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Can the Euro rival the United States dollar and become the world currency?

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Abstract:
Due to the outstanding performance of the Euro since its advent, the public may wonder whether the Euro would, one day, replace the US dollar (USD) which has all along been a force to be reckoned with all around the world. By tracing the chain of contributions the USD (the United States of America) and the Euro (European Union) have made to the world economy in the past and at present, we hope to arrive at some conclusions. However, the paper will give primacy to predicting the future trends for them separately.

1. Introduction

The US dollar (USD) is the most widely used currency in international transactions; about 85% of all currency transactions in the world involve the USD. Moreover, major commodities contracts like crude oil and gold are priced and settled in USD on various exchanges. There are 25 different currencies pegged to the USD and countries like Panama and Ecuador use the USD as their official currency. Most importantly, the USD is the world's primary reserve currency. (*Wikiinvest*)

On the other hand, the Euro is the single currently currency shared by 17 member states of the European Union (EU). The Euro was introduced in 1999 and was a major step towards European integration. It has also been one of its major successes. Around 330 million EU citizens now use it as their currency and enjoy its benefits, which will spread even more widely as other EU countries adopt it. It is therefore not surprising that the Euro has rapidly become the second most important international currency after the USD. (European Commission, 2012)

How did the USD become such a dominant currency on the international stage? Can the possible growth in membership of the Eurozone, economy and political integration enable the Euro to dethrone the USD as the world's primary reserve currency?

Those are some of the questions we would like to address in this paper. Section I is concerned with the emergence of the USD as the world's primary reserve currency and an analysis of the Euro/USD exchange rate over the past 5 years. Section II addresses the current and future economic situation for the US and the Eurozone and Section III gives a set of recommendations for the Eurozone regarding how to enable the Euro to dethrone the USD as the world's primary reserve currency. Last but not least, Section IV tries to answer the purpose of this paper.

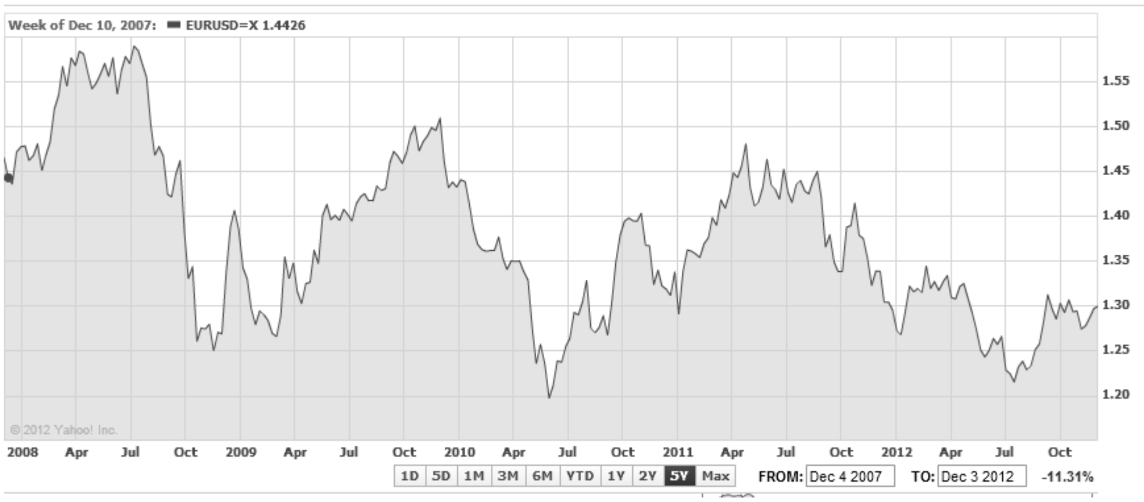
1.1 Emergence of the USD on the International Stage

A currency's value is determined by the underlying nation's economy. If the country's economy is performing well, there will be a significant demand for that nation's currency and vice-versa. In 1880, the US was the world's largest economy with a gross domestic product (GDP) of USD 10.4 billion which represented about 70% of the combined GDP of the three leading European economies namely England, France and Germany. By 1913, the economic lead of the US had widened; the GDP of US exceeded by 20% the combined GDP of the leading European countries.

