Abstract

The international role of a currency is focused on the so-called vehicle currency theory. This theory is based on the observation that currencies with high volume share like the dollar are also characterized by particularly low transaction costs. It was, therefore, enough to emphasize the role of order processing costs for determining the bid-option spreads in the international markets. If there are conspicuous and visible fixed costs due to the presence of a dealer, the high volume transactions reduce the processing costs per transaction due to economies of scale. In other words, it implies that in a competitive dealership market the currencies with high volumes should have lower spreads. This inverse relationship between the volume and transaction costs has important implications for the emergence of a dominant international currency. This paper intends to address the issue of identifying the factors affecting the currency-selection in invoicing the international trade. It also empirically analyses the change in composition of the foreign exchange reserves across countries on the basis of COFER data and their relation to invoicing currency in foreign trade. The paper discusses the mechanisms of exchange-rate pass through into prices of goods as they enter a country. And in the end, it discusses about the future role of Euro in trade balance and in foreign assets reserves and the policy implications of the same.

Keywords: Currency, Dollar, Euro, FOREX.

1. Introduction

The choice of currency for trade invoicing came to depend on many factors especially after most of the world’s currencies became freely floating. This leads to not only price uncertainty but also to uncertainties of demand. One of the main findings of the early literature is that traders seek to avoid currency risk by using their own currency. If prices are set before the exchange rate fluctuations are known, and orders are placed after the shock to the exchange rate, then the exporter faces ‘demand uncertainty’ if the exporter invoices the transaction in his own currency (PCP). If the exporter, on the other hand, prices the goods in local currency (LCP), as the exporter does not know which price he will receive (in his own currency), ‘price uncertainty’ arises. The data on trade invoicing are very scarce. However, it depends on many microeconomic considerations at firm level. If the demand for the exported goods is not sensitive to price in the importing country, the exporting firm can invoice in its home currency i.e. PCP. However, if the demand of the exported goods is sensitive to prices in the importing country, the exporting firm will have to take into consideration the impact on prices of the goods on pass through the exchange rate fluctuations. The demand in the importing country is also governed by many factors including the macroeconomic policies of the country, barriers to trade in terms of tariff-related barriers or non-tariff barriers etc. Exchange rate pass through can also be avoided by invoicing the trade in a vehicle currency, which is a third currency traded by both the countries. Unless the traded-product is highly differentiated, the invoicing for most of the homogenous goods is done in vehicle currency. Therefore, lots of pre-requisites are there for achieving the trade balance adjustments. It may also be possible
that the importing country has such distributing companies which absorb the price rise because of exchange rate volatility and the effect is prevented from getting passed on to the consumer. On the other hand, if the exchange rate pass through is complete, the effect can be both ways i.e. the imported goods can be cheaper or costlier. In the former case it will replace local production of the good to some extent and generate greater demand for the imported good. However, if they become more expensive as compared to the local produce, the quantity of import may come down. Either way, the balance of trade is disturbed.

The theory and evidence suggest that exchange-rate pass-through into US imports is very less as compared to other countries of the world because dollar is a major international vehicle currency and a unit of accounting. As a consequence, the effect of depreciation of dollar with respect to other currencies will have significantly lesser impact on the US demand for imports while potentially leading to large increases in the world demand for US exports which will become cheaper in foreign currency terms. The present trade imbalance in the US can perhaps follow a path of dollar depreciation. However, the role of Euro cannot be ignored. It would, therefore, be interesting to note the effect on Euro since it came into being in terms of trade invoicing as well as a share of the foreign currency assets of various countries. However, data on trade invoicing in terms of currencies and foreign reserves are scarce.

2. Currency Selection in International Trade

The main determinants of invoicing currency choice are identified as transaction costs, market depth, market size, exchange rate volatility and macroeconomic volatility. Low transaction costs in one currency make it the preferred choice of currency and the transaction cost depends on the extent of liquidity of the currency in the international foreign exchange markets. This further depends on the depth of the markets measured by volumes of trading in the currency as well as by the availability and quantum of trading in even the derivatives markets.

As far as industry characteristics are concerned, the firms will use single currency in pricing and invoicing in case of homogenous goods because of the competition among them.

