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The U.S. dollar vs the Euro in Latin America: A love-hate relationship

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The U.S. dollar vs the Euro in Latin America: A love-hate relationship

The United States enjoys exorbitant privileges because of the status of the dollar

- M. d'Estaing

Introduction

Since the start of the Economic and Monetary Union (EMU) and the introduction of the euro, a debate began on whether the euro would challenge the US dollar hegemony as an official reserve currency. The introduction of the euro greatly changed the functioning of the financial markets worldwide. The euro's financial market has increased the currency's liquidity and breadth over the years, comparable to those of the dollar markets. This brewing strength has made monetary authorities reconsider the currency composition of their reserves in order to accommodate the euro, which was expected to erode the pre-eminence of the US dollar as a reserve currency.

This paper investigates whether the euro has developed into an official reserve currency on par with the US dollar. This is of significance specifically for Latin American countries which have been historically debating the dependency on the US dollar. Nevertheless, the findings of this study will show that the introduction of the euro has not yet resulted in a significant change in the currency composition of official reserve holdings, not even in Latin America. The US dollar still maintains its place as the dominant reserve currency in Latin America.

The Euro as an International Currency

The euro was nominally introduced on January 1st,1999. Since its inception, the euro has been a successful common currency for all countries of the Eurozone. As the data shows, the euro has contributed to integration on many levels. Eurozone Member States have experienced an increase in trade as the euro has not only reduced both direct and indirect trading costs but has also removed the exchange risk and the cost of a currency hedge. The euro, as a common currency, has also allowed for price transparency and has reduced price discrimination. Most importantly, the euro has reduced competitive devaluations, which have helped bolster foreign direct investments. Ultimately, the euro has brought countries together.

Despite its integrating effect, the euro is nothing but money. Economic theory explains that money refers to circulating currencies assigned legal tender status by a national state and government. A national currency can become an international currency when it serves as a unit of account, a store of value, and as a medium of exchange (Truman 1999) in both the private and public sector. Just a handful number of national currencies can be considered international currency which implies that they play an active role in both international trade and financial transactions. Table 1 outlines the three major functions that all currencies must fulfill in order to become an international currency (Pollard 2005, 260).

Table 1. Functions of an International Currency

	SECTOR	
Function	***Private***	***Public***

Unit of Account	*Invoice*	*Exchange Rate Peg (monetary anchor)*
Store of Value	*Financial Assets/Banking*	*Reserves accumulation*
Medium of Exchange	*Vehicle/Substitution*	*FX Intervention*

The euro is an international currency which has also taken on the role of an alternative currency for countries that have constantly complained about the US dollar hegemony and have blamed the North American currency for their respective lack of economic and financial development. Mundell (1999, 4) explains that a currency is international “when it is used outside the domain in which it is legal tender.” The markets, rather than national governments, decide which currency will become international. The size of the economy, the strength of the financial system, the value and stability of the national currency and political situation of the country are the biggest determinants. According to Benjamin Cohen (2007, 104), there are four benefits to becoming an international currency: the potential for seigniorage, flexibility to implement macroeconomic policy, gain in status and prestige or “soft power”, and increase influence from the monetary dependence of others, in a form of “hard” power.

The euro has become not only a successful integrating currency, which is now the common currency of nineteen of the twenty eight European Union member state, but also, as Trichet explained, demonstrated that ¨one single currency is more efficient than multiple currencies in performing the roles of a medium of exchange and unit of account (Trichet 2006, 2). Thus, soon after its introduction, it has succeeded in becoming an international currency and as a reserve currency which as Pedro Gomis- Porqueras and Joaquín Roy (2007, 230) explained, has come to interrupt the almost century long hegemony of the US dollar as the de facto reserve currency available. The introduction of the euro has changed this monopoly, whose strength rests not only “on the ability of policy makers to implement consistent and sustainable economic policies that can promote economic growth,” but also on being “a symbol of common identity, shared values and the success of European integration in bringing the people and nations of Europe together” (230).

A Reserve Currency: The euro worldwide

Gabriele Gelati and Philip Wooldridge (2006) explained that an international currency used by the “official sector” to “support their use of the exchange rate in their monetary policy framework, to intervene in foreign exchange markets, or to safekeep wealth” (7) is referred to as a “reserve currency.” Further, they explain that “the emergence of a reserve currency is influenced by at least four factors.” (7) They state that the country’s share in world output and trade, macroeconomic and price stability, financial market size and liquidity, and other’s reasons to accumulate a reserve currency truly shape the evolution to a reserve currency.

