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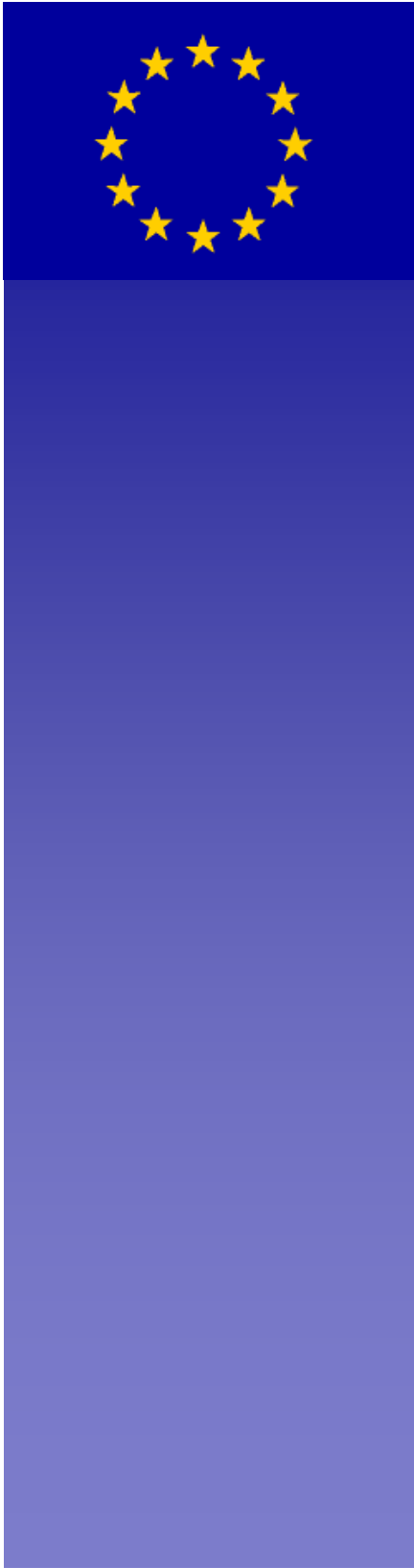
Five Years with the Euro

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EUMA

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European Union Miami Analysis (EUMA) is a bi-weekly service of analytical essays on current, trend setting issues and developing news about the European Union.

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Among the topics to be included in the series, the following are suggested:

- The collapse of the Constitution and its rescue
- Turkey: prospects of membership
- Immigration crisis and cultural challenges
- Security threats and responses
- The EU and Latin America
- The EU as a model and reference in the world
- The Common Agricultural Policy and other public subsidies
- The euro and the dollar
- EU image in the United States

These topics form part of the pressing agenda of the EU and represent the multifaceted and complex nature of the European integration process. These short papers also seek to highlight the internal and external dynamics which influence the workings of the EU and its relationship with the rest the world.

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Five Years with the Euro

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February 2007**

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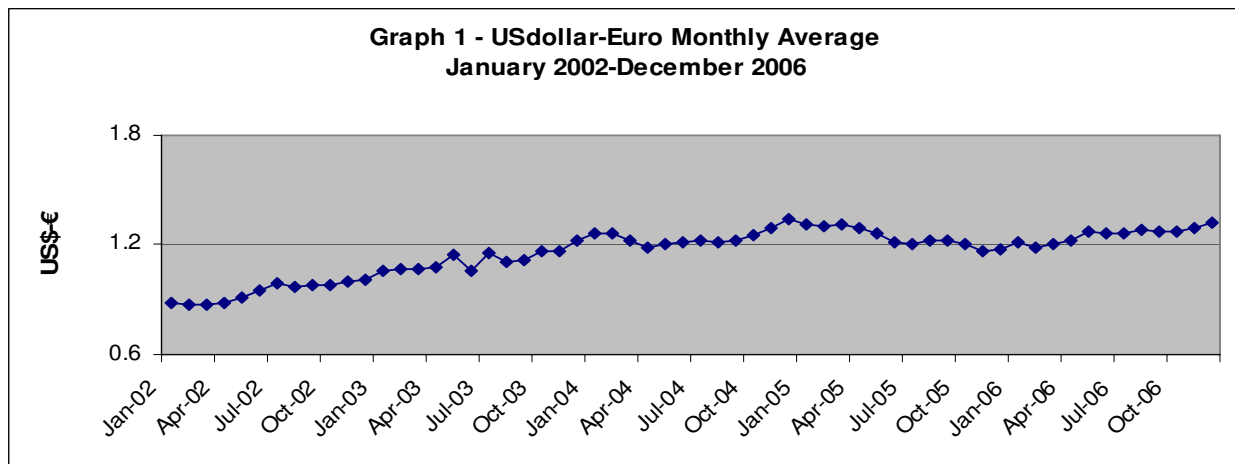
Five Years with the Euro

