The Euro at 10

Europeanization, Power, and Convergence

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OXFORD
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Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
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Published in the United States
by Oxford University Press Inc., New York

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First published 2008

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British Library Cataloguing in Publication Data

Data available

Library of Congress Cataloging in Publication Data

The euro at 10 : Europeanization, power, and convergence / edited by Kenneth
Dyson.
p. cm.
ISBN 978-0-19-920886-9
1. Euro. 2. Euro area. 3. Europe–Economic integration. 4. Economic and
Monetary Union. 5. European Union countries–Economic policy. I. Dyson,
Kenneth H. F.
HG925.E86785 2008
332.4'94–dc22 2008016930

Typeset by SPI Publisher Services, Pondicherry, India
Printed in Great Britain
on acid-free paper by
CPI Antony Rowe, Chippenham, Wiltshire

ISBN 978-0-19-920886-9

1 3 5 7 9 10 8 6 4 2

2

The Euro in a Global Context: Challenges and Capacities[1]

Benjamin J. Cohen

The birth of the euro in 1999 was expected to create a new power in international monetary relations. Even without the participation of Britain and some other European Union (EU) members, the Euro Area would constitute one of the largest economic units in the world, rivalling even the United States in terms of output and share of foreign trade. Consequences for the geopolitics of finance promised to be momentous. Europe's Economic and Monetary Union (EMU) would become a major player on the monetary stage. Europe's new money, building on the widespread popularity of Germany's old Deutschmark (D-Mark), would pose a serious threat to the predominance of America's greenback as an international currency.

A decade later, how have matters turned out? The purpose of this chapter is to evaluate the experience of the Euro Area to date in a broad global context. The central question is: How has the creation of the euro affected the power of participating states to cope with external challenges?

International monetary power, as I have suggested elsewhere (Cohen 2006), may be understood to have two dimensions, internal and external. The internal dimension has to do with the ability to exercise policy independence—to act freely, insulated from outside pressure. A useful synonym for this meaning of power is *autonomy*. The external dimension has to do with the ability to shape the actions of others—to exercise leverage or enforce compliance. A common synonym for this meaning of power is *influence*. Challenges for the Euro Area encompass both dimensions.

With regard to the dimension of autonomy, two key issues are involved. One is the global macroeconomic environment, including especially the evolution of exchange rates and regional payments imbalances. Though Europe

[1] I am indebted to Kenneth Dyson and Jim Rollo for useful comments. The research assistance of Heather Arnold is gratefully acknowledged.

itself has remained relatively close to payments equilibrium in relation to the rest of the world, EMU cannot help but be affected by any stresses created by broader global imbalances or the risk of contagious debt defaults. How well equipped is the Euro Area to deal with any threat of financial instability? The other issue is the potential competition with the greenback for use as an international currency. Perhaps the greatest benefit of an international currency is the ability to finance external deficits with one's own money, thus enhancing internal policy flexibility (Cohen 2004). Can the euro compete effectively with America's dollar in global markets? With regard to the dimension of influence, the key issue has to do with institutional participation. Does membership in the Euro Area enable EU governments to play a more authoritative role in the International Monetary Fund (IMF) or other financial forums?

Overall, this chapter concludes, EMU has failed to live up to expectations. Though exposure to exchange-rate disturbances has obviously been reduced inside Europe, member states remain vulnerable to fluctuations of the euro's exchange rate vis-à-vis outside currencies. The Euro Area is largely a passive participant in global payments developments and, if anything, has become even more exposed to threats of financial instability. Likewise, the euro has failed to mount a significant challenge to the dollar and the bloc continues to punch below its weight in monetary diplomacy. The fundamental problem lies in the 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 interstate agreement, not the expression of a single sovereign power. Hence EMU's power to cope with external challenges is structurally constrained. It is difficult to become a major player when speaking with many voices.

Financial Stability

In one key respect, EMU has clearly enhanced the autonomy of its members. With a single joint money replacing a plethora of national currencies, participants no longer have to fear the risk of exchange-rate disturbances inside Europe. For a continent long plagued by currency instability, that is no small accomplishment. But in other respects vulnerability remains considerable, particularly in relation to the world outside Europe. The Euro Area is largely a passive participant in global payment developments, leaving members critically exposed to fluctuations of the euro's exchange rate vis-à-vis the US dollar and other major currencies. Moreover, even though European states could hardly expect to be unaffected should a crisis hit the broader financial system, the Euro Area remains remarkably unprepared to cope with any major disruption in banking or credit markets.

