Could the euro replace the dollar as the globe’s anchor currency?

The euro is a credible challenger to the dollar in the wake of the financial crisis of 2008.

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The euro is a credible long-term challenger to the dollar. Euroland is roughly as big as the United States, and the euro has shown itself a better store of value than the dollar. It’s true that in the current credit crisis, the dollar has retained its reputation as a safe haven for fearful investors around the world. I might have predicted the crisis would have started to undermine the dollar’s position by now. But U.S. Treasury bills have still been considered the safest thing around.

Taking a longer view, however, the causes of the crisis and the costs the U.S. will face in stopping the collapse are negatives for the dollar. Whether you measure that in terms of an increasing federal budget deficit, or the damage to New York’s reputation as a financial center, it certainly seems like a big blow to confidence in the dollar and in U.S. financial markets.

As the crisis eases, there will be more rethinking of the dollar. We will go back to the more mundane macroeconomic issues, which have been overshadowed by the crisis of the past year. The federal budget deficit is rising, and that could renew downward pressure on the dollar. The current account deficit may grow. Monetary authorities in China and the Persian Gulf have been reluctant to shift out of dollars because they are afraid of setting off a run on the dollar, and they would be the biggest losers. But once the crisis is past, they may see an incentive to reduce dollars holdings slowly and quietly, on tip toe.

To be sure, rankings of international currencies change very slowly. The United States surpassed the United Kingdom in economic size in 1872, in exports in 1915, and as a net creditor in 1917, yet the dollar did not surpass the pound as number one international currency until 1945. In 2005, when Menzie Chinn (University of Wisconsin) and I created a model to determine the factors that create a dominant global currency, even our pessimistic scenarios did have the euro overtaking the dollar until 2022. But the dollar has continued to lose ground. We updated our calculations earlier this year, particularly to recognize that London is usurping Frankfurt’s role as the financial capital of the euro, notwithstanding that the United Kingdom remains outside of the European monetary union. Now we find that the tipping point could come sooner; the euro overtake the dollar even as early as 2015.