1. Introduction

Since the start of the European Monetary Union there has been an intense debate on whether the euro would challenge the U.S. dollar's dominant role first as an international currency, and then as an official reserve currency.

Five years after the euro was born, it is considered without doubt an international currency since it has been reported that "in December (2006) the currency came of age by overtaking the U.S. dollar in terms of the value of notes in circulation"¹. Moreover, since the euro has successfully developed a solid financial market, it is consequently eroding some of the advantages that historically supported the hegemony of the U.S. dollar as a reserve currency. There are two intertwined reasons that explain why the U.S. dollar remains the leading international currency. To begin with, there is (1) inertia in the use of the U.S. dollar due to years of currency pre-eminence which (2) has helped the U.S. dollar to have an edge over the euro in terms of the size, credit quality and liquidity of the dollar financial markets over the euro market.

Despite all this, the euro has been enjoying a successful moment in the last years since it is appreciating against the U.S. dollar especially since mid-2002 – as the graph shows (graph 1).



Source: Data was collected manually from eSignal data provider (www.esignal.com) and was recorded in excel in order to create the above graph.

Hence, five years later, the European Central Bank (ECB) has reported that "the stock held outside the eurozone must be worth at least €55bn, and that it is almost certainly too low an estimate given the net outflow accounted for by tourists"². In fact, the ECB has "estimated that between 10 and 20 per cent of the €600bn notes in circulation are held outside the eurozone"³.

¹ Ralph Atkins, "A Coming of Age for the European Currency", *Financial Times*, Thursday December 28, 2006.

²Ibid.

³Ibid.

Finally, the "Survey On the Use of Euro Cash outside the EU"⁴, explains that the exchangeability of euro cash abroad seems to have generally improved, with a number of delegations noting wider acceptance and availability of the currency at banks and exchange offices. The biggest progress seems to have been made in improving general awareness of the euro on an international level, with a number of responses referring specifically to the rise of the euro exchange rate as being a major factor in enhancing the image of the currency.

2. The Euro Five Years Later: a Success Story with a Role as Reserve Currency and International Money

By definition money is the set of assets in an economy regularly used to buy goods and services, and it has three fundamental functions which are going to determine its importance as a reserve currency and as international money. Due to these three roles that money plays, economists have agreed that the world needs to have a currency respected world-wide and that is considered an "international currency"; that is, a currency that is used outside its home country by nonresidents for transactions with residents of the home country or with residents of third countries⁵.

In order to become international money and reserve currency, it is extremely important to evaluate how a currency performs in reference to the three fundamental functions such as, a medium of exchange which is linked to the authorities' decision of the currency they are going to use when intervening in the foreign exchange market. As a unit of account, the Euro is used to post prices and record debts. Finally, it is a store of value which is used to transfer purchasing power from the present to the future, assuring that the value of the currency remains reliable in terms of future purchasing power.

