

# Global Currency Rivalry: Can the Euro Ever Challenge the Dollar?\*

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## Abstract

Can the euro ever challenge the dollar as an international currency? This article argues that Europe's new money is fated to remain a distant second to America's greenback, for four reasons. First is the persistent inertia of monetary behaviour, which will inhibit any rapid switch to the euro. Second is the cost of doing business in euros, which is unlikely to decline below transactions costs for the greenback. Third is an anti-growth bias built into EMU, which will limit returns on euro-denominated assets. And fourth is the ambiguous governance structure of EMU, which sows doubt among prospective euro users.

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## Introduction

Europe has a powerful new symbol – the euro. What could better express the desire for an 'ever closer union among the peoples of Europe' than a single joint money, replacing diverse francs, lire and marks? Within a generation, a population will come of age knowing no other currency than the euro. Inevitably, citizens of the European Union (EU) will begin to feel themselves bound together more closely as part of the same social entity. Money, we know, can have a profound effect on how individuals see themselves and, therefore, how they see themselves in relation to others. Much like a flag or an anthem, money contributes to a sense of collective identity – of belonging to a single community. Already Europeans speak of participating nations as a distinct unit, popularly known as 'the eurozone' (or 'euroland'; officially the 'euro area'). Europe's sense of identity will never be the same.

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But can the euro do more? For many, ambitions have been even grander. The aim was never just to help underwrite the integration project inside Europe. At least as importantly, it was to enhance Europe's role on the world stage by creating a potent rival to the US dollar, the dominant international money of the era. Resentment has long simmered among Europeans sensitive to the inordinate power that the greenback's widespread popularity gives to the United States – America's 'exorbitant privilege', in Charles de Gaulle's memorable phrase. Europe is the equal of the United States in economic output and trade. Why should it not be America's equal in monetary matters, too? Economic and monetary union (EMU) was also meant to challenge the dollar for global currency supremacy. Economist Charles Wyplosz calls this 'the hidden agenda of Europe's long-planned adoption of a single currency' (1999, p. 76).

Can the euro ever truly challenge the dollar? The purpose of this article is to explore prospects for the euro as an international currency. My assessment, which will disappoint many, is deeply sceptical. The euro will, of course, dominate monetary relations within the European region and may even extend its influence to some neighbouring areas, such as the Mediterranean littoral or sub-Saharan Africa – what the European Central Bank, the ECB (2001), calls the 'Euro-time zone'. As Wyplosz remarks: 'This is the euro's turf' (1999, p. 89). But elsewhere, for the foreseeable future, Europe's new money is fated to remain a distant second to the greenback, however much many Europeans would prefer otherwise.

There are four interrelated reasons for the euro's dim prospects. First is the persistent inertia, characteristic of all monetary behaviour, which can be expected to inhibit any rapid market switch from the dollar to the euro. Second is the cost of doing business in euros, which is unlikely to decline to a level significantly below current transactions costs for the greenback. Third is an apparent anti-growth bias built into EMU, which will impact negatively on rates of return on euro-denominated assets. And fourth is the ambiguous governance structure of EMU, which sows doubt and confusion among prospective users of Europe's new currency. Though none of these barriers is insurmountable, there is little sign that they will be overcome in the foreseeable future. Any challenge to the dollar, therefore, will be feeble at best.

## **I. A Rosy Future?**

From the very beginning of negotiations for a common currency in the late 1980s, culminating in the Maastricht Treaty of 1992, a rosy future has been predicted for the euro. Typical is the view of Robert Mundell, a Nobel laureate in economics, who expresses no doubt that the euro 'will challenge the

status of the dollar and alter the power configuration of the system' (2000, p. 57). Similarly, Daniel Gros and Niels Thygesen, two prominent European economists, assert that 'the most visible effect of EMU at the global level will be the emergence of a second global currency' (1998, p. 373). The conventional wisdom is clear. The dollar will indeed face a potent rival. In the oft-quoted words of Jacques Delors, former head of the European Commission, '*le petit euro deviendra grand*'.

In fact, the only questions seem to be: how great a rival will the euro become, and how soon? For Fred Bergsten (1997), a former US Treasury official, the answer in an early commentary was, very great, and very soon. Because of the inherent strengths of the European economy, Bergsten declared enthusiastically, the euro would achieve 'full parity' with the dollar in as little as five to ten years. And that happy forecast has been echoed by many others, such as economists George Alogoskoufis and Richard Portes (1997, p. 4), who contend that 'the fundamentals point toward a potentially large shift in favor of the euro ... The dollar would immediately lose its importance as a vehicle currency' (see also Portes and Rey, 1998; Walter, 2000; Frenkel and Søndergaard, 2001). Not everyone agrees, of course. Other analysts have adopted a more cautious tone, stressing factors that might slow the ascent of the euro (see, e.g., McCauley, 1997; Wyplosz, 1999; Frankel, 2000; Rosecrance, 2000; Neaime and Paschakis, 2002).

