

Feb. 11, 2002

The Euro versus the Dollar: Resolving a Historical Puzzle

by

Ronald McKinnon¹

Elsewhere in this volume, Peter Kenen provides an excellent statistical overview of the continued dominance of the dollar as “the” international currency. Although the euro has been extremely successful in unifying financial markets within Europe since its introduction on January 1, 1999, it has not significantly displaced the dollar’s central role in the world’s foreign exchange markets as many had anticipated.

This puzzle has a dual historical aspect. First, why under the postwar dollar standard did the evolution of a separate regional money in Europe eventually become necessary? Second, given the success of European Monetary Union (EMU) by 1999, why has the new euro done surprisingly little to displace the dollar’s role as international money outside of Europe? I shall try to explain both aspects of this puzzle. But first consider Kenen’s evidence.

The Dollar as International Money

Comparing 1998 to 2001, Kenen’s Table 1 shows that the dollar retains its dominant role as vehicle currency by being on one side of about 90 percent of foreign exchange transacting. In his Table 5, he also shows that the dollar remains the dominant official reserve asset of governments. If one allocates the “other” category (his Table 5) in proportion to acknowledged foreign exchange holding, developing countries hold more than 70 percent of their official foreign exchange reserves in dollars. Other than the United States which holds negligible official reserves in foreign currencies, the other industrial countries hold more than three-quarters of their official reserves in dollars. In the realm of worldwide primary commodity trade in oil, copper, wheat, and so on, there is no evidence yet of any switching away from dollar invoicing.

The dollar’s continued monetary dominance may seem surprising given that Euroland is now of an economic and financial size, particularly with its rapidly growing euro-denominated bond market, comparable to the United States. Most puzzling is the absence of any significant move toward official international portfolio diversification elsewhere—where treasuries and central banks diversify out of dollars into euro-denominated reserve assets. Before January 1 1999, financial pundits generally expected the euro to appreciate against the dollar as foreign central banks chose to diversify their asset portfolios away from the dollar toward the euro.

¹ William E. Eberle Professor, Department of Economics, Stanford University, Stanford California 94305-6072. E-mail: mckinnon@leland.stanford.edu, [Http://www.stanford.edu/~mckinnon/](http://www.stanford.edu/~mckinnon/)

What explains the surprising persistence of the dollar as international money in the face of competition from other national monies such as the newly created euro? The stock answer is that an international money is both necessary and a natural monopoly. In the absence of a purely non national international money such as gold, world financial and goods markets will naturally pick one national currency to be at once the interbank vehicle currency, the invoice currency of choice in international trade, the preferred official intervention currency, and the principal official reserve asset. To facilitate international exchange, the network effects and cost saving from using just one national money are so strong that, once established, it cannot easily be displaced.

A second complementary role of an international money is to provide a *nominal anchor* for the price levels of some or most of the other countries in the system. After the U.S. dollar had become generally accepted as the central facilitating currency in 1945, other countries naturally tended to peg their currencies to the dollar as the nominal anchor of their domestic price levels. And in the 1950s well into the 1960s, sufficient intra European exchange rate stability was achieved by the simple expedient of all the European countries pegging to the dollar under the cover of the old Bretton Woods par value system.

But this nominal anchor role of the dollar could only work well *if the American price level was stable*. As my figure shows, the American price level—as measured by what is now the U.S. producer price index, but was then called the wholesale price index—was remarkably stable up to about 1968. Thus, the Europeans had no great incentive to begin thinking of separate currency arrangements before 1968.

American Inflation in the 1970s and the Rise of the Deutsche Mark as Key Currency in Europe

Calls for a separate European monetary regime to support European economic integration began only *after* cumulative American inflation caused the collapse of the Bretton Woods par value system in 1971. The high and volatile U.S. inflation in the 1970s into the 1980s—see the middle three panels of the figure—made necessary a separate fixed exchange regime within Europe to support the deep economic integration that the Europeans had in mind.

However, a fixed exchange rate regime is not feasible unless one currency serves as the nominal anchor or key currency around which the others can peg. By the early 1970s, Germany emerged as the one big European country with both a stable domestic price level (at least more stable than the American) and no capital controls on currency flows. Although the European Monetary System (EMS) was formalized in 1979 with bilateral exchange rate bands as if it was a partnership among equals, in fact everybody knew that the EMS was a D-Mark zone.

Within Europe, the D-Mark zone in the 1980s well into the 1990s worked similarly to the way the dollar standard works on a worldwide scale. Germany provided the nominal anchor for the intra European exchange rate regime, and the other European

countries strove—albeit imperfectly—to peg their currencies to the D-Mark. Because of perceived lower risk, D-Mark assets became the preferred “risk free” assets in the European financial system. European countries on the German periphery were then subject to periodic runs from their currencies into the stronger D-Mark, the fundamental money in the system.

The German monetary system became stronger as the financial systems of other European countries weakened—with higher risk premia in their interest rates and shorter terms to maturity in bond markets denominated in their national currencies. This unfortunate currency asymmetry in European financial markets was then swept away by the prospective and actual advent of the euro in late 1990s. Now all the European countries are on a financial par with more or less the same, if lower, interest rates—and German hegemony has vanished. EMU has been a big success in integrating the European financial markets and lengthening terms to maturity in European bond markets.