A Bystander

To date, the Euro Area has been something of a bystander in global monetary affairs, more reactive than active. For the newly created European Central Bank (ECB), the highest priority was to establish its own anti-inflationary credentials, consistent with its narrowly drawn mandate under the Maastricht Treaty, EMU's founding document. Policy was targeted almost exclusively on the domestic price level. The balance of payments and exchange rate were left largely to their own devices.

As measured by the current account (the balance on trade in goods and services plus unilateral transfers), EMU's external position has been very near balance throughout the period since 1999, varying from mild deficits in 1991–2001 to small surpluses in most succeeding years. Imbalances in either direction have never exceeded 1 per cent of the Euro Area's gross domestic product (GDP) and in most years have amounted to a mere fraction of 1 per cent, adding little to global disequilibrium.

Variations in the euro exchange rate have been greater but have largely reflected the fluctuating fortunes of the US dollar. Born at a time of substantial dollar strength, Europe's fledgling currency first depreciated sharply, dropping from an initial value just above $1.18 to a low near $0.82 in October 2000 before settling around 90 cents for the remainder of 2000 and 2001. Then, when a weakening trend began to afflict the greenback, the euro came roaring back, passing $1.00 in mid-2002 and peaking in late 2004 at above $1.36. In 2005, the euro again declined modestly as US interest rates rose, languishing around $1.20 until mid-2006. In the latter half of 2006, a new ascent began, surpassing $1.35 by mid-2007. Rates in relation to other major currencies have largely mirrored the euro's movements in relation to the greenback. Overall, the trade-weighted ('effective') exchange rate of the euro has differed little from its bilateral dollar rate (Zestos 2006: ch. 5).

An appreciation of some 40–60 per cent from the euro's lows in 2000–1 was a source of some satisfaction to the ECB, which had been worried about the effect of the currency's initial depreciation on the credibility of Europe's grand monetary experiment. 'I welcome the recent appreciation of the euro', declared the Bank's first President, Wim Duisenberg (quoted in *The New York Times*, 10 January 2003: C11). Many Europeans experienced a surge of pride when their new currency left the greenback in its wake. But there was also an obvious downside—the dampening effect that a more expensive euro might have on economic growth. In the words of one commentary: 'A stronger euro may give Europeans bragging rights, but it has also hobbled their exports' (Landler 2004). By one common rule of thumb, a 5-per cent rise in the euro's trade-weighted exchange rate would be expected to have the same negative impact on growth as an increase of 1 per cent in interest rates (*The Economist*, 10 May 2003: 66). Predictably, appreciation brought an anguished chorus of

complaints from European exporters. Jean-Claude Trichet, the ECB's second President, called the rise 'brutal'.

Particularly distressing to many Europeans was the knowledge that the appreciation had more to do with dollar weakness than with euro strength. Confidence in the greenback, already undermined by America's persistent payments deficits, had been shaken by the Wall Street slump and consequent recession of 2001–2, as well as by war fears prior to the invasion of Iraq in 2003. Later came the bursting of America's real estate bubble and the sub-prime mortgage crisis in 2007. And compounding it all was a distinct change of tone by the US government, especially once John Snow took over as Treasury Secretary two years into the administration of George W. Bush. Gone was the 'strong dollar' rhetoric of the previous Clinton administration. Instead, Snow now spoke of the benefits of a 'modest realignment of currencies', suggesting that some depreciation of the greenback would not be at all unwelcome in Washington as a means to improve US trade competitiveness. In effect, America seemed to be 'talking the dollar down' at Europe's expense, rankling many Europeans. Declared the chief economist of Germany's Deutsche Bank: 'The U.S. has always had the philosophy, "the dollar is our currency, and your problem". We have to come to grips with that' (quoted in *The New York Times*, 25 May 2003: WK5).

But Europe could not come to grips with that. Except for one brief episode in the fall of 2000, the ECB has studiously avoided any manner of direct intervention in the foreign-exchange market. Partly, this is because the anti-inflationary impact of a rising currency is welcome to the Bank's management. But mainly it reflects an understanding 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 Area can do little but remain passive witness to its currency's appreciation.