Historically, there have been three main motives behind accumulation of international reserves (Roger 1993). First, reserve currencies may be held for financing foreseeable foreign exchange demands of the public and/or the private sector; a minor issue for developed countries with good access to international capital markets but of otherwise significant importance for developing countries. Secondly, reserves are also important for the purpose of foreign exchange intervention as a precautionary measure, especially for those countries with very open goods and capital markets and/or fixed exchange rates. Finally, there is the wealth diversification component which entails that “the central bank has some responsibility for managing the net foreign currency exposure of the public sector or, perhaps, of the country as a whole.” (Roger 1993, 13) There are three sources of data on the composition of reserves, but they are all incomplete: national sources, surveys and counterparty data. This study will use national sources which provide the most detailed, but still very limited data, as not all central banks publish detailed accounts on their reserves or have, otherwise, very short time series. The IMF reports quarterly the total Currency Composition of Official Foreign Exchange Reserves (COFER) of U.S. dollars, euros, pounds, yens, Swiss francs, and other currencies. Unfortunately, the IMF does not report what is the reserve currency composition of each particular country because countries are not mandated to report it. Table 2 presents a summary of the four main reasons behind central banks' interests in holding a particular currency as an official reserve currency. It is of particular interest, the so-called "other's reasons" which could be summarized as the need to maintain reserves to face foreign exchanges demands and allow for intervention in the markets, and to help with wealth diversification.

Table 2: Official Reserves

A. World output and trade	
B. Macro and price stability	
C. Market size and liquidity	
D. Other Reasons such as:	
	Foreign exchange demands
	Foreign exchange intervention
	Wealth diversification

The Bretton Woods agreements witnessed the demise of the Pax Britannica and the rise of the Pax Americana, in which the U.S. dollar replaced the British pound sterling as the world's reserve currency. This was a logical substitution as the US became the leading economic world power, and the U.S. dollar was, at that time, the currency with the greatest purchasing power and the only currency truly backed by gold. Nowadays, despite all economic and political contingencies, the US dollar still maintains its hegemony as a secure and portable asset that will hold its value over time. However, Figure 1 demonstrates that the green-back has been gradually declining as a reserve currency worldwide, while curiously, the euro has been adopted in more developed than developing economies. Nonetheless, the level of U.S. dollar holdings as an official reserve currency has not suffered a dramatic decline nor has the level of the euro increased significantly.

After its inception, the euro became not only the second most held international reserve currency after the US dollar, but also the second most used reserve currency. The North American currency continues to be the primary reserve currency of most commercial and central banks. Nonetheless, since its introduction, the possibility of the euro becoming the first international reserve currency, and how it could be used to substitute the dominance of the US dollar have been debated (Freizas et al. 2004; Swoboda 1969, Cohen 1971, Mckinnon 1979, Kindleberger 1981, Krugman 1984, Eichengreen 2006, Flandreau and Jobst 2006). Some believe that the euro will not challenge the dollar supremacy (Frankel 1995, Feldstein 1997, Cohen 2003, Cooper 2000, Truman 2004, and Eichengree 1998) while some believe that the euro will (Kenen 1995, Bergsten 1997, Alogskoufis and Portes 1997, Chinn and Frankel 2005).

An analysis of the evolution of reserve composition in developed countries from the first quarter of 2000 to the first quarter of 2014 shows that the North American currency has suffered a decline from 71.20% to 64.42% while the euro has increased its presence from 17.48% to 21.59%. This shows a decrease in US dollar of 6.78% as well as an increase in euros of 5.11% as a reserve currency. The analysis of the composition in emerging economies does however provide a different picture. According to the Currency Composition of Official Foreign Exchange Reserves (COFER), the allocated reserves claim in US dollars decreased from 73.53% to almost 67.8%. The euro, meanwhile, increased from 18.21% in the first quarter of 2000 to a record high of 30.57% in the second quarter of 2009 to suffer a significant decrease to levels of 18.22% in the first quarter of 2014. (Figure 1) It must be stressed that the real composition of foreign currency reserves is not easy to calculate because ¨fifty percent of total reserves are disclosed, 24% are not disclosed and another 26% are held by sovereign wealth funds (SWF) and are only estimated because they are not exactly known.¨ (Guillermo de la Dehesa 2009, 12)

