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The US Dollar and the Euro as International Currencies

For many decades the US dollar has remained unchallenged as the world's dominant international currency. What is behind its persistent pre-eminence in the international monetary system and can this be expected to last? Could the euro rival or even surpass the dollar as the leading currency? If it did, what would be the consequences for Euroland?

Ramkishan S. Rajan* and Jose Kiran**

Will the Greenback Remain the World's Reserve Currency?

Prior to World War I, Britain was the world's leading trading nation, and around 60 per cent of world trade was invoiced and settled in pounds sterling. London was also the undisputed financial capital of the world and, as a result, the pound was the logical invoicing currency for debt securities and other financial instruments. Conscious efforts were also made to encourage the use of the pound throughout the British Empire as a medium of exchange so as to simplify transactions. In addition to the pound's roles as a vehicle and invoicing currency of choice, given that it was fully convertible, central banks used the pound most often to intervene in foreign exchange markets. All of this led to the pound becoming the pre-eminent reserve currency of the world. The pound's share in the foreign exchange holdings of official institutions stood at 64 per cent in 1899, more than twice the total of its nearest competitors, the French franc and the Deutsche mark (Table 1), and much greater than the US dollar.¹

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Rise of the US Dollar

By 1919 the USA had surpassed the UK in terms of overall productive capacity, aggregate trade flows and as a net international creditor.² In addition to the growing relative strength of the US economy, economic historians have argued that the creation of a Federal Reserve System in December 1913 and the subsequent development of New York as the world's financial centre provided another strong impetus for the rise of the US dollar's role as a major international currency. However, it was only after the shock of the two world wars and the resulting devastation of the other European economies, as well as the gross mismanagement of the British economy that the USA took over the role of the world's reserve currency, thus breaking the de facto "sterling standard".

¹ For details, see B. Eichengreen: Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition, NBER Working Paper No. 11336, 2005; B. Eichengreen: The Euro as a Reserve Currency, mimeo, November 1997; J. Frankel, M. Chinn: Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?, NBER Working Paper No.11510, 2005.

² Cf. B. Eichengreen, op cit.

Table 1
Shares of Currencies in Known Official Foreign Exchange Assets, 1899 and 1913

	End of 1899	End of 1913
Pound sterling	64	48
Francs	16	31
Marks	15	15
Other currencies	6	6

Notes: Percentages may not sum to 100 due to rounding.

Source: B. Eichengreen: Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition, NBER Working Paper No. 11336, 2005.

The Bretton Woods system of pegged exchange rates centring on the US dollar which was put in place in the mid-1940s consolidated the position of the US dollar as the world's reserve currency in the post-war period. The US dollar share of world's reserves peaked at almost 85 per cent in the early 1970s. In contrast, the pound's share continued to drop dramatically following its successive devaluations in the 1950s and 1960s. Despite the collapse of the Bretton Woods system in 1971, the US dollar remained the dominant international currency, though its share of global reserves began to decline, reaching a trough of 50 per cent in 1990, only to bounce back to about 60 per cent since the late 1990s (Table 2).

What is behind the persistent pre-eminence of the US dollar in the international monetary system and can it be expected to last?

Studies have estimated that every one per cent increase in a country's share of world product (measured in PPP terms) is associated with a rise of between 0.9 and 1.3 percentage points in that currency's share of central bank reserves.³ So economic size is clearly important in determining the choice of a reserve currency. Referring to Tables 3 and 4, we note that on the basis of economic size, the USA is still the single largest economy in the world even though its relative share of world GDP (in PPP terms) has declined somewhat over the past two decades. The USA is followed by China, Japan and India. However, if considered in aggregate, the eurozone with its 12 member economies becomes the world's second largest economy. If we add Denmark, Sweden and the UK, the EU15 surpasses the USA in economic size. In view of this, it is generally believed that the euro in particular, but also the yen pose the most likely near-term challenges to the dominance of the US dollar. The Chinese renminbi and possibly the Indian rupee are viewed as much longer-term contenders to rival the US dollar. This said, while the euro and yen have remained the second and third most important reserve currencies, together they still constitute only about a quarter of the world's reserves and have hitherto failed to come anywhere close to challenging the US dollar.⁴