As a group, therefore, members remain critically exposed to damaging fluctuations in the euro's exchange rate—though, individually, effects are likely to vary considerably. For the bigger participants, such as Germany and France, the negative consequences of a prolonged appreciation are regrettable but manageable. For some smaller members, by contrast, impacts could be much more painful, possibly more than offsetting the evident benefits of the new currency stability within Europe. Countries like Finland or Ireland, with their more open economies and greater dependence on trade outside the Euro Area, appear to be at particular risk.

Coping with Instability

Worse, European states seem remarkably unprepared to cope with any wider instability that might erupt in international finance. The Euro Area's

prevailing rules are not at all clear about who, ultimately, is responsible for management of a monetary crisis, should one occur.

Two central issues have dominated the global macroeconomic environment over the last decade. One is the huge gap in America's balance of payments, matched by corresponding surpluses in East Asia and among energy-exporting nations. The world has never seen such a massive monetary disequilibrium. The other is the continuing vulnerability of emerging or transition economies to the kind of financial disruptions that struck Asia in 1997–8 or Argentina in 2001. Though market conditions have been relatively benign in more recent years, the risk of instability remains an ever-present threat. At any moment, global imbalances or a debt default could explode into a full-fledged crisis, destabilizing asset prices and possibly spreading illiquidity or insolvency among financial institutions. EMU, however, does not seem well equipped to maintain stability in the event of such rude shocks.

According to the Maastricht Treaty, the ECB has no specific powers to deal with any disruptions that might occur. Financial integration among EMU members has bourgeoned since the euro's birth; as a result, the risk of contagion within the bloc, should troubles hit, has clearly grown. In the words of the European Central Bank (2007*a*: 74): EMU has 'led to broader and deeper systemic inter-linkages between Member States, increasing the likelihood of potential financial market disturbances in one Member State spreading across borders'. Yet the ruling principle of the Euro Area remains decentralization, otherwise known as subsidiarity—the notion that the lowest level of government that can efficiently carry out a function should do so. Formal authority for crisis management continues to reside at the national level, as it did before EMU. Each central bank is charged with responsibility for the financial institutions and markets based within its own borders.

There is only one exception. General language in the Maastricht Treaty does appear to empower the ECB to backstop TARGET, the large intra-European clearing system, in the event of a payments gridlock or other difficulties. One of the basic tasks of the ECB (Article 105: 2), declares the Treaty, shall be 'to promote the smooth operation of payment systems'. But for any other contingency, such as a sudden wave of illiquidity in the banking sector, the Treaty is as uncommunicative as the Oracle of Delphi. Nothing is said about any authority for the ECB to act as a lender of last resort. Economist Garry Schinasi (2003: 3) says that this silence makes the ECB the 'ultimate "narrow" central bank'. The ECB has a mandate for price stability but not for financial stability.

The Treaty's silence in this regard has been a source of much debate. Some specialists interpret it as a form of 'constructive ambiguity'—an indication that, in practice, the ECB's crisis-management powers could be enhanced if and when needed. As one legal commentator puts it: 'The wording of the

subsidiarity principle leaves the door open for a possible Community competence' (Lastra 2003: 57). But others disagree, arguing that, because the responsibility has not been specifically delegated, it must remain at the national level. The Treaty's language is seen as restrictive rather than permissive. In practice, as in pre-EMU Europe, the lender-of-last-resort function has been left to the individual central banks. In September 2007, EU officials again declined to fix rules in advance on how to bail out banks that have cross-border operations within the union. No one, it appears, is directly accountable for the stability of the Euro Area as a whole.

Can such a decentralized arrangement be counted on to ensure smooth operation of the overall system? The European Central Bank (2007*a*: 84) remains optimistic, emphasizing the extent to which member states, by a variety of measures, have sought to provide 'a comprehensive, multi-layered and flexible framework ... with the potential to adapt to the specific challenges that a crisis situation may pose'. But there is certainly room for doubt.

What would happen, for instance, if in a given country a large financial institution with extensive cross-border business were to find itself in trouble? Would the national authorities be evenhanded in their response, fully recognizing the interests of claimants elsewhere in the Euro Area? Or would they act protectively, even at the risk of conflict with the regulatory authorities of partner countries? We have no way of knowing. The scheme 'may work well', observes Schinasi (2005: 119–20), 'but this still remains to be seen.... It is [not] obvious that national supervision in Europe would tend, as a first priority, to focus on European priorities.... It is difficult to imagine the national supervisor pursuing European interests first and national interests second.' The International Monetary Fund (2007*a*: para. 12) echoes this concern in a recent review of Euro Area policies: 'Progress on the ground is being held back by the governance framework. The core problem is the tension between the impulse toward integration, on the one hand, and the preference for a decentralized approach, on the other.... This setting rules out efficient and effective crisis management and resolution.'

