

THE COMING OF THE EURO: INTERNATIONAL MONEY AND GLOBAL POLITICS

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There is no doubt at all that the objective of the promoters of European Monetary Union (EMU) was for Europe (and France above all) to challenge the hegemony of the dollar and of the United States leadership of the free world. The euro is targeted at the dollar. Euroland (and a fortiori the French) resent the power exercised by the United States through its control of the world's money. (De Gaulle complained bitterly that the Americans plundered Europe by printing bits of green paper and exchanging them for French industries. He tried, and failed, to force us back to payments in gold.)

The U.S. dollar is the intermediary in exchange. Until recent years, exchange between one currency and another was virtually always done through the U.S. dollars. It was the medium of exchange. It enables thick markets in currencies and all the derivatives. Just as people trade in their home-based domestic currencies, so banks--and particularly central banks--trade with dollars. For example, until recently the Bundesbank kept virtually all its reserves in U.S. dollars. Even as late as the early 1990s, when, in protecting the French franc against speculative capital flows, it acquired a lot of francs, it spent the next months converting them back to U.S. dollars.

A proximate explanation of the ubiquitous use of the U.S. dollar as a reserve currency is its acceptability. The main reasons for such ready acceptance are the stability in value, the "liquidity" (meaning that one can unload U.S. dollars in virtually unlimited amounts without affecting the price), the fact that most commodities are priced in dollars, so one can readily switch assets, and the absence of restrictions on using dollars. Although there are restrictions on criminal activity and rogue governments, the U.S. government does not inhibit the use of U.S. dollars in any portfolio or trade.

Furthermore there has been no "shortage" in the supply of the world's money. The United States has long run deficits on the current account of the balance of payments. These have been used to meet the demand for liquidity that has grown considerably faster than world GDP.

The triumph of the dollar, however, was largely due to the restrictive policies imposed on alternative currencies. Yen were restricted in all sorts of ways by regulation and capital controls. As for the Deutschmark, the Bundesbank did not want to encourage any substantial use of it as an international reserve currency, since, they thought, that it would inhibit them operating a stable monetary policy. (Note the contrast in the Swiss franc.)

The Uses of the Euro

One of the striking features of the euro is that, although a managed currency, it is not the liability of a sovereign state. The European Central Bank has access only to the severely limited (and likely to remain so) sovereignty of the European Union. In particular the tax raising powers are much more limited than those of the United States are--and so there is a considerable constraint on the operation of lender of last resort. (Note that there was no such thing with the Deutschmark, as distinct from other central banks in the EU). I doubt, however, whether this will be a considerable disadvantage for the euro.

There is another more significant disadvantage for the euro. It is a new currency. Instead of doing the logical least-costly thing by making the Deutschmark the European single currency, political egos dictated that there had to be a new currency. We do not know how this new currency is going to behave. In principle, it should be managed in a non-politicized way in the interests of the whole EU. In practice, the ECB is likely to be much more controlled by the politicians than most observers imagine.

The treaty states that the political authorities, not the ECB, shall be responsible for the international aspects of monetary policy. Since there is no European state that is a counterpart to the ECB, there is something of a political vacuum. This has been identified by the French and there is an informal (i.e., non-treaty) agreement to establish a committee EURO-X to "guide" the ECB. On past form in the EU, this committee is likely to be dominated primarily by the French/German axis.

There are other potential potholes in the euro structure that would much affect its attraction as a reserve asset currency. Particularly pertinent at this time is that, with only a qualified majority--that is to say, no country can exercise a veto--the EU can impose exchange controls over the whole union. Of course such measures would only be considered under crisis conditions, but in 1992/3 and more recently, they are not to be thought of as entirely beyond the pale. (If they were a no no, then why was paragraph 73(j) in the treaty?) Fashionable economists and statesmen, such as Paul Krugman and Mahathir Mohammed, have praised and implemented exchange controls. Even talk about such measures, particularly by the French, must have some effects on the attraction of the euro.

The tendency of central banks to manage their reserves in pursuit of a high rate of return has become more common over recent years. The miserable real rate of return on U.S. Treasury bills, compared with 7 to 9 percent on a portfolio of equities is the basis for such asset management. The countries in euroland have very limited equity markets compared with the United States. Liquidity is a prime consideration of central banks. They want always to be able to unload (and buy) large numbers of shares without affecting the market price. On these grounds, the dollar is much to be preferred to the euro.

The fund-management aspects of the reserves are important. The euroland countries contribute 50 billion euros to form the ECB's reserves. However the ECB does not manage those

funds. The national central banks manage their own contributions as well as their own noncontributed reserves. But what about the currency composition? Here be dragons--as ancient mariners said when they had not explored the territory. It is understood that, above a certain amount yet to be revealed, the national central bank will be required to get permission from the ECB. And similarly any exchange rate agreements negotiated by ECOFIN or Euro-X will have to be controlled through the ECB; but how it will work in practice is still in dragonland.

But, apart from the issues of accessibility and market depth, the ultimate fate of the euro vs. dollar will depend mainly upon the stability of the currency. Volatility is an anathema to central bankers. Uncertainty is equally obnoxious.

Perhaps the greatest count against the euro is its volatility and potential uncertainty. Although nominally fashioned on the Deutschemark, there is an enormous number of questions yet to be settled. Most important is that we do not yet know whether there will be a monetary growth target or an inflation target. We have no history to guide us on the appropriate definitions with this new currency.

And how will the Euro-X work? We do not know. Whereas in the case of the dollar it is the devil we do know. Consequently my conjecture is that, granted the U.S. continues with Greenspanian stability. There is going to be only the modest penetration of the euro.