Closer Look at the Possible Rivals to the US Dollar

In the heyday of the Japanese economy in the 1970s and 1980s, the yen's share of global reserves peaked at almost 9 per cent of global reserves in 1991, and there was a concomitant decline of the US dollar's

Table 2
Share of Currencies in Total Identified Official Holdings of Foreign Exchange, 1965-2003

	1965	1973	1977	1982	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
US dollar	56.1	64.5	76.2	57.9	55.7	55.1	51.8	50.1	50.6	54.7	56.1	53.1	53.4	56.8	59.1	62.6	64.9	66.6	66.9	63.5	63.8
Pound sterling	20.0	4.2	1.5	1.8	2.1	2.5	2.5	3.1	3.4	3.2	3.1	2.8	2.8	3	3.3	3.5	3.6	3.8	4	4.4	4.4
Deutsche mark	0.1	5.5	6.4	11.6	13.3	14.5	18.0	17.3	15.9	13.7	14.2	15.3	14.7	14	13.7	13.1	—	—	—	—	—
French franc	0.9	0.7	1	1	0.8	1.0	1.4	2.3	2.8	2.5	2.2	2.5	2.4	1.9	1.5	1.7	—	—	—	—	—
Swiss franc	—	1.1	0.8	2.3	1.8	1.8	1.4	1.3	1.2	1.0	1.1	0.6	0.5	0.5	0.5	0.5	0.4	0.5	0.5	0.6	0.4
Netherlands guilder	—	0.5	0.4	1	1.2	1.0	1.1	1.0	1.0	0.6	0.6	0.7	0.5	0.4	0.5	0.5	—	—	—	—	—
Japanese yen	—	0.1	1.2	4.1	6.9	7.0	7.3	8.1	8.7	7.7	7.7	7.8	6.7	6	5.1	5.4	5.4	6.2	5.5	5.2	4.8
ECU	—	—	—	13.8	13.6	11.7	10.8	10.1	10.6	10.1	8.6	7.7	6.8	5.9	5	0.8	—	—	—	—	—
Unspecified currencies ¹	22.9	23.6	12.3	6.5	4.6	5.4	5.8	6.7	5.7	6.3	6.3	9.5	12.1	11.5	11.3	12	12.1	6.6	6.4	7.1	6.8
Euro	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	13.5	16.3	16.7	19.3	19.7

Notes: ¹ The residual is equal to the difference between total foreign exchange reserves of IMF member countries and the sum of the reserves held in the currencies listed in the table.

Source: IMF: Annual report, various years; M. Chinn, J. Frankel: Will the Euro Surpass the Dollar as Leading International Reserve Currency, mimeo, June 2005; B. Eichengreen, D. Mathieson: The Currency Composition of Foreign Exchange Reserves: Retrospect and Prospect, IMF Working Paper No. 00/131, 2000.

Table 3
World's Largest Economies in PPP Terms, 2003
(in millions)

Rank	Country	PPP GDP 2003
1	United States	10,923,376
2	China	6,446,033
3	Japan	3,567,804
4	India	3,078,024
5	Germany	2,291,007
6	France	1,654,018
7	United Kingdom	1,610,579
8	Italy	1,563,332
9	Brazil	1,375,756
10	Russian Federation	1,323,839

Source: http://www.worldbank.org/data/databytopic/GDP_PPP.pdf.

share from 55 percent in 1987 to 50 percent in 1991 (due also to the intensification of European monetary integration). However, the main factors hindering the yen's global use at that time were a conscious policy on non-internationalisation of the yen and its underdeveloped financial markets. While the Japanese have been keen on promoting the international use of the yen since the mid and late 1990s, the economy stagnated and its financial sector became burdened by inefficiencies and non-performing loans (following the burst of the asset bubble). In addition, Japan's bank-based financial system has precluded the country from developing as deep and liquid financial and capital markets as available in the USA or Western Europe. Thus, despite Japan's rapid rate of growth in the pre-1990s, the yen has failed to become a significant competitor to the US dollar. The yen's share has in fact declined since the 1990s, falling to less than 5 per cent in 2003.