In common usage, money refers to the many circulating currencies with legal tender status conferred by a national state. However, governments do not decide which currency will become international money; rather it is the private market which reaches a tacit agreement on which currency to use based on the economy size, the financial system, confidence in the currency's value, political stability, and a network of externalities⁶.

Before the euro was launched, the debate centered around whether the euro would be able to perform highly in these three areas to break with the U.S. dollar usage inertia and become an international currency on the same scale as the U.S. dollar. After five years, the statistics show that as a store of value the euro comes close to challenging the dollar. However, as a unit of account and medium of exchange, the dollar maintains its pre-eminence, although this role is not as secure as it once was.

Some of the arguments used by the Bank of International Settlement (BIS) explain that the euro as a medium of exchange is very close to overcoming the U.S. dollar. One reason given was that the U.S. Treasury Market enjoys the highest credit quality rating AAA while the euro equivalent market rate only reaches AA++— since several Euro area governments are rated below AAA. Because of this, the euro credit rating ranks lower than the U.S., helping the U.S. dollar to be more widely traded. This makes the U.S. dollar foreign exchange market more liquid and, from an investment point of view, more profitable than the euro counterparts. However, the difference between AAA and AA+ credit rating is minimal according to Standard and Poor's, which is considered the world's foremost provider of independent credit ratings.

⁴ European Commission, Directorate General, Economic And Financial Affairs, Survey On The Use Of Euro Cash Outside The EU Results of a survey of Commission delegations carried out during February 2004, Brussels, 13 April 2004, p. 8.

⁵ Ewe-Ghee Lim, "The Euro's Challenge to the Dollar: Different Views from Economists and Evidence from COFER and other Data," International Monetary Fund, WP/06/153, p. 3.

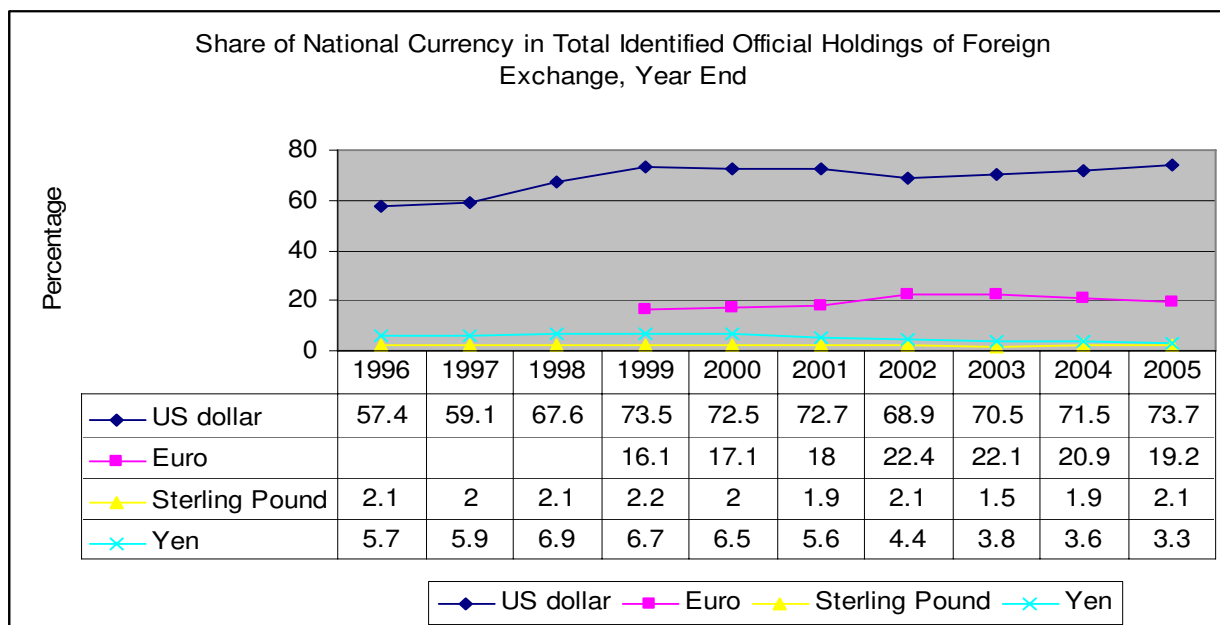
⁶ IBID page 7-8.