In spite of its large economy, the USD was not widely held as a reserve currency. The UK pound sterling was the leading international currency followed by the French franc and the German marc. One of the reasons was that the US was a net capital importer whereas the leading European economies were net capital exporters. Moreover, the US did not have a central bank and was prone to multiple financial crises.

However, half a decade later, by 1919, the US in a dramatic role reversal became the world's largest creditor nation and the dominant financial power and by the 1920s the USD achieved the status of world's reserve currency. Some of the reasons to this incredible role reversal were mostly World War I (1914-1918) and perhaps the introduction of the Federal Reserve in 1914. World Ward I forced the European economies to heavily borrow from the US. Moreover, the war was devastating for the European economies in terms of standing and resources. The leading European economy namely England experienced a severe recession; GDP fell by nearly 49.15% from 1913 to 1920 whereas, over the same period the GDP of the US grew by 136.36%. (Sylla, 2011)

1.2)The Euro/Dollar Exchange Rate (2007-2012)



(Yahoo Finance)

The reasoning behind the Euro/USD exchange rate analysis is that since exchange rates are determined by market forces and that a currency reflects a country's underlying economy, a constant appreciation of the Euro would mean that investors' demand for the Euro is high and that the Eurozone economy is doing well. Based on the direction of the Euro/USD exchange rate, we hope to be able to give some answers to our question: Will the Euro dethrone the USD as the world's primary reserve currency?

We can see from the graph that the Euro/USD exchange rate has been volatile over the past years. But, the interesting thing to notice for our paper is that the Euro/Dollar exchange rate was 1.5893 Euro/USD on July 7' 2008 and went all the way down to 1.1978 Euro/USD on May 31, 2010; a 24.63% depreciation of the USD over the period. However, the USD appreciated against the Euro and reached its peak on April 25' 2011 at 1.4810 Euro/USD but never reached its previous peak on July 7' 2008. Similarly, On July 16' 2012 the exchange rate was 1.2156 Euro/Dollar reflecting a Euro appreciation but not anywhere close to its peak on May 31, 2010. Since July 16' 2012, the trend has been for the USD to appreciate with a current exchange rate of 1.3094 Euro/USD.

This analysis of the Euro/USD exchange rate shows that there is competition between those two currencies and it is difficult to designate a winner as of now. However, in the remainder of this paper we will analyze each economy in order to predict which one will supersede the other.

2. Economic Situation

2.1 Current Economic Situation of the U.S Economy

In September of 2008, the financial crisis broke out in the US The financial crisis caused substantial damage to the US economy and has since hindered the U.S economic growth.

From the end of 2008 to present, the US economy has been experiencing the most serious recession and slowest recovery since the Second World War. The GDP of the US contracted by 0.3% in 2008 and then a further contraction of 3.5% in GDP occurred in 2009; the most serious contraction since World War II. However, the US economy began a slow recovery from the second half of 2009 (Xiu & Zhang, 2009).

A closer look at the current state of the US economy shows there are three substantial problems which raise doubts on whether the US can continue to be the hegemonic power of the world and whether the USD can continue to be the world's dominant currency. The US suffers from a high unemployment rate, a heavy debt burden and declining real estate prices. Although the US economy is yet to fully recover, the GDP of the US is still the highest in the world. According to the data from the IMF World Economic Outlook, published in April 2011, in 2010 U.S GDP totaled USD 14.66 trillion, accounting for 23.3% of the world's GDP; while China's GDP was USD 5.88 trillion, accounting for 9.3% of the world's GDP. Japan's GDP was USD 5.46 trillion while Germany's GDP was USD 3.32 trillion accounting for 8.7% and 5.3% of the world's GDP respectively. The combined GDP of China, Japan and Germany totaled USD 14.66 trillion; almost the same as the total economic output of the US

Moreover, for more than half a century, the USD has been not only the currency of the US but also the world's primary reserve currency.

However, the status of the US as the economic superpower of the world and the USD as world's primary reserve currency are heavily tied to the future of the US economy. In the coming section, we will discuss the future economic outlook of the US economy to see if the US will be able to maintain its supremacy.

2.2 Future Economic Outlook of the US Economy

The US has the world's most developed market economy, with a strong self-adjustment and repair capacity. In the US, the corporate culture, capital markets, education and research and many other areas are considered best practice. In order to fix the economy, the US launched a series of policies. One of the main policies was the quantitative easing (QE) policy. The QE policy of the US aimed to increase the money supply in a bid to boost economic recovery; three rounds of QE have been launched since the beginning of the financial crisis.