American Price Level Stability in the 1990s

Now we come to the second part of our historical puzzle. Why hasn't the successful introduction of the euro done more to displace the dollar in world financial markets at large? The euro must now compete with a dollar stronger than it was in the 1970s when the idea of EMU was born. The remarkable return to actual price level stability in the United States in the 1990s is evident in the figure. But equally important is the return to stable price-level *expectations* as manifested by the much lower nominal interest rates today in U.S. financial markets than was the case in the 1970s and 1980s.

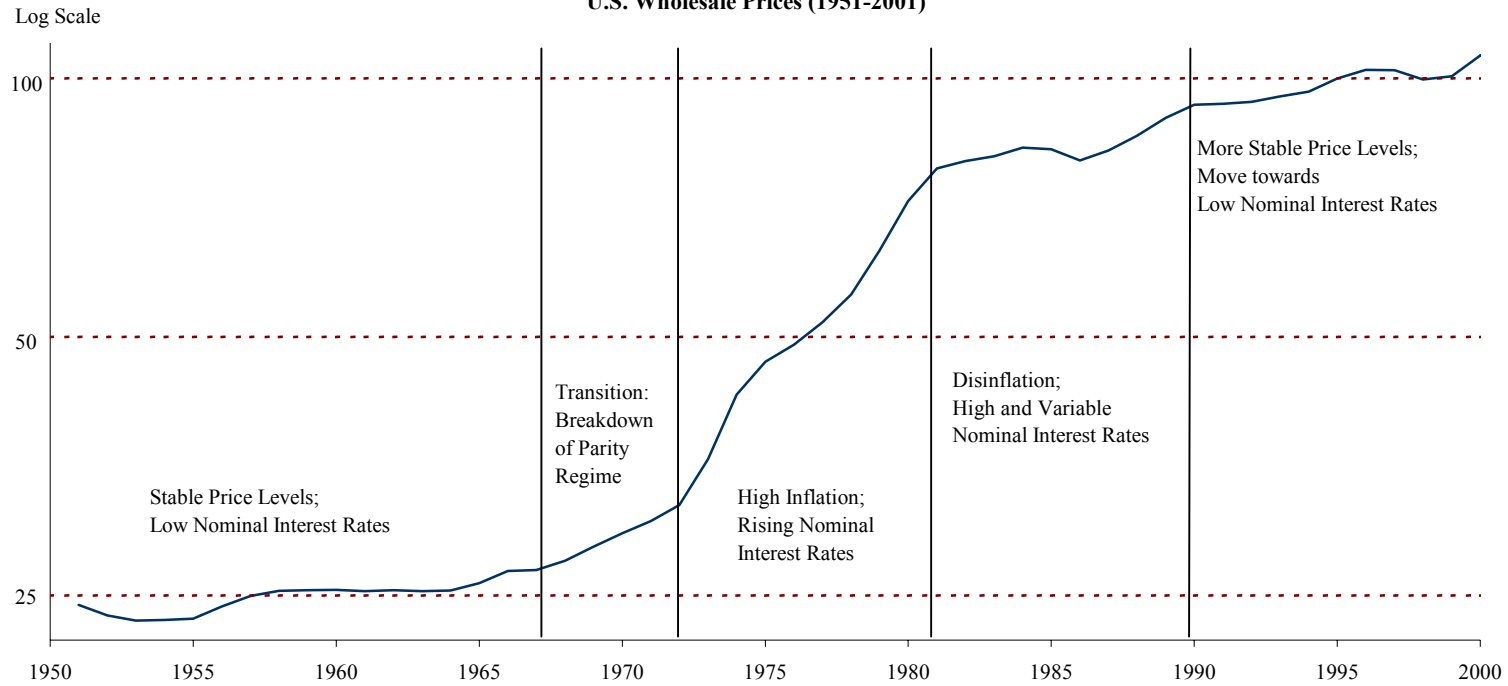
So all the natural monopoly functions of a single international money—vehicle currency, unit of account, reserve asset, and so on—are reinforced if the central money is itself stable valued. Back in the American inflation of the 1970s, if by some miracle a full fledged and stable valued euro had then been introduced, the displacement of the dollar role would have been substantial. At the very least, foreign central banks would have hastened to build up the proportion of euros in their official exchange reserves.

Instead, the advent of the euro occurred when the dollar standard had been reinforced by ongoing price stability in the United States. In these circumstances, the entrenched central role of the dollar in the world's money machine is simply too hard to displace by the arrival of new strong monies on the international scene. Although in the 1970s monetary instability in the United States provided the initial impetus to develop a separate European money, the return to American monetary stability now prevents any significant erosion of the dollar's international role outside of Europe.

References

Kenen, Peter, “The Euro Versus the Dollar: Will There be a Struggle for Dominance?”, Panel, Annual Meeting, American Economic Association, Atlanta, Jan.4, 2002.

**Figure: The World's Nominal Anchor:
U.S. Wholesale Prices (1951-2001)**



Source: International Financial Statistics, IMF (March 2002)