But largely these have been quibbles about speed, not trajectory. Few knowledgeable observers doubt that, overall, the markets will ultimately elevate the euro to a top rank alongside the greenback.<sup>1</sup> The mainstream view has been best summarized by political scientist Randall Henning:

When it is introduced, there will probably be no large, precipitous displacement of the dollar. Nonetheless, much of the increased role of the new European currency can be expected to come at the dollar's expense, and this would reinforce the gradual historical decline in the role of the dollar exhibited over the last several decades. (1996, p. 93)

Top rank, in turn, would be expected to yield considerable benefits for Europe, which of course is precisely what prompted the euro's hidden agenda in the first place. Though minimized by some (e.g. Wyplosz, 1999, pp. 97–100), the advantages to be derived from a global currency can in fact be considerable. As I have argued elsewhere (Cohen, 1998, 2003), four distinct gains are possible – two economic in nature, two political.

One economic gain is the potential for what economists call *seigniorage*: the implicit transfer, equivalent to an interest-free loan, that goes to the issuer of a money that is widely used and held abroad. Because it may remain in

<sup>1</sup> For some rare exceptions, see Feldstein (1997), Calomiris (1999), and Bush (2000).

foreign circulation indefinitely, an international currency is like a claim that might never be exercised. But because it is virtually costless to produce, it enables the issuer to acquire vast amounts of goods, services and assets from the rest of the world at little or no sacrifice – an exorbitant privilege if there ever was one. The United States is conservatively estimated to earn at least \$15–20 billion a year from the circulation of dollar banknotes around the world (Blinder, 1996), a phenomenon known as informal dollarization.<sup>2</sup> A second economic gain is the increased flexibility of macroeconomic policy that is afforded by the privilege of being able to rely on one's own money to help finance external deficits. The issuer is less constrained by balance-of-payments concerns in pursuing ambitions on the global stage.

In political terms, one advantage of an international currency is the status and prestige that goes with market dominance. 'Great powers have great currencies', Mundell wrote (1993, p. 10). In effect, an international money becomes a potent symbol of primacy, if not hegemony – an example of what political scientist Joseph Nye (1990) has called 'soft power', the ability to exercise influence by shaping beliefs and perceptions. Foreign publics cannot help but be impressed when someone else's money successfully penetrates the domestic currency system and gains widespread acceptance. And second is the direct political power that derives from the monetary dependence of others. Not only is the issuer of an international currency better insulated from outside influence or coercion in the domestic policy arena, it is also better positioned to pursue foreign objectives without constraint, or even to exercise a degree of influence or coercion internationally.

In view of all these potential benefits, is it any wonder that many Europeans have hoped to create a rival to the dollar?

## II. Performance

So how well has the euro actually fared since its introduction in 1999? Viewed purely in exchange-rate terms, the currency's record of performance has been mixed – first embarrassing, more recently a point of some pride. From an opening value of \$1.17 the euro initially drifted downward, sinking to a low near \$0.83 by mid-2000 and subsequently languishing at well below par for nearly two years. In mid-2002, however, the new currency began an impressive recovery, climbing decisively past \$1.00 in November 2002 and continuing to rise well into 2003. Today, the euro appears to stand tall in relation to the greenback.

<sup>2</sup> This is in contrast to formal dollarization, which occurs when a foreign government officially adopts a currency such as the greenback in place of its own national money, as did Ecuador in 2000 and El Salvador in 2001. For more discussion of formal and informal dollarization, see Cohen (2003).

Exchange rates, however, are not the issue. A currency's price is at best an imperfect indicator of its international status. The real issue is not price but *use*: the extent to which a money is voluntarily chosen by market actors outside the euro area itself for the standard functions of a medium of exchange, unit of account and store of value. Central banks may also adopt the euro, of course, as an intervention medium, currency anchor, or as part of their foreign reserves. But currency use by state actors understandably tends, for the most part, simply to reflect prevailing market practice. The key issue is what happens to the preferences of *private* actors. If the euro is ever truly to challenge the dollar, it will be by displacing the popular greenback for any or all of the traditional roles of money in the broad global marketplace.

Viewed in these terms, there is little evidence yet of any significant displacement of the dollar, precipitous or otherwise. Accurate analysis demands that we compare the euro not just with its most popular predecessor, Germany's old Deutschmark (DM) – which had already attained a rank among international currencies second only to the dollar – but with all of the euro's other 'legacy' currencies as well.<sup>3</sup> A look at data available to date suggests that, in most categories of use, the euro has held its own as compared with the past aggregate shares of EMU's 12 constituent currencies, but that is about all. In its first four years of existence, little more has been achieved.

