INTERNATIONAL JOURNAL OF INNOVATIVE RESEARCH & DEVELOPMENT

ISSN: 2278 – 0211 (Online)

Euro Will Replace Dollar As World Currency

Dr. Devajit Mahanta
Vice President, Benzcom Consulting Pvt. Ltd.
Ambari Guwahati, Assam, India

Abstract: *After nearly a century of domination in world monetary affairs, the dollar is about to face stiff competition when the Euro is created. On 1st January 1999, Europe was host to one of the most important events in economic history. Eleven of the fifteen European Union member states formed an Economic and Monetary Union (EMU) and adopted the Euro as their single currency.*

However, in examining the US economy in the recent past we realize that the trouble has already begun for. The dollar will likely be replaced for a couple of reasons; the first is that of inflationary weakness. The long-term fiscal outlook for the US is weak at best, with the entire US economy becoming progressively more dependent on welfare and structural problems that require massive spending, requiring more and more decreasing marginal productivity of the debt. Hence, in conclusion we can safely say that Euro does indeed pose a significant threat to the US dollar.

Keywords: *Euro, Foreign reserves, International currencies, EMU, Fiscal deficit*

1. Introduction

After nearly a century of domination in world monetary affairs, the dollar is about to face stiff competition when the Euro is created. On 1st January 1999, Europe was host to one of the most important events in economic history. Eleven of the fifteen European Union member states formed an Economic and Monetary Union (EMU) and adopted the Euro as their single currency. Clearly, peaceful currency unification among such a number of independent countries of such a size is a unique historical event. The introduction of the euro and the rising current account deficits and external debt of the United States have increased the pressure on central banks to diversify away from the US dollar. A major portfolio shift would significantly affect exchange rates and the status of the dollar as the dominant international currency.

In the last couple of years, the national debt of US has hit $5 trillion more. The impact has been fairly mute. The Fed is also been working to increase the money supply, though the impact has been far less damaging than the fiscal problems, at least in terms of future inflation. The dollar will likely be replaced by euro for a couple of reasons; the first is that of inflationary weakness. The long-term fiscal outlook for the US is weak at best, with the entire US economy becoming progressively more dependent on welfare and structural problems that require massive spending, requiring more and more decreasing marginal productivity of the debt.

2. Review of Literature

In the recent past due to spending habits of American has undermined the dollar's reputation as world currency, with excess supply of dollar on world markets depressing its price. In a recent survey of European Central Bank (2005) said that China is concerned about the depressing value of dollar and suggested International Monetary Fund (IMF) to develop a single global currency to replace dollar as the world reserve currency.

Despite the apparent swift U.S. military success in Iraq in March 2003, the U.S. dollar has yet to benefit as safe haven currency. A hidden war between the dollar and the new Euro currency for global hegemony is at the heart of this new phase (Chinn and Frankel, 2008).

To understand the importance of this unspoken battle for currency hegemony, Goldberg (2005) expressed that we first must understand that US hegemony has rested on two unchallengeable pillars. First the overwhelming US military superiority over all other rivals. The US today spends on defense more than three times the total for the entire European Union, some $ 396 billion versus $118 billion last year. The second pillar of American dominance in the world is the dominant role of the U.S. dollar as reserve currency. The Petrodollar has been at the heart of the dollar hegemony since the 1970's. As long as the dollar remains the dominant currency, especially in oil trade, it is difficult to see how the U.S. can be dislodged from its position as the world's dominant economic power.

Also if we analyze the perspective of dollar it will be clear that U.S. Government not impose the Dollar on the world, it is the world that had adopted the U.S. Dollar as their collective global currency of exchange convenience (Kenen, 2003).

In this context Kamps (2005) mentioned that on October 2000, a UN panel approved an Iraqi request to receive oil-export payments in Euros rather than the US dollar, which has been the norm for oil transactions for decades. Iraq's effort to defy the "petrodollar" standard prompted a number of analysts to conclude that the invasion of Iraq was not an oil war, but an oil currency war. That's why after the invasion of Iraq in March 2003, the US secured oil areas first. The only government building in Baghdad not bombed was the Oil Ministry. The war in Iraq may be a war for oil, but at a deeper level it is a war for the defense of the continued control of the world oil economy through the dollar.