The third most important argument emphasizes that macroeconomic policy and volatility could influence the selection of vehicle currency. Lesser the volatility of a currency, greater will be the chances that traders invoice in that currency. Other features considered important are price elasticity of demand for particular goods.

2.1 Transaction Costs, market depth and size

Transaction cost is a very important factor which affects the choice of currency. The lesser the cost greater invoicing takes place in that currency as the settlement takes less time. The currency market needs a number of derivatives enabling parties to trade specific financial risks, such as interest rate risk, currency, equity and commodity price risk, and credit risk etc. to enable other entities who are not willing or better suited to take or manage these risks, even without trading in a primary asset or commodity. However, the financial derivatives are linked to a specific financial instrument or indicator or commodity and through which the specific financial risks can be traded in the financial markets. They serve a number of purposes such as risk management, hedging, arbitrage between markets and speculation. Financial derivatives contracts are usually settled by net payments of cash. This requires greater liquidity in the currency involved. In foreign exchange markets the theory of economies of scale is also applicable. In private international transactions, the dollar is the main unit of account. In the trade in manufactured goods between industrial and developing countries, the currency used is mostly the currency of the industrialized country or that of a third nation which is mostly in dollars. Trade between developing countries is often priced in the currency of a third country and that currency is most likely the US Dollar. The role of Euro is comparable with the role of the Deutsch Mark prior to EMU and so the US dollar continues to be the most important vehicle currency. The euro accounts for a fifth of the global foreign exchange market turnover. This is because the US financial markets are more in depth, with greater variety of derivatives and low cost of transactions in the US Dollar. Although, the share of Euro in currency invoicing has increased after formation of the EMU, particularly in case of trade among the EMU partners and some other countries which have pegged their currencies to Euro, on the global map, the financial market is not as deep as the dollar market is.

As practically all the market turnover goes through the hands of brokers and dealers, the transaction costs can be measured by the spread between the particular currency’s bid and offer rates. The most determining factors affecting this spread is
the exchange rate volatility, market volume and the order-processing costs of market-making. An efficient domestic financial system encourages capital inflows which increases the liquidity of the bilateral foreign exchange market involving that domestic currency which increases the chances of becoming a vehicle currency. Thus, on this analogy, Euro can become an international vehicle currency if the international Euro market integrates. The following data indicate the size of the domestic financial market of three most important zones in terms of currencies markets.

**Table 1**: (In Billions of $, June 1999)

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Euroland</th>
<th>United States of America</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank deposits</td>
<td>4918</td>
<td>4909</td>
<td>4623</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>6351</td>
<td>4300</td>
<td>4331</td>
</tr>
<tr>
<td>Outstanding domestic Debt Securities</td>
<td>5613</td>
<td>14636</td>
<td>5238</td>
</tr>
<tr>
<td>Stock Market Capitalization</td>
<td>4650</td>
<td>14831</td>
<td>6715</td>
</tr>
<tr>
<td>Total size of Financial Market</td>
<td>21532</td>
<td>38676</td>
<td>20907</td>
</tr>
</tbody>
</table>

It can be seen from the above data that by eliminating exchange rate risks, the EMU has been able to integrate the European Capital Market to considerable extent. The bid-ask spread has also fallen to the level of USD. But one should not be very much impressed by these figures as they do not reflect the real changes as several factors continue to segment European Capital markets. Some of the important irritants are as follows:

2.1.1 Although the European Bonds market is large, it is not dominated by a single issuer such as the Treasury in the US. National bonds are traded separately still and have different yields. Moreover, US T-bills can be straight away used for payment at virtually no cost. There is nothing comparable to this in either the Europe or in Japan.

2.1.2 The primary dealing in government securities in Europe remains at the national level whereas the US government securities are very widely traded in the international market. Most of the countries in the world are mostly keeping their foreign reserve stock in the form of US government securities as they are the most liquid instruments available which can be traded irrespective of time and location in the world at virtually no cost.

2.1.3 The national markets in Europe also are divided in respect of tax-policies, regulatory practices etc.

2.1.4 Euroland still does not represent a central state like the US, neither at domestic levels nor at international level.

2.1.5 Despite all expectations, the European Central Bank does not act as the lender of the last resort as opposed to the US Fed and that the bank supervision is continued to be performed on the national level. This makes the European financial systems more fragile than the US.

