



Is the Euro Ready for 'Prime Time'?

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Summary points

- When Europe's Economic and Monetary Union (EMU) became effective nearly a decade ago, the euro was seen as having the potential to be the second pillar of the international monetary system. It was expected to share leadership in monetary affairs with the United States.
- Ten years later, however, the story looks quite different. Although the euro has firmly established itself as an international currency, the degree of change has been considerably less than expected. Europe's joint money remains at a distinct disadvantage in relation to America's greenback, limiting the role it can play in global monetary governance. The euro is not yet ready for 'prime time' and can at best play only a subordinate role to the dollar in the global system. This can be described as a one-and-a-half currency system – certainly not a two-pillar world.
- The problem lies in the governance structure of EMU. Because the euro is a currency without a country, based on an inter-state agreement, participating members find it difficult to speak with a single voice.
- The solution lies in a reform of EMU's governing rules and institutions that would put greater emphasis on the euro's external dimension. On the one hand this calls for more proactive management of the currency's exchange rate by the European Central Bank (ECB), together with an explicit commitment by the Eurogroup – the euro zone's informal committee of finance ministers – to undertake effective coordination of national fiscal policies. On the other hand it means designating a single representative of EMU with real authority to speak on behalf of members in international councils. Unless the euro zone can learn how to project power more successfully than it has until now, dual leadership of monetary affairs at the global level will remain out of reach.

Introduction

Even before Europe's Economic and Monetary Union came into existence in January 1999, a brilliant future was predicted for the euro as an international currency. At last, many argued, the EU would have a currency that could challenge the global dominance of the US dollar. Typical was the confident assertion of two prominent European economists, Daniel Gros and Niels Thygesen (1998: 373) that 'the most visible effect of EMU at the global level will be the emergence of a second global currency'. The conventional wisdom was clear. Leadership in monetary affairs would no longer be the privilege of the United States alone. The currency system would now rest on two pillars, not one.

Reality, however, has turned out to be quite different. There is no doubt that the system has changed. The euro has firmly established itself as an international currency, smoothly taking its place as successor to Germany's old Deutschmark, which had already attained a rank second only to the dollar. The euro zone has grown from eleven members to fifteen, with one more (Slovakia) due to enter in January 2009, and as many as a dozen or more set to join in the future. Yet the degree of change has been considerably less than expected. Euro enthusiasts assumed that once the tilt began, a new two-currency system would naturally emerge. But this was based on a fundamental misunderstanding of the nature of monetary power. In fact, the tilt has been braked by structural constraints on Europe's ability to project power in monetary affairs. EMU is largely a passive participant in global payments developments and remains a weak force in monetary diplomacy.

This paper argues that the euro is not yet ready for 'prime time' and currently can at best play only a subordinate role to the dollar in the global system. This can be described as a one-and-a-half currency system – certainly not a two-pillar world. The paper addresses two critical questions. First, just how has the global system been changed by the arrival of the euro? Second, what can Europe do to overcome the euro's disadvantages and thus enhance its role as the second pillar of the system? The main imperative is to improve EMU's

ability to project power effectively. Dual leadership at the global level is not out of reach but will require determined reform of EMU's governance structure.

One-and-a-half currencies

Predictions about the euro's brilliant future were not misguided. From the start, the euro clearly enjoyed many of the attributes necessary for competitive success as an international currency, including a large economic base, unquestioned political stability and an enviably low rate of inflation, all backed by a joint monetary authority, the European Central Bank, that was fully committed to preserving confidence in the currency's future value. Moreover, there was every reason to believe that sooner or later the global position of the dollar would weaken, owing to the United States' persistent payments deficits. Surely it was only a matter of time before the balance of monetary power across the Atlantic would tilt significantly in Europe's direction. But this was based on a fundamental misunderstanding of the nature of power in monetary affairs. In fact, capabilities in the broader currency system have changed much less than anticipated.

