

## Can the Euro Compete with the US Dollar?: The View from the BRICs (ARI)

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**Theme:** As things now stand, for the BRIC countries (Brazil, Russia, India and China) the euro poses no threat to the US dollar from a material standpoint. However, as far as ideas are concerned, there has in fact been a change in the status quo of the international monetary system.

**Summary:** This ARI is a summary of a study focused on how the financial elite in Brazil and China perceive the rivalry between the US dollar and the euro in their battle to be the international system's dominant currency. The more than 40 interviews carried out show that these financial leaders are unhappy with the dollar but also feel that for now the euro is no rival to the greenback, mainly because there is no integrated market for European public debt. For this reason, the material impact of the euro in Brazil and China has been limited. But its influence in the realm of ideas has been considerable. The Brazilian and Chinese financial elite see the European Monetary Union as a model to emulate in their respective regions. The single European currency has shown these leaders that monetary regionalization and even globalization is possible and, inadvertently, the euro has touched off a race to win over geo-monetary space outside the dollar's sphere of influence. In this race, the Europeans have started with a certain advantage from the outset but if they do not join forces, they might soon be left behind.

### **Analysis:**

#### *Introduction*

Since its creation and consolidation as an international currency, the euro has triggered extensive academic debate on its potential for unseating the US dollar as the anchor of the world economy. The analyses vary greatly, and for now there is no clear consensus. Research focuses on the strengths and weaknesses of the two monetary zones and because of this it reaches disparate conclusions. However, where there is homogeneity is in the point of view. Almost all of the research centres on analysing the US and the euro zone and on reflecting academic studies, interpretations and assessments from experts and politicians in these two areas. This ARI seeks to examine the same issue from a different perspective. Here, the goal is to study how the financial elites of the emerging countries (especially the BRICs –Brazil, Russia, India and China–) see the rivalry between the dollar and the euro in their struggle to be the world's benchmark international currency.

The results presented here come from a review of secondary literature and documentary and archival work, but mainly from 40 semi-structured interviews with financial leaders in Brazil and China. Those interviewed include senior officials of the finance ministries,

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central banks and government-owned investment banks, private banking executives, finance and economics professors from prestigious universities, analysts with leading think tanks and journalists from media specialising in finance. The choice of China and Brazil for this study stems from their important role in defining the international currency of the global economy. China is on the verge of overtaking Japan as the world's second-largest economy, and its foreign currency reserves total nearly US\$2.5 trillion. Meanwhile, Brazil is an emerging power that is among the world's 10 largest economies and many times it has served as the standard-bearer for the BRICs in international negotiations.

Here we present the three most important lines of argument that emerged from our research. The first centres on the discontent of the Brazilian and Chinese financial elites with how the dollar is performing as the main international currency during the current economic crisis. The currency that anchors the system should be stable in terms of inflation and exchange rates. The second condition is not being met, and the first is in jeopardy, as a result of which these leaders are starting to seek alternative solutions. One of these might be to replace the dollar with a currency that is stronger and more stable, such as possibly the euro. In the second part of this study, however, we explain why the euro is not an option for these elites. For the time being, the material influence of the European single currency is limited. But its impact in the area of ideas has been very great. In the third and final section we will show how the financial elite in Brazil and China have come to consider the euro a good example of monetary cooperation that should be imitated in their respective regions. The euro has shown the elite that monetary regionalisation, and even globalisation, is possible. And it has inadvertently triggered a race to win over geo-monetary space outside the dollar's sphere of influence, one in which the Europeans have started off with something of an advantage but will soon lag behind if they do not wake up.