2.1.6 Another very important difference between Euro and Dollar as international vehicle currencies is the exposure to the foreign exchange exposure. As calculated by Gross (2000), Euroland is about six times more exposed to external financial shocks as compared to the US. The following table (table-2) demonstrates this fact. Here the percentage of exports and imports of merchandise goods to GDP of the country at current prices in 2014 has been taken into account.

**Table-2**

<table>
<thead>
<tr>
<th></th>
<th>Euro Area</th>
<th>European Union</th>
<th>United States</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports and imports of merchandise as % of GDP (2014) (1)</td>
<td>68.77</td>
<td>65.90</td>
<td>23.15</td>
<td>24.6</td>
</tr>
<tr>
<td>Exchange rate variability (2)</td>
<td>11.4</td>
<td>11.0</td>
<td>5.2</td>
<td>6.5</td>
</tr>
<tr>
<td>Financial Exposure=(1)*(2)</td>
<td>7.8</td>
<td>7.2</td>
<td>1.2</td>
<td>1.599</td>
</tr>
</tbody>
</table>

1 Salvator (2000)
2 World Trade Organization, and World Bank GDP estimates
The role of US dollar remains considerably larger than the relative economic size of the US whereas the roles of other currencies remain considerably smaller than their share in the world GDP and world trade. This is because the USD intermediates in financing of trade between the EU and third countries as well as trade among third world countries.

### Table 3

<table>
<thead>
<tr>
<th>Share of world GDP in %</th>
<th>Euroland</th>
<th>United States</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>15.5</td>
<td>20.8</td>
<td>7.4</td>
</tr>
<tr>
<td>Share of world exports in %</td>
<td>19.6</td>
<td>15</td>
<td>8.5</td>
</tr>
</tbody>
</table>

Annette Kamps in No. 665/August 2006 in the Working Papers Series of the European Central Bank has tried to empirically evaluate the effect of various factors on Euro Export Invoicing like share of export to Euro-area, share of differentiated goods, exchange rate volatility to Euro, inflation differential to Euro area, forward market and currency being pegged to Euro. All these factors were found to be affecting Euro invoicing. Also, he has evaluated the factors affecting home currency export and import invoicing which include share of exports in world exports, relative exchange rate volatility to USD, inflation rate differential to US and forward market. Among the main findings of his study is that the membership or prospective membership of a country in the EU plays a decisive role in the choice of the euro as invoicing currency in its trade. Another conclusion arrived at by him was that the introduction of the common currency in the euro are increased the invoicing in euro at the expense of dollar. The paper also finds ambiguous evidence for the importance of the exchange rate risk as a determinant of currency invoicing.

However, in this paper, I have tried to find out whether the increase in the euro invoicing only has taken place at the expense of the Dollar and also tried to empirically calculate the role of the home currency in replacing dollar. From the same data used by Kamps (2006), it was found that the replacement of dollar as the vehicle currency by Euro varies in different zones in the world i.e. Euro Zone, Euro-28, Euro Candidates, Rest of World and North America. Under the assumption of *ceteris Paribus* with the available data, the results of regression for various areas were as under. The percentage of trade in USD was taken as the dependent variable during the time series 1993 to 2014, wherever data were available. It is very relevant to mention that in case of some countries only one year’s data were available and in case of others data were available for many years. This slewed data is supposed to affect the result but the results do indicate towards the trend being followed.

### Table 4

<table>
<thead>
<tr>
<th>Zone</th>
<th>No. of countries’ Data</th>
<th>Exports R²</th>
<th>Co-efficient</th>
<th>Imports R²</th>
<th>Co-efficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro Zone</td>
<td>6 (32 years)</td>
<td>0.83</td>
<td>-1.094</td>
<td>0.77</td>
<td>-0.839</td>
</tr>
<tr>
<td>Euro-28</td>
<td>10 (22 years)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home Currency</td>
<td></td>
<td>0.99</td>
<td>-0.9529</td>
<td>0.99</td>
<td>-1.0142</td>
</tr>
<tr>
<td>Other European Countries</td>
<td>5 (33 years)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Euro</td>
<td></td>
<td>0.96</td>
<td>-0.8029</td>
<td>0.99</td>
<td>0.8719</td>
</tr>
<tr>
<td>Other countries</td>
<td>3 (28 years)</td>
<td>0.96</td>
<td>-1.0672</td>
<td>0.97</td>
<td>-1.1284</td>
</tr>
<tr>
<td>Home Currency</td>
<td></td>
<td>-0.8680</td>
<td>-0.8952</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
2.1.7 In the core Euro Zone countries, for which the data were available in respect of exports and imports currency of trade, it is found that in these countries which have adapted the Euro as the official currency, there has been a tangible effect of replacing dollar after introduction of Euro as international currency in 1999. The data from 1993 to 2014 have been considered. The substitution is almost 10% in case of exports and in imports. This shows that some of the imports are not denominated in Euro but in dollars, which are perhaps from dollar dominated countries and for homogenous manufactured goods.