2.2.1 Quantitative Easing One

QE1 was launched in November 2008 and lasted for 16 months. When the Federal Reserve's launched QE1, the US government bought USD1500 billion of mortgage debts and loans from financial institutions to strengthen financial balance sheets of institutions. In order to prevent the quantitative easing money from flowing into the financial markets and cause inflation, the US Treasury Department issued bonds of the same amount and the financial institutions purchased those bonds. As a result, the bad assets shifted from the balance sheets of financial institutions to the Federal Reserve's balance sheet. By doing this, the Fed effectively stabilized the market and played an important role in avoiding economic recession. According to *Ming Pao*, QE1 was relatively successful as it caused the Standard and Poor's stock index to increase by 50% (http://www.mingpaomonthly.com)

2.2.2 Quantitative Easing Two

QE2 was launched by the US government on November 3, 2010. The main purpose of QE2 was for the Federal Reserve to purchase about USD75 billion worth of long term bonds every month. When QE2 was released, the Dow Jones Stock index began to rise and investor's holdings of financial assets increased. In addition, people's wealth and consumption increased. During QE1 and QE2, the U.S. stock market increased from the lowest point of 6469.95 in March 6, 2009 to 12,414.34 index points (As of June 30, 2011). **(http://hk.finance.yahoo.com)**.

2.2.3 Quantitative Easing Three

Finally, QE3 was launched on September 13, 2012. The US stock market kept rising and reached 13,661.87 points on October 5th, 2012. Moreover, the unemployment rate also declined from 8.1% to 7.8%. It shows that QE3 is playing a significant role on the stock market and the job market. The purpose of the Federal Reserve to buy MBS is to keep interest rates low and reduce the burden of the people. The Federal Reserve tries to encourage people to increase consumption and also to stimulate economic growth within in the economy. In addition, another purpose is to boost the recovery of the US housing market to provide support to the whole economy.

So far, the implementation of the QE has produced different effects on the US economy. Most importantly, it has changed the pace of the US economic recovery and also has had a profound impact on the world economy. Currently, the economic situation in the US is improving according to the World Bank; US GDP is forecasted to grow by 2.4% in 2013 and 2.8% in 2014**.** (World Bank)

All in all, we believe that the recession in the US is nearly coming to an end and that the economic activity will pick up as forecasted by the World Bank. Consumer confidence and spending largely determines the growth prospects of the US economy. According to the data from The Conference Board, American families are more optimistic of the economic outlook due to the improvement of the job market. In addition, the consumer confidence index increased and reached a new high since October 2008. (The Conference Board)

2.3 Establishment of the EU

"The EU is a unique economic and political partnership between 27 European countries". It was created after the Second World War and has continued to grow since its inauguration. The main aim of the EU is to foster economic cooperation between its member states and allow for free trade across borders without any restrictions. The EU continues to promote peace, stability and prosperity among its member countries. As a result of the creation of a single trading market and the formulation of the single currency, the Euro, the Eurozone has become a major trading power in the world **(http://europa.eu/about-eu).**

The population in the EU accounts for 7% of the world's total population. The EU's trade with the rest of the world accounts for approximately 20% of global trade. In addition, the EU is the world's biggest exporter and the second biggest importer of goods and services **(http://europa.eu).**

2.4 Current Situation within the EU

2.4.1 Public Unrest

The European debt crisis and the current ongoing disputes within some members of the EU are casting a substantial doubt over the future of the EU. As European citizens continue to fervently protest the austerity measures that are being implemented in the hopes of reducing the major budget deficits, there is a feeling among the European citizens, that they are the ones suffering for their country's mistakes. Many Spanish and Greek citizens have taken to the streets to express their discontent with their government and the austerity measures being implemented by the EU.