In short, the possibility that central banks might work at cross-purposes, aggravating a crisis, is certainly not outside the realm of possibility. There is no Invisible Hand for public agencies. Decentralized decision-making among sovereign governments without some form of coordination is potentially a recipe for disaster.

Competition with the US Dollar

At the time of EMU's birth, many predicted a bright future for the euro as an international currency. Though the dollar had long reigned supreme in monetary affairs, Europe's new currency was expected to quickly assert itself as

a major competitor. If the Euro Area could be the equal of the United States in output and trade, why should it not be America's equal in monetary matters, too? Typical was the view of Robert Mundell (2000: 57), a Nobel laureate in economics, who expressed no doubt that the euro 'will challenge the status of the dollar and alter the power configuration of the system'. In the oft-quoted words of Jacques Delors, when he was President of the European Commission, '*le petit euro deviendra grand*'.

In reality, however, Europe's little euro has not become big—and for good reason. The currency clearly did start with many of the attributes necessary for competitive success, including a large economic base, unquestioned political stability, and an enviably low rate of inflation, all backed by a joint monetary authority, the ECB, that was fully committed to preserving confidence in the money's future value. But, as I have argued previously (Cohen 2003), the euro is also hampered by several critical deficiencies, all structural in character, that dull its attractiveness as a rival to the greenback. These include limited cost-effectiveness, a serious anti-growth bias, and, most importantly, ambiguities at the heart of the monetary union's governance structure. Only in the EU's immediate neighbourhood, where trade and financial ties are especially close, does the euro enjoy any special advantages. That is EMU's natural hinterland—'the euro's turf', as Charles Wyplosz (1999: 89) calls it. Elsewhere, Europe's money is at a distinct disadvantage.

Cost-Effectiveness

The first problem is the cost of doing business in euros. Transaction costs directly affect a currency's attractiveness as a vehicle for exchange transactions or foreign trade. From the start, it was clear that the dollar would continue to be favoured unless euro transaction costs, which began high relative to the widely traded greenback, could be lowered to a more competitive level. The same-scale economies and network externalities that encourage use of a money such as the dollar in the first place are also responsible for what economists call 'hysteresis' or 'ratchet' effects. Switching costs can be steep. Hence, international adoption of a new currency like the euro tends to be resisted unless the money can be expected to be truly cost-effective.

Could the euro become sufficiently cost-effective? That, in turn, depended directly on what might be done to improve the structural efficiency of Europe's financial markets (see Chapter 17 by Macartney and Moran). In practical terms, much has indeed been accomplished to knit together previously segmented national markets, particularly in short-term money-market instruments, syndicated bank lending, credit derivatives, and the corporate bond sector. Though numerous obstacles remain—including significant differences in clearing and settlement systems, tax structures, and accounting and business conventions—the EU seems well on its way to creating the

largest single-currency capital market in the world. In turn, costs have shrunk considerably as measured by spreads in bond markets or the market for foreign exchange. Costs have not shrunk enough, however, to overcome the greenback's natural advantages of incumbency.

The core problem is evident. The euro is condemned to remain at a disadvantage vis-à-vis the dollar so long as EMU is unable to offer a universal financial instrument that can match the US Treasury bill for international investor liquidity and convenience. This is a deficiency that will be impossible to rectify so long as the Euro Area, with its separate national governments, lacks a counterpart to the federal government in Washington. As Ben Bernanke (2005: 187), chair of the Federal Reserve Board of Governors, has observed: 'The European government bond market... has not attained the liquidity of the US Treasury market (and may never do so).... The fundamental difference [is] that eurozone debt is the debt of 12 sovereign entities rather than one, as in the United States.' The best the Europeans could do was encourage establishment of selected benchmark securities for investors. Gradually, 3 euro benchmarks have emerged: the German Bund at 10 years, the French bond at 5 years, and the Italian bond at 2 years. But such a piecemeal approach falls far short of creating a single market as large and liquid as that for US government securities.