2.1.8 In Euro-28 countries, import displacement of dollar is more than the export displacement of dollar. Moreover, home currency displacement of dollar both in exports and imports are more than the displacement caused by Euro.

2.1.9 In other European countries, the displacement of dollar by Euro is lesser in exports than in imports.

2.1.10 In other countries like Australia, Indonesia, and Thailand, the replacement of dollar by Euro is more than the displacement in the Euro-Zone countries. Even the local currency invoicing in exports and imports have also displaced dollar. The reason is that the currencies of these countries are also traded to considerable extent in the international trade.

Therefore, it can be seen that the phenomenon of currency displacement has been limited mostly to the Euro countries, among which also only Euro was not fully responsible for the same but the home currencies also played significant role in the phenomenon.

2.2 Exchange Rate Volatility and International Currency Invoicing

Most of the Central Banks in the world target inflation and fiscal deficit to stabilize their economy. Therefore, a currency showing higher volatility is not very likely to emerge as a major international currency replacing the existing vehicle currency, which presently is ‘dollar’. As most of the Euro countries have pegged their currencies to Euro, the emergence of Euro as an alternative to dollar depends on its volatility. U.K. is a very important country in Europe which has not yet joined the EMU. The following figures plot last five years’ price of major currencies of the world with respect to dollar.

1. Euro: -

2. Great Britain Pound
In the above figures, exchange rates have been plotted from March 2002 to December, 2006. MACD, (Moving Average Canvagance and Divergence), as defined by Gerald Appel in 1960s, shows the difference between a fast and slow exponential moving average (EMA) of closing prices. The standard periods are 12 and 26 days.

\[ \text{MACD} = \text{EMA (12)} \text{ of price (--) } \text{EMA (26)} \text{ of price (Shown in blue line)} \]
\[ \text{Signal} = \text{EMA (9)} \text{ of MACD.} \]
\[ \text{Histogram} = \text{MACD (--) signal.} \]

The upper graph is the price of the currency concerned. However, it is relevant to mention here that the trend of inflation has remained by and large the similar since 2006 till 2014 and the dollar’s exchange rate has been resilient and has adjusted quickly to intermittent upheavals.

From the above figures for Euro, G. British Pounds and Japanese Yen it can be seen that in case of Euro, its price relative to dollar has mostly been bearish because since its inception the value of Euro with respect to Dollar has been falling and in May-June 2002 itself it crossed through zero down and continued to be below the zero line even up to December, 2006 which was against the expectations when EMU was formed. Also, the MACD line has mostly been below the signal line. As per normal trading rules, when MACD line crosses down the signal line, the currency should be sold. Up to May-June 2004, the MACD line continued to be below the signal line even while crossing zero. Only slight recovery has occurred since then and the MACD line still remaining below the Zero line (Bearish trend continues). This supports the findings on currency invoicing which has not increased significantly in Euro terms except in the Euro Zone. Therefore, behind the marginal displacement of dollar by Euro is limited to mostly the Euro- Zone countries. It is far from becoming a currency of international importance challenging the Dollar.

G. British Pound has followed almost a similar trend vis-à-vis dollar during the period. Hence, it can be safely concluded that almost all European currencies have been weak as compared to dollar in the international market during this period of four years.

However, Yen followed a slightly different trend. After remaining bullish up to April 2004, the currency’s MACD line crossed below zero and remained bearish vis-à-vis dollar up to September, 2006 since when it is again behaving bullish and the MACD line is also running above the signal line indicating the time for the traders to buy Yen.