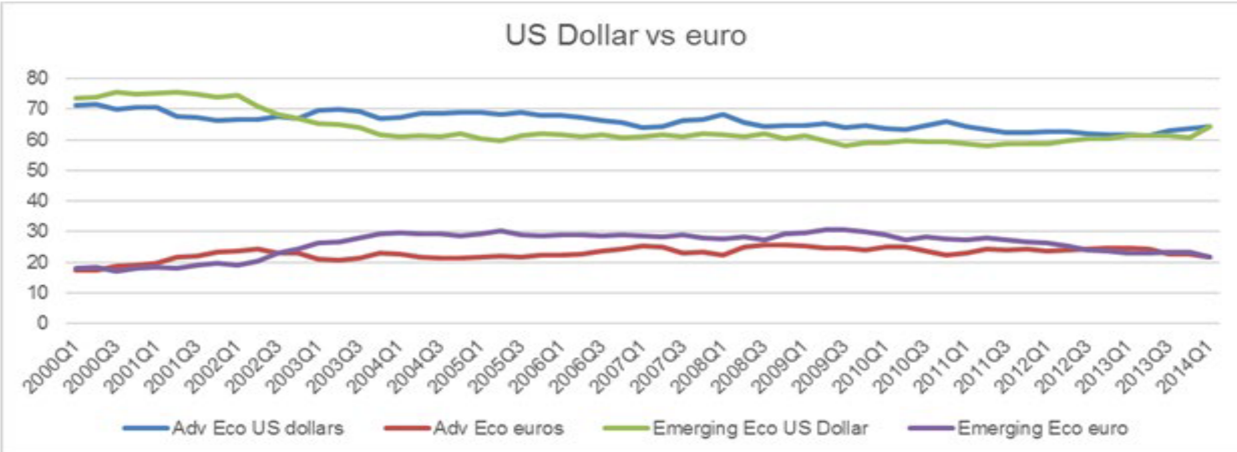

Figure 1: The US dollar and the euro

Source: International Monetary Fund, "Currency Composition of Official Foreign Exchange Reserves (COFER)." http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf (accessed October 2, 2017).

The European Central Bank (2016) corroborates the findings presented above. The ECB explained that the euro "remained the second most important currency in the international monetary system, but with a significant gap to the US dollar" (4). The ECB recognized that the international role of the euro as an official reserve has fallen significantly since its peak in 2009. However, the net monthly shipment of euro banknotes to countries outside the euro area, which is another indicator of the international use of the euro, has increased significantly since January 2009, which has peaked in mid-2015 and remained stable since. (ECB 2016, 6) Nonetheless, the US dollar has also suffered a decline, reaching 64% in 2015— which is the lowest share since 1999. The ECB explains that "the decline in the shares of both the euro and the US dollar may suggest a trend towards greater multipolarity in the international monetary system." (ECB 2016, 5)

However, Jeff Frankel and Menzie Chinn (2005, 14) concluded that the euro would take over the dominance of the U.S. dollar as a reserve currency *if* the Eurozone economy was to become larger than the U.S. economy and *if* macroeconomic instability were to "undermine … confidence in the value of the dollar, in the form of inflation and depreciation." It is in fact true that when the Great Recession hit the US economy and the US dollar began to depreciate against the euro, it was indeed suggested that the green-back was on the road to lose its status as a reliable reserve currency. Regardless of such downswing in the US, it is expected that the euro will continue to increase its presence as a reserve currency as both China and Middle Eastern countries continue to reduce their currency pegs to the U.S. dollar and increase their reserves with respect to the euro along with a basket of multiple other currencies. Figure 2 shows the evolution of the US dollar, the euro and the British pound from 2002 to 2015.

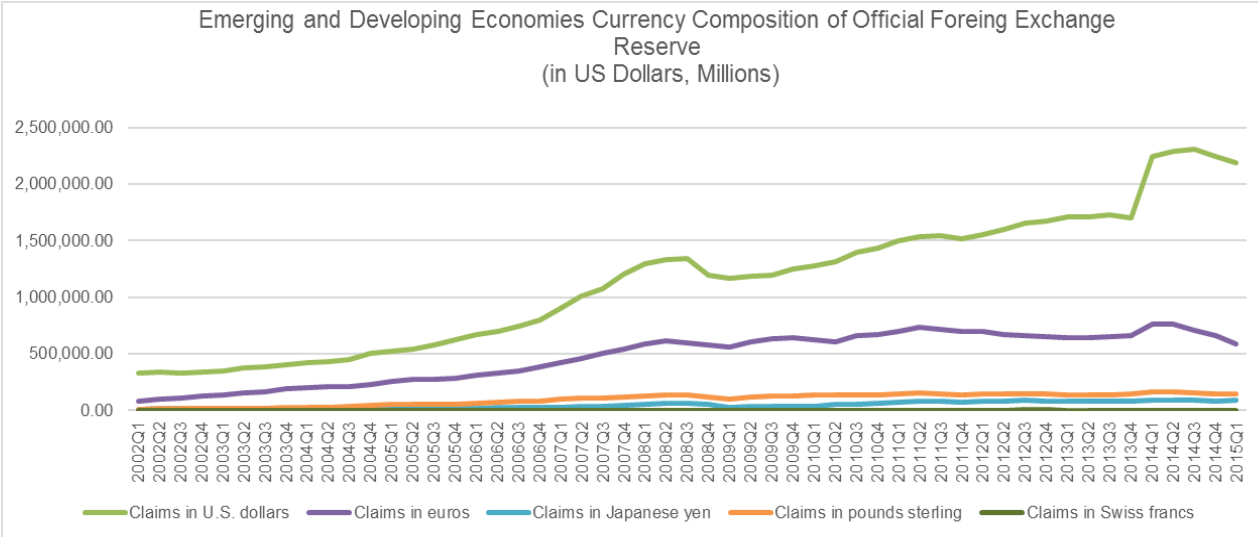

Figure 2: Evolution of currencies as reserve currencies according to the IMF

Source: International Monetary Fund, "Currency Composition of Official Foreign Exchange Reserves (COFER)." http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf (accessed October 2, 2017).