#### *Discontent with the Dollar*

This is not the first time that the dollar has been questioned as the anchor currency for the world economic system. Many people spoke out against its dominant status in the 1970s, with the collapse of the Bretton Woods system, and also in the 1980s, when it depreciated against other, second-tier, international currencies such as the Japanese yen and the German mark. But the situation today is a bit different. In the first place, in the euro the dollar now has a rival currency with enough economic foundation to challenge its leadership role. Secondly, the emerging countries, such as China and Brazil, which in the next few years might catch up with the US as engines of the world economy, are not the faithful allies that Germany and Japan were in the 1980s. Then there is perhaps the biggest difference of all: the financial crisis that we are now enduring originated on Wall Street, not at the edges of the system as occurred so many times in the last few decades.

So it should come as no surprise that the BRICs feel that more than ever they now have the right to criticise the dollar's position as the system's anchor currency. Ever since March 2008, when the ever-restrained Chinese Prime Minister Wen Jiabao publicly questioned the greenback at the national congress of the Chinese Communist Party, senior BRIC officials (mainly Russians, Chinese and Brazilians) have never passed up a chance to challenge the status of the dollar in the global system. Since then, either as a bloc or individually, the BRICs have brought up the issue at international forums on global governance, be it at the G20, the G8+G5 or the yearly meetings of the International Monetary Fund and the World Bank.

This criticism of the dollar has been widely supported by the people who took part in this

study. The comment that best sums up this position was made by a senior executive with one of China's commercial banks in explaining that the main function of the anchor currency (the name speaks for itself) is to stabilise the system. For this reason it is always said that it is better to have just one international currency, because supposedly with just one anchor everything is safer, as Kindleberger explained in his theory of hegemonic stability. The problem arises when the anchor begins to fluctuate too much, and those who are tied to it (in this case the Chinese government and exporters in both China and Brazil) start to get shaken around with it. The Chinese interviewee said this is an unsustainable situation and there is no choice but to seek better alternatives.

The dollar was highly volatile before the current crisis, but its volatility grew after the failure of the investment bank Lehman Brothers in September 2008. At first, the dollar suddenly shot up because of investors' aversion to risk (proving, by the way, that it is still the currency that investors trust the most). But once the worst of the crisis passed, the dollar dropped sharply against other currencies. Many of the Brazilians that took part in our study, and most of the Chinese, referred to the Triffin Dilemma with regard to the greenback. It holds that the country which issues the international currency cannot at the same time offer the world the necessary liquidity without also weakening its balance of payments. In other words, the dollar's central position in the system forces the US to constantly increase its deficit. But there comes a point when this deficit is unsustainable and investors lose confidence in the dollar. This would not be bad for the US, which could thus quickly devalue its foreign debt. But it is in fact a problem for China, which has US\$2.4 trillion in its central bank coffers. The big fear of China's financial elite is that the US might reduce its debt through the inflation generated by injecting enormous amounts of dollars. This is known as *quantitative easing* (QE), a measure taken by the Fed when interest rates get close to zero.

#### *Is the Euro a Good Alternative?*

Therefore, the Chinese find themselves in what Paul Krugman has called the 'dollar trap' or what Larry Summers labelled the 'balance of financial terror'. Can the euro become an alternative for getting out of this predicament? Over the past 10 years the euro has proved itself to be a currency with a stronger exchange rate and a more stable inflation rate than the dollar. Furthermore, the EU is the main trading partner of both China and Brazil. So why not dump the dollar and switch to the euro? Those interviewed said the idea in and of itself is appealing, but it will probably not happen. The big problem with the euro is that it does not have a public debt market that is liquid enough to compete with US government debt. In Europe, there are different treasury bonds from the various countries of the euro zone, so those markets are much more fragmented and much more reduced. As one senior official close to the Chinese central bank explained it, if China were to start investing aggressively in any of the European public debt markets, that market would collapse in a matter of days. The price of the bonds would go through the ceiling, and interest rates would hit rock bottom. Euro-zone debt markets are simply too small for a player the size of China.

