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Currency Competition and the future role of the Euro

HWR Berlin, Studium Generale
Europe‘s role in a multipolar world,
April 18, 2011

The Topicality of the Problem

- Since the 1970s
  - A multi-currency system with a hegemonic US-dollar as a centerpiece
  - Emergence of informal structures in labour, politics and finance
  - Liberalisation of financial markets
  - Rise of neoliberal ideology and concepts
- Since 2000
  - Emergence of the Euro and an increasing currency competition, even „currency war“
  - Outbreak of the great financial and economic crisis
  - Hegemonic contest: USA – Europe – China – BRICS
- 2011: the world in search of a new global monetary and financial order, of a new financial culture
  - After the „culture of risk“ of Wall Street (of „atlantic capitalism) has pushed the world into the deepest crisis of economic history
  - A new financial culture must emerge; the difficulties are obvious

Exchange Rate Regimes in History

MONEY

The history of money is the history of its de-materialization: From „intrinsic value“, poduced as gold by labour to a de-materialized social relationship, regulated by political institutions (Central Bank) together with private market actors (financial institutions)

Money lets the world go round…

….but the wheels are different

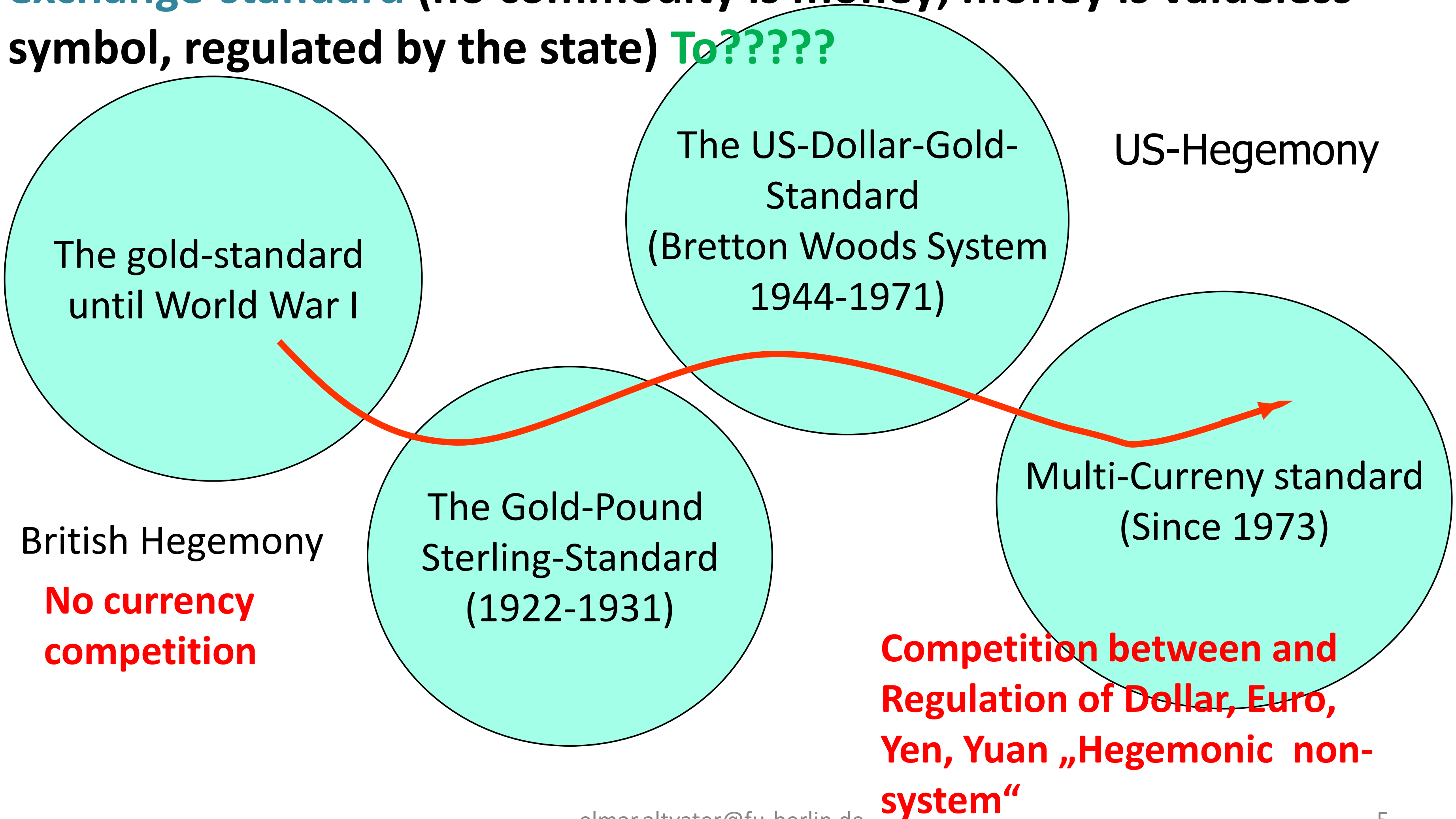
From Gold, physically produced by labour; with an intrinsic value

→ to paper money with a politically secured value

→ To electronic money (bits and bytes), protected against fraud

CURRENCY (international money in competition with other moneys)

The history of currency regimes: From the gold-standard (one commodity is money) to the gold-exchange-standard to the exchange-standard (no commodity is money; money is valueless symbol, regulated by the state) To?????



Hegemony and lead currencies in history

- The gold-standard and its imperfect working under British hegemony:
  - One world – one currency: gold with an intrinsic value
  - How international flows of gold influence national money supply
  - The absence of a central bank and of government regulation
  - The Polanyi-thesis: The gold-standard as a currency regime fosters a regime of free trade, of free capital flows and of free labour markets
- Its limitations
  - due to the contradiction between the limitedness of the golden ore and the requirements of an unbounded process of capital accumulation
  - The special role of financing World War I
- The attempts to restore the gold-standard after the war 1922 and the failure 1931

From 1931 – 1944 times of chaos, crisis and war

The world in depression,
The breakdown of the currency system and
the devaluation-race
The collapse of world trade
Failing attemps to stabilize the system
The rise of faschism and nazism,
Times of imperialist expansion Japan, Germany, Italy
Finally the world war 1939 - 1945

The Bretton Woods era from 1944 – 1973: The gold-US-dollar-standard and the „Triffin-Dilemma“

The world economic crisis of the 30s and the transition from the gold-pound-sterling-standard to the gold-dollar-standard of Bretton Woods

From British to US-American hegemony

The **Triffin dilemma: security versus disposability of the hegemonic currency or gold versus USD**

What are the factors, on which the two attributes of a lead currency – i.e. security and disposability - depend on?

- Systematically?
- In their historical dynamics?