Monetary power

Briefly summarizing an argument that has been developed at greater length elsewhere (Cohen 2006), this paper suggests that international monetary power may be understood to comprise two critical dimensions: autonomy and influence. More familiar is the dimension of *influence*, defined as the ability to shape events or outcomes. An actor, in this sense, is powerful to the extent that it can effectively pressure or coerce others; in short, to the extent that it can exercise leverage. As a dimension of power, influence is the essential *sine qua non* of systemic leadership. The second dimension, autonomy, corresponds to the dictionary definition of power as a capacity for action. An actor is also powerful to the extent that it is able to exercise operational independence – to act freely, insulated from outside pressure. In this sense, power does not mean influencing others; rather, it means not allowing others to influence you.

The distinction between the two dimensions of power is critical. Logically, power begins with autonomy. Influence is best thought of as functionally derivative – inconceivable in practical terms without first attaining and sustaining a relatively high degree of operational independence. First and foremost, an actor must be free to pursue its goals without external constraint. Only then will it be in a position, *in addition*, to exercise authority elsewhere. But influence does not flow automatically from autonomy. The actor must also be in a position to *actualize* its potential leverage – in practical terms, to translate passive autonomy into effective control. To aspire to a leadership role, an actor must have both the will and the ability to project its power onto others.

Herein lies the problem for the euro. EMU may have succeeded in augmenting Europe's autonomy in currency affairs, albeit by less than might be thought. But it has yet to endow its members with enough direct influence to match the degree of leverage traditionally exercised by the United States.

Greater autonomy ...

That there has been a gain of autonomy is without question. With one joint currency replacing a plethora of national currencies, EMU's members no longer have to fear the risk of exchange-rate disturbances inside Europe. In the words of the European Commission (2008: 4): 'The exchange rate realignments that periodically traumatised the European economies have become a thing of the past.' For a continent long plagued by currency instability, that is no small accomplishment. Moreover, with the now widespread acceptability of the euro, EMU countries have come to enjoy a much improved international liquidity position. Deficits that previously had required foreign exchange may now be financed with Europe's own money. Operational independence plainly is greater than it was before.

The gain should not be exaggerated, however. In some respects considerable vulnerability remains, particularly in relation to the world outside Europe. The euro zone is largely a passive participant in global

payments developments, leaving members critically exposed to fluctuations of the euro's exchange rate *vis-à-vis* the dollar and other major currencies. Indeed, to date, the bloc has been something of a bystander, more reactive than active. For the ECB, the highest priority has been to establish its own credentials as a fighter for monetary stability, consistent with its narrowly drawn mandate under the Maastricht Treaty, EMU's founding document. Policy has been targeted almost exclusively at the domestic price level. The balance of payments and exchange rate have been left largely to their own devices.

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A near doubling of the euro's value relative to the dollar since its lows in 2000–01 has been a source of satisfaction, including to the ECB which initially had worried about the effect of the currency's early depreciation on the credibility of Europe's grand monetary experiment. Many people in Europe have experienced a surge of pride as their currency has left the greenback in its wake. But there is also an obvious downside – the dampening effect that an increasingly expensive euro could have on trade competitiveness. Particularly distressing is the knowledge that the appreciation has more to do with dollar weakness than with euro strength. The euro has been favoured by currency traders because of policy failures on the US side, not because of relative productivity improvements or brighter growth prospects in Europe.

Yet except for one brief episode in the autumn of 2000, the ECB has studiously avoided any manner of

direct intervention in the foreign-exchange market. The bank's management knows that any attempt to reverse the rise abroad, via sales of newly issued euros, would simply undermine the battle against inflation at home. In practice, the euro zone can do little but remain a passive witness to its currency's appreciation. Overall the bloc's gain of autonomy, while undeniable, remains slighter than many had hoped.

... but not greater influence

But that is not the heart of the problem. The issue is not the scale of the gain of autonomy, but what the governments of Europe have been able to do with it. Slight or not, greater autonomy has not been translated into more effective influence. Though freer now to pursue internal objectives without outside constraint, the euro zone has yet to actualize its potential for overt leverage over others.