3. Foreign Currency Reserves and International Currency Invoicing

In my analysis I have used COFER data to arrive at the currency composition over time. COFER is an IMF database that keeps end-of-period quarterly data on the currency composition of the official foreign exchange reserves. The currencies identified in COFER are:- i) US dollar, ii) Euro, iii) Pound Sterling, iv) Japanese Yen, v) Swiss Franc, and vi) Other currencies.

Before the Euro was introduced in 1999, the European currencies identified separately were:
1) European Currency Unit (ECU)
2) Deutsche Mark
3) French franc
4) Netherland Guilder.

The limitation of COFER data is that FOREX
reserves do not include holdings of a currency by the issuing authority. The purpose for which these data are being used is not affected by this. However, the major assumption is that a country will build its FOREX reserves as per its import currency invoicing needs which further depends on the openness of the country. The data are grouped in three groupings of countries: -

1) All countries
2) Industrial countries
3) Developing countries

In case of developing countries, there is huge amount of unallocated reserves because of non-reporting to IFS or COFER. In case of industrial countries, it is very small and the figures are very accurate. Below are being reproduced the currency composition of all the three groups of countries: -

(1) **Industrial Countries.** Percentage of unallocated reserves = 1.02%

Therefore, in case of the industrial countries, the foreign exchange reserves have on an average increased their euro component slowly from 1999 to just about 22.4% and dollar still forming above 62% in 2014. The Japanese Yen reserves have slightly decreased.

(2) **Developing Countries.** Unallocated reserves = 47.53%
The above figure shows results which are in congruence with the data in table-4 above. In these countries, both Euro and home currencies have displaced dollar in currency invoicing much more than the European countries. This is because, the developing countries, after the East Asian Crisis, have diversified their trade and also their trade with Euro countries has increased. As can be seen from Table-3, the percentage share of global business is more than their percentage share of GDP in case of Euro-land and Japan whereas in case of US, it is less than GDP in percentage terms. This in turn supports increasing trade of developing countries with the Euro-land.

(3) **All Countries.** Unallocated reserves = 25.58%.

With limitations of data from many countries, including the missing data of China, which is one of the major economies of the world, the world reserves of dollar have hardly fallen by 5% whereas the share of Euro touched almost 25%. But dollar is still being used as the vehicle currency by a majority of countries.

The explanation for weakness of euro from 1999 to 2002 is given by Meredith (2001) better than any other economist. He refers to many reasons like Initial conditions or structural weakness in euro (e.g. labor market rigidity, size of welfare states, difficulties in establishing sound fiscal policies), political factors (e.g. Danish referendum not joining the EMU), world oil shocks, policies of the ECB (e.g. uncertainties), contrast with US new economy (e.g. productivity growth in the U.S. and export-led growth in Europe), portfolio shifts (e.g. increased international issuance of euro-denominated bonds) and the ‘herd behavior’. European countries are main creditor countries in the world and so euro was expected to rival dollar, US being net debtor. Another most important good in the world is ‘oil’. According to WTO, the Western Europe was the largest importer of oil from the rest of the world. So from this point also the presumption that euro will gain against dollar gets strength. One school of thought, of course, is that because of the military might of the US, it may not allow nations to sell oil in Euro. Invasion on Iraq is also believed to be an attempt towards this goal. Similarly, the threat to Iran, according to this view, comes because of Iran’s announcement to invoice oil in euro rather than in dollars. But the established fact is that most of the oil markets are operational in the U.K. and the US. So, if UK stays away from EU, the dominance of the incumbent dollar will continue.