The view of the IMF and of mainstream and other economists (Ewe-Ghee Lim: The Euro‘s Challenge to the Dollar, IMF working paper WP/06/153)

- Facilitating factors for a national or regional currency to become the vehicle currency are:
  (1) Large economic size, i.e reduced transaction costs – average cost fall with size
  (2) Well-developed financial systems, i.e. a well working collusion between the central bank and the private banking system (two tier-system) and a broad global network of private banks
  (3) Confidence in the currency‘s value
  (4) Political stability
  (5) Network externalities which drive a vehicle currency to market dominance

The requirements of an hegemonic monetary order and the dimensions of securtity and disposability of diferent currencies and their appropriateness as a world currency

	USD	Euro	Yuan	SDR (not currency, only reserve)	Regional Currencies	„Multi“-currencies
Security						
Against inflation	+/-	+/-	+/-	+/-	+/-	+/-
Against devaluation	+/-	+/-	+/-	+/-	+/-	+/-
Property rights	+	+	+/-	-	+/-	+/-
Assets	+	+	+	-	+/-	+/-
Reserves, Gold	-	+/-	+	+	+	+
Military power	+	+/-	-	-	+/-	-
disposability						
Current account deficit	+	+/-	-	-	+/-	+/-
Capital account-surplus	-	+	+	-	+/-	+/-
Position of the national financial system in the global financial system	+	+	+/-	-	+/-	+/-

Historical contradictions of the Bretton-Woods-System and the dynamics of the Triffin-Dilemma

(1) The gold coverage of the US-Dollar und the diminishing gold reserves of Fort Knox: the conflict between security (gold coverage) and availability (USD in global circulation) escalates (cf. Next slide)

(2) The USD as a trade currency in which 90% of world trade are circulated, the requirements of currency stability, and the diminishing competitiveness of the USA: the argument for a devaluation of the USD, but the impact on the stance of the USD as the lead currency

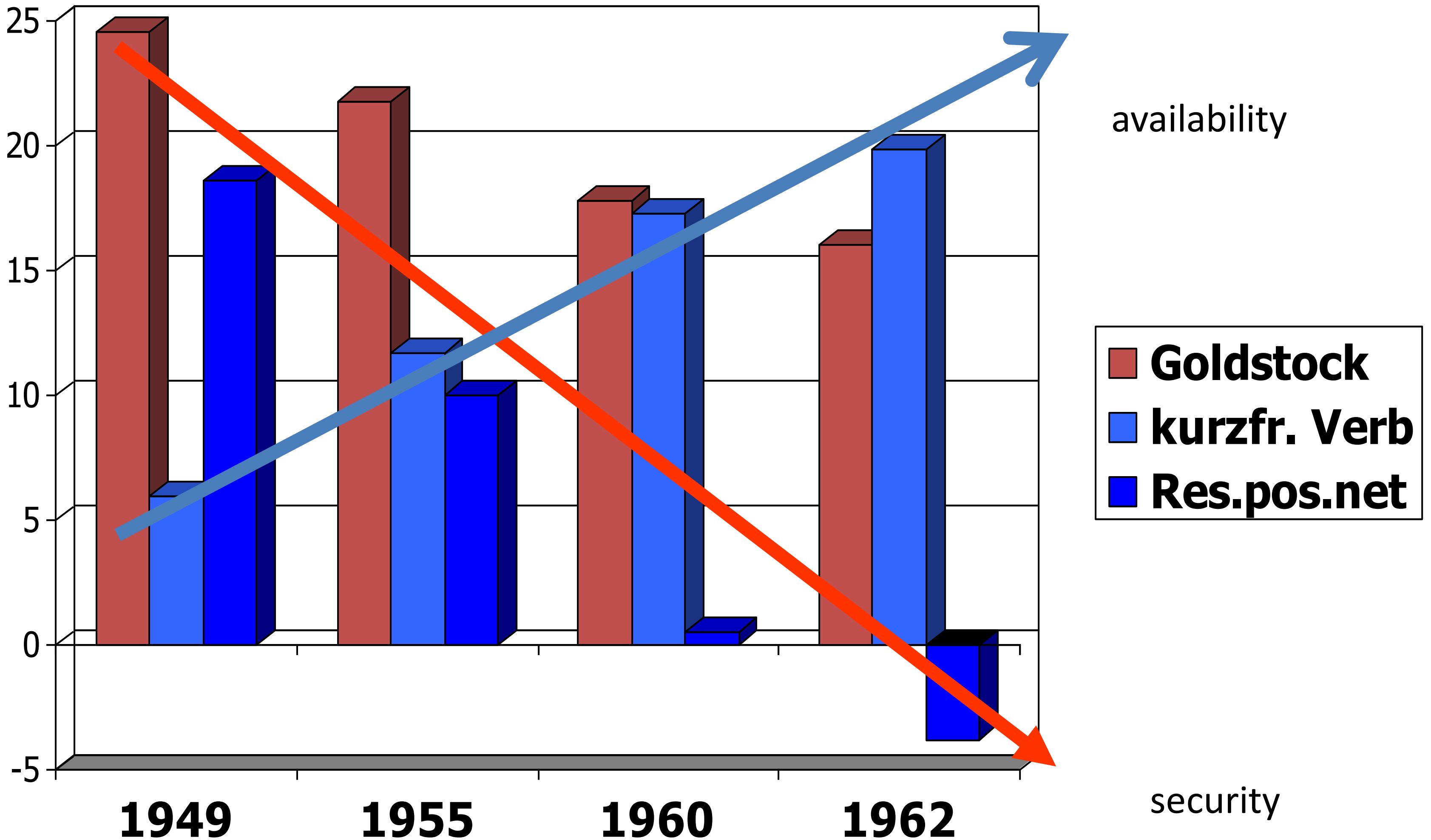
(3) The emerging Eurodollar markets, financial liberalization and the USD as the key reserve-currency and the leading currency of financial transactions: the pressures to warrant security

(4) Availability is in the hands of private financial markets (of Wall Street)

(5) The special influence of the Vietnam war on the value of the USD and its impact on the security of the currency

(6) The fixed exchange rate became untenable. The rescue efforts in the 1960s: Goldpool, General Agreement to Borrow, Swap-Agreements, Establishment of Special Drawing Rights 1969; the abolishment of gold-convertibility of the USD in 1971 and the transition to e flexible exchange rate regime 1973

The empirical evidence:
USA: Monetary stocks of gold, short term financial liabilities vis-a-vis foreign and net reserve position of gold (in billion US-Dollar)



The collapse of the BW-System 1971/ 1973 and the outbreak of financial chaos

After the „orderly" system of Bretton Woods a „non-system" (Robert Triffin) comes up. Several options are possible in between the „extremes" of fixed and flexible exchange rate regimes:

1. Official use of a foreign currency: **dollarization** (e.g. Ecuador) oe eurozation, respectively (Montenegro, Kosovo)
2. **Currency board**: Fixed exchange rates and fixed relation between money supply and currency reserves (e.G Argentina until 2001)
3. Fixation of the exchange rate at an **anchor currency** (e.g. Eastern European and Central Asian countries)
4. Definition of **fluctuation margins**
5. **Target zones** between different countries (proposal of Oskar Lafontaine 1999 and of UNCTAD)
6. **Crawling Pegs:** adjustments of the exchange rate according to inflation rates (temporarily in Western Europe after 1973)
7. **Managed Floating**: control of the exchange rate by the central bank (e.g. China)
8. **Free Floating** without political control (Several developing countries)
9. The agreement on **currency areas**: the EMS 1979, Maastricht 1991, Euro 1999

The cancellation of the system of fixed exchange rates and the introduction of a flkexible exchange rate system can be interpreted as the **Privatization of a public good**: the formation of one of the decisive prices of the global economy.