Admittedly, yield differentials in the public debt market have shrunk since the euro was born, suggesting that interchangeability among national issues has increased considerably. But the convergence of yields is hardly complete. Investors continue to treat the obligations of EMU governments as imperfect substitutes, mostly owing to differences in perceived default risk. And these differences of perception could eventually be compounded as a result of a decision by the ECB in November 2005 to limit the collateral it will accept in refinancing ('repo') operations with European commercial banks. Previously, the ECB had accepted all Euro-Area government bonds indiscriminately, as if the debts of EMU member states were all of equal creditworthiness. Now, however, the Bank is more selective. Bonds must have a single A-rating or better from at least one of the three main rating agencies (Moody's, Standard and Poor's, and Fitch). Observers predict that this decision will lead commercial banks, in turn, to be rather more selective in their choice of issues, accentuating yield spreads.

On balance, therefore, segmentation of the public debt market is proving difficult to overcome; and that, in turn, means that the cost of doing business in euros is likely to remain a drag on the currency's appeal for years to come. Though, to date, efficiency gains in financial markets have been substantial, they clearly have not, on their own, been enough to make the euro more cost-effective than the dollar. The greater liquidity and convenience of the US Treasury bill market continues to give an advantage to the greenback.

Anti-Growth Bias

A second critical factor inhibiting the internationalization of the euro is a serious anti-growth bias that appears to be built into the institutional structure of EMU. By impacting negatively on yields on euro-denominated assets, this bias directly affects the currency's attractiveness as a long-term investment medium.

When EMU first came into existence, eliminating exchange risk within the European region, a massive shift was predicted in the allocation of global savings as compared with holdings of European assets in the past. Yet, as the European Central Bank (2007*b*) has ruefully noted, international portfolio managers have actually been quite slow to commit to the euro. Liquid funds have been attracted when there was a prospect of short-term appreciation, as in 2002–4. But underlying investor preferences have barely budged, in good part because of doubts about prospects for longer-term economic growth in the Euro Area. Many factors contribute to these doubts—aging populations, which limit manpower increases and stress old-age pension systems; rigid labour markets, which hinder economic adaptability; and extensive government regulation, which can constrain innovation and entrepreneurship. Europe's monetary union, regrettably, adds yet one more brake on growth.

The core problem here lies in EMU's institutional provisions governing monetary and fiscal policy, two key determinants of macroeconomic performance. In neither policy domain is priority attached to promoting output expansion. Rather, in each, the main emphasis is on other considerations that tend to tilt policy towards restraint, producing a distinct anti-growth bias to the Euro Area as a whole. As *The Economist* (29 April 2006: 38) laments, the euro 'has provided currency stability but has done little to promote growth'. Opportunities for future investment returns thus are even more limited than they might be otherwise.

On the monetary policy side, the ECB, unlike many other monetary authorities, was created with just one policy mandate—to maintain price stability. Moreover, the ECB is formally endowed with absolute independence, largely insulating it from political influence. Legally, the ECB is free to focus exclusively on fighting inflation, even if over time this might be at the cost of stunting growth. In practice, naturally, the ECB is not wholly insensitive to growth concerns. Nonetheless, the overall orientation of ECB priorities is clear. Since EMU's start, the bias of monetary policy has mainly been towards restraint, not expansion. Summarizes Hannes Androsch (2007: 48), formerly finance minister of Austria: 'The ECB is obliged to focus on fighting inflation, not promoting general economic development, and they are overdoing it. . . . We are not fully using the growth potential I think Europe has.'

Similarly, on the fiscal policy side, Euro-Area governments have formally tied their hands with their controversial Stability and Growth Pact (SGP). The SGP, first set up in 1997, was intended to implement the 'excessive deficit procedure' called for by the Maastricht Treaty (Article 104c). The Pact's key provision is a strict cap on national budget deficits at 3 per cent of GDP. That tight restraint makes it difficult for elected officials to use budgetary policy for contra-cyclical purposes, to offset the anti-growth bias of monetary policy.

The Pact is not air-tight, of course. In reality, we know, practice has increasingly diverged from principle, with a number of EMU's original members—including, most notably, France and Germany—repeatedly missing the 3 per cent target. We also know that little has been accomplished to make the Pact more effective, apart from some limited reforms in 2005. To many, these facts mean that the SGP has no 'bite'. But as Chapter 4 by Hallerberg and Bridwell indicates, empirical evidence clearly demonstrates that overall the Pact has in fact exercised a significant discipline, with an especially strong impact on most of EMU's smaller members. Moreover, can anyone doubt that in most cases deficits might be even larger in the absence of the SGP? Historically, many EMU governments routinely ran deficits in excess of 3 per cent; most had to struggle to qualify for membership in the first place. De facto, if not de jure, the SGP straitjacket remains a constraint on Euro-Area states, perpetuating an anti-growth bias in fiscal policy, too.

