RICHARD W. STEVENSON, "In the Wings: Euro as Potential Rival to the Dollar," *New York Times,* April 28, 1998

WASHINGTON -- For the better part of this century, the dollar has reigned supreme in global finance, both a symbol of American economic might and a contributor to it. But a new rival to the dollar could eventually prove more powerful than the German mark or the Japanese yen: a single European currency.

This weekend, the 11 nations of the European Union that have chosen to participate in the first stage of monetary union will take a big step toward making the long-planned single currency a reality: They will lock their exchange rates together in preparation for the program's formal start on Jan. 1.

The international influence of their new currency, the euro, will ultimately depend on the economic strength of these European partners -- 11 of the 15 members of the European Union.

Given the high unemployment rates and other problems now afflicting the Continent -- never mind the uncertainties about the willingness or ability of the individual countries to subordinate their needs for the common good -- the new system's success can by no means be taken for granted.

Despite those doubts, there is a growing consensus on both sides of the Atlantic that monetary union will have substantial ripple effects on the United States. And the euro could bring profound changes to an international financial system in which the dollar has been the anchor since a system of fixed exchange rates collapsed in the early 1970s and the dominant currency since the British pound started to lose influence and strength in the 1930s and '40s.

"Although the political, cultural and economic challenges are formidable," an International Monetary Fund study said, "the euro has the potential to reshape European and international financial markets and to transform" the world monetary system.

For the United States, the benefits of a successful euro could include greater political and economic stability on a continent that has spawned world wars. It could also make Europe an easier, less expensive region for American companies to sell their products and services.

But the United States could lose some of the prestige and diplomatic influence that goes with having a dominant currency. Borrowing costs could rise for the government and companies. Economic growth could be reduced.

Some prominent economists in the United States, like Paul Krugman of the Massachusetts Institute of Technology, say the euro's potential impact on American interests is overstated. And no one is predicting that the euro will any time soon displace the dollar as the standard against which other currencies are measured.

But many economists and some American and European officials said the euro, if properly managed, would quickly establish itself as the undisputed No. 2 world currency.

Given that the combined economies of Europe already rival the American economy in size, economists said there was no intrinsic reason why the euro could not one day achieve parity in global status with the dollar.

"We will move from a purely dollar-centered world to a bipolar monetary world," said C. Fred Bergsten, director of the Institute for International Economics in Washington.

"The euro will move up alongside the dollar as the second key currency and will attain market share pretty close to the dollar within three to five years," Bergsten said. "It will shift the whole structure of the international financial system."

The dollar has far greater weight in global finance than is indicated simply by the size of the American economy. The United States accounted for 26.7 percent of world output in 1995 and 18.3 percent of world trade, roughly equivalent on both counts to the combined 15 national economies in the European Union.

But the dollar accounted for 61.5 percent of the foreign-currency holdings of central banks and governments in 1995, the most recent year for which figures are available, according to the International Monetary Fund. The German mark accounted for 14.2 percent and the Japanese yen, 7.4 percent.

In foreign-exchange markets, the dollar was the currency being bought or sold in 83 percent of transactions in 1995, compared with 37 percent for the mark and 24 percent for the yen, according to the European Union.

European officials, even as they defend their nascent currency's credibility and potential strength, have been careful not to ruffle American feathers. "I do not expect brutal changes overnight," said Yves-Thibault de Silguy, the union official in charge of the single-currency project.

Hugo Paemen, the European Union's representative in the United States, said it would be naive to think that a successful euro would not have implications for the balance of global financial power. "If you create a single European currency for 300 million people, it is going to be a very important force in the international financial sector," he said.

The Clinton administration has played down concern about the effect of the euro on the dollar and American interests generally.

"If the euro works for Europeans, it will work for us," said Lawrence Summers, the deputy secretary of the Treasury. "It will mean a larger, more rapidly growing market for our products and a stronger partner for the U.S. around the world."

The dollar's standing, Summers said, will continue primarily to reflect the economic performance of the United States.

"As long as we keep our fundamentals strong, the dollar will do fine," he continued. Any shifts in international currency holdings out of the dollar and into the euro "are likely to be gradual and not to pose a threat to our economy," the Treasury official said.

But since the benefits of the dollar's leadership have been considerable, the United States has much at stake as the euro takes its place in the world financial system. The dollar has long been a safe haven for world investors, enabling the United States to attract vast amounts of foreign capital and to finance borrowing needs at lower interest rates than purely domestic demand for dollar assets would have allowed.

Money from abroad, especially Japan, helped finance the huge federal budget deficits of the 1980s and early '90s. And financial crises in Asia last summer and fall sent a flood of money into the United States as investors looked for a safe place to park their money, driving down interest rates and helping set off a wave of mortgage refinancings that have reduced housing costs for many Americans.

The American trade deficit, though, has kept rising, and the United States thus needs to keep attracting money from abroad to paper over a huge current-account deficit, the broadest gauge of trade. Many economists consider this imbalance the biggest threat to the nation's long-run prosperity.

The dollar's standing in the world has gone hand-in-hand with the size and sophistication of American financial markets, helping Wall Street retain its role as the center of global finance. International investors buy dollars and dollar-denominated securities in confidence that they can easily sell them. When Japan's central bank needed dollars earlier this month to buy yen in the open market, supporting the yen's exchange value, it was reportedly able to sell $12 billion of Treasury bonds in New York in half an hour without upsetting the market.

The United States also benefits from the desire of foreigners to hold dollars in cash. By some estimates, the majority of American notes are held abroad. In developing countries and in those experiencing high inflation rates -- as well as among drug smugglers and other criminals -- dollars have become the all-but-official currency. Notes circulating abroad are a semipermanent, interest-free loan to the United States -- indeed, if Washington had to instead borrow the equivalent amount of money, say in Treasury bills, the interest payments would run in the billions annually.

Some economists dismiss the idea that the euro will soon be a serious challenger to the dollar because the dollar's status reflects more than half a century of American might.

Even if the euro does come to rival the dollar, they said, it will not necessarily have any substantial impact on the United States, especially since the country is running budget surpluses and does not need as much foreign capital. In an article this month in Fortune magazine, Krugman of MIT put the potential loss to the American economy at just one-tenth of a percentage point of economic growth.

But another camp of economists thinks that the results will not be so benign for Americans. Richard Portes of the London Business School and Helene Rey of the London School of Economics said in a paper published last week that the United States could lose up to half a percentage point of annual growth from the establishment of a credible euro while the Europeans could gain half a percentage point of growth. The United States grew 3.8 percent last year, while the 11 nations expected to take part in the euro grew 2.4 percent.

Portes said their analysis assumed that the euro would stimulate the development of Europe's financial markets, creating a bigger and more liquid market for euro-denominated securities and supporting the euro's use in foreign-exchange transactions. One implication, he said, would be a tilt in the geopolitical balance in Europe's favor.

"Ultimately we're going to have to have a more cooperative and less U.S.-led process in things like international financial crises, where clearly the European voice is much less than its weight in the world economy," Portes said.

Return to Vinnie's Home Page

Return to European Union Page