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Will the dollar lose its crown to the euro?

By WILLIAM L. SILBER

NEW YORK — Much of America's dominance in world finance comes from the dollar's status as international money. America's commitment to free capital markets, the rule of law, and price stability confer credibility on the dollar as a store of value. But American spending habits have undermined the dollar's reputation, with the excess supply of dollars on world markets depressing its price.

This spring, the euro's exchange rate against the dollar reached an all-time high, and central banks have increased the euro share of their international reserves. Is the dollar about to lose the crown of world finance to the euro?

History suggests otherwise, despite a vulnerable dollar.

American financial supremacy in the 21st century resembles Britain's position in world finance a century ago. Before the outbreak of World War I in August 1914, the pound sterling served as the currency of choice for international transactions, just as the dollar does today, and the world's borrowers visited the City of London to raise capital.

British economist John Maynard Keynes worried that countries would not use sterling to settle trading balances with each other if the pound were not viewed as a reliable store of value. The "future position of the City of London," according to Keynes, depended on the pound sterling continuing to serve the business world as the equivalent of gold. Britain maintained the pound's convertibility into gold at the outbreak of World War I to preserve its credibility as the international medium of exchange.

The dollar could not challenge sterling's role as the world's currency without matching its reputation. August 1914 provided the opportunity. The biggest gold outflow in a generation imperiled America's ability to repay its debts abroad. Fear that the U.S. would abandon the gold standard sent the dollar plummeting on world markets.

But Treasury Secretary William G. McAdoo secured American financial honor in August 1914 by remaining true to gold while everyone else, except for the British, abandoned their obligations. Despite the dollar's instant credibility, however, it took more than a decade for

America's currency to match Britain's as an international medium of exchange. Payment habits melt at a glacier's pace.

Britain's transformation from international creditor to international debtor during World War I gave the dollar a second wind in its battle with sterling. The British were forced to abandon gold convertibility in April 1919 — a tactical withdrawal intended to pave the way for Britain's return to the former \$ 4.8665 parity with the American dollar. Six years later, in April 1925, Britain confirmed its monetary credibility and returned to the gold standard. But the pound had already suffered irreparable damage.

The experience of 1914 implies that a credible alternative can replace an entrenched world currency, especially after an unfavorable balance of trade has weakened it. But even then, dethroning the reigning king of international exchange takes time.

Today, the euro — a currency without a country — lacks a long track record of credibility. Thirteen countries in the European Union use the euro as money. But the commitment of these independent political entities to the euro cannot match the history of America's commitment to the dollar.

The European Central Bank, established in 1998, has a mandate to manage the new currency to maintain price stability. But the ECB needs time to establish its inflation-fighting credentials. It cannot hitch a ride on gold, the way America did a century ago. So **the euro must earn its reputation crisis by crisis to confront the dollar's dominance as the currency of choice for international transactions.**

Recent experience with the euro as an official reserve asset is instructive. Between 2000 and 2005, the dollar lost more than 25 percent of its value against the euro. Meanwhile, the fraction of international reserves held in euros grew from 18 percent to 24 percent, and the dollar's share dropped from 71 percent to 66 percent. In short, the euro has clearly made some headway during this period of U.S. balance of payment deficits, but this reflects an evolutionary decline in the dollar's dominance, not a revolutionary regime shift.

What might trigger a fatal run on the dollar in world markets? While a broad and abrupt selloff by major foreign holders of dollars — for example, China — appears unlikely, a cataclysmic event, similar to the outbreak of World War I in 1914, could prompt a search for a new international medium of exchange. In the modern era of automated payments, the upheaval might come from a terrorist attack that undermines the computerized transfer facilities of the world's banking system. A catastrophic loss of electronic records could surely destroy the credibility of the dollar as the international medium of exchange.

But exactly what would replace the dollar under such circumstances remains an open question. After all, a loss of computer records would make the euro equally suspect. Perhaps gold, a store of value impervious to physical distortion, could make a comeback. Of course, one can only hope that such a scenario remains pure conjecture.

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