In principle, currency unification should have been expected to enable Europe's governments to play a much larger role in monetary affairs. Joined together in EMU, European states would surely have more bargaining power in inter-state negotiations than they would had each continued to act on its own. Europe's voice would be amplified on a wide range of issues, from policy coordination or crisis management to reform of the international financial architecture. Power would be more effectively exercised in a purposive manner.

In practice, however, Europe's voice has remained muted. A comparison with the United States is telling. Even without the participation of Britain and some other EU countries, the euro zone constitutes one of the largest economic units in the world, rivalling the US in terms of output, population and share of foreign trade. Yet despite the dollar's recent tribulations, Washington still speaks with a much louder voice in global forums such as the International Monetary Fund (IMF) or Group of Seven (G-7). As the European Commission (2008: 11) unhappily acknowledges, Europe 'still punches below its economic weight in international fora'. EMU has proved no match for the US heavy-weight.

The reason is evident and lies in EMU's governance structure – the constellation of rules and institutions that constitute the framework for euro-zone economic policy. Under the terms established by the Maastricht Treaty, no one knows who, precisely, speaks for EMU. No single body is formally designated to represent the group in international discussions. As a result, Europe is at a permanent disadvantage in any effort to exert influence. EMU, laments euro enthusiast Fred Bergsten (2005: 33), 'still speaks with a multiplicity, even a cacophony, of voices Hence it dissipates much of the potential for realizing a key international role.'

The result is a lack of coherence that saps much of the authority that the euro zone might otherwise be expected to exercise. Informally, efforts have been made to address the problem through tactical cooperation among the group's members on an ad hoc basis. But in the absence of a strategic commitment to achieve and defend common positions, backed by genuine political agreement, such actions are bound to lack impact. As one senior official of the European Commission concedes, speaking anonymously: 'We're a political dwarf and an economic giant.' Without significant change, the euro area will remain condemned to lasting second-class status.

What can Europe do?

The problem for Europe lies in the fundamental mismatch between the domain of EMU and the jurisdictions of its member governments. The euro is a currency without a country – the product of an inter-state agreement; not, like the dollar, the expression of a single sovereign power. Hence the euro zone's capacity to project power is structurally constrained. It is difficult to become a major player when speaking with many voices. The solution, therefore, lies in reform of EMU's governance structure.

Institutional framework and governance

Addressing EMU's structure of governance is critical because of the institutional complexity of a monetary union established by a group of states that retain their sovereignty in most economic matters other than

monetary policy. In EMU, governance broadly covers four policy areas – monetary policy, fiscal policy, market structure and exchange rates – all aiming at the same goals of economic growth and employment. Not all policy areas, however, are addressed at all levels of policy-making. Monetary policy is a matter for the ECB while fiscal policy and strategic exchange-rate policy remain in the hands of EMU member states. The locus of responsibility for the external value of the euro is divided ambiguously.

When EMU was established the focus was placed single-mindedly on EMU's internal conditions. The development of the euro as an international currency was not identified as an explicit policy goal. In the words of the ECB (2008: 96): 'From a policy perspective, the Eurosystem has adopted a neutral stance on the international use of its currency. It does not pursue the internationalisation of the euro as a policy goal.' Even during the recent credit crisis Jean-Claude Trichet, the ECB's president, maintained that price stability was the ECB's sole priority, reinforcing the bank's inflation-fighting credentials. The ECB, he declared, would not bow to political pressures to ease monetary policy in order to promote economic growth.

The ECB has played the 'confidence game'¹ well and has successfully established a track record of preserving market confidence in the value and usability of the euro zone's money. After ten years, however, it is becoming clear that a single-minded focus on internal conditions is no longer enough if Europe is to be able to project power in monetary affairs commensurate with the growing international role of the euro (Cohen 2008; Subacchi et al. 2008). Sound domestic policy and a credible central bank are obviously necessary for the successful exercise of monetary influence. But they are clearly not sufficient. Closer attention should also be paid both to the euro exchange rate and to the role of the euro zone in international monetary forums.

