

ECONOMICS FOR ALL

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Can the euro challenge “King Dollar”?

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In his State of the Union speech in Strasbourg on 12 September, European Commission President Jean-Claude Juncker announced that proposals would be presented before the end of year aimed at “strengthening the international role” of the euro against the dollar. “It is absurd, he lamented, that European companies buy European planes in dollars and not in euros”. But does the euro have the means to challenge the hegemony of the dollar?

It is a fact that in nearly twenty years of existence, the euro has never managed to depose the dollar as the international reference currency.

The euro is the second most important currency in the international monetary system, far behind the US dollar:

- 63% of central banks’ foreign exchange reserves consist of securities in dollars, vs. 20% for the euro.
- The dollar is the currency of denomination of 56% of global outstanding bonds - vs. 23% for the euro –, of 62% of international debt – 23% for the euro – and it is used in 44% of transactions in the foreign exchange market – 16% for the euro.
- The reference prices used for almost all commodities trade, starting with oil, are expressed in dollars.
- Only in the case of international payments is the dollar closely followed by the euro (40% vs. 36%).

The Americans derive considerable benefits from the dollar's domination, both economic (seigniorage revenue, lower interest rates, etc.) **and political.** For example, the US justice system considers paying for a transaction in dollars to be a connecting link to the United States making it possible to extend the application of US law to any company, regardless of its nationality. Accordingly, the **United States’ withdrawal** on 8 May **from the Iranian nuclear agreement**, effectively reimposing US sanctions against Iran, put the Europeans between a rock and a hard place: **any company that continues to use the dollar in its transactions with Tehran will be subject to sanctions.**

In this context, Mr. Juncker’s renewed ardour to make the euro “the face and instrument of a new more sovereign Europe” is understandable. But **does the euro have the means to challenge the hegemony of the dollar?**

To do so, **the euro has two major assets:**

1. **The economic power of the European Union (EU):** the euro is the currency of the leading global trading power, the EU. And its population is much larger than the population of the United States (511.8 million inhabitants, vs. 325.7 million in the USA) with almost equivalent GDP.

2. **The independence of the European Central Bank** and its commitment to price stability which **inspire confidence** and make the euro a reliable reserve currency and a potential anchor currency for foreign countries seeking to gain monetary credibility.

However, it suffers from **four disadvantages compared to the dollar**:

1. **European financial markets are less developed and less integrated than in the USA.** In particular, European bond markets remain fragmented, so that the euro is unable to offer the rest of the world a bond market that can compete with US Treasury bonds in terms of size, depth and liquidity.
2. **The eurozone has a massive current account surplus.** For the euro to impose itself as a global reserve currency, the eurozone must be able to offer a sufficient net supply of liquidity to meet the needs of the global economy, which implies a persistent current account deficit.
3. **The euro remains an incomplete currency.** The heterogeneity of European economies – the euro's original flaw – coupled with the eurozone's still incomplete architecture (fragmented capital markets, uncompleted banking union, lack of significant financial transfers between States) brings the ultimate risk of the collapse of the eurozone.
4. **The inertia of international currency status.** It is very difficult to compete with a currency already in place, since this currency benefits from economies of scale and network effects.

Consequently, we are probably still a long way from the day where the euro is able to pose as a really serious competitor to the dollar.

Is the dollar's supremacy therefore destined to be everlasting? In theory, no. This is the **Triffin paradox**: the persistence of US current account deficits, accompanied by the accumulation of external debt must inevitably, over the long term, undermine the confidence which is the basis of the status of reserve currency.

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