The clearest indicator of a money's international status is the amplitude of its use as a medium of exchange in the foreign-exchange market where, according to the latest survey of the Bank for International Settlements (2002), average daily turnover in 2001 approximated some \$1.2 trillion worldwide.<sup>4</sup> Top currencies are bought and sold not only for direct use in trade and investment, but also as a low-cost intermediary – a 'vehicle' – for the trading of other currencies. A vehicle role is a direct consequence of high market turnover, which yields substantial economies of scale. Typically, it will be less expensive for a market agent to sell a local money for a vehicle currency and then use the vehicle currency to buy the needed foreign money than it would be to exchange one infrequently traded money directly for another. And no currency has more market turnover than the dollar, reflecting the large size of the US economy and its leading role in world exports. The low transactions costs that result from high market volume explain why the greenback has long been the most favoured vehicle for global currency exchanges, appearing on one side or the other of some 90 per cent of all transactions in 2001

<sup>3</sup> The term 'legacy' currency, referring to the separate national monies replaced by the euro, was suggested by Detken and Hartmann (2002).

<sup>4</sup> The figure of \$1.2 trillion represented a significant drop from nearly \$1.5 trillion in 1998 (though still a considerable increase from \$590 billion in 1989, the first year for which such data are available, and \$820 million in 1992). The drop after 1998 was accounted for by several special factors including, notably, the introduction of the euro in 1999, which eliminated trading among its constituent currencies.

(unchanged from its share in 1989). The euro, by contrast, entered on one side of just 38 per cent of all transactions in 2001. That was higher than the share of the Deutschmark, which had appeared in 30 per cent of transactions in 1998, but lower than that of all euro's legacy currencies taken together (53 per cent).<sup>5</sup> Only in trading in the EU's immediate neighbourhood – e.g. in the Nordic countries and east-central Europe – is the euro clearly the dominant vehicle currency (Detken and Hartmann, 2002).

The greenback also remains the most favoured vehicle for the invoicing of global trade, which adds the role of unit of account (currency of denomination) to that of medium of exchange (currency of settlement) for international contracts. Overall, the dollar is estimated to account for nearly half of all world exports (Hartmann, 1998) – more than double the US share of world exports. The DM's share of trade invoicing in its last years, prior to its replacement by the euro, was 15 per cent, roughly equivalent to Germany's proportion of world exports. Preliminary evidence from the European Central Bank (2001, p. 18) suggests that this share was maintained by the euro after its introduction in 1999, but has not yet shown any sign of increase.

Likewise, the dollar remains the most favoured store of value in global capital markets, where the euro has yet to catch on significantly as an investment medium for international portfolio managers. True, there has been some increased use of the euro as a financing currency (a vehicle for borrowing). Non-Europeans have been attracted by the opportunity to tap into the much broader pool of savings created by the consolidation of EMU. In bond and money markets, new foreign issues jumped sharply after the new currency's introduction and have remained significantly higher than the share of EMU legacy currencies prior to 1999. Indeed, for a brief time in 1999, euro-denominated international bonds and notes issuance actually exceeded dollar issues for the first time, before levelling off at an average share of some 29 per cent in subsequent years (as compared with a dollar share of some 43 per cent). The average share of the euro's predecessor currencies in global issuance in the five years prior to 1999 had been just 19 per cent (ECB, 2001, pp. 7–8; Detken and Hartmann, 2002, pp. 566–7). Equity issues have also grown substantially, while the euro share of international bank lending has risen by several percentage points. But these developments represent an increase only in the supply of euro-denominated assets, not demand – and on the demand side, foreign managers so far have been slower than anticipated to add to their holdings of euro-denominated assets, despite the greater depth and liquidity on offer. Overall, the euro's share of world portfolios has changed little from the previous aggregate of legacy currencies.

<sup>5</sup> Because each foreign-exchange transaction involves two currencies, the total of shares sums to 200 per cent rather than 100 per cent.

Of course, half a decade is not a very long period in such matters. Given enough time, the euro's rosy future could yet materialize, just as many argue. But might the mainstream view be mistaken? Could the issue really be trajectory, not just speed? In fact, with each passing year, it becomes increasingly clear that serious obstacles lie in the path of the euro's ascent. Though dominance within the European region seems assured, there are strong reasons to believe that, on the broader world stage, grander ambitions for the euro will be disappointed.

### III. Inertia

One reason is simply inertia, a characteristic that is inherent in all monetary behaviour. Two sources of inertia in currency choice can be identified. First is the pre-existence of already well-established transactional networks, which generate a well-documented stickiness in user preferences – what specialists call hysteresis or ratchet effects. In effect, prior use confers a certain natural advantage of incumbency. Switching from one money to another is costly, involving an expensive process of financial adaptation, as numerous analysts have emphasized (see, e.g., Dornbusch *et al.*, 1990; Guidotti and Rodriguez, 1992). Considerable effort must be invested in creating and learning to use new instruments and institutions, with much riding on what other market agents may be expected to do at the same time. Hence, as attractive as a given money may seem, adoption will not prove cost-effective unless others appear likely to make extensive use of it too. In the words of economists Kevin Dowd and David Greenaway (1993, p. 1180): 'Changing currencies is costly – we must learn to reckon in the new currency, we must change the units in which we quote prices, we might have to change our records, and so on ... . [This] explains why agents are often reluctant to switch currencies, even when the currency they are using appears to be manifestly inferior to some other'.