The exchange rate system no more is the outcome of political agreements between nation states, but

The spontaneous result of decisions undertaken on liberalized financial markets

The dramatis personae in the theatre now are bank- and fund manager, speculators and central bank officals who follow the rules of the market and not politically, in a democratic process elaborated objectives

The formation of exchange rates takes place under economic constraints: „Mundell‘s trilemma“

It is impossible to reach the three goals:

- Stability of flexible exchange rates
- Free capital flows
- autonomous and independent fiscal- and monetary policy

Only two are possible, a third goal has to be given up
The question is: Which one?

- The Liberalisation of capital flows is a crucial element of the globalization of financial markets
- The stabilization of exchange rates is a necessity in global currency competition
- Therefore fiscal and monetary policy have to adjust to the external constraints. Consequences are:
    - Loss of interest souvereignty (vis-à-vis financial markets)
    - Conditionality of the IMF (hard political constraints)
    - Maastricht-criteria of the EU (binding and obligatory hard budget rules)

Mundell‘s Trilemma or the„Impossibility Theorem“: Only two of three options are possible, the third is a necessity

	Fixed and stable exchange rates	**Autonomous monetary and fiscal policy**	**Free capital-flows**
1st case	x	X	Control of capital flows (not possible)
2nd case	X	Abandonment of a sovereign economic policy (the only option remaining)	X
3rd case	Flexibilization of exchange rates (not to revoke)	X	x

The choice between (1) one country – one currency and (2) a currency union: Is there an optimum currency-area?

In general: The real economy (i.e. unit labour costs as the most synthetic indicator) must a allow a monetary union. Most important conditions of optimality

(1) Factor mobility within the area, and immobility in moving outside

(2) Volume of trade and of capital investment high

(3) Similar level of productivity and wages (unit labour costs)

(4) Reasonable integration of social and economic policy

(5) Fiscal transfers across countries in the area possible, i.e. a „transfer union“ based on a high degree of mutual assistence

The contemporary European case: A monetary union without an appropriate political union. Therefore the EU is today at the crossroads:

- **Either a deepening of integration or a disintegration and dissolution of the European project**
- **Different trajectories in the EU between North and South, deficit- and surplus-countries**

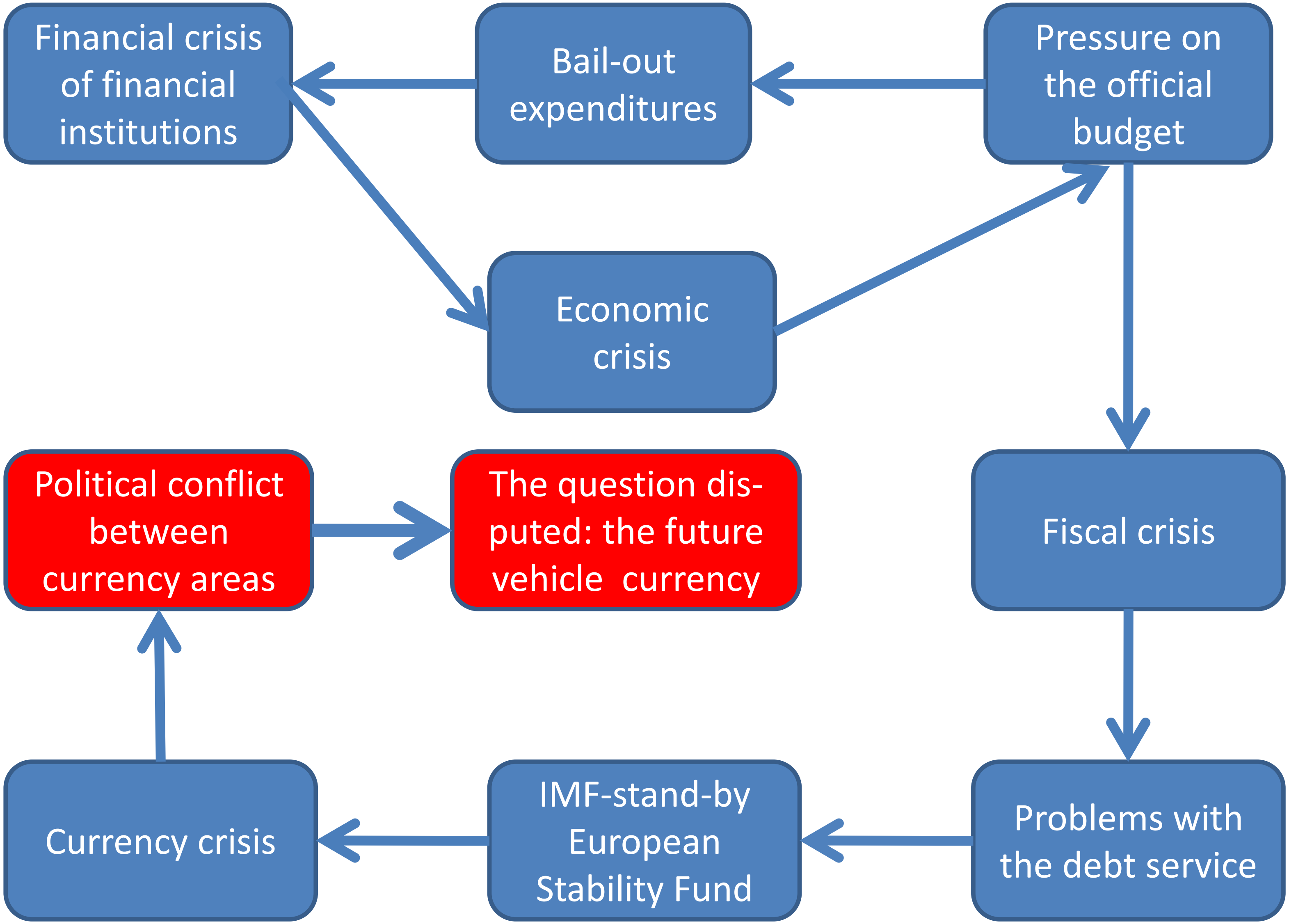
Financial markets and the „transfer-union“

- The majority viewpoint: Financial stability is a public good and a prerequisite for the proper working of financial markets
- Financial stability requires (aside from the Mundell-conditions)
  - A sustainable relation of equity capital to outstanding credits and debentures (Basel III)
  - an orderly debt service by debtors
    - The debt service of private debtors stems from income flows, i.e. from surpluses (first and foremost from profits) produced in the „real economy“
    - When growth is slow or negative, surpluses may not be sufficient as to service the debt…
  - A financial culture of responsibility and precaution, not of risk and greed
  - The „stress tests“ of financial stability performed in the EU
- The general question of financial transfers, value trasnfers and the „modifications of the law of value in international relations“ (the Marxian debate on the law of value under the condition of differing levels of productivity)

….The financial crisis breaks out

- Debtors become illiquid, some insolvent and a few go bankrupt
- Creditors have to write-off assets – and that can drive them into insolvency, when equity is insufficient, unless the „lender of last resort“ comes back in to **bail out** private creditors by means of
  - A „socialization“ of financial institutions (more correct: a privatisation of state revenues in favour of financial institutions)
  - Helping them to get rid of toxic securities (in „bad banks“)
  - By providing access to cheap central bank money („monetary easing“)
- The consequence is an **increase of public debt** and thus of public debt service. The advantage for creditors: public debt is serviced out of tax revenue and therefore an outcome of **political redistribution** measures
- The size depends on
  1. Interest rates set by the **central bank (nationally or regionally - ECB)**
  2. the rating of debtors and of financial vehicles by **rating agencies, i.e. private instisturions**
  3. the conditionality imposed by **international organizations (EU, IMF etc.)**
- The private debt crisis transforms into a public debt crisis, into a currency crisis of
  - A national currency or
  - a currency union, the EURO-area?