Some EU countries, the so-called PIGS (Portugal, Ireland, Greece and Spain) have already received bailouts from the International Monetary Fund. (www.bbc.co.uk).Worryingly, events which started in Greece are having a domino effect on the rest of the Eurozone. Similar to the situation in Greece, Spanish citizens continue to pour into the streets of Spain to show their concerns about the increasing unemployment rate. However, it is not only the 'PIGS' that are experiencing economic difficulties, other European countries such as Italy have since added to the deterioration of the Eurozone economy (Mason, 2011)

2.4.2 Conflicts of Interest between EU Members

Public unrest is just one of the many concerns within the Eurozone. Many European countries have been hit by speculators and there remains a general lack of confidence within the Eurozone. This has led to a rise in the cost of borrowing. As a result, countries needed bailouts from the International Monetary Fund and other EU countries. The powerhouse country of the EU, Germany, has urged other EU members to try and finance themselves by implementing more austerity measures. From the onset of the crisis, Germany has been a substantial creditor to Greek government. Since the Greek economic situation continues to deteriorate, Germany and other creditors have suffered from the Greek debt. It seems that countries such as Germany and France have different views on how to solve the current Eurozone debt crisis. Many EU leaders have questioned the role of Germany and argued that Germany is only pursuing its interests. As a result of these conflicts, many summit meetings have collapsed as EU leaders fail to agree. It still remains to be seen whether or not the EU can cooperate to solve this on-going European debt crisis. Thus, until the problem is solved, the potential of the Euro to replace the USD as the dominant currency of the world remains very much in doubt. (http://www.guardian.co.uk).

2.5 Future Economic Outlook of the EU

2.5.1 A Break-up of the EU

As the gravity of European problems grow, commentators have begun speculating about the possibility of an EU break-up either in the form of a country deciding to leave or being forced to leave by its peers. “This essentially leaves two scenarios: a "weak country" exit (Greece, Ireland, Portugal, for example), or a "strong country" exit (Germany, France, for example)”, (Ezrati and Milton, 2011)

Since the inception of the EU, no country has yet left the EU. Many treaties such as the treaty of Rome and the Maastricht treaty are govern the EU. However, these treaties do not deal with an EU break-up. Therefore, it could be catastrophic if an EU country leaves the EU and reconverts its currency. For example, if Greece decided to abandon the Euro, there would be a contagion effect throughout the Eurozone. The banking system could face a possible collapse and the impacts on businesses, the currency markets and governments could be dire. In addition, if one country decides to leave, other countries may decide to follow. Investors would lose confidence in the Euro and bank runs may happen. No investors would like to hold the Euro as their reserve currency or even use the Euro for international trade. Thus, there would be a rapid devaluation of the Euro and any hope of the Euro replacing the USD would be all but lost. (www.telegraph .co.uk).

2.5.2 Greece Leaving

Recently, there have been on-going discussions about whether or not Greece will become the first country to leave the Euro. In 2001, Greece succeeded to join to EU after meeting two essential criteria set by the EU: One criterion is that the budget deficits should be controlled within 3% of GDP and the other is that the leverage ratio should be less than 60% of GDP. **(希腊债务危机为何产生，2012)**. It turned out that Greece had met the two criteria because of the so-called “debt deceit”.

According to the polls on June 17, 2012, fortunately, the conservative New Democracy Party who supported the austerity measures put forward by the EU was projected to win the parliamentary elections. It is worth mentioning that the claim by Antonis Samaris the following day to the effect that Greece would like to stay in the EU, allayed the fears of the whole world, especially those countries in the Eurozone.

Since the problem of Greece’s probable secession from EU was laid to rest, there is no indication of any country’s exit from EU as of now. Moreover, a new 13.5 billion Euro (USD 17.3 billion) austerity package required as a condition for the release of bailout loans from

EU and IMF was narrowly approved on November 9, 2012, further enhancing Greece's prospects to remain in the EU. (希腊债务危机为何产生，2012).

2.5.3 Turkey Joining

There is an opposite scenario which could help the Euro become a stronger currency. Despite the current situation in Europe, undoubtedly there are many other countries that have been making efforts to join the EU. One of such countries is Turkey.

Turkey has undergone a series of changes, starting from substantially changing its constitution to successfully making anti-recessionary policies after the 2008 financial crisis in order to join the EU. Turkey's burgeoning economy, entrepreneurial society as well as its key transit point for oil and gas means its addition could be beneficial to the EU and the Euro. Apart from its own efforts, there were some supporters for Turkey's stalled bid to become a full member of the EU.

In other words, the EU could become more prosperous and stronger in the future if countries like Turkey were allowed to join the EU. As long as more and more countries are willing to adopt the Euro as their currency, there is the potential is there for the Euro to take over the leading role played by the USD.