4. **Trade invoicing and exchange-rate pass through**

We have overviewed the current state of the dollar and euro use in invoicing of international trade
transactions and related them with the exchange-rate changes and the foreign assets reserves of various countries. A related concept is the so-called exchange rate pass through. A European exporter can invoice a good in dollars and then pass through the change in exchange rate to the prices. However, in practice, prices are not frequently reset. In that case the European exporter will fix rate in dollar for delivery at a future date but will leave the price unchanged even if the USD/EURO exchange rate moves between the date of contract and the date of delivery. This example represents a case of zero pass through. The empirical evidence documented in the previous section identifies an asymmetry resulting from the prominent role of the US dollar. With US exports and imports both predominantly invoiced in dollars, the prices of US imports are more insulated from exchange rate fluctuations than prices in local currency terms paid by foreign importers. Exchange rate changes continue to produce large changes in import prices across Euro area countries. Import prices influence consumption prices of traded goods which interact with local demand elasticity and solicits changes in quantities imported. In this way real adjustment to exchange rate takes place. However, in this process, the local distribution channel can to some degree absorb the changes reducing the net effect on consumers. In a symmetric world, due to exchange rate pass through, switching of expenditure can take place. Thus the price sensitivity of demand is a central aspect in trade adjustment. If the demand reacts more than proportionately to price changes, then a depreciation of dollar boosts the US exports by enough to reduce the trade deficit and even create trade surplus. However, if the demand for the US exports is relatively unresponsive to prices, the depreciation of dollar will have only a moderate impact on US exports and thereby worsening the US trade deficit. This scenario is a theoretical model in a symmetric world where complete pass through of the exchange rate takes place.

But, practically, the world is asymmetric with a predominant role of dollar as an invoicing currency. This invoicing role implies that exchange rate pass through to US import prices is limited, while the pass through in other countries around the world is substantially higher. Therefore, a dollar depreciation keeps the prices in the US relatively steady but affects the euro prices faced by European consumers on imports from other countries that had been dollar invoiced. A depreciation in dollar leads to a nominal trade surplus with little effect on imports and increase in exports from US as both imports and exports are presently more insulated from exchange rates as compared to other countries. As per the simulation exercise done by Gust and Sheets (2006), a 10% depreciation of US dollar increases the trade surplus in dollar terms by 1% of GDP at a horizon of 6 quarters. But the pattern of adjustment in all other countries varies.

5. Policy Implications

5.1 The role of US dollar as a key invoicing currency in international trade transactions is related to the presence of the US as a main producer and destination market for goods. We have argued that a depreciation of dollar would have an asymmetric effect on flows between US and its trading partners. The impact of depreciation of dollar on US will result in slight surplus in trade balance for US and the US goods will become cheaper in the rest of the world. The use of dollar as an invoicing currency also affects the trade adjustment between countries even beyond the effects of direct trade links with the US. If the trade is invoiced in dollars, the bilateral terms of trade are insulated from exchange rate movements and the adjustment comes entirely through the volume of trade. Thus, dollar is likely to remain the dominating global vehicle, invoicing and reserve currency for quite some time. On the other hand, the recent debt crisis of the European countries especially that of Greece, which had almost bankrupted all the banks in the country drying liquidity to the lowest level and the problem of refugees infiltrating in all the European countries as a result of war in Syria and Iraq, the European economy is set for an economic beating. Although Greece crisis has been bailed out by the ECB, second time since the onset of the debt crisis, it remains to be seen how stringent controls Greece can impose on local expenditure, raising taxes etc. IMF has also given an ultimatum to Greece to resolve its governance issues, lest further aid would be very difficult. In these circumstances, much remains to be seen and hence one cannot be very optimistic about Euro’s ascendancy above the dollar.

Refugees’ issue is a humanitarian issue and there is pressure from the rest of the world too. Hence, the position taken by various countries on the issue needs to be seen.

5.2 Another important factor is whether the U.K. will join the EMU and if so, how soon so that euro’s liquidity grows and transactions cost comes down to
the American level. Even then dollar is advantaged by inertia network externalities. Summing up, the role of the euro as vehicle currency in trade seems to be limited when compared to the US dollar.

5.3 As most of the traded commodities are undifferentiated goods, the role of dollar as vehicle currency increases. Producer currency invoicing is likely only if highly differentiated goods are produced at places other than the US and traded. But as far as services are concerned which are forming major part of GDP in the presently most developing economies like India, the choice of currency of payment is not subjected to exchange rate pass through especially through the MNCs. With the present level of technological development in the US as compared to any other part of the world, pricing in producer’s currency other than dollar appears to be remote possibility to take shape in recent future. Another very great advantage with the US is its military might with which it is leveraging economic benefits for itself.

5.4 There are a number of institutional factors which need to be addressed within the EU. The countries of the EU differ on many political, economic and international issues, e.g. there exist wide differences among the EU nations on the issue of Iraq War.