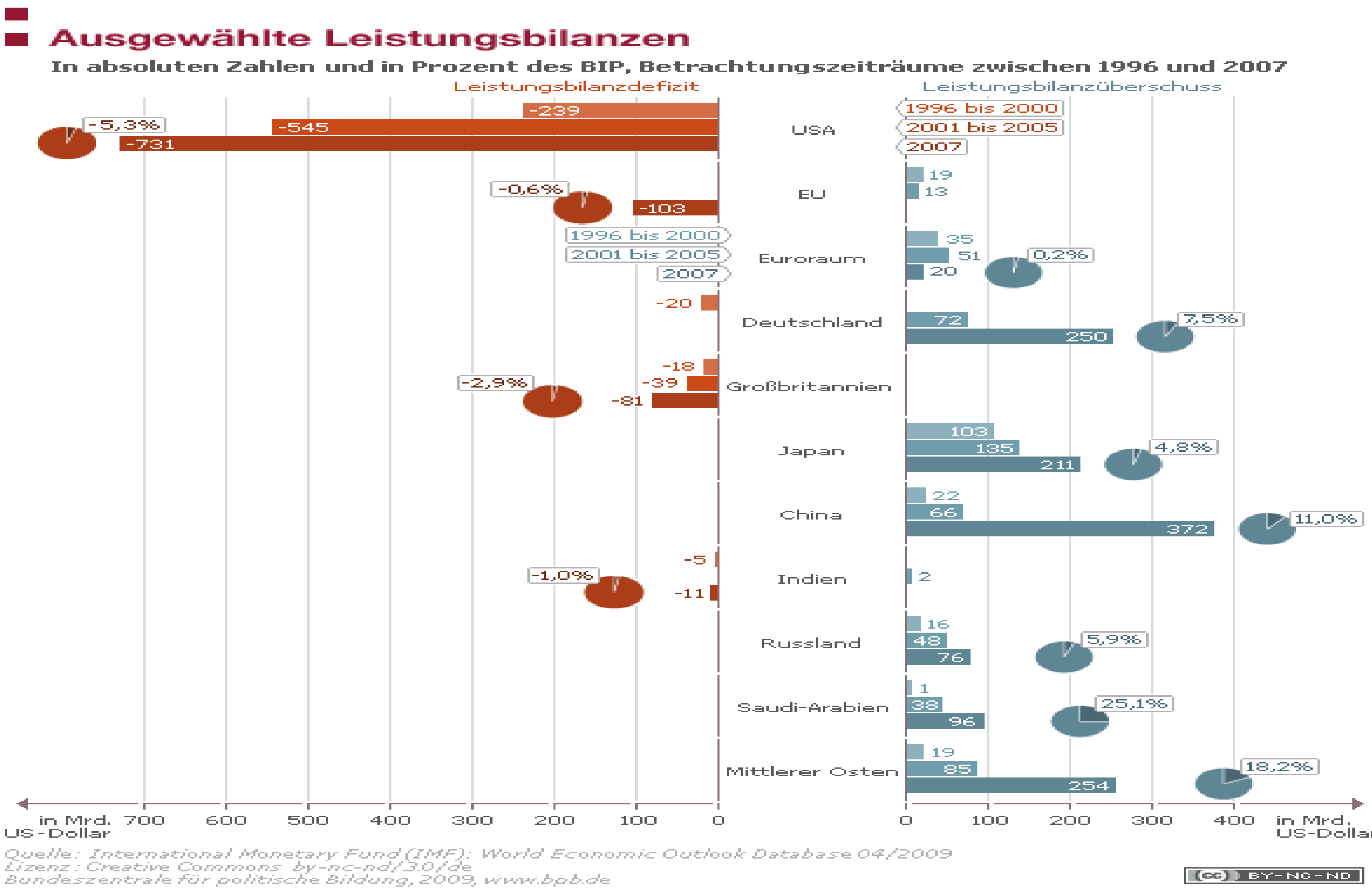
From the financial crisis to a currency crisis and to political conflict