The US dollar in Latin American countries: Dollarization and prosperity?

Governments have held reserve currency in significant quantities for many economic reasons, such as having a means of international payment, financing imports, paying foreign debt, helping determine sovereign rating, and intervening in currency markets in order to manage the exchange rate.

The introduction of the euro made interesting the study of how countries worldwide, especially in Latin American countries, have diversified their reserve holdings compositions.[1] Robert Gilpin (1987) explained that "the world economy in the 1980s is in the midst of a significant transitions from the norms and relationships embodied in the Bretton Woods system towards a different mode of organization and functioning of the global economic system." (360) The demise of this system has brought about a new reality of "sub-systems" which are based upon different key currencies. These currency areas coexist as being the "dollar bloc," with one of them operating in Latin America. Pfister and Suter describe these as a "feudal structure of the world-system … a situation with a highly structured core and a rather passive and unstructured periphery." (1987, 262)

These currency areas have created a power relation which can be interpreted as a new element of dependency in relations between the US and Latin America (Jameston 1990). This influences how Latin

[1] Reserve currencies are held at the nation's central bank. While most central banks offer an estimate of the total currency reserve held, each central bank is free, however, to report the foreign exchange reserves composition by currency.

America makes decisions (Dos Santos 1970) and, most importantly, helps develop a dependency which since 1980, has been taken as a preventing factor for the prosperity and development of the region (Gunder Frank 1969). Thus, the introduction of the euro could have been seen as the needed element for some Latin American countries to break their highly debated dependency on the US dollar.

In Latin America, the US dollar has been the currency of reference sometimes willingly or unwillingly, which explains the different degrees of dollarization that can be found in the region. Dollarization can range from full to partial, depending on the demand of foreign currency by local economic agents. Dollarization takes place when high inflation, often times hyperinflation, prevents the national currency to act a stable medium of exchange and/or a store of value.

Partial dollarization has a number of costs and benefits for the country utilizing it. It is likely the country will experience the Gresham's Law by which the weak currency will drive out the hard currency resulting in hard currency hoarding. Full dollarization is a strategy in which one country adopts the currency of the USA because of its position as a dominant trade and investment partner. This produces a currency substitution. Full dollarization is, therefore, on the other end of the dollarization spectrum and as of today, only three Latin American countries has chosen this option: Panama adopted the dollar in 1904 right after its independence from Colombia, Ecuador made the switch in 2000, and El Salvador in 2001.

It is more common to see that countries in Latin America chose to hold large sums of a foreign currency in reserves in order to support national currencies as a means of payments or as a store of value. Adopting the currency of another country does not guarantee any short path to economic and/or political success. The adoption of the US dollar as the national currency in Panama, Ecuador and El Salvador has not helped improved economic prosperity which can be measured by analyzing the 2017 Index of Economic Freedom[2] published by The Heritage Foundation and the Global Competitive Report 2017- 2018 published by the World Economic Forum[3]

The Global Competitiveness Index shows that these three countries have systematically lost competitive ground since 2001[4] with Panama ranking 48 out of the 137 countries tested, El Salvador placing 64th, and Ecuador coming in at 72nd. In 2016[5] Panama dropped to the 50th place, El Salvador to 97th, and Ecuador to a worrisome 109th position out of the 137 countries ranked. Figure 3 shows the evolution of Index of Economic Freedom in these three countries from 1995 to 2017. It clearly shows that while economic freedom is on the rise worldwide, these three countries are experiencing a significant decline of their own economic freedom. These two studies demonstrate that adopting a currency is not necessarily a ticket to economic prosperity, stability, and growth. It also does not guarantee economic competitiveness and freedom. To achieve such economic benefits, countries must complement dollarization with deep structural and institutional reforms.

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[2] The Heritage Foundation, "2017 Index of Economic Freedom." http://www.heritage.org/index/about

[3] The World Economic Forum, "The Global Competitive Report 2017-2018," Oxford University Press, 2017. https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018

[4] World Economic Forum, "The Global Competitiveness Report 2001-2002," Oxford University Press, 2001. http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.476.4940&rep=rep1&type=pdf

[5] World Economic Forum. "The Global Competitiveness Report 2017-2018." http://reports.weforum.org/global-competitiveness-index-2017-2018/preface/