2.5.4 The Threat of England Seceding from the EU

Last but not least, there were some deep apprehensions about Britain's membership in the EU. At the EU summit on December 9, 2011, England protested the EU's proposal for fiscal regulations. This isolated England from other member countries and questions started emerging regarding the future of Britain in the EU. David William Donald Cameron, British Prime Minister, was of the opinion that the Eurozone was always inclined to force the rich to assist the poor (英国被迫退出欧盟可能性渐现, 2012). Later, he also declared that he should guard England from the treaties proposed by EU which were not in the best interest of Britain.

In October, 2012, the Labour Party in England proposed cut in Britain's assistance to the recovery of European economies, which threatened worsened the already tense relationship between Britain and the EU. Although the proposal was eventually rejected, it worsened the relationship between Britain and the EU and brought the Britain's commitment to the Europe into question.

London as an international financial center plays a critical role in Europe and Britain's secession from the EU will seriously affect the EU. In the same vein, Britain benefits immensely from being a member of the EU and its economy will be adversely affected if it were to leave the EU. Whatever happens, the posture of Britain will seriously affect cooperation and teamwork within the EU. Also, the seeming frosty relationship between

Britain and the EU cause other states to be more in-ward looking and pursue their own interest instead of working together with the EU. The infighting therefore, has the potential of negatively affecting the ability of the Euro to surpass the USD as the dominant currency of the world. (英国被迫退出欧盟可能性渐现, 2012).

There is still a great deal of doubts regarding the future of some countries in the EU. With the current economic instability experienced by many EU members, a default in an EU country could is a possibility and this could prove catastrophic the future of the Euro. For example, the default by Greece would hit hard the economy of other Eurozone countries and would undermine their confidence at the same time. In this sense, this would result in some countries leaving the EU and prevent some countries from establishing any economic relationship with Eurozone countries. Many countries may reconsider whether or not they should go to greater length to join the EU; and if they do decide to join the EU, it is hard to say whether they will be ready to replace their home currencies with the Euro.

3. Recommendations

3.1 Recommendations for the European Central Bank

The European Central Bank (ECB) acts as the main central bank for the European Union countries and conducts the monetary policy for 17 members within the EU. Together with the national banks of each member, the EU has formed the European System of Central Banks. This European System of Central Banks is very similar to the Federal Reserve System in the United States and in order for the Euro to become the dominant world currency, it is recommended that they make changes to their policies and to the ECB. Since the issuance of the Euro currency in 2002, the circulation of the Euro has continued to grow through tourism, international business travel and cross boarder shopping. However, whether it will continue to grow until it becomes the most widely used currency for international trade and as the main reserve currency for countries, surpassing the USD, remains to be seen **(http://www.ecb.europa.eu)**

The Federal Reserve System in the US is very similar to the ECB as the Federal Reserve also controls the monetary policy within the US. However, the Federal Reserve uses the "produce money and purchase" approach (Table 3.0) while the ECB uses the "produce money to lend" approach (Table 4.0). When printing money, the Federal Reserve produces money and uses this money to purchase US treasuries. In contrast, the ECB produces money and lends it to the banking system for a short period of time and in return, some form of collateral is given. Both approaches produce more money in circulation in the economy and create additional reserves for the banks. However, a substantial flaw with the European system is that, independent governments can take advantage of this one central bank system to finance their budget deficits. A perfect example of this is Greece. Other European countries may believe that the ECB will always have sufficient funds to rescue their country from defaulting, thereby developing a desire to take more risks and increase their expenditure. In order to prevent this, more severe punishments should be used to prevent independent governments from corruption.

The Federal Reserve acts as a regulator for the banking system in the US as they set the standards regarding the operations and activities of the banks. However, the European System of Central banks have no direct supervision of banks. Responsibility for supervision remains within the national central banks of each country. As a result of this lack of supervision, Greece was allowed to hide its debts and started the European debt crisis in 2010. Since then, there has been a contagion effect throughout Europe. Countries like Ireland, Spain and Italy have been suffering from substantial budget deficits and needs the ECB to bail them out with large amounts of loans or they would default on all their debts. Therefore it is recommended that the European System of Central Banks should have more direct supervision of banks. With direct supervision of banks, this could prevent future debt crises from occurring. Perhaps, the Greek debt crisis and the collapse of the Irish banking system could have been prevented if policy changes have been implemented earlier (Pollard, 2003).

