The euro’s success could also be its downfall

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Since the second world war, the US dollar has been the world’s hegemonic currency. It took over that role from the British pound. So it is not surprising that the story of the pound often looks like a memento mori, the skull that medieval rulers placed before them to remind themselves of the transience and fallibility of the human condition. By the second world war, the US was obviously a much more powerful economy than Britain.

Now, given the combination of the rapid decline of the dollar and the eurozone overtaking the US as the world’s largest economic area, we may be set for another seismic currency shift. It is one in which the euro takes over the baton from the dollar.

The story of the decline of sterling mirrors Britain’s slow transformation from the world’s largest creditor to a pariah status as an impoverished debtor. British weakness was driven by declining rates of economic growth and fading competitiveness. The decline was also punctuated by stark political crises.

The end to sterling’s global role came because of the massive costs of the two world wars – which forced Britain to liquidate its international assets – and from the emergence of the US as the main international creditor. The milestone years marking sterling’s road to decline were 1931, the dramatic crisis when Britain was forced off the gold standard, and 1956, the political crisis associated with the Suez intervention.

How many lessons from the decline of the British currency can be applied to the transformation of the US from the world’s largest creditor to its largest debtor?

The US currently sucks in something like three-quarters of all net international capital movements. Unlike mid-20th century Britain, which increasingly relied on its imperial possessions for credit in the form of currency reserves held in pounds, the US draws in capital because it is an innovative society that is growing rapidly. The US is also attractive because it seems secure. The safe haven dimension of flows into America explains the often noted paradox that foreigners are willing to accept much lower rates of return on investments in the US than US residents typically receive on their investments abroad.

However, the dramatic growth of Asian and Middle Eastern reserves over the past decade has raised the specter of a humiliation of the kind that hit 20th century Britain. It is possible to imagine a combination of 1931 and 1956 presenting a perfect dollar storm.

In a Suez-like panic a controversial foreign policy action might lead to a politically motivated run on the dollar. In the 1931 scenario, foreign investors would be convinced that political pressures within the US were the real driver of interest rate policy, such as cuts to avoid a disaster in the housing market. As in the British interwar panic, the central bank might be unable to raise interest rates because of fear of bad domestic consequences. In this case, there would be an impossible predicament for monetary policy. Tightening would depress the economy and reduce the level of stability and prosperity that had previously helped to drive capital inflows. A loosening of monetary policy would reduce returns on capital, so that the current account deficit would no longer be funded.

The crisis of the old currency is only one part of the challenge. The new currency has different problems, which may be greater for the rest of the world. In the first years after the second world war, critics worried about a permanent dollar shortage, with concern that the world would not be able to acquire enough dollars to pay for the goods that it needed (at the time, this included machine tools, engineering products and food). Economists such as Thomas Balogh feared that the dollar’s new role as the hegemonic currency would impose deflation on the rest of the world.

The euro is showing all the signs of strain that comes from being the new international key currency. Politicians in many countries across Europe are pressing to have more influence on monetary policy. For many of their constituents, the euro has become one of the whipping boys of globalization. The euro is a much younger currency than the dollar was in 1944 and it exists in a political environment in which the governance structures for the new currency are not clearly defined. That makes the stakes within Europe much higher.

Yet the external, geopolitical stakes of currency shifts are high too. Unlike Britain in the aftermath of the second world war, the US remains indisputably the world’s only superpower. It will resent what it will call the deflationary impact of the Europeans and deploy a formidable arsenal of diplomatic powers to defend the status of the dollar.

In 1944 the dollar became the world’s key currency because the US was both the world’s leading economic and military power. In 2008, the European Union has many economic advantages but also substantial political vulnerabilities. It is not easy being the world’s main currency. It is even possible that the new strains might lead to the break-up of the monetary union.

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