Is it any wonder, then, that the anticipated shift of global savings has turned out to be largely illusory? Is it any wonder that many politicians, including France's new President Nicolas Sarkozy, have been calling for improvements of EMU's 'economic governance'? EMU's built-in tilt towards restraint exacerbates an already serious growth problem in Europe. Dim prospects for returns on euro-denominated assets inevitably discourage use of the currency for investment purposes.

Governance

Finally, there is the governance structure of EMU, which for the euro's prospects as an international currency may be the biggest handicap of all. The basic question is: Who is in charge of monetary policy? From the start, uncertainty has reigned over how decisions are to be made in EMU's core agency, the ECB.

The problem goes back, once again, to the institutional provisions of the Maastricht Treaty. Practical operational control of monetary policy was to lie in the hands of the ECB's Executive Board, made up of the President, Vice-President, and four other members. Overall managerial authority, however, was formally lodged in the Governing Council, which in addition to the

six-member Executive Board would include the heads of the central banks of all participating states, each with the same voting rights. Evidently, the drafters of the Treaty were not overly concerned that the large size and mixed representation of the Governing Council might be inconsistent with efficient governance.

The flaw is obvious. Even before the EU's recent enlargements in 2004 and 2007, the Governing Council—with the 6 Executive Board members and 12 (now 15) national governors—was already significantly larger than the top managerial unit of any other central bank in the world. With the entrance of a dozen new countries into the EU, bringing total membership to 27, the size of the Council threatened to become utterly unwieldy as the Euro Area enlarged. Upon joining the EU, all new members immediately gain observer status on the Council, with voting rights to follow once they adopt the euro. Cyprus, Malta, and Slovenia have already made the jump to full participation. The number could thus grow to as many as 30, with even more governors to be added down the road as other candidate governments successfully negotiate their way into the club (or if Britain, Denmark, or Sweden ever decide to adopt the euro). A gaggle of three dozen or more strong willed individuals could hardly be considered conducive to efficient decision-making. With so many bodies around the table, discussions would undoubtedly be time-consuming and complicated. As one source commented sarcastically, enlargement would leave the Council with 'too many to decide on where to go to dinner, let alone agree on how to run monetary policy for more than 400 million people' (Baldwin 2001). In short, the ECB had a 'numbers problem'.

To their credit, Europe's leaders did come soon to recognize the problem and sought to provide a remedy. In March 2003, a reform was approved, restricting votes on the Council to a smaller total on a rotating basis. Membership of the Council will continue to include the Executive Board and all national central bank governors; moreover, all six members of the Executive Board will retain their individual votes. But voting rights of national governors are now to be limited to no more than 15 and will rotate among governors according to a specified formula, taking explicit account of the diversity among member states.

The remedy, however, may be worse than the disease. On the one hand, the reform leaves intact the large number of bodies at the table. Every national governor, as well as the six Executive Board members, will continue to participate in all policy discussions, with full speaking rights. The approach has been defended on the grounds that it is vital to promoting the legitimacy of the euro enterprise. No other EU institution denies representation to any member state. In addition, it is argued, full participation may be expected to facilitate consensus building and contribute to a better flow of information. But the approach can also be criticized for perpetuating all the inefficiencies of the

ECB's numbers problem. As one astute observer puts it, the Governing Council will remain 'more like a mini-parliament than a decision-making body' (Gros 2003: 124).

On the other hand, the reform may well deepen rifts within the Governing Council, since the rotation model is so unabashedly state-based. Votes are allocated strictly along lines of national identity. In principle, governors are supposed to be fully independent professionals operating in a personal capacity, making monetary policy objectively for the Euro Area as a whole. In practice, however, they may now be forgiven for thinking first of their own countries rather than in terms of collective interests. In the words of a prominent German economist: 'The reform proposal does not meet the rationale of an integrative monetary policy.... It re-nationalises European monetary policy' (Belke 2003: 122). The dollar's advantage in this regard is obvious.