Therefore, the role of the ECB remains questionable which makes the future of the Euro also questionable. In order for the Euro to surpass the USD and become the world currency, it is recommended that they need to change their policies in order to make the Euro a more stable currency.

3.2 Should the Euro be fixed to gold?

From the study of the evolution of international monetary system, we know that during 1945 and 1972, there was an unvarying dollar price of gold (about 35 USD in terms of a unit of ounce), attributing to each country's calling for fixed exchange rate against USD. Moreover, the USD finally became the only currency that was conveniently convertible to gold. Thus, USD, as well as gold was willingly held by other countries not only for official reserves, but also as international means of payments. After all, it was the advantages from a certain currency fixed to gold outweighing its disadvantages that reinforced the dominance of USD all along. The practicality as well as the actual improvements that a peg to gold will bring to the Euro is difficult to measure.

In 2010, a soft peg to gold, the so-called "modified gold standard" named by Robert Zoellick, the president of the World Bank, with the feature that gold was allowed to circulate as a domestic or international means of payments among residents, was likely to be adopted in Eurozone and hence the Euro may be forced to soft peg to gold in the end (Zoellick, 2010). It has aroused some disputes especially in the event of the European crisis.

Later in 2011, Mundell, the father of the Euro, had a positive view about the undeniable role of gold in the world economy and urged the Euro to be pegged to gold. When he was interviewed about whether we were on the way back to the application of Classical Gold Standard that was popular before the First World War, he hoped for a system similar to that. He himself approved of the superiority given by gold and looked forward to the Euro and USD being linked together to gold at the same time in the future (Benko, 2011).

In summary, if the Euro we believe that if the Euro was pegged to gold, it would have more scope for hegemonic control. In other words, it is suggested that the Euro should be pegged to gold in order to catch up with the USD, and even gain much more popularity in the whole world in the near future.

4. Conclusion

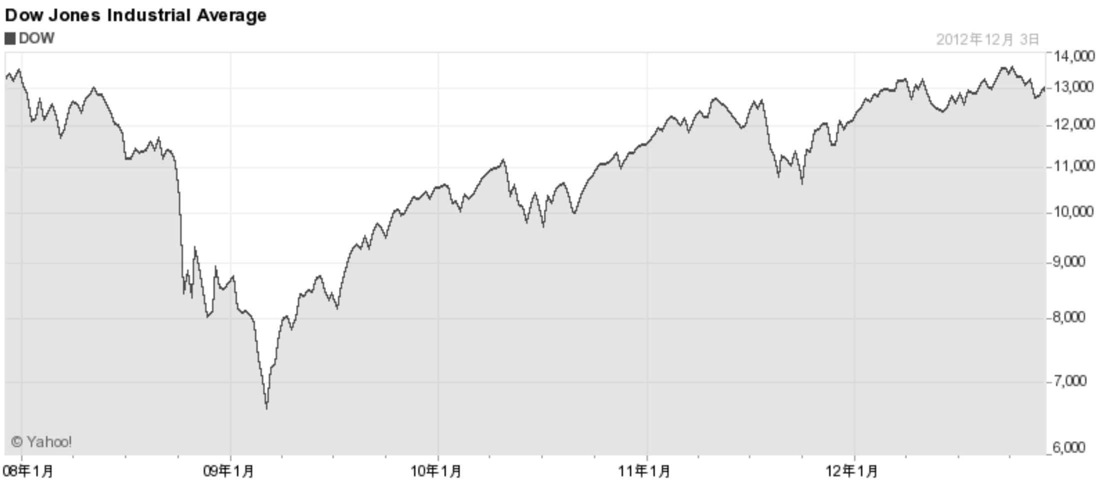
For the Euro to dethrone the USD as the world’s primary reserve currency; global investors would have to significantly increase their demand for Euro over the USD. However, we know that the value of a currency is nothing but a reflection of its underlying economy. As of now, the United States remains the world’s largest economy despite the recent financial crisis and is still dominant in a variety of industries. Moreover, the Obama administration seems to have been successful in restoring market confidence and reducing employment. The World Bank has forecasted a 2.4% and 2.8% increase in GDP for 2013 and 2014 respectively. The Euro/USD exchange rate has been rising overall since July 16, 2012. We believe that although the US economy was severely affected by the 2008 financial tsunami, the US government was able to put in place successful policies such as “Quantitative Easings” to enjoy economic recovery and we agree with the World Bank that this trend will persist.