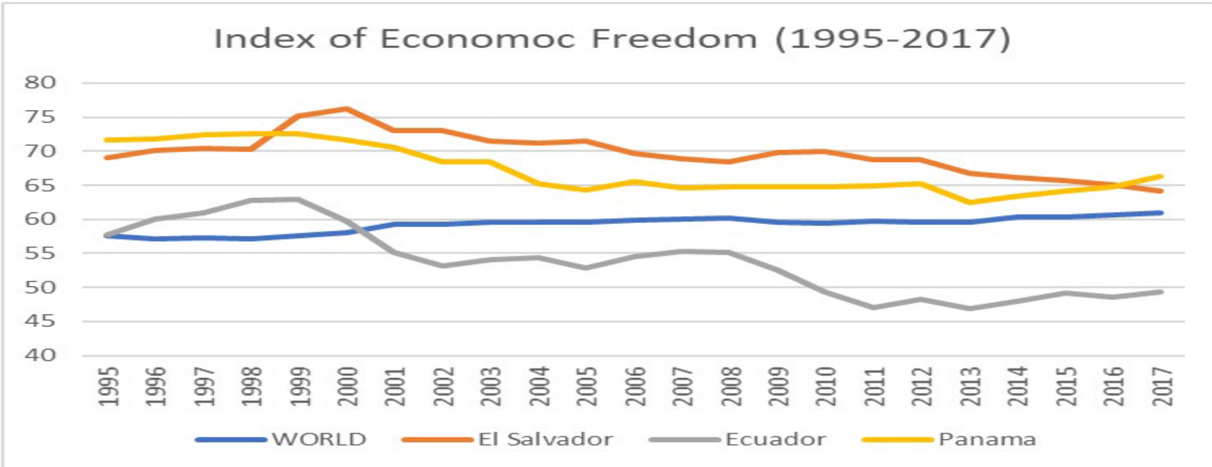

Figure 3: Index of Economic Freedom from 1995 to 2017

Source: The Heritage Foundation. "Index of Economic Freedom."
http://www.heritage.org/index/visualize

The Economist Intelligence Unit (EIU) publishes two indexes which demonstrate that democracy has not been strengthened with the adoption of the US dollar. The Democracy Index[6] measures the state of the democracy of countries based on five criteria—electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture—classifying them as "full democracy" ranging from 8 to 10 points; "flawed democracy" ranging from 6 to 8 points; "hybrid regime" from 4 to 6; and "authoritarian regime" from 0 to 4 points. According to this index, both Panama and El Salvador have been classified since 2007 as flawed democracies while Ecuador has been classified as a hybrid democracy. Figure 4 plots the evolution of this index for these three Latin American countries as well as the US. The Political Instability Index measures the level of threat posed to local governments by social protest and ranks countries on distress and vulnerability to unrest.[7] The 2009/2019 results show that out of the 165 countries analyzed—with Norway being the most stable country with an index of 1.2—Ecuador is the most unstable of the three ranking 14th with an 7.7 instability index, followed by Panama raking 33rd with a 7.1 instability index, and El Salvador raking 113th with a 5.2 instability index.[8]

[6] The Economist Intelligence Unit, "The Democracy Index." https://www.eiu.com/topic/democracy-index
[7] The Economist Intelligence Unit, "Political Instability Index."
http://viewswire.eiu.com/site_info.asp?info_name=social_unrest_table&page=noads&rf=0
[8] The Economist Intelligence Unit, "Political Instability Index."
http://viewswire.eiu.com/site_info.asp?info_name=social_unrest_table&page=noads&rf=0

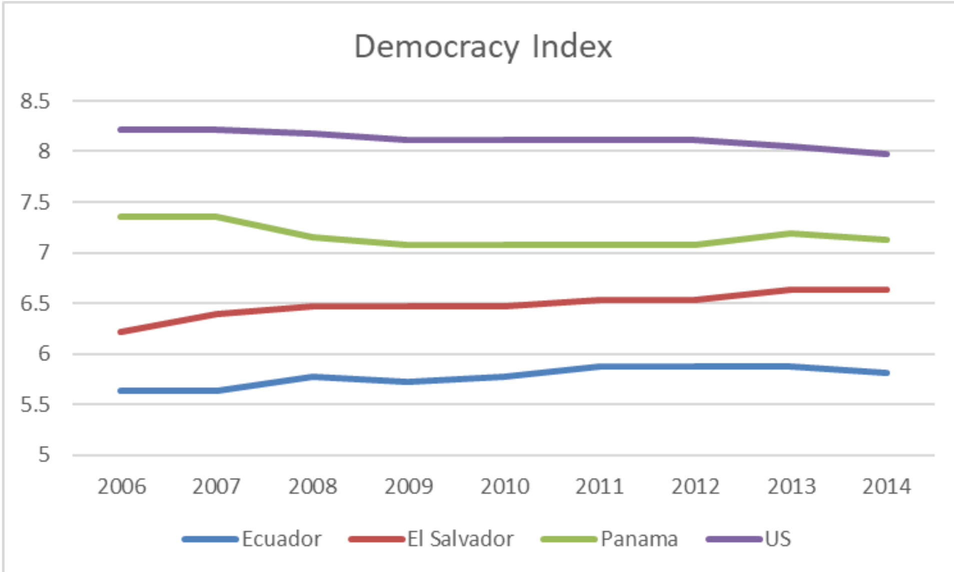

Figure 4: Democracy Index from 2006 to 2014

Source: The Economist Intelligent Unit, "Explore the Democracy Index Results 2006 to 2016." https://www.eiu.com/topic/democracy-index

The Euro in Latin America: Breaking the Dependency?