A Regional Destiny

For all these reasons, it should be no surprise that the euro's experience as an international currency to date has been underwhelming, even allowing for the characteristic stickiness of monetary preferences. In most categories of cross-border use, adjusting for the elimination of intra-EMU transactions, the euro has managed roughly to hold its own as compared with the past aggregate shares of EMU's 'legacy' currencies. This means that Europe's joint money has smoothly taken its place as successor to Germany's old D-Mark, which among international currencies had already attained a rank second only to the dollar. But that is about all. After an initial spurt of enthusiasm for the new currency, use in most market segments has leveled off or even declined in recent years. Moreover, since its birth, the euro's only enduring gains have been among neighbouring states with strong regional or political ties to the EU—what might be described as EMU's natural hinterland. In the European Central Bank's words (2007*c*: 7), a 'strong institutional and regional pattern continues to characterise the internationalisation of the euro'. Beyond the European region, the euro remains very much in the dollar's shadow.

For example, in the foreign-exchange market, according to the European Central Bank (2007*c*), the euro entered on one side of just 39 per cent of all transactions in the period from mid-2005 to end-2006—less than half the dollar's share (93 per cent). That was higher than the share of the D-Mark, which had appeared in 30 per cent of transactions in 1998 (its last year of existence) but lower than that of all euro's legacy currencies taken together (53 per cent) and actually down from a high of 41 per cent in the preceding 12-month period from mid-2004 to mid-2005. Only in the Nordic states and East-Central Europe, where commercial ties are largely concentrated

on the EU, is the euro the favoured vehicle. Likewise, evidence from the IMF on trade invoicing (Bertuch-Samuels and Ramlogan 2007) suggests that at best the euro has been able to maintain the D-Mark's share of world exports—roughly 15 per cent, less than one-third the dollar's share. It has yet to show any sign of increase except, again, in neighbouring European states.

There has been some new use of the euro as a vehicle for lending. Once the new currency was born, outside borrowers were attracted by the opportunity to tap into the much broader pool of savings created by the consolidation of EMU financial markets. Overall, the euro's share in the stock of international bonds and notes rose strongly, from roughly a fifth in 1999 to nearly half by the end of 2005, before falling back by a few percentage points in 2006. But again, most of the increase came from immediate neighbours (mainly recent or prospective EU members). Borrowers in Asia and Latin America continue primarily to use the dollar. Moreover, these developments represent growth only in the *supply* of euro-denominated assets. On the demand side, as indicated, foreign portfolio managers have been slower than anticipated to add to their holdings of euro-denominated claims, despite the greater depth and liquidity on offer. Most issues have been taken up by investors inside Europe itself, making them in effect 'domestic'. Outside EMU, the euro's overall share of portfolios has changed little from the previous aggregate of legacy currencies. Similar patterns have also prevailed in international banking markets (European Central Bank 2007*c*).

Only in official reserves has there been a sustained increase of use as compared with the D-Mark and other legacy currencies. From its birth in 1999 to end-2006, the euro's share of currency reserves advanced from 18 per cent to nearly 26 per cent. It is noteworthy, though, that as much as half the growth came at the expense of Japan's yen and miscellaneous 'other' currencies rather than the dollar. Moreover, much of the increase vis-à-vis the greenback has been the result of exchange-rate shifts rather than deliberate dollar sales. Direct conversions from the greenback to the euro have been cautious and slow. As economists Edwin Truman and Anna Wong (2006: 36) conclude: 'The available evidence suggests that the amount of *active* diversification of countries' foreign exchange reserves has been limited to date' (emphasis in the original). The dollar's share of reserves is still two and a half times that of the euro.

None of this, therefore, adds up to a serious challenge to the greenback. The dollar's appeal may be eroded by America's persistent payment deficits. But that by itself does not ensure success for the euro so long as the new currency's own deficiencies remain uncorrected. The euro clearly does have a future as an international currency. But its allure is not unqualified and, worse, seems limited mainly to the EU's own backyard. The currency's destiny appears to be regional, not global.

Institutional Participation

Finally, there is the issue of institutional participation. With a population presently exceeding 300 million and a GDP rivalling that of the United States, the Euro Area was expected to start playing a major role in international monetary diplomacy. Joined together in EMU, it was widely thought, members would surely have more bargaining leverage than if each acted on its own. Europe's voice would be amplified on a broad range of macroeconomic issues, from policy coordination or crisis management to reform of the international financial architecture. Yet, here too, experience to date has been underwhelming. In practice, membership in EMU has not enabled EU governments to play a more influential role in the IMF or other global forums. Europe's voice has been muted at best.

