The euro could surpass the dollar within ten years

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One of the world’s leading international economists explains how the euro could surpass the dollar as the premier international currency and examines the geopolitical implications of such a shift.

*The International Economy* recently asked experts: Ten years from now, which will likely be the next great global currency?

My answer is that it just might be the euro. Contrary to fevered popular speculation in the 1990s, the yen and the mark never had the potential to challenge the dollar as the leading international currency: their home economies were smaller than the US and their financial markets less well-developed and liquid than New York. The euro, however, is a credible challenger: Euroland is roughly as big as the United States, and the euro has shown itself a better store of value than the dollar.

To be sure, rankings of international currencies change only very slowly. Although the US surpassed the UK in economic size in 1872, in exports in 1915, and as a net creditor in 1917, the dollar did not surpass the pound as number one international currency until 1945. Thus one must account for the lags. In 2005, when Menzie Chinn and I used historical data on central bank holdings of foreign exchange reserves to estimate the determinants, even our pessimistic scenarios did not have the euro overtaking the dollar until 2022. Thus we could not have asserted that the dollar would be dethroned “ten years from now.”

But the dollar has continued to lose ground. We have now updated our calculations, particularly to recognize that London is usurping Frankfurt’s role as the financial capital of the euro, notwithstanding that the UK remains outside of EMU. Now we find that the tipping point could come within the ten-year horizon: the euro could overtake the dollar even as early as 2015.

**Figure 1. The euro and the dollar’s projected international reserve shares**

Source: Chinn and Frankel (2008).
Figure 1 shows one of our simulations. In this scenario, the UK does not join the euro, but 20% of London turnover counts toward euro area financial depth, and currencies depreciate at the 20-year rates experienced up to 2007. The result is that the euro overtakes the dollar by 2015.

**Geopolitical Implications**

One might ask why this would matter. Some of the reasons are economic: the US would lose the “exorbitant privilege” of being able to finance its international deficits easily. But there are also possible geopolitical implications.

In the past, US deficits have been manageable because allies have been willing to pay a financial price to support American global leadership; they correctly have seen it to be in their interests. In the 1960s, Germany was willing to offset the expenses of stationing US troops on bases there so as to save the United States from a balance of payments deficit. The American military has long been charged less to station troops in high-rent Japan than if they had been based at home. Repeatedly the Bank of Japan, among other central banks, has been willing to buy dollars to prevent the US currency from depreciating (late 1960s, early 1970s, late 1980s). In 1991, Saudi Arabia, Kuwait, and a number of other countries were willing to pay for the financial cost of the war against Iraq, thus briefly wiping out the US current account deficit.

Unfortunately, since 2001, during the same period that the US twin deficits have re-emerged, America has lost popular sympathy and political support in much of the rest of the world. The hegemon has lost its claim to legitimacy in the eyes of many. In sharp contrast to international attitudes at the dawn of the century, opinion surveys report that the US is now viewed unfavourably in most countries. The next time the US asks other central banks to bail out the dollar, will they be as willing to do so as Europe was in the 1960s, or as Japan was in the late 1980s after the Louvre Agreement? I fear not.

The decline in the status of the pound during the course of the first half of the 20th century was part of a larger pattern whereby the United Kingdom lost its economic pre-eminence, colonies, military power, and other trappings of international hegemony. As some wonder whether the United States might now have embarked on a path of “imperial over-reach,” following the British Empire down a road of widening budget deficits and overly ambitious military adventures in the Muslim world, the fate of the pound is perhaps a useful caution. The Suez crisis of 1956 is frequently recalled as the occasion on which Britain was forced under US pressure to abandon its remaining imperial designs. But the importance of a simultaneous run on the pound and President Eisenhower’s decision not to help the beleaguered currency through IMF support unless the British withdrew its troops from Egypt should also be remembered.

*Editors’ Note: This column is based on posts on Jeff Frankel’s weblog.*

**References**


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