For the Euro to supersede the USD, the future Eurozone economy would have to be significantly brighter than the one of the United States. However, the lack of political stability, fuelled by conflict of interests between Germany and other member states such as Greece, the massive unrests sweeping all across the Eurozone are clear signs to us and to global investors that the future economic outlook of the Eurozone is gloomy. Compared to the US, the World Bank GDP forecast for the Eurozone is only 0.7% and 1.4% for 2013 and 2014 respectively. Does it mean that the Euro will never dethrone the USD as the world’s primary reserve currency?

As of now, the Euro is not near to becoming the world's primary reserve currency for the various reasons stated in this paper. But if the Eurozone wants to supersede the US economy and raise the Euro to the status of world's primary currency, it will have to undergo massive collective reforms to achieve an even higher integration on the political level. For example, it would be beneficial for the Eurozone to see the emergence of a President of Europe, to see each Eurozone state member give up their sovereignty for the sake of a true European Identity. Moreover, some of our recommendations focus on the role of the European Central Bank (ECB) and fixing the Euro to gold. With regard to the ECB, we recommended direct supervision of the banking sector to achieve higher financial stability. It was also our belief that if the Euro was to be fixed to gold, it would instil confidence into investors to widely hold the Euro.

Appendix

Table 1.0: Dow Jones Stock Index (2008-2012)