In contrast to Japan, Europe's financial markets have depth and liquidity (which has been further enhanced with the advent of the euro in 1999),⁵ and many European policymakers have been keen on promoting the euro as an alternative to the US dollar since its inception. Prior to the launch of the euro and

³ The lower figure (0.9 percentage points) is probably more appropriate as it incorporates lagged or inertial effects. See B. Eichengreen: *The Euro as a Reserve Currency*, in: *Journal of Japanese and International Economics*, Vol. 12, 1998, pp. 483-506; B. Eichengreen, J. Frankel: *The SDR, Reserve Currencies and the Future of the International Monetary System*, in: M. Mussa, J. Boughton, P. Isard (eds.): *The Future of the SDR in Light of Changes in the International Financial System*, Washington DC 1996, IMF.

⁴ Almost all global reserves are held in five currencies, viz. the US dollar, the euro, the yen, the pound sterling and the Swiss franc.

⁵ For an analysis of the impact of the euro on European financial markets, see G. Galati, K. Tsatsaronis: *The Impact of the Euro on Europe's Financial Markets*, BIS Working Paper No.100, 2001.

Table 4
Size of USA versus Europe, 2003 and 2004
(in US dollars trillion)

	2003	2004
United States	11	11.5
Eurozone (12 Countries)	8.8	9.0
Eurozone pre-January 2004 (15 Countries)	11.3	11.5
Eurozone post-January 2004 (25 Countries)	11.8	12.1

Source: M. Chinn, J. Frankel: *Will the Euro Surpass the Dollar as Leading International Reserve Currency?*, mimeo, June 2005.

ever since then, a number of observers have argued that it would challenge the US dollar's hegemony.⁶ In contrast, however, Barry Eichengreen noted as far back as 1997:

"(I)ncumbency is a strong advantage in the competition for reserve-currency status. Both historical and econometric evidence point in this direction. The dollar being the reigning champion, it accounts for a larger share of global foreign exchange reserves than suggested by a simple comparison of US and EU GDP's, and it should do so for some time to come. A more institutionally-oriented analysis reinforces the point. Reserve currencies are those which are issued by the governments of countries that are international financial centres. The United States gained its status as a financial centre and the dollar its reserve-currency role only once the country acquired a central bank ready and willing to engage in day-to-day liquidity management and prepared to mount lender-of-last-resort operations. The Maastricht Treaty does not foresee the European Central Bank as assuming comparable responsibilities. This will tend to slow the development of the eurozone as an international financial centre and, by implication, limit the euro's reserve-currency role."⁷

A number of other factors have further held back the rise of the euro as a dominant reserve currency. First is the lack of economic dynamism in the eurozone compared to the USA and the urgent need for significant structural adjustments in many of the major Western European countries. Second is the widening yield differentials between the USA and the eurozone (though this is only a transitory factor).⁸ Third and more recently, the clear dissatisfaction of many European citizens with the eurozone (as evidenced by the rejection of

⁶ For a balanced discussion on the challenge posed by the euro to the US dollar, cf. R. Portes, H. Rey: *The Emergence of the Euro as an International Currency*, in: *Economic Policy*, Vol. 26, 1998, pp. 306-32.

⁷ B. Eichengreen: *The Euro as a Reserve Currency*, op. cit., pp. 23-24.

the EU constitution by France and the Netherlands in 2005) has been a further setback to the euro's challenging the US dollar. In relation to this, there remain persistent concerns that the lack of forward movement in political union in Europe has implied that the euro is a "currency without a state". For instance, an analyst from Morgan Stanley has observed:

"Europe's widening political fractures and economic divergences raise the spectre of an EMU break-up over the next five to ten years. I don't believe (and I certainly don't hope) that this is the likely outcome, but the break-up risk is larger than generally perceived. In my view, the lingering risk of an unravelling of the euro project implies that the euro will not be able to rival the dollar as a reserve currency, despite the dollar's own problems."⁹

So, in the short and medium terms, while the euro is closer to challenging the US dollar as the world's dominant reserve currency than is the yen, it is unlikely that Asian and other central banks will be willing to shift a significant share of their US dollar denominated reserve portfolios into these currencies. There has been speculation that the one currency that could possibly challenge the US dollar is the Chinese renminbi given that China is likely to become the world's largest economy and trader within the next half century. For instance, one observer has noted:

"Whatever China does, it will reveal the emergence of a wide and significant renminbi-bloc. Asia is not a dollar, or yen-bloc but a renminbi-bloc. China's likely status as the world's largest economy and trader well before 2050 marks it out as the most likely usurper of the dollar's status as the financial world's numeraire."¹⁰

While this is an interesting point of view, the acute weaknesses of the Chinese financial system and shallowness of its financial markets, the non-convertibility of its currency, and the persistent restraints on the capital account, make the possibility of the Chinese

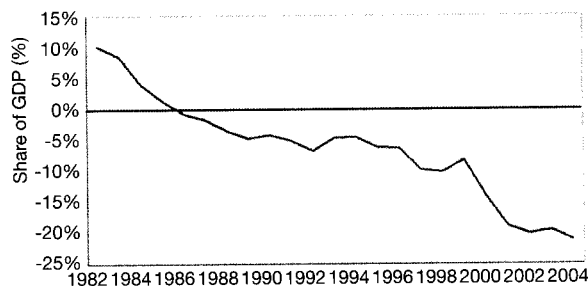
⁸ In other words, there is a need to distinguish the role of the US dollar as a funding (reserve) currency from its role in terms of providing relatively higher yields. The former is structural in nature while the latter is transitory. Cf. S. Jan: USD: From a Funding to a High-Yield Currency, in: Global Economic Forum, 30 September 2005, Morgan Stanley, <http://www.morganstanley.com/GEFdata/digests/20050930-fri.html>.

⁹ J. Feis: Global: Global: Pondering the Composition of Central Bank Reserves (Part 1), in: Global Economic Forum, 18 October 2005, Morgan Stanley, <http://www.morganstanley.com/GEFdata/digests/20051018-tue.html>; cf. also F. Bergsten: The Euro and the World Economy, mimeo, April 2005.

¹⁰ A. Persuad, S. Spratt: The New Renminbi Bloc, mimeo, June 2004.

Figure 1

US Net International Investment Position (NIIP) as a percent of GDP, 1982-2004



Source: US Bureau of Economic Analysis (BEA).

renminbi as a challenger to the US dollar extremely remote anytime in the near future.¹¹ Similar concerns rule out the currency of the other Asian giant, India, for the time being. While India's financial system is far stronger than that of China and arguably has better respect for property rights, India lags behind China in terms of trade and investment linkages with the rest of the world.

End of the US Dollar Hegemony?

Ever since 1990, once the USA became a net external debtor (cf. Figure 1), persistent concerns have been expressed about the external store of value of the US dollar – i.e. the possibility of capital losses due to sharp or prolonged US dollar depreciation.¹² This concern is a structural one and will re-emerge once the recent cyclical rebound of the US dollar (since early January 2005) dissipates. Other things being equal, the greater the unease about the prospects for the long-term sustainability of the US dollar, the more rapid will be the transition away from the US dollar. Robert Mundell, for instance, noted in 1998:

"It would be a mistake to ignore ... (the fact that) ... in the last 15 years US current account deficits have turned the US from the world's biggest creditor to its biggest debtor ... The low-saving high-debt problems will one day come home to roost ... There will come

¹¹ This point has been emphasized by B. Eichengreen: Sterling's Past, Dollar's Future ... , op. cit.

¹² It is unclear whether there is some upper limit to the amount of net claims that foreigners are willing to hold against the USA. The issue of sustainability of the US external debt position is an area in need of further research. For detailed computations and discussions of this issue see P. Gourinchas, H. Rey: From World Banker to World Venture Capitalist: The US External Adjustment and the Exorbitant Privilege, mimeo, May 2005; N. Roubini, B. Setser: The US as a Net Debtor: The Sustainability of the US External Imbalances, mimeo, November 2004. Also cf. The Passing of the Buck?, in: The Economist, December 2, 2004.

a time when the pileup of international indebtedness makes reliance on the dollar as the world's only main currency untenable ... The fact that the bulk of international reserves is held in dollars makes the currency a sitting duck in a currency crisis ... Sole reliance on the dollar as the main reserve, invoice and intervention currency presents risks that are no longer necessary."¹³