During a speech in Spain Javad Yarjani (2003), chief Petroleum Market Analyst for the Organization for Petroleum Exporting Countries (OPEC), said that *"OPEC will not discount entirely the possibility of adopting Euro pricing and payments in future."* Many of the Muslim countries of South East Asia have already begun looking to the Euro as an alternative to the dollar for national foreign-exchange reserves. The Governor of Indonesia's central bank announced that the country would consider using Euros for its foreign exchange reserves, a process Iran began in 1999.

The Reserve Bank of India in its 1997-98 annual report (RBI, 1997-98) has warned that Indian corporate should be ready to pay or invoice in Euro as they may encounter customers and suppliers in the European Union who are willing to deal only in the Euro.

Allan Greenspan (2004), the Chairman of Federal Reserve of the United States mentioned that the dollar's exchange rate has been declining since early 2002, increasingly tight competitive conditions in the United States, as elsewhere, in 2002 and 2003 apparently induced exporters to the United States to hold dollar prices to competitive levels to ensure their market share and foothold in the world's largest economy. For example, from early 2002 to early 2004, the dollar's exchange rate against the euro on average, declined about 30 percent. The trend to adopt the Euro as a reserve currency has greatly benefited the European economy apart from the prestige and power gained by the European Central Bank.

3. Different Approaches

Conventional wisdom has suggested that the US dollar is on the verge of losing its reserve currency or anchor currency position in international monetary markets after the EURO arises. A reserve currency, or anchor currency, is a currency that is held in significant quantities by many governments and institutions as part of their foreign exchange reserves. It also tends to be the international pricing currency for products traded on a global market, and commodities such as oil, gold, etc. In fact, many authors believe that the structural American current account deficits, and the counterpart in Germany, Japan, and China's surpluses, the so-called global imbalances, would eventually lead to a run on the dollar. Unsustainable current account deficits would lead agents worldwide to dump the dollar for assets denominated in other currencies, presumably the euro (Eichengreen and Flandreau, 2009). Over the past ten years the euro has proved itself to be a currency with a stronger exchange rate and a more stable inflation rate than the dollar. Furthermore, the EU is the main trading partner of both emerging economies of China and Brazil.

A 2011 study about the current dominant reserve currency in central banks shows that dollar may not be the obvious dominant currency. The table-1 revealed that the USD is losing its trends since 1999 though still accounts 62 percent in 2011 and on the other hand EURO gaining popularity from 17.9 percent in 1999 to 25 percent in 2011.

Currency	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
USD	71	70.5	70.7	66.5	65.8	66	66.4	65.7	64.1	64.1	62.1	61.8	62
EUR	17.9	18.8	19.8	24.2	25.3	24.9	24.3	25.2	26.3	26.4	27.6	26	25
GBP	2.9	2.8	2.7	2.9	2.6	3.2	3.6	4.2	4.7	4	4.3	3.9	3.8
JPY	6.4	6.3	5.2	4.5	4.1	3.8	3.7	3.2	2.9	3.1	2.9	3.7	3.5
CHF	0.2	0.3	0.3	0.4	0.2	0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Others	1.6	1.4	1.2	1.4	1.9	1.9	1.9	1.5	1.8	2.2	3.1	4.4	5.3

Table 1: Currency composition of official foreign exchange reserves
Source: Wikipedia
Note: All figures are in percentage

If we plot a chart over time, it seems that the USD is losing its status as a reserve currency. Although the trend of the USD as a reserve currency is negative, it still accounts for 60% of global foreign exchange holdings around the world. The euro on the other hand is increasingly gaining popularity (Chart-1). If the trend continues like this, the euro could become the reserve currency by 2020.