Inertia is also promoted by the exceptionally high level of uncertainty inherent in any choice between alternative monies. Uncertainty encourages a tendency toward what psychologists call 'mimesis': the rational impulse of risk-averse actors, in conditions of contingency, to minimize anxiety by imitative behaviour based on past experience. Once a currency gains a degree of acceptance, its use is apt to be perpetuated – even after the appearance of powerful new competitors – simply by regular repetition of previous practice. In effect, a conservative bias is inherent in the dynamics of the marketplace. As one source has argued, 'imitation leads to the emergence of a convention [wherein] emphasis is placed on a certain "conformism" or even hermeticism in financial circles' (Orléan, 1989, pp. 81–3).



The salience of inertia in this context is well illustrated by the dollar's own experience when it first began to rival the pound sterling, the dominant currency of the nineteenth century. Even after America's emergence as the world's richest economy, it took literally decades for the greenback to ascend to top rank among currencies. As Paul Krugman has commented: 'The impressive fact here is surely the inertia; sterling remained the first-ranked currency for half a century after Britain had ceased to be the first-ranked economic power' (1992, p. 173).<sup>6</sup> Similar inertia has been evident for millennia in the prolonged use of such international moneys as the Byzantine solidus (otherwise known as the bezant) or the Spanish silver peso (later known as the Mexican silver dollar) long after the decline of the imperial powers that first coined them (Cohen, 1998, ch. 2). In fact, such inertias are very much the rule, not the exception, in global monetary relations.

Exceptional or not, even the most stubborn inertias can in time be overcome, as these historical examples also illustrate. But to defeat the conservative bias in market behaviour, a new contender like the euro must first offer substantial advantages over the incumbent. The dollar was able to do that, in relation to sterling, once New York overtook London as the world's pre-eminent source of investment capital. The problem for the euro is that, apart from its appeal as a financing currency, it presently offers no comparable advantages in relation to the dollar.

#### IV. Transactions Costs

Consider, for example, the cost of doing business in euros, which directly affects the currency's attractiveness as a vehicle for foreign-exchange transactions or international trade. Europe's new money does offer many positive features for market agents, including especially a high degree of transactional convenience. It also offers a large and expanding network of constituents. Twelve of the European Union's 15 members have already adopted the euro; the reluctant trio of Britain, Denmark and Sweden may yet do so as well; and so too, eventually, will all the ten applicant countries that are due to join the EU in 2004. But even so, America's greenback will be favoured by the natural advantages of incumbency unless euro transactions costs, which historically have been higher than those of the more widely traded dollar, can be lowered to more competitive levels. In turn, the level of euro transactions costs, as measured by bid-offer spreads, will depend directly on what happens to the structural efficiency of Europe's financial markets. Economists Richard Portes and Hélène Rey put the point most succinctly: 'The key deter-

<sup>6</sup> For more detail, see Cohen (1971).



minant of the extent and speed of internationalization of the euro will be transactions costs in foreign exchange and securities markets' (1998, p. 308).

On the face of it, prospects for the efficiency of Europe's financial system would seem good. In purely quantitative terms, introduction of the euro promises to create the largest single-currency capital market in the world. The aggregate value of euro-denominated financial claims (fixed-income securities, equities and bank loans) is already almost as great as that of the United States, and will undoubtedly keep growing in the future, particularly if Britain ever decides to join the euro area. Beyond that, there are bound to be major qualitative improvements in market depth and liquidity as previously segmented national markets are gradually knitted together into an integrated whole. The elimination of exchange risk inside EMU has already intensified competition among financial institutions, particularly in such hotly contested activities as bond underwriting and syndicated bank lending, encouraging cost-cutting and innovation. Over the longer term, harmonization of laws and conventions and the development of new cross-border payments systems should enhance the marketability of euro assets of all kinds. Empirical studies repeatedly confirm the ample scope for benefits in the future (see, e.g., Giannetti *et al.*, 2002; Heinemann and Jopp, 2002; London Economics, 2002).

