MAGAZINE DESK

THE CAPITALIST; Euro Neurosis

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For more than 50 years washington longed for a strong Europe as a political and economic partner. With the limited introduction of the euro last week, will the gods be punishing us by granting our wish?

The birth of the euro is the most important change in the international financial arena since 1971, when President Nixon announced that the dollar would no longer be exchangeable into gold. The "euro zone" will have a larger population than America's and the second largest economy in the world. For the first time since pre-World War I days, when the British pound was the world's key currency, a potential rival to the U.S. dollar is on the horizon.

What difference could all this make to Americans? Three scenarios, all set approximately five years from now, when the euro is fully established in world markets, give a glimpse of what may lie ahead.

1. TRADE WAR Suppose a series of global trade negotiations is reaching its conclusion in 2004. Let's assume that the entire negotiation becomes stalemated, with recriminations and threats flying across the Atlantic. To pressure Washington, the European Central Bank -- the equivalent of our Federal Reserve -- begins to lower interest rates, thereby weakening the euro. As a depreciating euro makes European products cheaper, imports begin to flood American markets.

Washington, fearing a rapidly rising trade deficit and slower economic growth, faces an agonizing choice: either push down the dollar in retaliation, thereby starting a global trade war, or give in on a few trade issues. Uncle Sam caves.

2. DOLLAR COLLAPSE Suppose American intelligence discovers that North Korea is mobilizing troops for an invasion. Washington visibly strengthens military ties with Tokyo to demonstrate to North Korea that both American and Japanese soldiers are prepared to defend South Korea.

China is offended by the American initiative because it has historically felt threatened by the United States-Japan military alliance, and because it wants to reduce the tensions in its own backyard by less confrontational diplomacy. Unable to pressure Washington any other way, Beijing begins to exchange a portion of its huge holdings of Treasury bonds for euro securities, which are seen as a good substitute for the greenback.

As dollars are sold, the greenback falls sharply in value. Aside from being livid that someone is manipulating its currency, Washington also has to be concerned about the threat of inflation that will arise because cheaper dollars will raise prices on imports. President Gore or President Bush offers to meet his Chinese counterpart to discuss less provocative ways to handle the confrontation.

3. LEADERSHIP CRISIS Asia has recovered from economic collapse, but a new financial debacle occurs in Latin America. Because America's trade and banking links to the region have become so strong, Washington quickly orders the International Monetary Fund to provide bailout funds. But wait. A new voice is heard from Frankfurt, headquarters of the European Central Bank.

"Not so fast," it says. "Latin America is your problem, not ours." The European Fed uses its voting power, which now aggregates at least 11 European nations, to veto Washington's plans. It is the first veto of such American action, and the President is forced to plead with Congress for taxpayer funds to rescue our friends to the south.

These aren't paranoid stories from the twilight zone. In the past, Washington hasn't hesitated to use dollar diplomacy to press Japan to open its markets, to force England and France to change their foreign policies and to muscle the I.M.F. to intervene abroad in economic crises. Now that there will be two powerful global currencies, why shouldn't the new big guy on the block exercise his clout from time to time?

The euro won't necessarily lead to confrontation between Europe and America. But if it succeeds, it will mark the passing of the old order for Europe, for Washington's dominance of trans-Atlantic relationships and for the conduct of international finance.

America had it easy when it was king of the hill, printing money to finance its chronic trade deficits and service its growing foreign debts. And in times of great crisis or uncertainty, the world parked its money in Treasury securities, contributing to a stronger dollar and lower interest rates. Now that there will be two economic giants, investors will have a choice, and America will have to play by someone else's rules.

The big question is whether Washington and Europe will cooperate closely to manage global monetary affairs, or whether they will try to practice traditional hardball financial diplomacy. For the sake of economic growth everywhere, let's hope they take the friendly path. Otherwise, the global economy is in for turmoil that will vastly overshadow anything that has happened in Asia recently. When the relationship between the dollar and the euro goes haywire, countries accounting for nearly half of world trade and production will be affected, and the ripples will insure that all global trade and investment will become unsettled.

Money is increasingly the currency of power these days, and the old patterns and relationships are about to change. How Washington and Wall Street handle this new challenge will say a lot about how the new century begins -- in America and around the world.

Illustration (Illustration by James Victore)