UNITED STATES DOLLAR TRIUMPHS OVER EUROPE

In a stunning worldwide move, the U.S. Federal Reserve in coordination with the European Central Bank, Bank of Canada, Bank of England, Bank of Japan, European Central Bank, Swiss National Bank and China's Monetary Authority agreed to temporarily "dollarize" the euro. Facing a vicious bank liquidity crisis and a political nightmare; the German dominated European Central Bank (ECB) agreed to the virtual outsourcing of Europe's monetary policy to the U.S. Federal Reserve. Although described as a precautionary arrangement for political cover; the "dollarization" of Europe has re-established the U.S. dollar as the world's only reserve currency.

Twenty years ago, European nations sought to form their own reserve currency to limit the power of the United States in controlling their economic destiny. Following World War II, the U.S. took control of European monetary policy by pouring over $50 billion of cash into the war shattered economies. Over time, sovereign currencies were re-introduced; but the U.S. maintained dominance over each nation's monetary policy through its reserve currency status.

In 1971, President Richard Nixon exercised this domination in a trade dispute with Europe and Japan by suspending the convertibility of the U.S. dollar into gold, setting wage and price controls, cutting taxes, and placing a 10% surcharge on all imports in an effort stimulate the U.S. economy by devaluing the exchange rate of the dollar. U.S. stock markets had their largest one day rally in history; while foreign stock markets crumbled. Four months later; the United States forced agreements for currency appreciation by Japan of 16.9%, Switzerland of 13.9%, Germany of 13.6%, France of 8.6%, and Britain of 8.6%. This effective devaluation of the dollar is credited as creating 700,000 American jobs and cementing President Nixon's reelection in 1972.

Having suffered from such manipulation under America's control over European financial affairs; in 1992 the nations of Europe began creating an economic integration that would lead to the introduction of the euro currency on January 1, 1999. Overnight, Europe became the largest trading block in the world and the euro with €890 billion in circulation became the world's second reserve currency.

Prior to the introduction of the euro; the southern European nations of Portugal, Italy, Greece, and Spain (PIGS) regularly devalued their currencies to remain competitive with the highly industrialized and sophisticated northern European countries. The introduction of the euro permanently fixed exchange rates for all euro members; but gave the PIGS access to loans from northern banks at less than half their prior interest costs.

The euro currency seemed to be a huge success as Greece, Spain, and Portugal experienced huge real estate booms powered by low interest rates. With the southern nations forbidden to devalue under euro membership regulations; the sales and profitability of German and other northern companies increased due to their higher productivity growth against southern companies. But after the 2008 credit crisis; German banks demanded the PIGS pay higher and higher interest rates. These higher rates crushed real estate prices and devastated the economies of the PIGS.

The ECB may have called itself the "Central Bank of Europe"; but it virtually no ability to act as "lender of last resort", like the U.S. Federal Reserve that prints unlimited amounts of money in an American banking crisis. As fear of potential defaults caused large depositors to pull money out of European banks and convert euros to dollars; the ECB was incapable of stopping a system-wide run on the banks. In desperation; the ECB was forced to surrender its sovereignty back to the U.S. Federal Reserve by agreeing to engage in 90 swaps of euros for dollars.

Given that U.S. banks operate with half the leverage of the European banks; the short-term structure of these arrangements will put pressure on the European banks to deleverage or risk the Federal Reserve refusing to roll over the swap by demanding repayment of dollars. This "dollarization" of the euro seems likely to be a prelude to defaults in the south as one or more of the PIGS seek to devalue by re-issuing their currencies back to escudos, lira, drachmas, and pesetas. But whatever happens; it seems clear that from now on decisions regarding European monetary policy will now primarily be made in Washington D.C.

I am extremely grateful for the contribution of Thomas Cheplick at Harvard for the development of this important report on the future of international economic policy.

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