Progress to date, however, has been disappointing, and it is not at all clear that the euro's promise in this respect can ever be converted fully into performance. In principle, the EU is firmly committed to financial integration under the financial services action plan first launched in 1999. In practice, however, resistance to many market-opening measures remains stubbornly strong. As a recent EU report on Europe's financial markets – the so-called Lamfalussy Report – firmly insisted: 'The European Union has no divine right to the benefits of an integrated financial market. It has to *capture* those benefits' – and so far, at least, the EU has not done a very good job of doing so (European Union, 2001, p. 8, emphasis added). According to the Lamfalussy Report market integration continues to be retarded by a plethora of interconnected factors and barriers, including the absence of clear Europe-wide regulation on a wide number of issues, an inefficient regulatory system, inconsistent implementation, and a large number of settlement systems that fragment liquidity and increase costs. Integration has made good progress in money markets and the corporate bond market, where instruments and procedures are already largely standardized (Santillán *et al.*, 2000). Primary equity markets have also expanded rapidly and become more closely integrated (Fratzscher, 2001), in turn spurring efforts to merge national stock exchanges. Although a projected merger of the Frankfurt and London exchanges failed to materialize, a successful partnership has been created by the bourses of Paris, Amsterdam and Brussels, under the label Euronext. Overall, however, as the

Lamfalussy Report concludes, the system remains 'ill-adapted to the pace of global financial market change' (Council, 2001, p. 7).

A real question exists, therefore, as to whether structural improvements in Europe's financial markets can ever lower euro transactions costs enough to overcome the powerful conservative bias of monetary practice. In key respects the dollar's advantages will persist. Most important, as frequently stressed by knowledgeable observers (Cooper, 2000; Henning, 2000), is the lack of a universal financial instrument to rival the US Treasury bill for liquidity and convenience – a deficiency that will be difficult, if not impossible, to rectify so long as the EU, with its separate national governments, lacks a counterpart to the federal government in Washington. Full consolidation of the euro area's markets for public debt is stymied by the persistence of different credit and liquidity risk premia among participating countries, as well as by variations in legal traditions, procedures, issuance calendar and primary dealer systems. Market segmentation has also been prolonged by intense competition between governments to establish their own issues as EMU benchmarks (IMF, 2001, pp. 99–111).

On balance, therefore, it seems quite unlikely that anticipated efficiency gains, though substantial, will soon be enough on their own to displace the greenback from top rank. Early studies (Detken and Hartmann, 2000; Danthine *et al.*, 2001) found little evidence of reduced transactions costs immediately after the currency's introduction. Indeed, for some types of transactions, bid–offer spreads have actually increased over time relative to the corresponding spreads for the DM, Europe's most widely traded currency prior to EMU (Hau *et al.*, 2002a, b; ECB, 2001; Goodhart *et al.*, 2002). In reality, no one expects that euro transactions costs will ever decline to a level substantially below those presently quoted for the dollar.

To be sure, this has not forestalled widespread use of the new currency in the euro area's immediate neighbourhood. For countries whose foreign trade is dominated by the European Union, the euro remains a natural choice even in the absence of a distinct cost advantage. Elsewhere, however, where commercial ties are less heavily concentrated on Europe, high spreads will undoubtedly be far more of a hindrance. Unless the euro can offer competitive transactions costs, it is hard to see what incentive market actors outside the Euro-time zone will have to switch away from the greenback on any significant scale when selecting a medium of exchange or unit of account.

## V. Anti-Growth Bias

The story is much the same with respect to the market's choice of a store of value. Europe's new money also offers many positive features as an invest-

ment medium, including in particular the prospect of relatively stable purchasing power. Yet here too it seems doubtful that advantages will be great enough to encourage a sizeable switch away from the greenback. For international investors, the store-of-value function involves not only stability of purchasing power, but also future rates of return. The problem in this instance is a serious anti-growth bias that appears to be built into the institutional structure of EMU, which can be expected to impact negatively on yields on euro-denominated assets.<sup>7</sup>

Few doubts were raised about the euro's prospective store-of-value role when the currency was first introduced – quite the contrary, in fact. A merger of the continent's cacophony of national currencies would, by definition, eliminate exchange risk on investments within the region. A massive shift was therefore predicted in the allocation of global savings as compared with holdings of European assets in the past. The world private portfolio of international financial assets, excluding intra-EU claims, was estimated at some \$6.1 trillion at the end of 1995 (Henning, 1997, p. 22), of which little more than one-quarter was accounted for by assets denominated in European currencies, compared with a dollar share of more than half. Holdings previously lodged outside the EU, it was assumed, would naturally be attracted by the European market's new depth and liquidity, enhancing the euro's global standing. Knowledgeable sources suggested that foreign demand for euro-denominated assets might soon rise by anything from \$400 billion to \$800 billion in total, mostly at the dollar's expense (see, e.g., Bergsten, 1997, p. 30; Henning, 1997, p. 22; McCauley, 1997, p. 39; McCauley and White, 1997, p. 358; Frenkel and Søndergaard, 2001). Few analysts expected the euro's share of world portfolios, as compared with the previous aggregate of legacy currencies, to change as little as it has done until now. Partly, this may be attributed to the spectacular productivity boom in the US economy in recent years, which helped preserve the appeal of dollar assets. But in good part as well, it plainly reflects a marked lack of appeal of investments in Europe despite the coming of EMU. Foreign investors obviously remain wary about the rates of return that can be expected on euro claims.