Exchange rates

Given the strengthening of the euro's external value since 2001, coupled with the persistently weak performance of the euro area's real economy, it is hardly surprising that the exchange-rate issue has by now become central to EMU policy discussions. The question for policy-makers is whether exchange-rate management and coordinated currency interventions should play a more prominent role in the euro zone's macro-policy toolkit.

Modern economic theory contends that a flexible exchange rate – where a currency's value is allowed to fluctuate according to the foreign-exchange market – is best understood as a forward-looking asset price determined at a level at which investors willingly hold a stock of a currency. This contrasts with the older view – no longer endorsed by most economists – that the exchange rate is determined by the flow demand and supply of foreign exchange. The exchange rate, accordingly, may be assumed to depend on expectations over future events rather than just on what is happening in the present or has happened in the past.² Given this theoretical framework along with abundant empirical evidence, direct intervention in currency markets can be expected to have little scope and effect. It may also risk sending the wrong signals to the markets and setting unmanageable expectations. Central banks can still play a useful role, but mainly by helping market actors to locate long-term equilibrium through signalling future changes in monetary policy and/or changing the relative supplies of different assets.

In the case of EMU, this suggests that the ECB should use its accumulated credibility to engage more proactively with the markets on the euro's exchange rate. In practice, that would mean focusing on the currency's long-term equilibrium rate as well as on the short-term process of transition to equilibrium, to counter the frequent tendency of market players to extrapolate recent exchange-rate changes into the longer-trend future.

¹ This expression comes from Paul Krugman (1998: 24).

² Current account outcomes also depend on saving and investment, with income flows and exchange rates both determined simultaneously in a general equilibrium setting. For a discussion of exchange-rate economics see Williamson (2008).

Effective exchange-rate management will also require a concerted parallel effort by EMU's member governments. Monetary policy cannot carry the load alone. Equally important is the role of economic policies as exercised by individual states, which can have a significant impact not only on the euro's external value, but also on real rates of exchange within EMU. Empirical evidence clearly points to growing divergences of real exchange rates within the euro zone (Subacchi et al. 2008). At the root of these divergences are differences in national inflation rates. These are not only a function of cyclical positions, but are also determined by the shape of national institutions – above all, labour markets. Sound national policies aiming at strong productivity growth can help real exchange-rate readjustment for converging economies with a fixed nominal exchange rate, and therefore improve competitiveness. Better coordination and surveillance of policies, in turn, would ensure that separate national targets and instruments are consistent with each other and are integrated in a non-conflicting framework in order to avoid negative spillovers. This is one of the three pillars in the European Commission's policy agenda (2008: 8).

The function of coordination would be best undertaken by the Eurogroup which, according to the Commission (2008: 287), has become 'a key body in the present EMU's system of economic governance'. The main strength of the Eurogroup is its relatively small size and cohesiveness, which enables it to debate issues thoroughly and with candour. Currently, it is charged with the surveillance of public finances and macroeconomic developments. In addition, in recent years, it has increasingly discussed microeconomic issues relevant to the functioning of EMU. The Eurogroup could certainly play a bigger role in overseeing structural reforms and policy linkages among its members.

Speaking with one voice?

Even with more effective exchange-rate management, however, the euro zone risks remaining a political dwarf on the global stage while it continues to speak, as it does now, with a cacophony of voices. The disadvan-

tages of EMU's lack of coherence in international negotiations are by now well understood. In a report marking the ECB's tenth anniversary, the European Commission explicitly identified the consolidation of EMU's external representation as a policy target: 'To be able to speak with a more coherent voice in global fora, the euro area needs to consolidate its external representation ... the time is ripe for launching this process of consolidation' (European Commission, 2008: 279).

One possibility mooted by the Commission as a 'long-term objective' would be the establishment of a single seat for all EMU members in such bodies as the IMF and G-7. Such a goal, however, is easier to enunciate than to implement, since member states that now occupy individual seats are unlikely to relinquish their privileged positions without a struggle. Given the diffuse scepticism and increasing disillusionment towards the European project that seem rampant across Europe today – well demonstrated by the Irish public's rejection of the Lisbon Treaty in a referendum in June 2008 – there is little appetite in Brussels for any move now that might seem to threaten such a key element of national sovereignty. Consolidation of representation in a single seat for the euro zone is simply not politically realistic in the current circumstances. More plausible is the possibility that a single EMU representative might be added to the EU's existing cast of characters, to speak specifically for the euro zone on matters of critical interest to its members.