The study of how some Latin American countries have welcomed the euro and diversified from the US dollars is quite interesting. The analysis shows that, on one hand, the American dollar is the preferred currency, although the introduction of the euro has slowly eroded the supremacy of the North American currency. However, the data shows that after the economic crisis of 2008, the euro lost all historic gain and its presence in most Latin American countries becomes almost non-existent.

When it comes to the analysis of the reserve accumulation and diversification, the Central Bank of Brazil defines "the allocation of the international reserves is based on criteria of safety, liquidity and profitability, prioritized in this order."[9] Since the introduction of the euro, the Bank of Brazil has not only included it as a reserve currency but also has changed its percentage weight over time. The following graph shows that the percentage of euros held reached 35.1% in 2004 dropping to 7% in 2009 and reaching just 4.4% in December 2016.[10] At the same time, the US dollar made 90% of the reserve currencies in 2017,

[9] Banco Central do Brasil, "International Reserve Management Report," December 2016, volume 8. http://www.bcb.gov.br/pom/gepom/relgestri-i/2016/12/intenational_reserves_management_report_2016.pdf
[10] Banco Central Do Brasil, "Relatorio de Gestao das Reservas Internacionais," Vol 9, September 2017. http://www.bcb.gov.br/pom/gepom/relgestri/2017/09/relatorio_anual_reservas_internacionais_set2017.pdf

while dropping to 83.5% in December 2016, because of "other"[11] currencies gaining terrain at the expense of both the US dollar and the euro. Thus, the US dollar is still the dominant reserve currency in Brazil although its percentage has been fluctuating and even declining. Meanwhile, the euro has not been gaining much terrain against the North American currency.

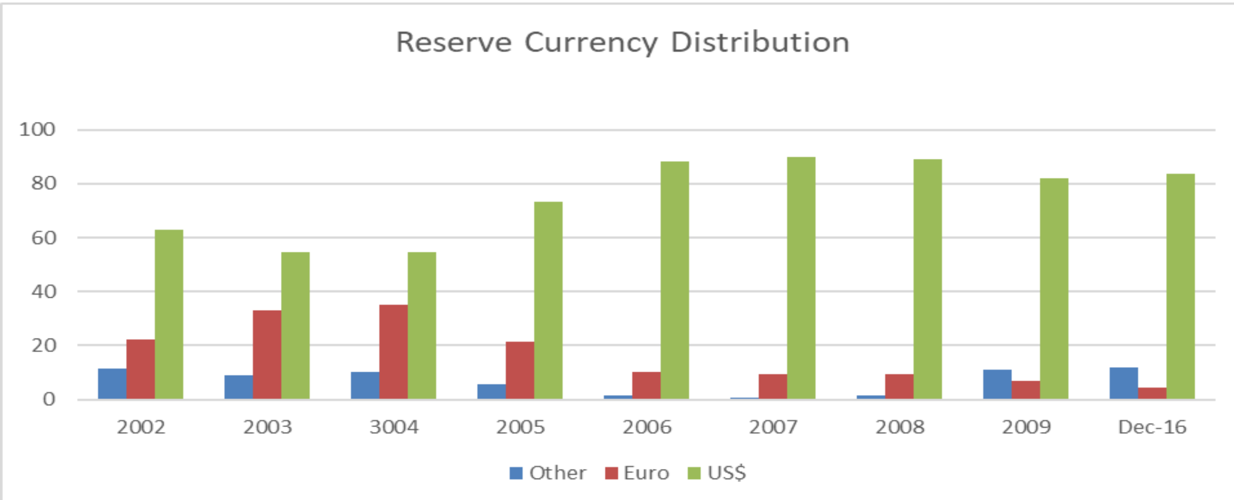

Figure 5. Banco Central do Brasil

Source: Banco Central do Brasil. 2010. "Relatorio de Gestao das Reservas Internacionais." http://www.bcb.gov.br/pom/Gepom/relgestri/relgestresint062010.pdf (accessed September 2, 2010)

The Currency Composition of Foreign Exchange Reserves for Chile and Peru shows that the share of the euro in the total foreign reserve holdings was extremely low for these respective countries. A detailed analysis of these findings in each country corroborates the conclusions. (ECB 2010)