However, the "US dollar standard" has proven to be very resilient since the second half of the 20th century. The US dollar functions as a reserve currency as it has been the preferred international currency of choice for the invoicing of transactions, for currency pegs, and as a medium of exchange.¹⁴ The military and geopolitical clout of the USA (particularly critical in this day and age of global terrorism) and the deeply entrenched network externalities that are enjoyed by the incumbent will work in tandem to ensure that the US dollar will remain the dominant reserve currency for a long time to come. This point has some empirical validation. A study of the currency composition of global reserves in the 1970s, 1980s and 1990s arrives at the following conclusion:

"We do not detect radical shifts in the currency composition of reserves over time. The choice of reserve asset by developing countries continues to be influenced by a dense web of exchange rate, financial and commercial links with the reserve-currency countries, which itself continues to develop gradually over time. To be sure, there are ongoing changes in these relationships and policies ... (b)ut these are evolutionary processes, which again suggests that the currency composition of reserves will change gradually, not discontinuously. There are plenty of potential sources of instability affecting exchange rates and the international monetary system. But ... instability in the demand for reserves seems unlikely to be one of them."¹⁵

While there may be some concern about the store of value function of the US dollar over time, the US economy will have to significantly underperform the

rest of the world on a sustained basis for it to lose its global dollar hegemony. Indeed, given the desire by central banks and other investors for greater yields on their reserves, it is possible that they will choose to shift more of their assets into longer yielding US assets rather than into other currencies. As such, while accepting the possibility of capital losses (in the event of a longer term decline in the US dollar), investors are at least being partly compensated for taking on greater liquidity risk by extending the duration of their portfolios. As noted by an analyst from Morgan Stanley:

"(A)s central banks shift from a traditional liquidity management posture to a return-enhancing investment strategy, reserve diversification ... does not necessarily mean US dollar selling or US dollar weakness ... The US corporate bond market accounts for close to three times the corporate bond market in euroland, and 3.5 times as big as in Japan. In fact, this market is bigger than the other corporate bond markets combined. Similarly, the total market cap of the US equity market is dominant, 2.5-3 times bigger than the markets in euroland or Japan. Therefore, as central banks diversify across assets, there is greater justification to increase their exposure to US dollar risky assets ... Thus, if central banks diversify ... it is far from clear it will be US dollar-negative."¹⁶

Conclusion

Summing up, while the US dollar may remain the dominant reserve currency, its share of global reserves may see a rather gradual but distinct decline over time. The world is likely to shift gradually to a multiple reserve-currency system involving the US dollar, the euro and one or more Asian currencies. This shift is more likely to occur if:

- European countries are able to overcome their continuing structural impediments economy and the institutional commitment to the eurozone is renewed, and some key players such as the UK (with its large financial markets) join the eurozone;¹⁷
- the Japanese economy is also successfully restructured and it returns to a path of sustained robust growth;
- some important commodities such as oil are increasingly invoiced in currencies other than US dollar, and

¹³ R. Mundell: The Case for the Euro - I and II, in: Wall Street Journal, March 24 and 25, 1998.

¹⁴ For an elaboration of the functions of an international currency, cf. P. S. Pollard: The Creation of the Euro and the Role of the Dollar in International Markets, in: Federal Reserve Bank of St. Louis Review, September/October 2001, pp. 17-36. Also cf. J. Frankel, M. Chinn, op. cit.

¹⁵ B. Eichengreen, D. Mathieson: The Currency Composition of Foreign Exchange Reserves: Retrospect and Prospect, IMF Working Paper No.00/131, 2000, p. 17. Also cf. J. Frankel, M. Chinn, op. cit.

¹⁶ S. Jens: USD: Is Reserve Diversification Negative for the Dollar?, in: Global Economic Forum, 16 September 2005, Morgan Stanley, <http://www.morganstanley.com/GEFdata/digests/20050916-fri.html>.

