Chapter VI

Evolution of the Euro and Currency Competition in the Global ICT Age

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Abstract

This chapter focuses on the function of international currencies as foreign exchange vehicles, which has a character of the network externality. On January 1999, the euro was introduced in Europe where the functions of the euro are limed as a currency. After January 2002, the euro had perfect functions, while the competition between the euro and the U.S. dollar was keen as the dominant international currency. We present the currency competition model with a decreasing transaction cost that reflects the character of the network externality, to investigate the competition between the euro and the dollar. We suggest the impact of introduction of the euro is the determinant for competition winner between the euro and the dollar.
Key Currency and International Monetary Regimes

International monetary regimes are arrangements that are made for agents to carry out foreign official and private settlements. These regimes include provisions pertaining to the use of international currencies as settlement currencies, exchange rates regimes and degree of capital mobility in order to decide the availability of foreign settlements. In particular, the international currency that is used primarily in international settlements is referred to as a key currency. Furthermore, there exists an inherent asymmetry in international monetary regimes between the key-currency country and the non-key currency countries. In other words, although the country providing the key currency can make foreign settlements using its home currency, the country providing a non-key currency cannot. Therefore, the key-currency country does not face exchange rate risks. Since the key-currency country is secure in the independence of its own policy objectives, it has the option of altering the exchange rates regime and the degree of capital mobility depending on the global economic situation. The degree of flexibility of the fiscal policy is also a criterion for the choice of an international monetary system. If a government intends to expand its fiscal deficits, it would be inclined to opt for a system wherein it is easier to raise finance from foreign agents. In brief, if liberalization is faced with a difficulty in sustaining a fixed exchange rate regime, the government will be able to liberalize capital controls in order to alter the flexible exchange rate regime.

Non-key currency countries use the key currency because of its easy availability and for international settlements. Under this circumstance, non-key currency countries choose an exchange rates regime and the degree of capital mobility taking into consideration the effects that exchange rates and capital mobility have on their economies. The choice of an international monetary system depends on the preference of the country or the government. For example, if a government prefers to stabilize exchange rates, it will not hesitate to restrain capital mobility. If a government prefers to import foreign capital, it will opt to liberalize capital controls and adopt a fixed exchange rates regime. However, such countries will face a difficulty in maintaining a consistency between free capital mobility and fixed exchange rates regime.

Historically, the international gold standard persisted before World War I with free capital mobility and fixed exchange rates. The pound sterling of Great Britain was the key currency at that time. The gold exchange standard survived through the interval period with unstable exchange rates and capital controls. Although the pound sterling continued to be the key currency during this period, its significance was diminished. Post World War II saw the emergence of the Bretton Woods regime with fixed exchange rates and capital controls. The U.S. dollar has since been the key currency. Since the 1970s, most major countries have experienced the flexible exchange rates regime. Although international capital movements were formerly restrained, these have gradually been liberalized in developed countries since the 1980s. This liberalization led to the emergence of a global financial economy and intensified capital mobility by hedge funds, mutual funds, pension funds and so forth.
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