Who might provide that representative? One possible candidate could conceivably be the ECB. As the euro zone's only truly collective institution, the ECB would in fact seem to be the most natural candidate to speak for EMU on global monetary issues. But that choice runs up against the tradition that in most such settings, countries are normally represented not by central banks but by finance ministers – officials with the political clout to speak for their respective governments. The ECB cannot claim that kind of authority. Indeed, it is difficult to imagine the elected governments of Europe ever delegating such a fundamental power to an institution that has been deliberately designed to be as free from political influence as possible.

The obvious alternative would be the Eurogroup, whose members do indeed have the necessary political clout. A start in this direction came in January 2005, with the creation of the position of Eurogroup president, now held by Jean-Claude Juncker of Luxembourg. Having improved the running of the Eurogroup's meetings, the president has come to play a key role in the economic governance of EMU and is now expected to represent and articulate the views of finance ministers in the relevant international forums. The president participates on a regular basis in G-7 finance ministers' meetings, albeit with no specified responsibilities. Likewise, when issues relating to the euro are discussed at the IMF, the president is invited to make a statement on behalf of all EMU members.

‘The euro’s external representation and governance need to fit within a framework where member states pursue their own goals without conflicting with EMU’s overall interests’

But this is only a start and clearly falls short of what is needed to fully transform EMU into a monetary heavyweight comparable to the United States. Because the Eurogroup remains an informal grouping within the EU, its president still lacks any sort of formal mandate to negotiate on behalf of EMU members. Worse, the president's ability to speak authoritatively for the euro zone extends only to issues on which the members are able to agree – which, of course, are usually the least controversial. The ruling principle within the Eurogroup is consensus, which effectively gives each member a potential veto. As a result, the president's voice can be easily muffled by policy differences among governments. Given EMU's present

governance structure, a single official cannot ignore or override the preferences of diverse sovereign states.

Can the voice of the president be strengthened? Certainly it would help if the role of the Eurogroup were to be formally institutionalized within the EU's complex governance structure. Likewise, the president's legitimacy and credibility could be enhanced by the grant of an official mandate to represent EMU in all international organizations and forums. And of course there would be great benefit if the finance ministers of the Eurogroup could somehow be persuaded to look more often at the bigger picture, reflecting a genuine sense of community and common identity. However, herein lies a difficult balancing act – that is, between the interests of the euro area as whole and those of member states. The euro's external representation and governance need to fit within a framework where member states pursue their own goals without conflicting with EMU's overall interests.³

Eventually, however, some way must be found around the *de facto* veto currently available to EMU members. One possibility might be to make the Eurogroup's decision-making procedures more transparent, in the hope of reducing temptations for opportunistic behaviour. Another, taking the ECB's executive board as a model, might be to create a small inner council of no more than, say, six elected members who would be authorized to decide on policies after consultations with all EMU members. And a third possibility might be to introduce weighted majority voting in the Eurogroup, with appropriate safeguards for smaller states. With any of these options, there would be grounds for concern about a possible democratic deficit in the delegation of authority over potentially critical matters to such a small group of decision-makers – a concern that is often expressed with regard to the ECB. But hopefully such worries could be alleviated by suitable provisions for accountability. For example, the Eurogroup president might be required to report regularly to the European Parliament, while finance ministers would continue to

³ On this see Pisani-Ferri et al. (2008).

report, as they do now, to their respective national legislatures.

In the end, of course, any step toward consolidation of euro-zone representation is bound to be accused of infringing on national sovereignty. Indeed, contestation over who speaks for the euro zone is inevitable as long as the euro remains a currency without a country. The trade-off is inherent in the inter-state agreement that underlies EMU. But if Europe really wishes to punch its true weight on monetary matters, there is effectively no choice. Without the reforms needed to project power more effectively, Europe will never be ready for prime time.

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