5.5 It is very difficult to have a joint representation at the UN. In order to gain economic control, it is also necessary to have political control over the UN Security Council in order to prevent the US from using its might for economic benefits.

5.6 Even if EMU is formed, a strong military capability equivalent to the US’s will be required to be developed and their presence has to be made to be felt as done by the US. On every continent, US military deployment is there. Military deterrent against the US is a pre-requisite for gaining economic supremacy.

5.7 A symbiotic relationship presently exists among the developing countries and the US. None of them would prefer to invite another economic crisis. A strong US Dollar is in the interest of most of the developing and under-developed nations of the world. Many of them thrive on the exports made to the US. Any depreciation in dollar value to a significant extent may wither away their economy by making their exports to the US costlier. As US is more insulated from exchange rate fluctuations, it can withstand some trade deficit. Moreover, to fill up this trade deficit, the dollar reserves of many countries are held by the US in the form of T-bills paying very nominal interest on them. Hence, the cost of deficit financing is very low for the US.

5.8 No country holding a large number of assets in dollar-denomination would like dollar to depreciate which will fetch them very poor prices even if sold back to the US.

5.9 In order to become a member of the IMF, amendment in the constitution of IMF will be required as present provisions do not allow a consortium of nations to be members.

5.10 U.K. is unlikely to join the EMU early as it is a close ally of the US.

5.11 There are large differences in productivity of the EU nations and the US.

5.12 Taking total scenario into account, the most optimistic situation for EU can be that euro comes to play as another major currency at par with the dollar available in the world that too after 2050 in the most optimistic of situations.

6. Conclusion

The official as well as the private investors alike around the globe have come to depend heavily on the financial assets denominated in U.S. dollars, especially because there are no alternatives at present which can offer the scale, liquidity and the depth the U.S. financial markets are able to provide. U.S. Treasury securities, which represent borrowing by the U.S. government, are still perceived as the ‘safest’ financial assets in the various global markets. That perception has resulted into a significant portion of U.S. capital inflows, which have surged in the past two decades. This dollar dominance has allowed the United States to live beyond its means, running sizable current account deficits financed by borrowing from the rest of the world at cheap interest rates. The U.S. central bank has adopted use of unconventional monetary policies which has increased the supply of dollars and created risks in the financial system. Moreover, the political gridlock which has made U.S. policymaking ineffective to some extent and has also started proving counterproductive to some extent in ensuring the economic recovery. Serious concerns also prevail about the recent fiscal tightening which has constrained the government’s ability to undertake expenditures in critical areas such as education, Medicare and infrastructure which are very crucial for long-term productivity growth of the US. The unusually high share of foreign ownership of its assets in the form of federal securities may perhaps make it tempting for the United States to simply print more dollars to cut its debt obligations, which would reduce the real (that is, after-inflation) value of that debt. Nevertheless, such an action, despite being...
tempting, appears to be totally unappealing and undesired on the part of the US, because it would likely fuel inflation and affect adversely not only the U.S. investors but also the U.S. economy as well. The foreign investors and the foreign central banks have accumulated enormous investments in these securities as well as other dollar assets. Therefore, they also have a very strong incentive to prevent the value of the dollar from crashing. In the US also there exists a delicate political balance existing which does not allow it to print dollars and reduce the huge debt burden accumulated by it over the years. Hence, there exists a kind of vicious synergy among various countries and the US in maintaining the dollar as the dominant currency for their own and different reasons. Moreover, there are no alternative currencies or investments that provide a similar degree of safety and liquidity in the quantities demanded by investors. Therein lies the genesis of the “dollar trap.”

The reason the United States appears so special in global finance is not just because of the size of its economy, but also because of its institutions—democratic government, public institutions, financial markets, and legal framework—which, for all their flaws, still confidence in various economies of the world such that despite the Federal Reserve’s protracted use of unconventional monetary policies, investors worldwide still appear to believe that the Fed will not allow inflation to get out of hand and diminish the value of the dollar. -Ultimately, getting away from the dollar trap will require significant financial and institutional reforms in countries that aspire to have their currencies erode the dollar’s dominance. This will require major reforms to global governance to reduce official demand for dollars by providing better financial safety nets for countries. Therefore, the dollar will remain the dominant reserve currency for a long time, mainly for want of better alternatives.

References


IMF, Statistics Department, COFER database.