What is the reason for investor caution? If portfolio managers are actively discounting the rewards to capital available in Europe, it must be because of doubts about the prospects for longer-term growth of output relative to productive capacity. Arguably, the main cause for such doubts may be said to lie in the core institutional provisions of EMU governing monetary and fiscal policy, the key determinants of macroeconomic performance. In neither policy

<sup>7</sup> The term 'anti-growth bias' is used here in preference to 'deflationary bias', as was once popular in the economics literature, because of the possibility that the latter might be mistakenly understood to mean a decline of prices rather than, as intended here, a decline or retardation of real output.

domain is priority attached to promoting real production. Rather, in each, the main emphasis is on other considerations that can be expected to limit opportunities for future expansion – imparting, as some observers have long feared,<sup>8</sup> a distinct anti-growth bias to the economy of the euro area as a whole.

Consider monetary policy. As is well known, the European Central Bank was created by the Maastricht Treaty with just a single policy mandate – ‘to maintain price stability’ (Article 105). That provision stands in sharp contrast to the charters of central banks elsewhere, such as the Federal Reserve, where comparable emphasis is placed on a responsibility to promote employment and output as well. The Treaty’s provision is partially qualified in an additional instruction to ‘support the general economic policies in the Community’, but only if this can be done ‘without prejudice to the objective of price stability’ (Article 105). Moreover, the ECB is endowed with absolute independence, insulating it from political influence of any kind. The ECB cannot ‘seek or take instructions from Community institutions or bodies, from any government of a Member state or from any other body’, nor may Community institutions or governments ‘seek to influence the members of the decision-making bodies of the ECB’ (Article 107). Legally, the ECB is free to focus exclusively on fighting inflation, even if over time this might be at the cost of stunting real growth.

In practice, of course, the ECB is not wholly insensitive to growth concerns. As students of monetary policy have long understood, a central bank is as much a political actor as any other public institution, keen to preserve its own privileges and prerogatives (see, e.g., Woolley, 1984; Goodman 1992). No monetary authority – however independent it may be in formal terms – can afford to be totally impervious to political considerations. In the ECB’s case, this has meant tolerating an inflation rate that for most of the period since 1999 has exceeded the Bank’s official target of 2 per cent per annum. On occasion – most recently in December 2002 when economic activity seemed particularly sluggish – it has even meant lowering interest rates despite possible dangers to the bank’s price objective. Nonetheless, the overall orientation of ECB priorities is clear. Since the start of EMU, monetary conditions in the euro area have been among the tightest in the industrial world. The bias of policy has plainly been towards restraint, not expansion.

Likewise, on the side of fiscal policy, the euro area governments have formally tied their own hands with the controversial Stability and Growth Pact (SGP), signed in 1997. In accordance with the Maastricht Treaty, the SGP mandates a medium-term objective of fiscal balance in all participating economies as well as a strict cap on annual budget deficits of just 3 per cent of

<sup>8</sup> For some discussion, see Henning (1997, pp. 7–9).

gross domestic product. The rationale for these fiscal restraints is clear. It is to prevent potentially profligate policy-makers from tapping into the EMU's broader pool of savings to finance large spending programmes at the expense of partner countries. But the effective impact of these restraints is equally clear. They make it far more difficult for elected officials to use budgetary policy for contracyclical purposes, to offset the anti-growth bias of monetary policy. Even in the best of times, most governments tend to run deficits of some magnitude. Little room is left, therefore, for participating states to raise public spending or cut taxes when needed to promote production and jobs. Indeed, under a strict reading of the SGP, officials might be obliged to act in a *pro*-cyclical manner, tightening policy even when the economy slows, in order to maintain momentum toward the goal of budget balance.

Here too, we know, practice has at times diverged from principle. Portugal, for instance, briefly exceeded the 3 per cent limit in 2001 in the run-up to a national election before getting its budget back under control once a new government was installed; and more recently, in early 2003, all three of EMU's largest members – France, Germany and Italy – were publicly chastised by the European Commission for failing to prevent rising deficits. In fact, the Stability and Growth Pact is widely detested across Europe. Typical are the biting words of the *Economist*, which contends that the SGP 'serves no positive purpose and risks doing serious harm'. Romano Prodi, President of the Commission, simply calls the fiscal restraints 'stupid' (*Economist*, 25 August 2001, p. 13). Some observers call for the replacement of the SGP with an economic government for Europe (Collignon, 2003). Others urge returning authority to national governments, either by scrapping the SGP altogether (Arestis and Sawyer, 2003) or by establishing autonomous fiscal-policy committees comparable to the monetary-policy committees now used by the Bank of England and other central banks (Wyplosz, 2002). Yet, until now, appeals for revision or repeal have made little headway. So long as the SGP remains binding on all euro area governments, an anti-growth bias will be perpetuated in fiscal policy too.