¹⁷ This point has been emphasised in the empirical analysis by J. Frankel, M. Chinn, op. cit.

the surpluses of major oil-exporting countries or "petrodollars" are consequently converted to "petro-euros";¹⁸

- Asian countries enhance regional financial and monetary cooperation,¹⁹ including taking further steps towards strengthening the Asian Bond Fund initiatives (where Asian bonds are issued in local currencies);

¹⁸ While the run up in oil prices has led to increased savings by oil exporting countries, their share of global reserves (relative to Asia) has declined significantly since the 1980s (though some non-OPEC member countries like Russia have seen a significant rise). This having been said, a significant shift into euro by oil exporting countries could have major consequences on currency markets. The data on the extent of recycling of oil revenues into US dollars or other assets appears to be too limited, however, to allow more specific comment on this issue. For useful discussions of this issue, see R. McCaughrin: Global: Pump Pains and Petrodollars, in: Global Economic Forum, 17 May 2005, Morgan Stanley, <http://www.morganstanley.com/GEFdata/digests/20040517-mon.html>; and S. Jen, M. Baker: Redirection of Petrodollars a USD Negative?, in: Global Economic Forum, 17 May 2005, Morgan Stanley, <http://www.morganstanley.com/GEFdata/digests/20030307-fri.html>.

¹⁹ For a detailed discussion of monetary and financial cooperation in Asia, see papers in Asian Development Bank: Monetary and Financial Cooperation in East Asia, Vols. 1 and 2, 2004, Palgrave-McMillan Press for the Asian Development Bank.

- Asian and other currencies continue to move way from pegging to the US dollar.²⁰

However, it is very likely that America's "exorbitant privilege" of being Asia's and the world's reserve currency will be sustained for some time to come.

²⁰ This point is of particular importance. While the US dollar's share of global reserve portfolios may be high relative to the global share of the US economy (in purchasing power parity terms), it is in line with the global share of the de facto dollar zone (i.e. those countries pegged to the US dollar). Cf. BIS: 75th Annual Report, Basle 2005. As the report notes: "(T)he notion can be disputed that official reserves are overweight in dollars. Excluding Japan, the dollar share of foreign exchange reserves may have been no more than 57% in mid-2004. (Unreported forward sales of dollars against euros could lower this figure further.) Such a share is high in relation to the share of the US economy in the world economy, but not necessarily in relation to the share of the dollar zone in the world economy. If one allocates economies, measured at purchasing power parity, to the dollar, euro or yen zones according to the behaviour of their currencies ..., the dollar zone produces an estimated 59% of global output ... This is almost identical to the current dollar share of reserves outside Japan ... In sum, the case for a portfolio imbalance, including in official portfolios, seems weaker than much commentary would suggest. There remains, however, a pending problem. The dollar zone has been shrinking, and any acceleration of this could eventually give rise to a portfolio imbalance in both the private and official sectors." (p.96).

Carsten Hefeker*

Rivalling the Dollar? Prospects for the International Role of the Euro

The introduction of the euro as a common currency for Europe is a tremendous change to the international financial architecture. Bringing together under one currency 12 countries, some 307 million people, a combined GDP that rivals that of the United States, and a share in world trade about 25 per cent higher than that of the USA, the new currency has by definition international importance. Moreover, as countries in eastern Europe and the further periphery of Euroland prepare for a later membership in the euro area, the currency will become even more important in the longer time perspective. But will the euro's role be confined to that of a regional currency only, not used outside the (enlarged) euro area, or will it be used in

other areas of the world as well, like the US dollar is used beyond the borders of the United States?

This is no trivial question because being a world currency has important advantages, as well as some disadvantages. Speaking about the US dollar under the Bretton Woods system, French president Charles de Gaulle lamented its "exorbitant privilege", enabling the US government to run current account deficits and simply pay for them by issuing domestic currency.¹ Much as Europe accepted the dollar as the leading currency, a similar role is now played by China,

¹ This is the basis of the famous "Triffin-Dilemma", described in R. Triffin: Gold and the Dollar Crisis, New Haven 1960, Yale University Press. The world being on a dollar standard in the Bretton Woods system required that the USA supply the world with enough dollars. Issuing too many dollars on the other hand would ultimately undermine the dollar's credibility. This is exactly what happened in the 1960s.

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