Republic or Kingdom of:	Credit Rating
Austria	AAA
Belgium	AA+
Germany	AAA
Denmark	AAA
Finland	AAA
France	AAA
Ireland	AAA
Italy	A+
Netherlands	AAA
Norway	AAA
Portugal	AA-
Spain	AAA

Source: Standard and Poor's Government Bonds Credit Rating List.
http://www2.standardandpoors.com/portal/site/sp/en/eu/page.topic/ratings_sov/2,1,8,0,0,0,0,0,0,0,4,0,0,0,0,0.html

As a unit of account, the U.S. dollar continues to be the leading pre-eminent currency benchmark especially after the failure of the Bretton Woods system. Nonetheless, the euro continues to play an even increasingly important role in the international exchange rate market. For instance, the International Monetary Fund reported in 2005 how the share of U.S. dollar holdings as foreign exchange reserves has changed in industrial countries. Analyzing this change in relation with the euro, the data represented in the graph below, shows that in the last year reported, the U.S. dollar rose to almost 74 percent while the share of the euro in industrial countries' foreign exchange reserves declined slightly to 19 percent in 2005⁷. However, comparing the statistics from 1999 to 2005, the data demonstrate a struggle between the U.S. dollar and the euro since in year the 2002, while the euro made a peak at 22.4 percent, the U.S. dollar hit the lowest level at 68.9 percent.

⁷ International Monetary Fund, Economic Outlook 2006, Appendix,
<http://www.imf.org/external/pubs/ft/ar/2006/eng/pdf/file11.pdf>



Source: Data has been gathered from the International Monetary Fund "Economic Outlook 2005".
<http://www.imf.org/external/pubs/ft/ar/2006/eng/pdf/file11.pdf>

Finally, as a store of value, the statistics show that even if the euro-denominated non-government debt security markets has increased in the last ten years, the gap is still quite open in real terms.

Non-Government Debt Security Market – in billions of U.S. dollars	U.S.\$ 1995	U.S.\$ 2005	€1995	€2005
Money Market	1.175	3.252	451	1.000
Bond Market	7.145	18.462	2.913	9.254
Total Outstanding: Domestic and International	8.319	21.714	3.364	10.254

Source: BIS Working Papers No. 218, page 24.

However, if we analyze the increase in percentage terms, we can see that the bond market and the total outstanding non-government securities show that the euro increase has outpaced the U.S. dollar demand in the last decade. This proves that the euro is slowly but surely challenging the U.S. dollar's dominant role, first as an international currency, and then as an official reserve currency.

Percentage Change in Non-Government Debt Security Market	U.S.\$	€
Money Market	63.87%	54.90%
Bond Market	61.30%	68.52%
Total Outstanding Domestic and International	61.69%	67.19%

Source: This graph has been elaborated manually using the data provided by the BIS and used in the previous table.

3. Conclusion

In fifteen years the European Union has been able to consolidate a single market, launch a single “international” currency, establish a common foreign policy, and double its size, among other things. However, all these astonishing achievements have sometimes been controversial and have oftentimes been the target of public opinion’s fear and confusion.

Nevertheless, the EU enjoys a strong economic performance which, helped by a strong euro, is having a positive impact on people’s economic wellbeing. Furthermore, the euro has been proved to lend a degree of collective macroeconomic stability, flexibility, and economic transparency to the economies of Europe that would have never been achieved on their own. Finally, the effect of such a currency has been not only economic but also politically significant since the euro has become an international currency with sufficient weight to garner for Europe some of the traditional political influences enjoyed solely by the U.S. due to the U.S. dollar’s hegemony since World War II.