Investor caution may be overdone, of course. Even with the prevailing provisions for EMU monetary and fiscal policy, contraction could be avoided if appropriate structural reforms were to be undertaken to facilitate adjustment to unanticipated shocks. *Inter alia* this would mean a significant reorganization of labour markets, to promote worker mobility and wage flexibility, as well as innovations in competition policy to encourage more efficient adaptation by business. The easier it is for markets to adjust at the micro-economic level, the less need there is for stimulative policy to promote growth at the macroeconomic level. Such reforms have long been sought in Europe's economies, which many have described as sclerotic. Indeed, as a practical

matter, some specialists have welcomed the potential anti-growth bias of EMU as precisely the justification needed to get such reforms enacted. In principle, EMU would provide the necessary political leverage for action.

In practice, however, in most EU countries, structural reforms remain a distant dream, owing to the stiff resistance of constituencies whose interests and privileges might be put into jeopardy – thus rendering the tactic moot. In the absence of radical political change, investors do indeed have every reason to anticipate disappointing rates of return on euro-denominated assets; and that in turn will continue to forestall any major shift in the allocation of global savings at the expense of the dollar. Within the euro-time zone, once again, there will undoubtedly be some movement to acquire euro claims as the natural counterpart to growing commercial ties. But elsewhere, Europe's new currency will remain very much at a disadvantage relative to the American greenback.

## VI. Governance

Finally, we come to the governance structure of EMU, which for the euro's prospects as an international currency may be the biggest obstacle of all. The basic question is, who is in charge of the euro area? The answer, regrettably, has never been clear. From the start, much confusion has reigned concerning the delegation of authority among governments and EU institutions. Prospective users of the new money, therefore, may be excused for hesitating to commit themselves to what seemingly amounts to a pig in a poke – even if transactions costs could be lowered to competitive levels and rewards to European capital could be significantly improved. For most market agents, particularly beyond the euro area's immediate neighbourhood, rationality would appear to dictate sticking to the tried-and-true. Many prefer the devil they know – the good old greenback – to the one they don't.

We tend to forget, after all, just how unique an enterprise EMU is – a group of fully independent states that have made a mutual commitment to replace existing national currencies with one newly created money. True, EMU is not entirely without precedent. Around the world other monetary unions do exist, including most notably the CFA Franc Zone in Africa and the Eastern Caribbean Currency Union in the western hemisphere. But these scattered groupings comprise mostly small developing nations and are based on institutional arrangements whose origins stretch back to colonial days. EMU, by contrast, is the initiative of established states of long standing, including some of the biggest economies in the world, engaged in a gigantic experiment of unparalleled proportions – 'a bold step into the unknown', in the words of a recent *JCMS* Annual Lecture (Buiter, 1999, p. 182). Involved here is what

one scholar (Litfin, 1997) calls a 'sovereignty bargain': a voluntary agreement to accept certain limitations on national authority in exchange for anticipated benefits. Because they are the product of negotiations which can often be quite arduous, sovereignty bargains typically embody a variety of artful compromises and deliberate obfuscations; and that is certainly true of EMU, for which there is no obvious prototype in the modern era. Precisely because the undertaking is by way of an experiment, ambiguities abound in the Maastricht Treaty – nowhere more so than in its provisions for the political management of the euro.

Three key provisions are at issue. First is the governance of EMU's core institution, the European Central Bank itself. Immediate operational control of monetary policy lies in the hands of the ECB's Executive Board, made up of the President, Vice-President and four other members. Ultimate authority, however, is formally lodged in the Governing Council, which in addition to the six-member Executive Board was, according to the Maastricht Treaty, to include the heads of the central banks of all participating states. That has made for a total of 18 individuals around the table, which is already greater than might seem consistent with efficient collective decision-making. Assuming future participation of Britain, Denmark and Sweden, as well as of the EU's ten incoming members, the size of the Governing Council would eventually grow to more than 30 – almost certainly too many for serious and productive discussion. As one source commented sarcastically, enlargement of EMU under Maastricht Treaty rules would have left the ECB with 'too many [members] to decide on where to go for dinner, let alone agree on how to run monetary policy for more than 400 million people'.<sup>9</sup> As a remedy, the ECB recently obtained approval from the European Council for a new set of rules limiting membership of the Governing Council at any one time to 21 members, including 15 central bank governors with rotating voting rights. But even this new arrangement would appear to leave the ECB with a serious 'number problem'.

Sooner or later, therefore, as so often happens in large multinational institutions, real power will have to devolve to a smaller 'inner' group formally or informally charged with resolving differences on critical issues.<sup>10</sup> But who will be allowed to join this exclusive club? Would it be the members of the Executive Board, who might be expected to take a broad approach to Euro-land's needs and interests? Or would it be a select coterie of central bank governors, whose views could turn out to be more parochial? For the moment, no one knows.

<sup>9</sup> Baldwin (2001). For an evaluation of alternative possible arrangements for ECB decision-making, see Berger (2002).

