were to integrate into a single one, they would acquire greater liquidity; this, in turn, would mean that China would be able to invest more of its reserves in euro and so achieve a greater diversification in its portfolio in pursuit of higher returns.

Seeing the advantages of this, the Chinese authorities and institutions would be encouraged to sell more of its products in euro to the EZ and this would mean that the euro would function more as a unit of account. The euro collected through this trade pattern would then presumably return to the

European financial markets for further investment and thus lower foreign exchange transaction costs for the euro, which would mean that the euro would also be increasingly attractive as a vehicle currency.

Path-dependency, and especially hysteresis, might hamper this process, but theoretically it is certainly possible. THE EURO VERSUS DOLLAR DEBATE IN ECONOMICS TODAY The Euro Challenge Hypothesis Reinvigorated More than 10 years after these opposing hypotheses on the euro challenge to the dollar were first laid out, the debate in the Economics field is still dominated by these two contending analyses. This was the case up to the current sovereign debt crisis in the eurozone and presumably, if the euro does not break up, it will continue into the future.

After being predicted in 2005 that the euro would possibly surpass the dollar in 2022 as the leading reserve currency, their latest econometric calculations in 2008 pushed the tipping-point even closer to 2015. Their predictions are based on the main factors that economists generally consider are determinant to gain international currency status: (1) economic size measured in output and trade; (2) deep, liquid and well-developed financial markets; (3) confidence in the value of the currency; and (4) network externalities.

The Euro Challenge to the Dollar Measured in Quantitative Terms Figure 1. Dollar-Euro(USD/EUR) exchange rate; 11. 11. 2006-11. 11. 2011 Source: www. oanda. com/currency/historical-rates/ The presentation of the econometric calculations in 2008 was timely as the dollar was depreciating

rapidly vis-i?? -vis the euro (see Figure 1) and triggered a rapid reaction by economists that were more sceptical about this outcome.

It is worthwhile presenting the response of De la Dehesa (2009), who provides a good summary of the international use of the euro to underscore his claim that the euro is still far from posing a challenge to the dollar. The Chairman of the European Central Bank Observatory, (OBCE), Guillermo De La Dehesa, assesses the euro challenge to the dollar through its relative weight in three different international markets: the international liability management market; the international asset management market; and the foreign exchange market.

International Liability Management: the issuing of euro-denominated securities around the world has increased substantially since the creation of the single currency. 'According to the ECB, in a narrow sense -excluding domestic issuance of debt securities at constant exchange rates, ie, adjusted by valuation effects-, the share of euro-denominated debt securities of the total stock grew from 20% at the start of EMU in 1998 to a peak of 33. 8% in mid 2005' (De la Dehesa, 2009, p. 7). This amount has dropped slightly in recent years, hovering just above the 30% mark.

In 2009 the actual figure was 31. 4% of total issuance (ECB, 2010). Dollar-denominated debt securities, by contrast, experienced a decline from 49% of total stock at the start of EMU in 1998 to a low of 41% in 2005, when the euro peaked. Since then, however, dollar-denominated issuance has increased and in 2009 (the latest figure to date) it stands at 46%. The data

show a rapid growth for the euro in the first years, with a plateau at around 30%. The dollar remains robust at around 45% (ECB, 2010, p. 17-18).