[11] Canadian dollar, Pound sterling, Australian dollar,

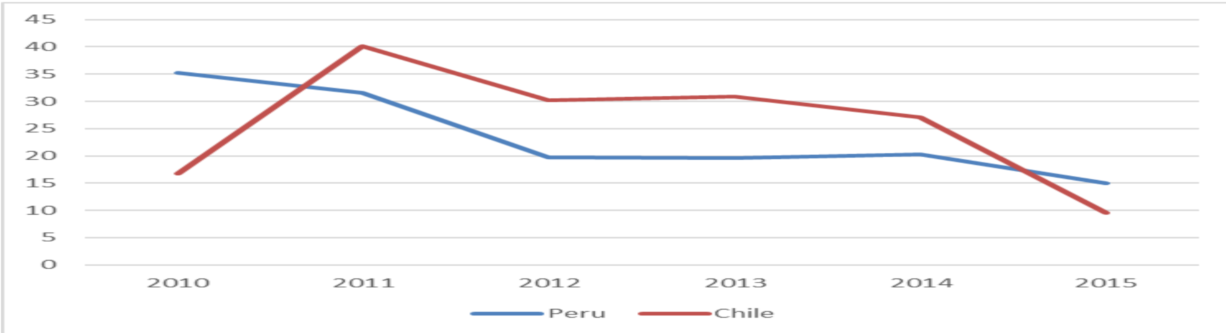

Figure 6: Currency Composition of Foreign Exchange Reserves

Source: European Central Bank. The International role of the euro. June 2016.

The Bank of Chile explains that the international reserves "are used to support monetary and exchange rate policy in compliance with the Central Bank's objective of safeguarding the stability of the currency and the normal functioning of the internal and external payment systems. Under the current floating exchange rate policy, their main function is to ensure access to liquidity in foreign currency in order to intervene in the foreign exchange market or to provide temporary liquidity in foreign currency in specific exceptional circumstances."[12] A detailed analysis of the currency reserve accumulation and composition in Chile demonstrates that the amount of US dollars held in reserves surpasses the amount held in euros. Starting in the first quarter of 2007, there was an increase in euros and a significant decrease of US dollars held at the Central Bank of Chile. This trend made some economists believe that both currencies were closely converging. However, by 2012, the euro amount held at the central bank had decreased to an almost non-existent level in terms of being a reserve currency.

[12] Banco Central de Chile, "Management of Foreign Exchange Reserves at the Central Bank of Chile 2012."

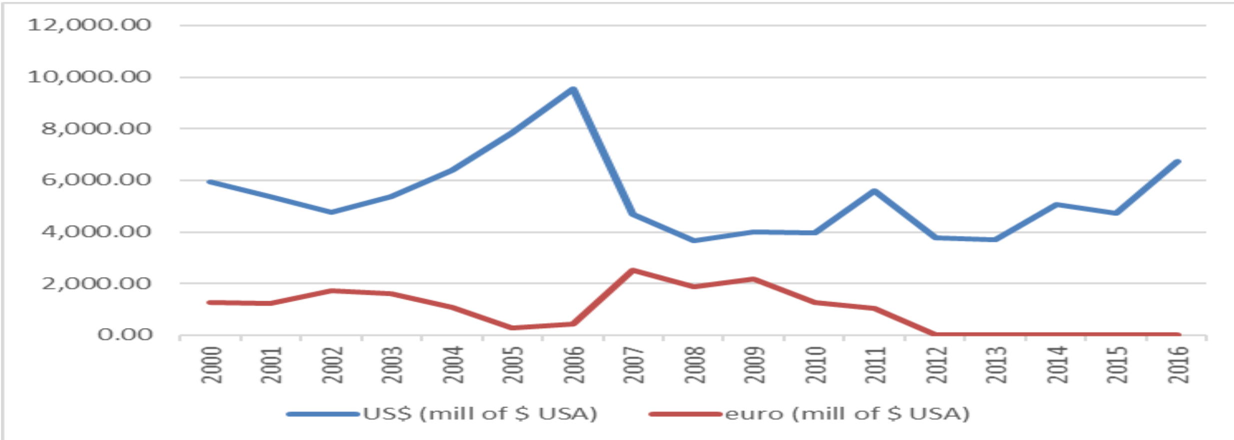

Figure 6. Central Bank of Chile, International Reserves

Source: Banco Central de Chile. "Reservas Internacionales."
http://si3.bcentral.cl/Boletin/secure/boletin.aspx?idCanasta=SF31O2149
http://www.bcentral.cl/eng/economic-statistics/series-indicators/index_es.htm

According to Article 84 of the Constitution of Peru, one of the four duties of the Central Reserve Bank of Peru (CRBP) is to manage international reserves.[13] Furthermore, the CRBP defines that "net international reserves (NIRs) are the international liquid assets required by a country to face adverse macroeconomic shocks (…) International reserves allow facing unexpected capital outflows and reducing the exchange rate volatility."[14] The official reserve evolution and composition data in Peru demonstrates that, from April 2002 to September 2017, the country has been experiencing an increase in the total amount of foreign reserves, while the currency composition of its reserves has only been slightly changing. In fact, the greenback makes up most of the percentage composition while the euro is included in the group of "other" currencies together with the Japanese yen, the pound sterling, and the Canadian dollar. Thus, the Central Reserve Bank of Peru does not view the euro as an alternative currency capable of breaking the sovereignty of the US dollar.