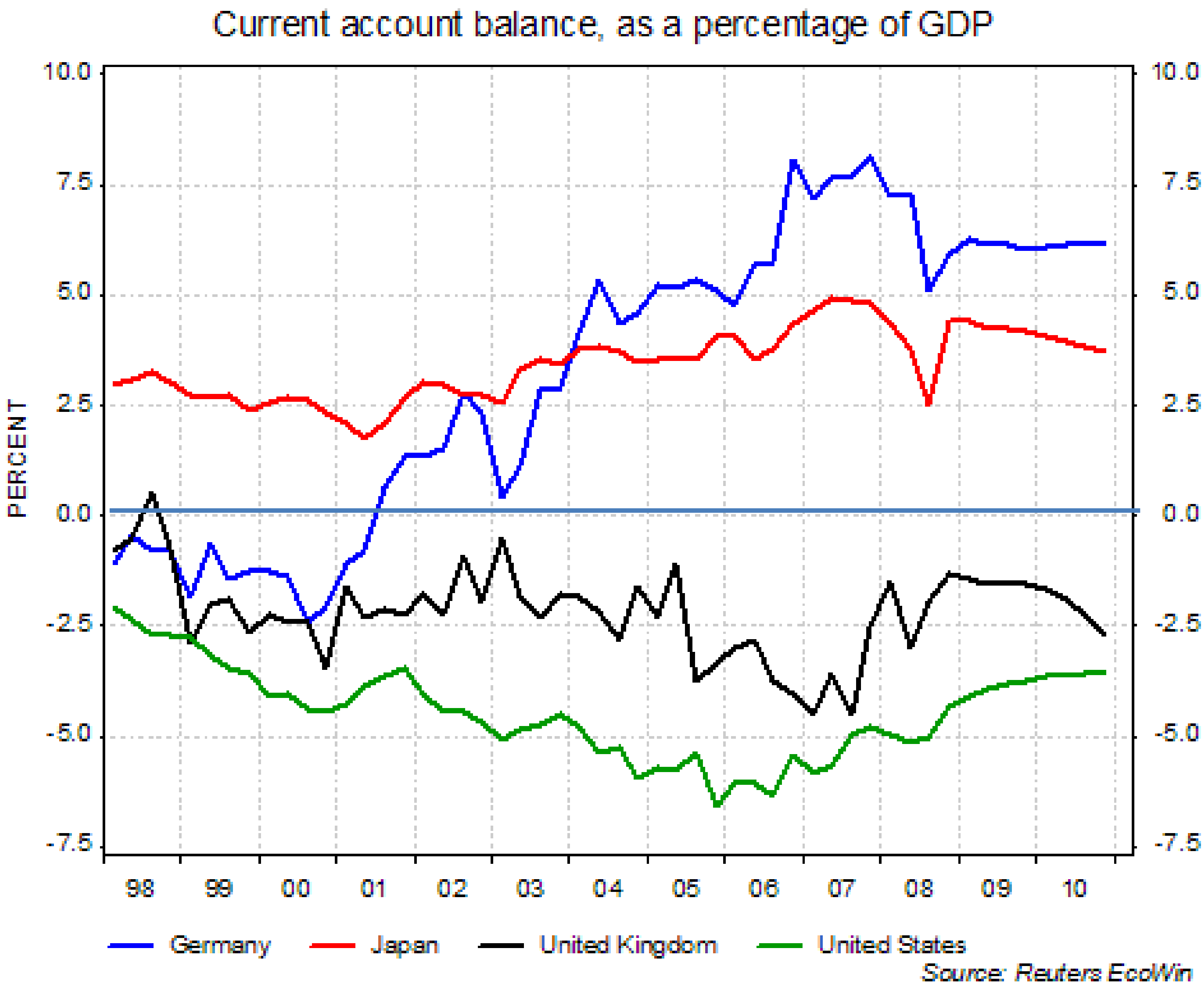


Conflicting functions of the key currency: the development of structural imbalances

(1) Function 1: Currency of trade and services: In which currency contracts are invoiced?
(2) Function 2: Currency of capital flows: In which currency are capital investments placed?
(3) Function 3: Reserve currency: diversification of reserve stocks (unknown; not reported by the IMF
(4) Function 4: Currency of economic interventions by the state: What is the currency of interventions into financial markets?
(5) Function 5: Oilcurrency: The currency in which oil is invoiced

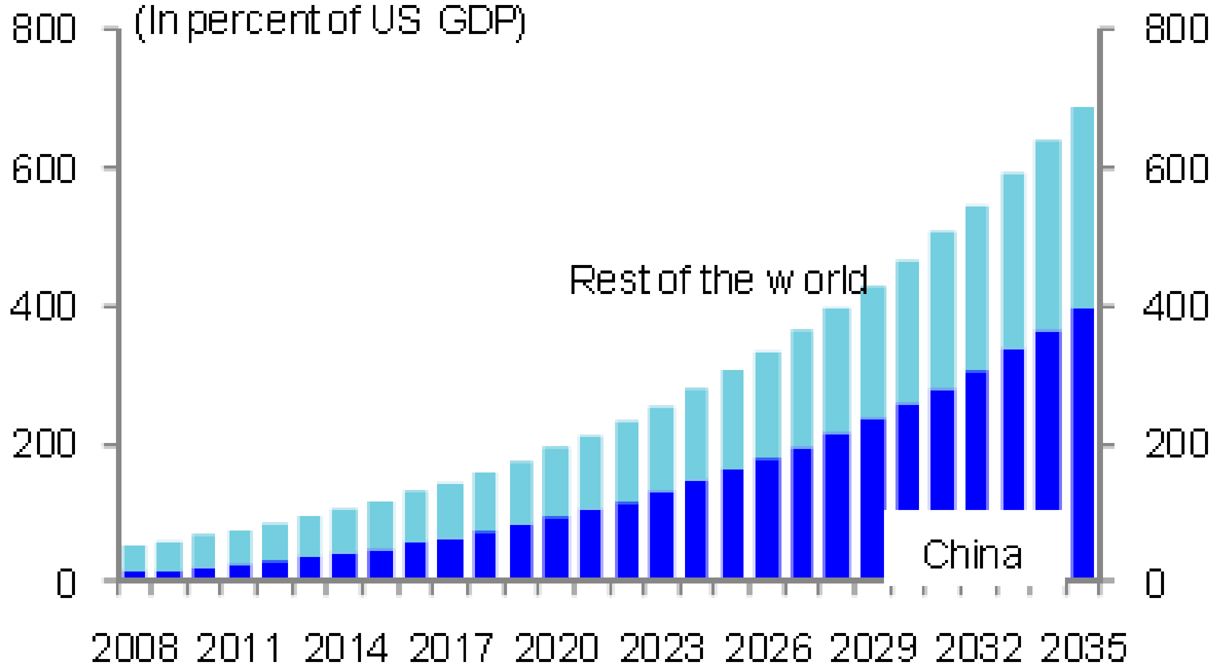
Strctural imbalances in current account (selected countries and regions)




Current account balance, as a percentage of GDP
PERCENT
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
-7.5
98
99
00
01
02
03
04
05
06
07
08
09
10
Germany
Japan
United Kingdom
United States
Source: Reuters EcoWin

Structural imbalances in the development of global currency reserves: why do reserves grow?

Figure 2. Global Reserves

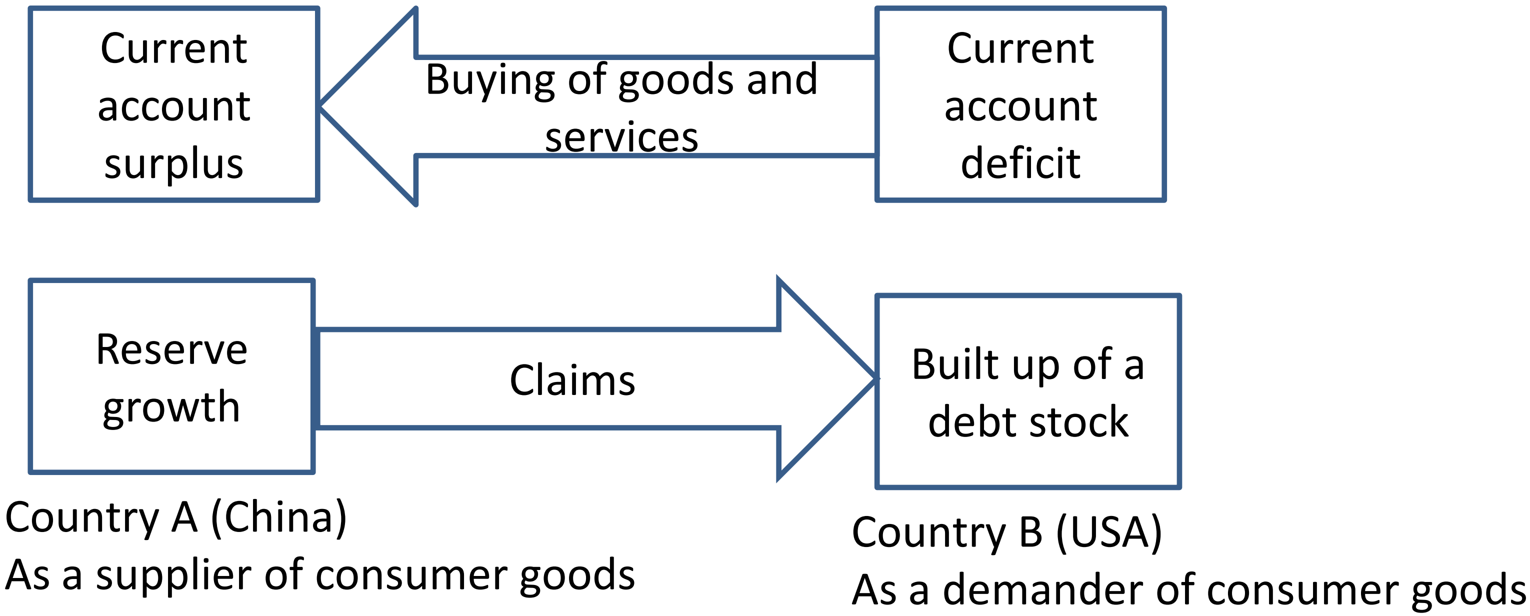


Sources: IFS, WEO, UN "World Population Prospects: the 2008 Revision", staff calculations.