Most of the Chinese and Brazilians interviewed for this study think the arrival and consolidation of the euro in the international financial system is a good thing. They view it as an anti-hegemony action by Europe that will discipline the US in its monetary policy and establish greater competition and, therefore, greater efficiency, in the international monetary system. Most of those interviewed reject the theory of hegemonic stability, according to which the global monetary system works better with just one international currency. They say having two or three international currencies does not necessarily

make for conflict. Indeed, they say the more competition there is, the better. For this reason most of those who took part in the study are in favour of a stronger and more united Europe. Many even express disappointment with the lack of progress in EU political integration. One participant went so far as to say that the Chinese are more pro-European than the Europeans themselves. In the multipolar world that both the Chinese and Brazilian financial elite aspire to, one important pole should be the EU. But for the EU to achieve this it needs a common economic and foreign policy. Creation of a pan-European public debt market depends precisely on this kind of progress. The euro will be able to compete with the dollar only if this integration is achieved; furthermore, it would require the creation of a pan-European finance ministry (a step that is unlikely for now because of reluctance on the part of Germany). Until this happens, the European currency will not be an alternative.

#### *The Importance of the Idea of the Euro*

In any case, the financial decision-makers in Brazil and China acknowledge the progress that the euro has made. Most of them praise the currency. For many, the creation of the euro is a unique event in monetary history. Many consider it a step that will shape an era. Many also see this financial crisis as the first big test for European monetary union. In this crisis we are seeing precisely the shortcomings that come with having monetary union without the economic and political union needed to ease tensions that are only natural when one tries to juggle different production and growth models under a single monetary policy. Despite the difficulties faced by countries such as Portugal, Ireland, Spain and, above all, Greece –which some Anglo media such as the *Financial Times* have described as being on the verge of abandoning the euro zone– most of those interviewed do not see the possibility of monetary union falling apart. To the contrary, they say that this crisis will show the Europeans the need to come together even more. For the Chinese and Brazilians, it is simply a matter of survival. The Europeans must either unite or fall behind. And the natural thing would be for them to close ranks, although it might take time.

Confidence in the European project is great: so much so, that the very idea of creating a monetary union has stirred enough interest among the elite of these two emerging nations for many of those interviewed to acknowledge they would like to build something similar in their regions. That is one of the unexpected results of this study. The impact of the euro on the BRICs' financial elites has not developed mainly at the material level; in other words, the physical realm of the coins and notes that people hold in their hands. It is not that these financial minds have just now seen the strengths of the euro zone and are going to replace their dollars with euros. That is not the case. Rather, what is sinking in about the euro is the very idea of it: the idea of creating a monetary union, or, in its absence, monetary cooperation so as to be better protected from turbulence coming out of the dollar zone. For this elite class, the euro is a model to emulate, although not to copy.

It is thus that we are seeing monetary cooperation initiatives gaining momentum in both regions. In the case of Brazil, the first step has been to start billing bilateral trade with Argentina in one of the two local currencies, thus dodging the volatility of the dollar. This programme inspired by the euro has gone well, and now the idea is to introduce the Local Currency Payment System in the entire MERCOSUR region. In recent years China has also made major efforts to encourage monetary cooperation in South-East Asia as part of what is known as the Chiang Mai Initiative (CMI). The idea over the long term has always been to create a single regional currency like the euro. For now, however, political tension and historic rivalry between Japan, China and South Korea have blocked progress

towards this goal. But the Chinese government, aware of these difficulties, has not held back. Since early 2009 it has been promoting the Chinese yuan as an exchange currency for regional trade relations. To do this, it has signed monetary agreements with its neighbours, including Hong Kong, South Korea, Malaysia and Indonesia.

The influence of the euro's example as a trans-national currency even goes beyond the regional aspect. For many Chinese who took part in the study, when the Governor of China's central bank, Zhou Xiaochuan, with explicit support from the BRICs, proposes IMF Special Drawing Rights (SDR) as possible substitutes for the dollar, he is clearly referring to the euro, the only currency based on a sharing out of national sovereignty. Those interviewed in Brazil also see a linear, abstract relationship between the consolidation of the euro, the formation of other regional currencies and the creation some day of a global currency in which there is a distribution of sovereignty between the world's major powers. This is an idea that has sprung from Europe. Let us not forget that it was the Europeans who, in the late 1960s (right when the Triffin Dilemma first emerged) pressured the US to introduce SDR in international payment systems.