<sup>10</sup> For an example of how this process has operated in the case of international trade organizations, see Cohn (2002).



Second is the critical matter of exchange-rate policy. Under the Maastricht Treaty, the ECB is assigned day-to-day responsibility for the euro's external value (Article 105). Authority over the more general orientation of policy, however, is shared uneasily with both the Council of Ministers, representing national governments, and the Commission, reflecting negotiating compromises that are now firmly embedded in the Treaty (Article 109). On the one hand, to satisfy member countries that wished to retain a role in such matters, it is the Council – not the ECB – that was empowered to 'formulate general orientations', albeit only on a recommendation from the Commission or ECB. But, on the other hand, to reassure those who were worried about the possibility of undue political interference in exchange-rate policy, the Treaty also states that 'these general orientations shall be without prejudice to the primary objective of the [ECB] to maintain price stability', which would seem to give the ECB, ultimately, something akin to a veto. Plainly, power over exchange rates was meant to be shared in some form of consensual process. But, equally, these provisions could turn out to be a sure recipe for political deadlock and drift. Again, no one knows.

Finally, there is the issue of external representation. Who is to speak for the euro area on broader macroeconomic issues such as policy co-ordination or the management of financial crises? Here there is no answer at all, leaving a vacuum at the core of EMU. Deeply divided over the question at the time the Maastricht Treaty was negotiated, EU governments – to use American football parlance – in effect chose to punt. No single body was designated to represent EMU at the International Monetary Fund or in other global fora. Instead, the Treaty simply lays down a procedure for resolving the issue at a later date, presumably on a case-by-case basis (Article 109). At a minimum, this cop-out increases confusion about who is in charge. 'The U.S. Treasury', Henning writes, has 'no coherent counterpart within the euro area when addressing politically sensitive international monetary and financial questions' (2000, p. 52). At worst, the vacuum condemns the euro area to lasting second-class status, since it limits the group's ability to project power in international negotiations. In the words of Kathleen McNamara and Sophie Meunier (2002, p. 850): 'As long as no "single voice" has the political authority to speak on behalf of the euro area, as the U.S. Secretary of the Treasury does for the American currency, the pre-eminence of the U.S. in international monetary matters, as in other realms, is likely to remain unchallenged'.

Given all these ambiguities, can the euro ever hope to rival the dollar? An improvement of EMU's political cohesiveness would certainly seem to be a necessary condition. On its own, institutional reform might not ensure widespread acceptance of the new currency. But without greater clarity about the sovereignty bargain's lines of authority, it is hard to see how the euro can ever

attain the level of credibility needed to play a global role. Even Fred Bergsten, the euro enthusiast, concedes that, as it stands, EMU's fissiparous governance structure 'dissipates much of the potential for realizing a key international role for the euro' (2002, p. 7). In place of decisive management, market agents see fragmented decision-making and a potential for chronic bickering. In this light, is it really surprising that the currency's ascent has fallen short of expectations?

## Conclusion

In short, predictions of a rosy future for the euro are beginning to look increasingly illusory. Even under the best of circumstances it would take years, if not decades, for the new currency to overcome the dollar's natural incumbency advantages. And EMU's circumstances are by no means the best. Europe's markets for public debt remain segmented, inhibiting a substantial reduction of transactions costs. Likewise, an anti-growth bias appears to be built into the institutional structure of EMU, dampening rates of return on euro-denominated assets. And worst of all, the euro area's governance structure continues to be riddled with ambiguities and obfuscations, perpetuating doubts about the credibility of the whole exercise. The issue really is trajectory, not just speed. A second global currency is not about to emerge.

This does not mean, of course, that EMU was a mistake. The euro will naturally dominate its own region, yielding at least some of the benefits of international use, albeit on a more modest scale than currently available to the greenback. Almost certainly, substantial new *seigniorage* revenues will be earned from growing circulation of euro banknotes in neighbouring countries, a process of 'euro-ization' analogous to the informal dollarization that has occurred in many other parts of the world.<sup>11</sup> Moreover, Europe's vulnerability to outside shocks will be significantly reduced by the creation of what Helmut Schmidt once called a 'zone of monetary stability'. In place of the continent's earlier collection of relatively small and open currency areas, EMU creates one much larger closed unit that is better able to protect the European economy from external disturbances.<sup>12</sup> And possibly most important of all, as indicated at the outset, the new currency will surely enhance Europe's sense of its own identity, greatly reinforcing the historic project of integration that was begun more than a half century ago. Is that not ambition enough for the peoples of Europe?

<sup>11</sup> In Russia, for example, where as much as \$50 billion in greenbacks is believed to be hoarded away, euro banknotes are rapidly gaining in popularity (see *New York Times*, 31 January 2003, p. A4).

<sup>12</sup> For Henning, this was indeed a principal motivation of EMU. In his words: 'Disturbances in the international system provided strong incentives for European governments to cooperate' (1998, p. 538).

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