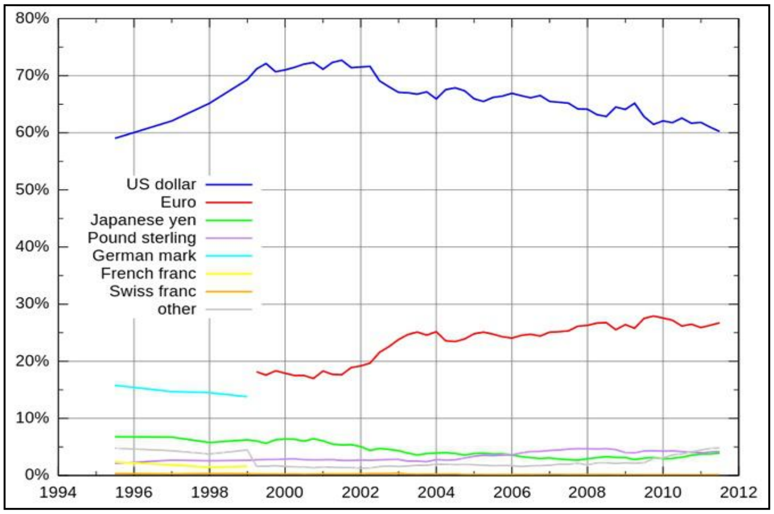

Chart 1: Currency trends
Source: Wikipedia

Given the size of the European market and the share of Europe in world trade, euro-invoicing is likely to develop, including for invoicing between third countries. Some of them might turn to the euro as an anchor. Currency competition between the euro and the dollar will likely be shaped by four factors:

- The possible development of the euro as an exchange rate anchor on a regional basis, or even a wider one;
- The possible development of euro-invoicing by third parties, including, significantly, oil-producing countries;
- A policy mix conducive to the internationalization of the currency; deliberate policies to foster the internationalization of the currency by making it attractive to hold by non-residents; and
- Relative performance in terms of the stability of the currency's purchasing power over the medium to long term.

The major payoff is predictions about scenarios under which the euro might in the future rival or surpass the dollar as the world's leading international reserve currency. That question appears to depend most importantly on two things-

- Whether enough other EU members join euro land so that it becomes larger than the U.S. economy and, in particular, whether the United Kingdom comes in, with its large financial markets; and
- Whether U.S. macroeconomic policies eventually undermine confidence in the value of the dollar through inflation and depreciation.

Whatever value this exercise has probably consists of estimating, contingent on those two things happening, how quickly the euro might rise to challenge the dollar. If all thirteen EU members who are not currently in the EMU join it by 2020, including the United Kingdom, then the euro overtakes the dollar a few years later. Even if some of these countries do not join, a continuation of the recent trend depreciation of the dollar, were it to occur for whatever reason, could bring about the tipping point even sooner.

4. Conclusion

In this new world of international monetary structure US need to be very careful about its economic policies. However, in examining the US economy in the recent past the dollar is a disappointment as regards the way it is performing as the anchor of the global economy. In addition to the huge current account deficit that the US has suffered for decades, now there are the difficulties that this superpower faces with its wars in Iraq and Afghanistan and the grave consequences of the financial crisis. The world's leading currency tends to be backed up by the world's leading nation, and in the view of many of these financial leaders the US is no longer the economic model to follow or the engine of world growth. The time has come for alternatives, and the consolidation of the euro is a first step in that direction. Hence, in conclusion we can safely say that Euro does indeed pose a significant threat to the US dollar. For now, only one thing is clear; the Euro has arrived.

5. Reference

1. Chinn, M., and J. Frankel. 2008. "Will the Euro Rival the Dollar? A Debate." InternationalFinance 11(1): 49–73.
2. Eichengreen, B., and M. Flandreau. 2009. "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading Reserve Currency?" European Review of Economic History 13: 377–411.
3. European Central Bank (2005). Review of the International Role of the Euro. December 2005, Frankfurt, Germany.
4. Goldberg, L. 2010. "Is the International Role of the Dollar Changing?" Federal Reserve Bank of New York, Current Issues in Economics and Finance 16(1): 1–7.
5. Greenspan, Alan (2004). Remarks at the European Banking Congress 2004, Frankfurt, Germany November 19, 2004.
    a. [Online]
    b. Available:http://www.hilbertcorporation.com.ar/greenspan-currentaccount.pdf
    c. Accessed on 09.09.2012.
6. Javad, Yarjani (2003). Speech on US government outlines 'dilemma' in event of Iraqi crackdown on Iranian dissidents.
    a. [Online]
    b. Available:http://www.guardian.co.uk/world/2011/apr/08/us-iraq-iranian-dissidents-mek
    c. Accessed on 02.09.2012
7. Kamps, Annette (2005). "The Euro in International Trade", mimeo, European Central Bank.
8. Kenen, Peter (2003). "The Euro and the Dollar: Competitors or Complements?" in the European Union and the United States, Michel Dumoulin and Geneviève Duchenne (eds.), pp. 251-274.
9. Reserve Bank of India, (1997-98). "The Annual Report on the Working of the Reserve Bank of India", Government of India.
10. Wikipedia, http://en.wikipedia.org/wiki/Reserve_currency, Accessed on 09.09.2012