[13] Central Reserve Bank of Peru, "About the CRBP." http://www.bcrp.gob.pe/about-the-bcrp/frequently-asked-questions.html#17
[14] Central Reserve Bank of Peru, "Frequently asked questions." http://www.bcrp.gob.pe/about-the-bcrp/frequently-asked-questions.html#17

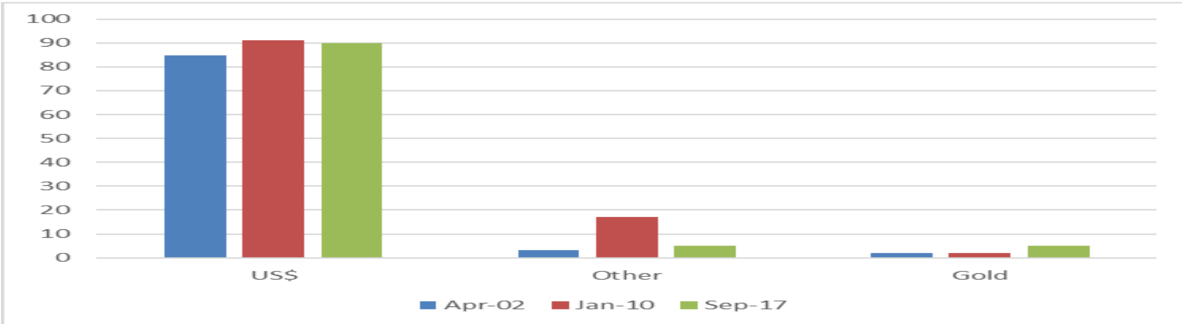

Figure 7. Currency Composition of Foreign Reserve Currency in Peru

Source: Banco Central de la Reserva de Peru, "Reserveas Internacionales."
http://www.bcrp.gob.pe/reservas-internacionales/gestion.html
(accessed September 2, 2017)

The Republic of Colombia has two clear objectives for the accumulation of international reserves. One is to have access to the foreign exchange market to maintain the Colombian peso stable. The second is to have access to international capital markets.[15] The Central Bank of Colombia maintains its reserves fixed with 80% invested in US dollars, 15% in euros, and 5% in Japanese yen.[16] The following graph shows that since 2000, the Central Bank of Colombia has been accumulating reserves at a significant rate.

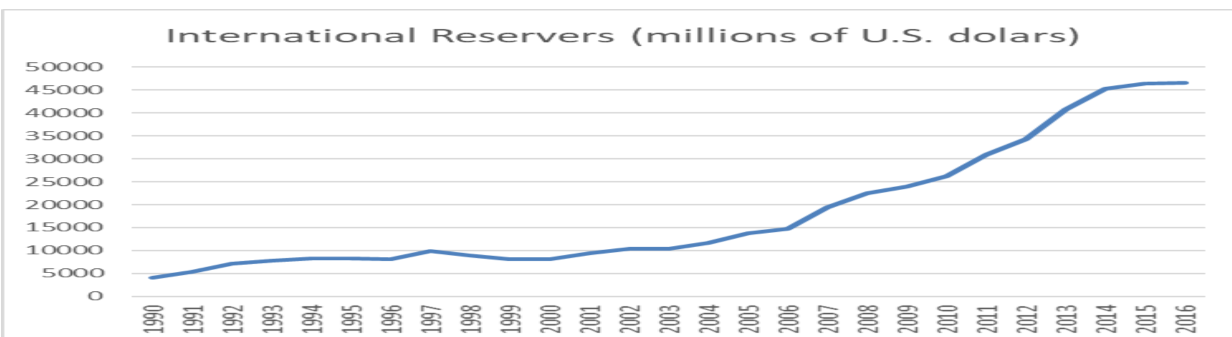

Figure 8: Central Bank of Colombia International Reserves from 1990 to 2016

Source: Banco de la Republica de Colombia. Saldo de la Reserva Internacionales.
http://www.banrep.gov.co/es/saldo-reservas-internacionales

[15] Banco de la Republica de Colombia, "Informe de administración de reservas internacionales," March 2017. http://www.banrep.gov.co/es/administracion-reservas-internacionales-marzo-2017
[16] Banco de la Republica de Colombia. "Que son las reservas internacionales." http://www.banrep.gov.co/es/contenidos/page/qu-son-las-reservas-internacionales

Final Words

The introduction of the euro as a common currency has been a success story for the Eurozone countries while it has additionally evolved to become a solid international currency. However, the euro as an official reserve currency has shown mixed results. While the percentage of euros held as official reserve currency has been significant among developed countries, its presence in developing countries, mainly in Latin America, has surprisingly deviated from what was expected. The reason for this lagging performance should be further analyzed in a more in-depth study in order to present a better understanding of this reality.

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