Now, however, the BRIC proposal has not stirred much enthusiasm in Europe (because of a lack of interest due to the strength of the euro, and because of the lack of a common pan-European position, or out of respect for the US) and naturally it has been rejected outright by the US. In any case, this lack of support from the Europeans and Americans has not weakened the BRICs' drive. To the contrary, it has prompted them even more to press on with their goal of boosting monetary cooperation as a way of avoiding using the dollar. Brazil and China have already begun to market their products bilaterally in their own currencies, and Russia is expected to follow suit soon. Brazil has even considered the possibility of billing its bilateral trade with the EU in euros, but the European Commission opposes this. While the Europeans were the first to ask for the creation of SDRs, and the first to create a single currency at the regional level, the lack of a common policy regarding the use of the euro at the international level might cause them to lag behind in the race to determine what currencies are going to be used in trans-regional trade in an increasingly multipolar world in which the BRICs will hold more and more sway.

**Conclusions:** One of the main conclusions of this study, centred on how the financial elite of Brazil and China view the current monetary system and its future, is that the dollar is a disappointment as regards the way it is performing as the anchor of the global economy. In addition to the huge current account deficit that the US has suffered for decades, now there are the difficulties that this superpower faces with its wars in Iraq and Afghanistan and the grave consequences of the financial crisis. The world's leading currency tends to be backed up by the world's leading nation, and in the view of many of these financial leaders the US is no longer the economic model to follow or the engine of world growth. The era of aggressive, made-on-Wall Street financialisation has come to an end, and with it the era of the dollar as the top international currency.

The time has come for alternatives, and the consolidation of the euro is a first step in that direction. It is not going to take over for the dollar as anchor currency over the short term. The European currency is still far from having that capacity, mainly because there is no pan-European market for public debt, nor a pan-European fiscal policy. However, the euro has in fact begun a new era in the configuration of the international monetary system. It is showing the financial elite of the emerging countries how, through regional monetary cooperation, countries can avert the volatility of the dollar when times are bad. With the

euro as their source of inspiration, both Brazil and China are boosting regional trade in their own currencies. Their desire to do without the dollar goes even further, and now most BRICs have set the goal of billing their bilateral trade in their own currencies. If this initiative prospers, the currencies of Russia, China and Brazil, as countries that dominate their regions, will consolidate their roles in those regions and the race to use certain currencies in trans-regional trade will be well under way.

Even though it launched this race, Europe for now seems unprepared to stay up front in it. As it does not have a common position on the use of the euro at the international level, in other words, as it lacks a joint project for the euro, the euro zone is in a position of weakness with regard to the US and the emerging powers. One good example is the current crisis. The region that is now bearing most of the costs of it is the euro zone. This is because it is the only power with an undefined exchange rate policy. The US was happy to let the dollar fall because this allows it to boost its exports. China has its currency anchored to the dollar because it does not want the yuan to appreciate against the greenback. Brazil, when it saw the real rising too much, imposed a small tax on short-term entries of capital to ease upward pressure on its currency, curb the bubble in the asset markets and increase tax revenue. What about Europe? What is the euro zone doing? For now it is at the mercy of the markets, which makes things hard for European exporters. The French President Nicolas Sarkozy has said this situation is unsustainable and that exchange rate volatility is inadmissible. Will he be able to convince the Germans and the rest of the euro zone countries to develop a common policy? As some of those interviewed for this paper said, it all depends on Europe's politicians. If they come together, Europe will decide jointly what the new international monetary system will be. If they do not, Europe will fall behind.

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