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The Euro Will Eventually Lead to Global Instability

by Nino Boezio

The single European currency, once a distant dream, has become a reality. In time, it can significantly change the way the world does business, and will have some important implications on the ability of the United States and its currency to dominate the world's political and financial system.

The Euro is expected to foster greater intra-European cooperation and economic growth on that continent. However, the ECU can also damage the economic health of North America as the United States' fiscal problems including its debt and trade deficits will no longer be masked by the U.S. economy's dominance in the world. It will also encourage Europe even more to guide its own destiny, even if its vision for the world widely differs from that of non-European nations.

Understanding Europe

Unlike the relative peace and prosperity enjoyed by most North Americans the past two centuries, Europe has not been so lucky. The nations of Europe have historically been plagued by distrust, envy, competition and strife. Warfare has been a regular part of its turbulent history. Even though that continent cannot afford another world war on its territory, especially since the weapons of mass destruction today have become so powerful, it does not mean that the European psyche has changed to one



predominated by a desire for peaceful coexistence with its world neighbors.

Being confined to a small continent

with a large population, and where much of its resources must come from without, it can easily be seen how European politicians can become "nervous" and want to exert some sort of political/military muscle, which continental Europe currently does not have but the United States does. Yet the United States has largely determined its own foreign policy independent of input of Europe.

Also unlike the United States which is hedged by very large oceans and peaceful neighbors, Europe has the always dangerous Middle East nearby, and an unstable Russia and turbulent Asia within striking distance. Problems with any of its foreign neighbors can easily land on its doorstep, and yet still not be of much concern to a relatively isolated United States.

The Soon Fading Dominance of the U.S. Dollar

Until recently, gold was the reserve currency of choice for central banks. With inflation, gold maintained its value and appreciated relative to the average currency. It was relatively easy to convert to another currency if the need ever arose, and it was well-accepted worldwide as a trading medium. The last few years however, with the cooperative attack by central banks on inflation, have diminished gold's usefulness.

Central banks have opted instead for the U.S. currency and U.S. denominated assets such as bonds rather than gold, since these are even more liquid (the latter provided an attractive yield) and inflation has been perceived to be relatively dead hurting gold's major appeal. Even though new gold demand has exceeded new supply since the early 1990s, this was not sufficient to maintain interest in gold, inciting central banks to liquidate their gold reserves. If there ever is renewed concerns about inflation or the strength of a currency such as the \$US, then there may be some exodus back to gold.

The ECU is being perceived by

some to be the most viable threat down the road to the \$US. Even though it will be a new medium of exchange, its acceptance and use by a large continent may quickly establish it as an important currency. And if relative yields on US stocks, bonds, real estate and other assets fall relative to those achievable in



Europe (which can occur if the European economies strengthen and the U.S. economy weakens or falls into recession) the dominance of the \$US dollar will quickly be undermined. Currently, trade deficits in the United States have been paid for through the acquisition of U.S. assets such as bonds by foreigners. If central banks decide to liquidate some of their U.S. assets and U.S. currency in favor of the ECU, we may find a severe depreciation in the U.S. currency worldwide and possibly U.S. inflation triggered not by robust economic activity but by too much currency with no place to go but back to the United States. The currency depreciation will help to alleviate the U.S. trade deficit but in the meantime could destabilize the world's financial system.

The World's Dynamics Will Change

If the ECU proves to be a dramatic success, or at least achieves a position of importance comparable to the \$US, we may find that the world will no longer be dominated by the United States in non-financial matters as well. We note that Europe and the United States have often had widely differing views on

Finance Research Funds Available

The Finance Research Committee of the Finance Practice Area has funds available for researchers and welcomes proposals dealing with any area of finance or investments and the impact on the actuarial profession. Grants of up to \$10,000 are available now. Proposals with larger budgets can be considered with joint sponsorship (i.e. this area and a section [Investment, Financial Reporting], an additional practice area, or CKER). However, the applicant should be aware that other practice areas or Sections may not have any funds available at this time.

Grants have been given for the following types of research in the past: modeling conference (in conjunction with the Ed Lew Award), papers on the 100-year-term structure, VAR, and currency risk. A study on the use of derivatives in the insurance industry was commissioned. Currently there is a grant outstanding to write a textbook on stochastic calculus that will be readable by actuaries whose statistical background is limited to that in the current educational syllabus.

The following areas should be covered in the proposal:

- Description of project:
 - Goal of research
 - Scope of proposed work
 - Researchers who will be used, individuals or a team
 - Approach planned
 - Proposed time frame
 - Where results will be published
 - Actuarial impact
 - i) Potential customers for results
 - ii) Potential uses of results
 - How it relates to the Finance Practice Area.
- Proposed peer reviewers to form Project Oversight Group (POG) and suggestions for chair
- Proposed budget
 - Cost of data
 - Cost of researchers time
 - Other expenses—if for example, related to a conference
 - Will staff resources be needed, if so attempt to estimate time required.

Completed applications should be submitted to:

Zain Mohey-Deen
Research Actuary
Finance Practice Area
The Society of Actuaries
475 N. Martingale Rd., Suite 800,
Schaumburg, IL 60173-2226

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foreign policy, including reactions towards events in the Middle East and Asia.

The United States has had different international interests, is not always perceived as a source of world stability from the European standpoint, does not understand Europe or its problems, and is too far away from the hot spots. For example, it is expected that oil demand will once again outstrip supply in the next 3-5 years. Any instability in the region will impact Europe much more than it would the United States, as over 50% of its oil is imported. Will the

United States come to the rescue (after all, its military has been substantially cut back, even since the Persian Gulf War)?

We will likely find that any success in European financial endeavors will likely precipitate into political, military and social pursuits. This will certainly contest the United States' role as the peacemaker and peacekeeper (the "PAX Romana" of today). Unlike the United States, European countries may not be considered to be less diplomatic or sensible, and may perhaps shoot first and ask questions later.

The concerns raised as part of the European 1992 initiative will once again be discussed. The prior initiative most likely failed because Europe fell into recession and various issues including excessive debt, could not be resolved quickly. The next 10 years could be quite interesting to watch.

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