Quelle: IMF (WP April 13 2011): Reserve Accumulation and International Monetary Stability

Structural imbalances…

- …and the development of unilateral flows from global saving to global spending (mostly consumption)



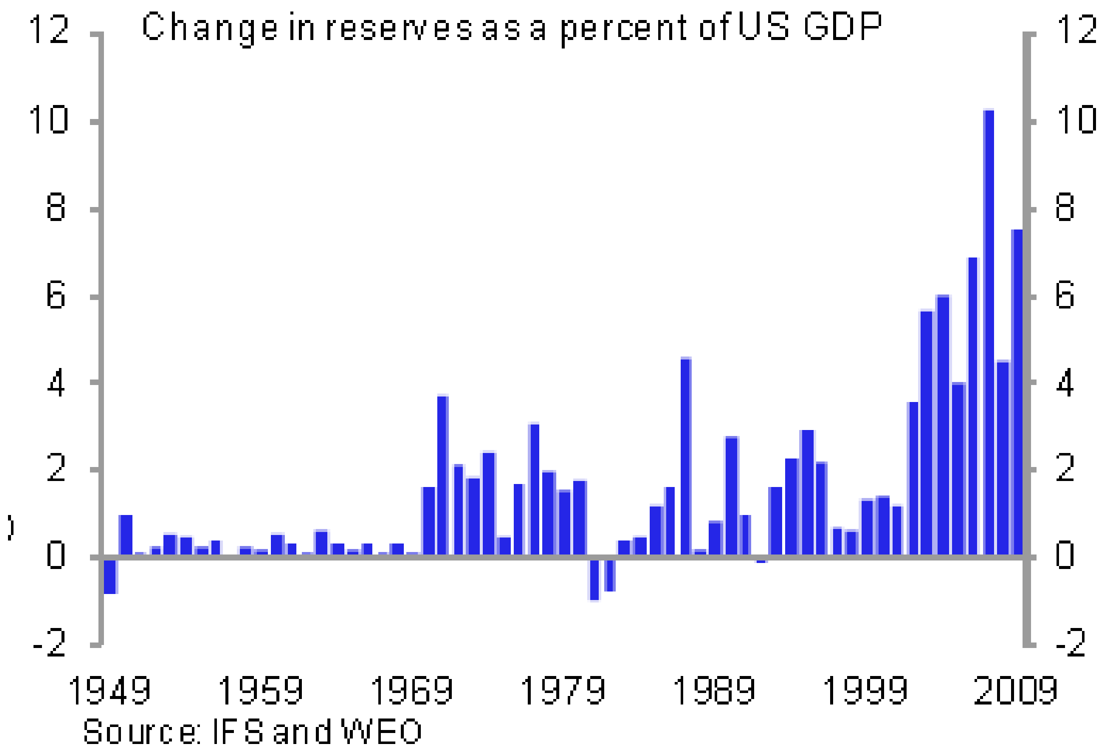
How to reduce structural imbalances?

Causes of currency reserves-piling

(1) Precaution
(2) As an insurance against external shocks
(3) As a „war chest“ against volatility and spevculation
(4) As a means of extending economic and political influence in the world. This is the reason for the build up of sovereign wealth funds instead of traditional currency reserves

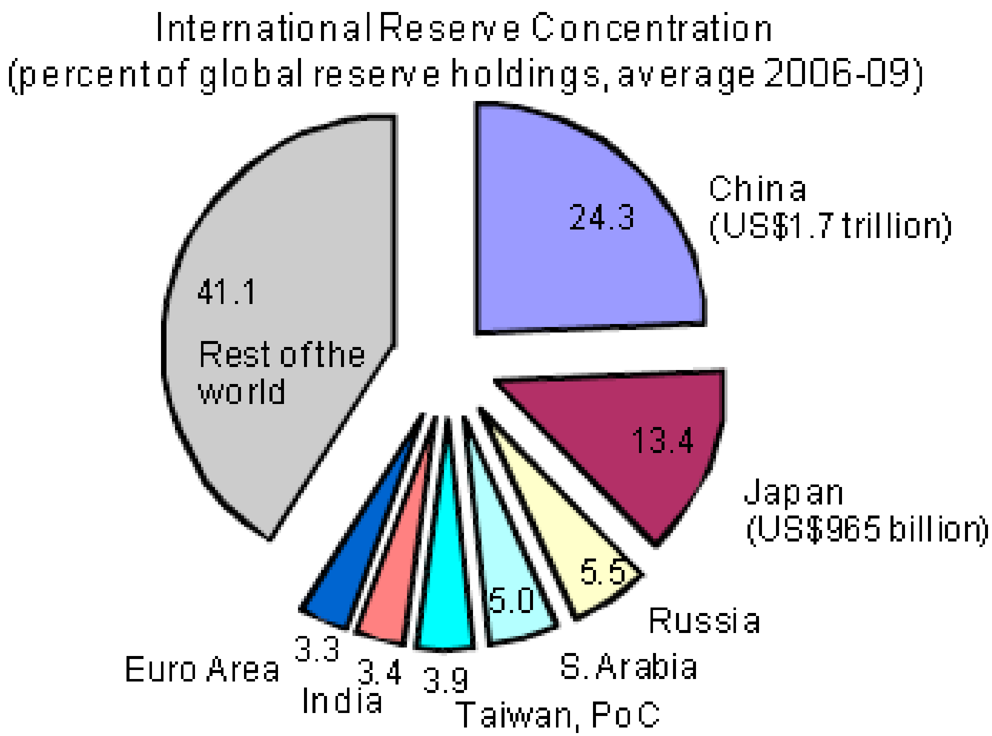
Reserve-holdings are expensive

(1) Because of opportunity costs (lower investment and thus negative influence on economic development)
(2) and because of waiving higher interest revenues
(3) The effects on financial efficiency (cf. A speech of Bruno Maghi, the ECB-view: http://www.ecb.int/press/key/date/2010/html/sp100210.en.html)



Quelle: IMF (WP April 13 2011): Reserve Accumulation and International Monetary Stability

The change of currency-reserves is dependent on the degree of monetary and financial stability: The more volatile the markets, the more „precautionary reserves“ are built up.