Sourced: http://hk.finance.yahoo.com

Table 2.0: Most Traded Currencies

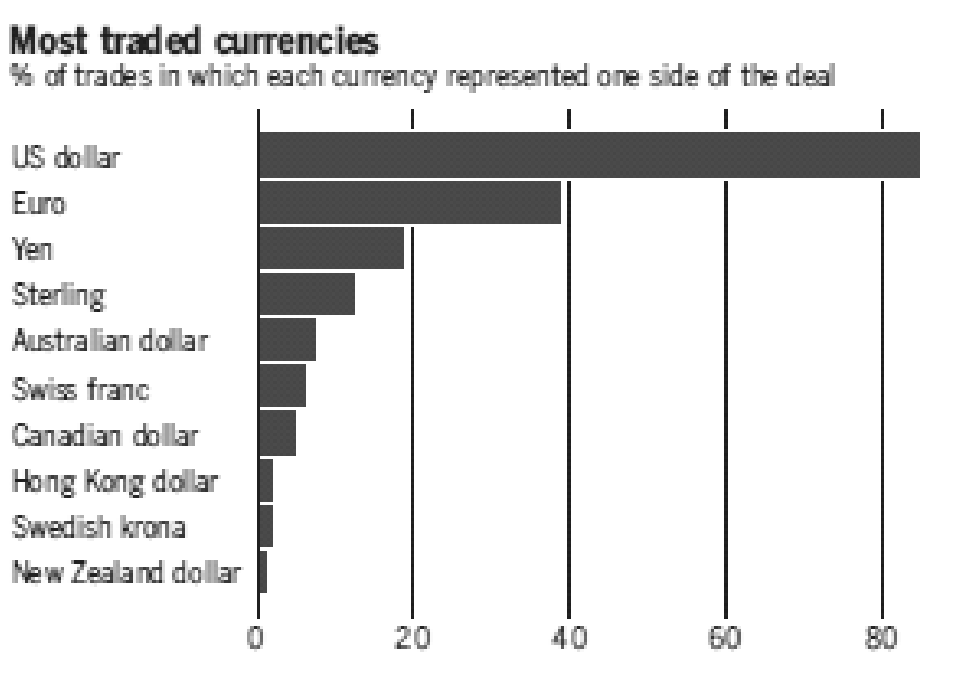
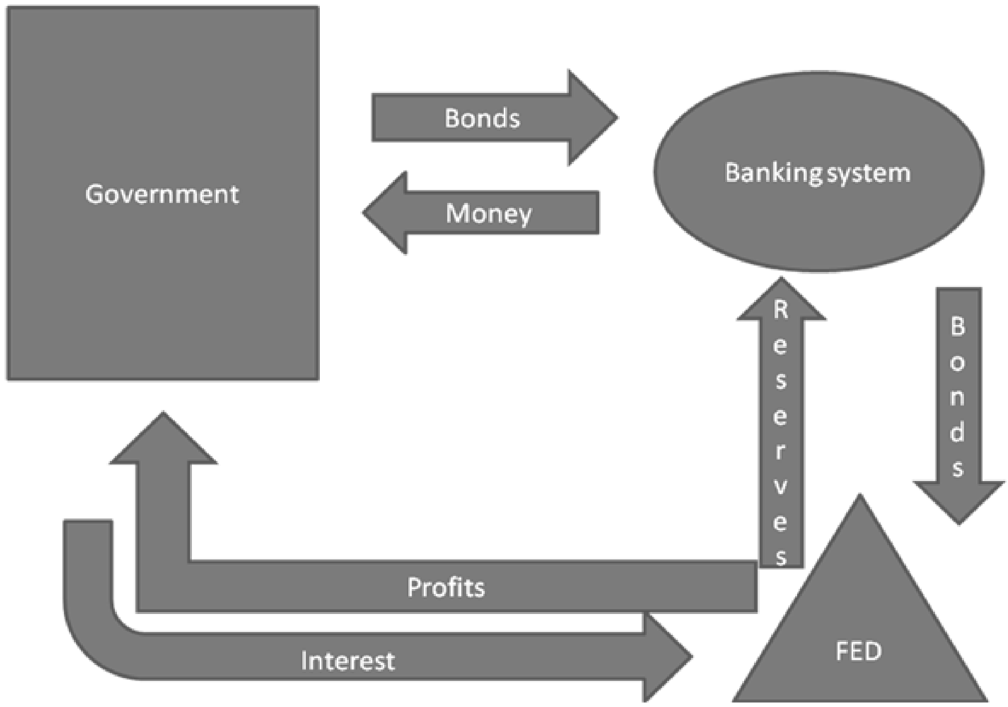
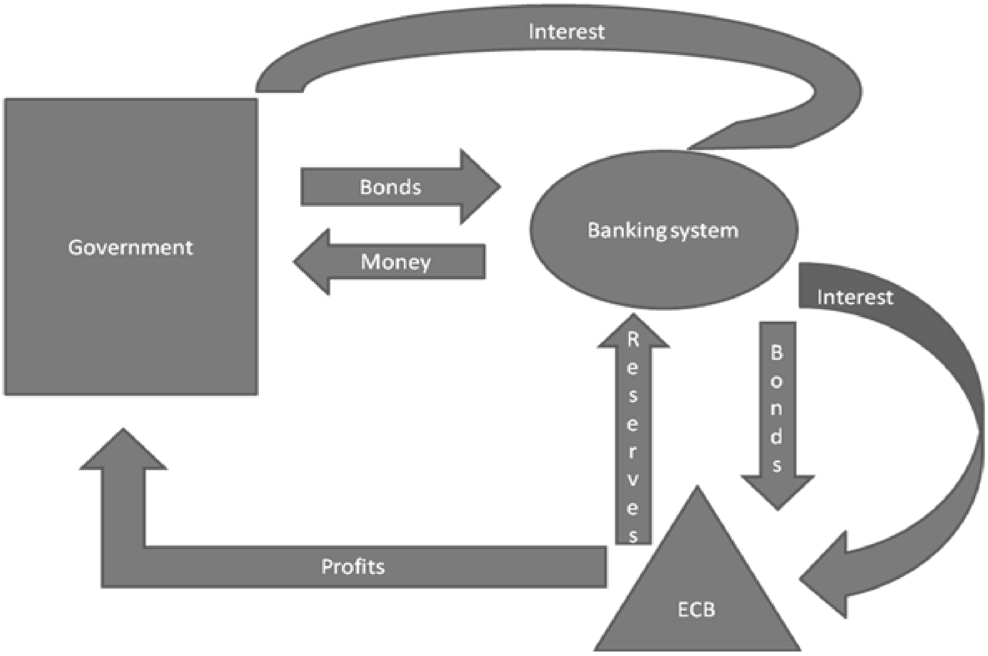


Table 3.0: How the FED finances the U.S government (Produce money and Purchase approach)



Sourced: http://mises.org/daily/5575

Table 4.0: How the ECB finances EU governments (Produce to lend approach)



Source: http://mises.org/daily/5575

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