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Europe shall not be crucified on euro's cross

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Jettisoning the grandiose dream of a global reserve currency and promoting viable national economies is the way out of the eurozone crisis

The rationale of the euro was never properly established through reasoned and open public discussion. Those who argue that monetary union was the next step in a necessary project of political integration left the economic argument obscure. One motivation of the euro's creators appears to have been to make a bid for status as a global reserve currency. Such a currency may be perceived to carry benefits if successful, such as enlarged *seignorage* (the purchasing power accruing to the money creator) and the "exorbitant privilege" of being able to purchase goods and services from the world without selling them in turn.

Reserve currency

What is a reserve currency and how does it come into being? A reserve currency is widely employed as a store of value (hence the term "reserve"). However, this role (as well as that as a widely used unit of account) typically derives from its role in transactions. This observation sheds light on the process through which a reserve currency emerges. For a reserve currency to be useful as a medium of exchange, it must be possible to employ it in transactions which have a sufficient volume (and involve a sufficient number of parties) to create a reliable demand. There must be a domain (a geographical area or perhaps a market for a commodity) in which such transactions take place freely and in sizeable quantities. Unsurprisingly, both the United Kingdom and the United States accounted for a large share of both world income and world trade during the periods of their respective emergence as reserve currency issuers.

In practice, there is a second condition. Suitable historical conditions for a reserve currency to emerge seem to occur only when the country issuing the currency generates a persistent and sizeable current account surplus, implying an ongoing demand for the country's currency in order to purchase goods and services from the country or to make factor payments to it. A persistent current account surplus also creates pressure for exchange rate appreciation, giving rise to a motive to hold the currency as a store of value. In contrast, for a reserve currency to emerge in the presence of a current account deficit would require that it be accumulated abroad on the promise of future current account surpluses or the emergence of the currency as a medium of transactions (which do not involve the country) beyond its borders. Although this scenario is logically possible, it is empirically implausible as it depends on expectations concerning the future which seem unlikely to emerge and to be sustained.

Triffin dilemma

How do we reconcile this requirement of current account surpluses with the Triffin dilemma (which holds that in a growing world economy a reserve issuing currency must inject a sufficient quantity of its currency into the world economy through current account deficits to meet the increasing demand for the reserve unit, but that these very deficits undermine this role)? The answer is that the process needed to establish a currency as a reserve is different from that needed to enable it to function as a reserve thereafter. This is why, historically, reserve currencies have emerged as such in the "surplus" phase of a rising country's development, before becoming ultimately subject to a version of the Triffin dilemma. In the surplus phase, the appetite of foreigners for a currency is in excess of the payments made to them in that currency. During this period, foreign accumulation of the currency is driven by expansion of its share of reserves rather than by increases in the overall demand for money. In contrast, in the deficit phase the payments made to foreigners in a currency are in excess of the appetite of foreigners for it. During this period, foreign accumulation of the currency is driven by increases in the overall demand for money and not by expansion of the share of the market for reserves. This historical trajectory prevailed for the U.K. and appears to prevail for the U.S. The U.K. had current account surpluses for decades prior to entering into a long period of deficits (mitigated by foreign exchange earnings from its colonies, in particular India) during which sterling balances continued to be accumulated abroad. The consequences were crises of confidence in sterling and the progressive diminishment of its role as a reserve currency. The U.S. dollar, similarly, gained its status as a reserve currency during a long period of U.S. current account surpluses (encompassing a post-war "dollar shortage") and has been glacially losing that position (as measured by its share of foreign exchange holdings) from the 1970s, when it began to experience chronic deficits.

This lens can help us understand the potential future role of the renminbi and the euro as reserve currencies. The renminbi is slowly emerging as a potential reserve currency due to China's persistent and substantial current account surpluses. It seems plausible that China will continue to experience surpluses in the intermediate term. In conjunction with China's pivotal role in world trade and its growing share of world income, this may help to establish the renminbi as a reserve currency (one of them). The renminbi has already started to emerge as a currency of settlement for a portion of China's international trade. This process is bedevilled by a "renminmbi shortage" abroad, which may be alleviated through increasing freedom of outward capital flows from China and an increasing role for China as a site of international financial transactions. Currencies of other emerging countries such as the Indian rupee and the Brazilian real do not yet come close to satisfying either of the required conditions. Although the yen satisfies both conditions to a degree, and therefore plays a role as a secondary reserve currency, the diminishing relative importance of the Japanese economy in the world means that its role will likely remain limited.

What about the euro? The eurozone as a whole has in the recent period swung between small overall current account surpluses and deficits. Efforts to address the eurozone crisis through real exchange rate depreciation (lowering of wages and prices, through administrative measures and economic contraction) in the European periphery and real exchange rate appreciation (through wage increases or demand expansion) in the European core have an *ex ante* ambiguous effect on the current account, since these factors push in different directions. The focus has been on measures of the former type, which aim to diminish the internal imbalances within the eurozone, within an overall punitive atmosphere of enforced austerity. Such unbalanced measures may succeed in shifting the eurozone to an overall surplus but are unlikely to do so dramatically, given the lesser role of the peripheral economies, and may well come at the cost of overall economic contraction. This does not augur well for the prospects of establishing the euro as a global reserve currency, even in the intermediate term.

Change in approach

The lesson is to focus first on what really matters to the people of Europe and not on grandiose illusions. Ironically, doing so is what can also best revive the euro, whatever its future as a reserve currency. Europe should jettison the strong euro, which in the absence of sizeable current account surpluses, has been underpinned by an inflation averse central bank and the demand for fiscal austerity. Instead, it should promote viable European economies. Such a strategy requires revisions to the institutional structure of the eurozone and to the policies which govern it, and in particular a central bank which serves as a genuine lender of last resort (which the ECB is at present prevented from being), a wage driven expansion of demand in the core, a major investment programme to create opportunities and increase productivity in the periphery, and write-offs needed to overcome crippling private and public debt overhangs. Such an approach can further the interests of Europe's people while also making a contribution to worldwide prosperity in the current climate of demand deficiency. The package of measures announced by eurozone leaders recently, introducing common support for ailing banks and additional aid for troubled sovereign borrowers, provides but a beginning. At stake is the difference between embracing obscurantist or sectional dreams and upholding the public good. Happily, the pursuit of the commonweal is just what is needed to save the euro.

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