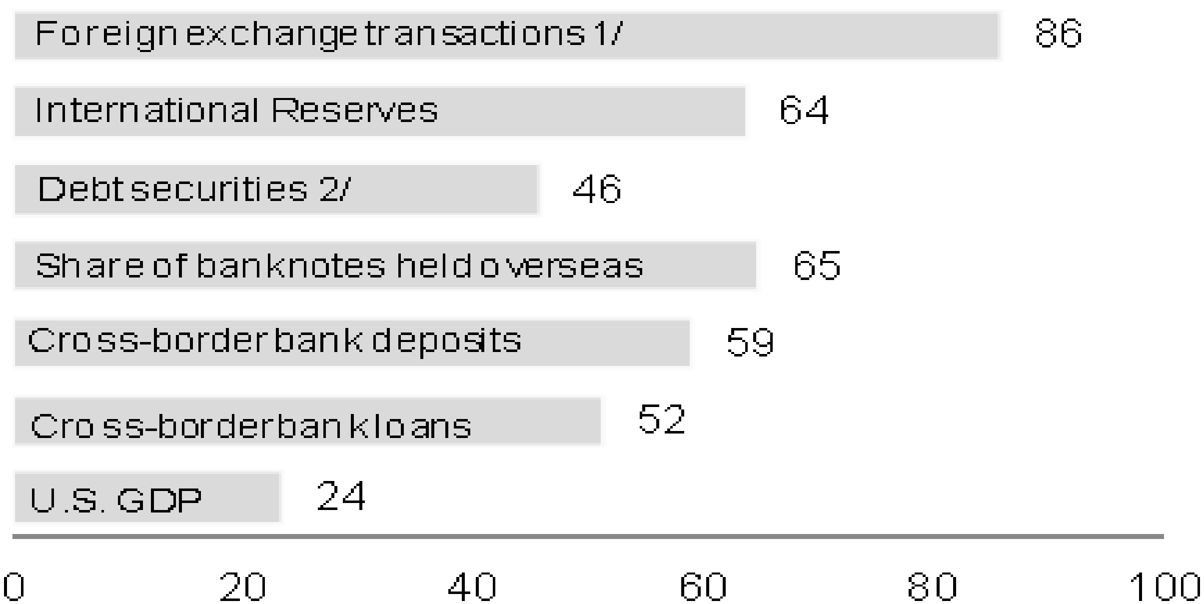


Source: COFER, IFS, WEO

Quelle: IMF (WP April 13 2010): Reserve Accumulation and International Monetary Stability

Despite the structural imbalances and the fundamental weakness of the US$ the US$ is still dominant as a lead currency

Figure 4: The Dollar in the World
(percent of world totals)



Sources: ECB (2009), BIS (2007), Goldberg (2010), COFER.
1/ Share from 200 (each transaction involves two currencies).
2/ Foreign currency debt sold outside the issuer's home country (which corresponds to the ECB's "narrow measure").

Source: IMF (WP April 13 2011): Reserve Accumulation and International Monetary Stability

What's about the USD as the **OILCURRENCY?**

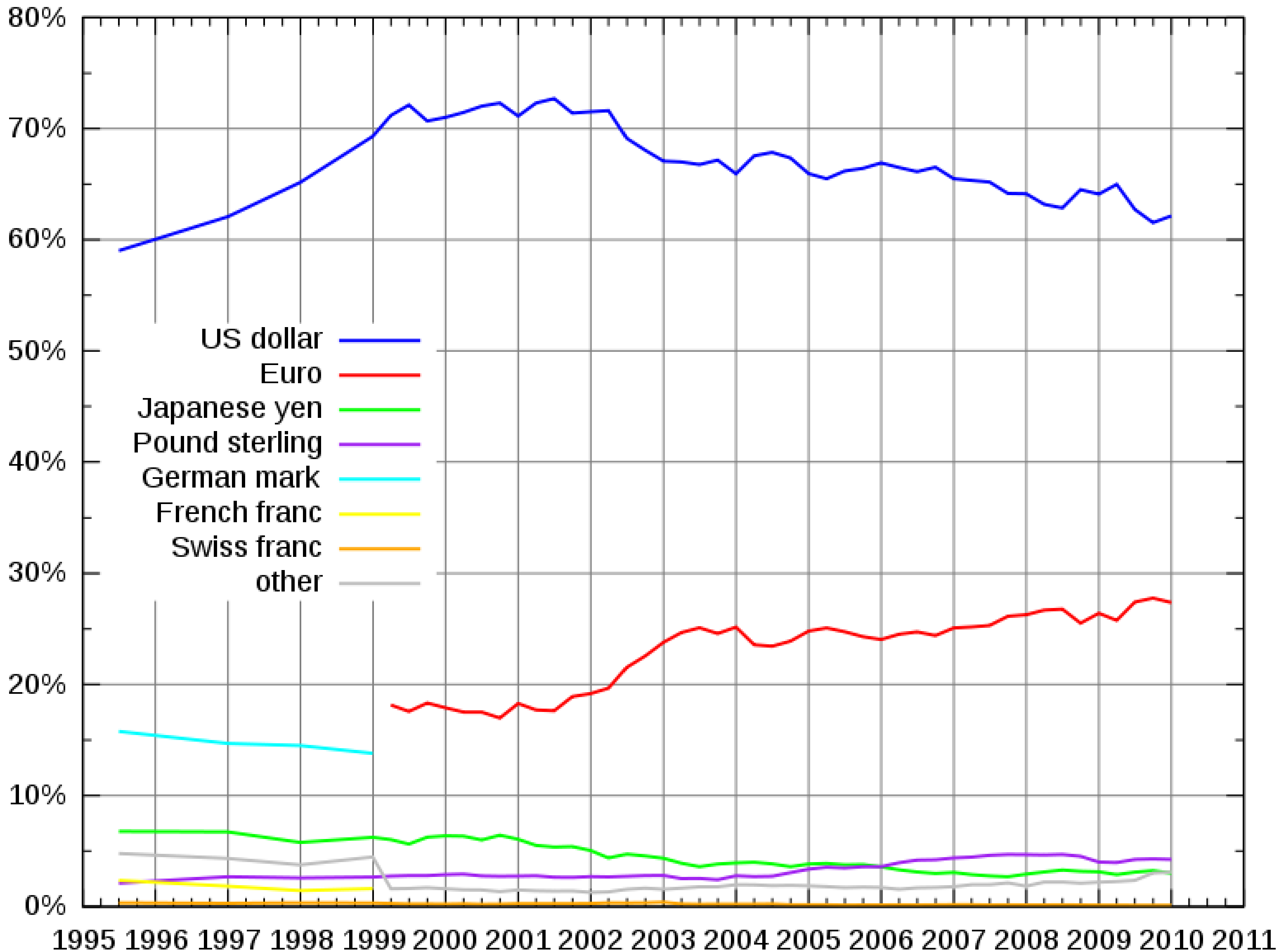
In the meanwhile the US$ lost ground vis-à-vis competing currencies, but still remains the quantitatively most important reserve currency, as Cofer-data show

Curency composition of official foreign exchange reserves 2010
(in millions of US$)

World	In US$	In percent
Total foreign exchange holdings	9.258.179	180,8
Allocated reserves	5.119.742	100,0
Claims in US$	3144256	67,2
Claims in Euro	1.347.933	26,3

Only ca. 55% of global currency reserves are reported!
In 1999 the share of the Euro in world allocated currency reserves was 17,9% according to the Cofer-data of the IMF. They exhibit an increasing diversification of currency reserves: http://www.imf.org/external/np/sta/cofer/eng/index.htm

The US$ and the Euro: A declining hegemon and a newly coming vehicle currency - or the emergence of a more diversified system?



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Global currency reserves (composition in %)

	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09
US dollar	59.0	62.1%	65.2%	69.3%	70.9%	70.5%	70.7%	66.5%	65.8%	65.9%	66.4%	65.7%	64.1%	64.1%	61.5%
Euro					17.9%	18.8%	19.8%	24.2%	25.3%	24.9%	24.3%	25.2%	26.3%	26.4%	28.1%
Pound sterling	2.1%	2.7%	2.6%	2.7%	2.9%	2.8%	2.7%	2.9%	2.6%	3.3%	3.6%	4.2%	4.7%	4.0%	4.2%
Japanese yen	6.8%	6.7%	5.8%	6.2%	6.4%	6.3%	5.2%	4.5%	4.1%	3.9%	3.7%	3.2%	2.9%	3.1%	3.0%
German mark	15.8	14.7%	14.5%	13.8%											
French franc	2.4%	1.8%	1.4%	1.6%											
Swiss franc	0.3%	0.2%	0.4%	0.3%	0.2%	0.3%	0.3%	0.4%	0.2%	0.2%	0.1%	0.2%	0.2%	0.1%	0.1%
Other	13.6	11.7%	10.2%	6.1%	1.6%	1.4%	1.2%	1.4%	1.9%	1.8%	1.9%	1.5%	1.8%	2.2%	3.1%

Sources: 1995-1999, 2006-2009 IMF: Currency Composition of Official Foreign Exchange Reserves
1999-2005 ECB: The Accumulation of Foreign Reserves

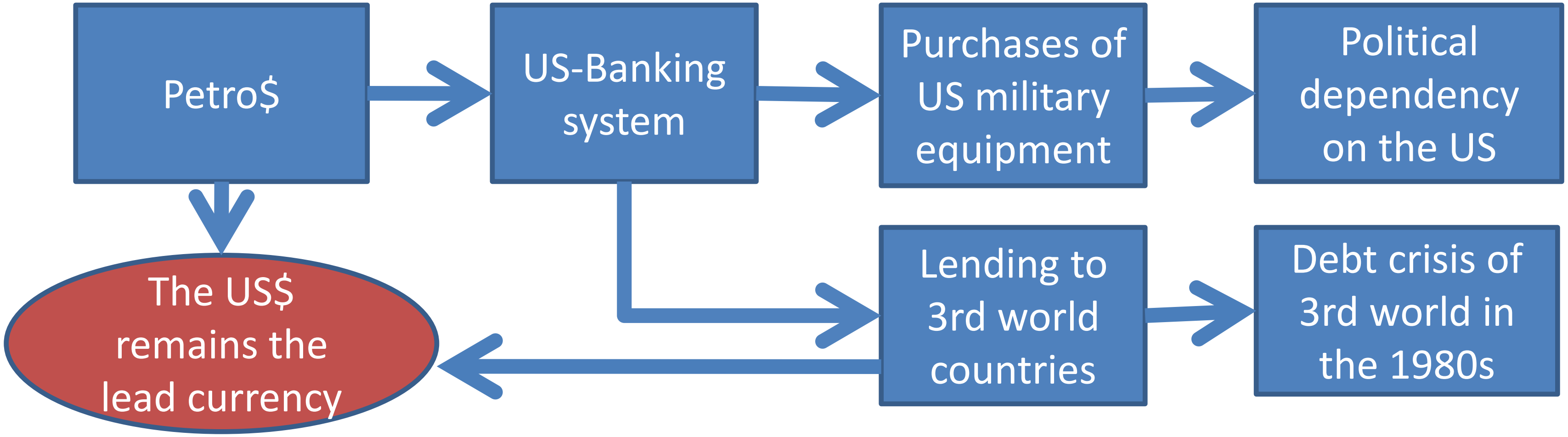
The USD as the oil-currency or the destiny to seignorage

Kissinger‘s Petrodollar-Coup

After the Jom Kippur war in October 1973 the oilprice quadrupled from about 3$ to nearly 12$ a barrel.

The result was the build-up of a stock of „petrodollars“

How to recycle them and simultaneously to neutralize the price shock of oil?



The USA are the only country which can provide the oilcurreny and buy oil without being enforced to generate a trade surplus or to go into debt in order to buy oil Therfore the huge current account deficit is not harmful to the USA. This is the decisive advantage of currency seignorage

Therefore there are attempts to reap the seignorage-advantages of the oilcurrency

Attempts of oil-exporters to invoice the oil bill in other currencies than the US$

- the failed attempt of Sadam Hussein and the Irak war
- The failed attempt of the foundation of a Iranian oil bourse
- the initiatives of Hugo Chavez

Attempts of oil-consumers to diversify the physical provision of oil and to diversify the currencies of the oil bill

- for wet oil on spot markets
- for paper oil on futrures markets

Currency conflicts thus include conflicts about trade, investment, energy
The affront against the US$ as an oilcurrency is a challenge on US-hegemony

Are there alternative currency-regime?

(1) A national currency as a world currency:
    (1) A „new Bretton Woods“ and a comeback of the USD ?
    (2) The coming role of the Renminbi (Yuan)?
    (3) Other regional currencies as a world currency – the future role of the EURO?
(2) Disintegration of the global system into regional blocks with regional currencies
(3) A new global currency
    (1) The Keynesian idea of 1944 a revival of the bancor?
    (2) The transformation of SDRs into a global currency vehicle

3.1. The third alternative of the „bancor“ (Keynes‘ proposal of 1944) is perhaps the most desirable but also the most unlikely , although a bulk of global governance literature is featuring it. It needs the establishment of a global central bank, i.e. a high degree of political cooperation.

3.2. More realistic is the revival of SDRs. But SDR are no full currency, they are only a reserve asset (transparency 21, function3), dependent on the currencies in the pool
China proposed its creation because substituting the US$ for SDR means that the weight of the US$ in global reserves diminishes. China can so reduce its vulnerability against a US$-devaluation.

2. The second alternative is more likely, although less desirable because the world is splitting up into new competing and contesting currency and trade blocks.
This also includes more protectionism in trade and more regulation of financial flows
There might be some advantages for the developing world

The first alternative includes several trajectories:

1. 1. the US$ can be defended against the challenges of sharpened currency competition. The US use their military power in order to compensate for losses of competitiveness and high indebtedness. The USA come out as the power which guarantees the global capitalist order. The highly globalized US-banking system remains the center of world finance and of energy provision - despite the devaluation pressures.
This is important for the US$ as the oil-currency . It permits the US to „print the money“ with which the oil bill is paid. So long as the oil-exporters accept this seignorage of the USA the US have no serious problem with their current account deficit.
However, the stability of this imbalanced system is low

1.2. The Renminbi (Yuan) is strong because of the high currency reserves, the strength of the sovereign wealth funds and the strong export performance of China. But the chinese banking system is not globalized enough to provide the national currency as a global reserve vehicle – and different from the USA which protected militarily their „willing“ allies China has a non-imperialist peaceful tradition
The different traditions in financial culture count

1.3. The future of the EURO depends in the first place on the further development of economic and political integration of the EU.

- Without a common, harmonized economic policy the EURO cannot be strengthened and will remain an important but not a vehicle currency.
- Nontheless the Euro can challenge the US$ because the US$ is structurally weak and a better integrated EU brings a higher economic power in than the USA
- Much depends on the future development of energy provision in the world. The oilcurrency very likely will be the vehicle currency – at least for the next decades until a a renewable energy-regime is established

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