The Problem

The problem is that no one knows who, precisely, speaks for the Euro Area. Here too the Maastricht Treaty is regrettably uncommunicative. No single body is formally designated to represent EMU in international discussions. Instead, the text simply lays down a procedure for resolving the issue of external representation at a later date, presumably on a case-by-case basis (Article 109). Some sources excuse this on the grounds that it achieves a balance between the need to convey a common position and the prerogatives of member states. But that seems too kind. In fact, it was a cop-out, a diplomatic formula to mask failure to reach consensus.

At a minimum, therefore, the Treaty compounds confusion about who is in charge. At worst, it condemns the Euro Area to lasting second-class status, since it limits its ability to project power on monetary matters. EMU, laments Fred Bergsten (2005: 33), a euro enthusiast, 'still speaks with a multiplicity, even a cacophony, of voices . . . Hence it dissipates much of the potential for realizing a key international role'.

At the IMF, for example, the Euro Area's 13 members in 2007 were split up among no fewer than 8 different constituencies. France and Germany each has a single chair on the Fund's 24-member Executive Board. The other 11 are all part of diverse constituencies that include non-EMU states as well as EMU members and in some cases are led by non-EMU governments. Belgium, for instance, provides the elected Executive Director for a constituency that includes four EMU countries, three non-EMU members of the EU, and three non-EU states. Italy, similarly, leads a constituency with three EMU countries, one non-EMU member of the EU, and three non-EU states. The Netherlands heads a group that includes not a single other EMU country, while Finland, Ireland, and Spain all are minority members of constituencies led by non-EMU governments. Collectively, EMU's membership accounts for some

23 per cent of total voting power at the Fund. But, because representation is so fragmented, it is difficult for the Euro Area to exercise a commensurate influence on decision-making or even to develop common policy positions.

Likewise, in the influential Group of Seven (G-7), which with nearly half of all IMF voting power plays a decisive role in Fund decision-making, only the three biggest EMU states—Germany, France, and Italy—are formally included. Each speaks for itself alone. Other EMU governments have no direct voice at all.

The result is a lack of coherence that saps much of the authority that the Euro Area might otherwise be expected to exercise. Informally, efforts have been made to address the problem through tactical cooperation among the Euro Area's members on an ad hoc basis (Bini Smaghi 2004). At the IMF, for example, EMU's representatives all stand together on issues related directly to the Euro Area and its single monetary and exchange-rate policies. 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. The point has been best put by political scientists Kathleen McNamara and Sophie Meunier (2002: 850): 'As long as no "single voice" has the political authority to speak on behalf of the Euro Area, as the US Secretary of the Treasury does for the American currency, the pre-eminence of the US in international monetary matters, as in other realms, is likely to remain unchallenged.' EMU will continue to punch below its weight.

A Single Voice?

Is there any way to provide that single voice? In principle, any of several bodies might be designated to represent the Euro Area internationally. In practice, however, none is fully up to solving the problem.

One possibility, for example, might be the ECB. As the Euro Area'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 this choice runs up against the tradition that in most such settings, states are normally represented not by central banks but by finance ministers—officials with the political clout to speak for their respective governments. The ECB obviously 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.

Alternatively, some have suggested the appointment of a single individual with sufficient credentials and legitimacy to act as the equivalent of a finance minister for the Euro Area (McNamara and Meunier 2002)—a Mr. (or Ms.) Euro, as it were. Precedent exists in the realm of foreign and security

affairs, where EU members already agreed a decade ago to name a single High Representative to stand for them all—a Mr. Europe (presently Javier Solana of Spain). But experience has shown that Mr. Europe's ability to speak authoritatively for the entire EU can be easily hamstrung by policy differences among individual governments. A single appointed official cannot ignore or overrule the preferences of diverse sovereign states.

A third possibility would be a collective one, centered on the informal committee of EMU finance ministers that has emerged since the birth of the euro—what has come to be known as the Euro Group. Like comparable EU institutions, such as the Council of Ministers or European Council, the Euro Group can be represented at any given time by its chair; the chairmanship itself, as with those other institutions, rotates periodically among members. This appears to be the Euro Area's preferred route to date. Already, in 2005, the Euro Group chair began attending meetings of the G-7, albeit with no specified responsibilities. Likewise, when issues related to the euro are discussed at the IMF, the chair is invited to make a statement on behalf of all EMU members. But here too the authority of EMU's voice can be easily constrained by underlying policy differences. In no venue is the Euro Group chair permitted to negotiate on behalf of EMU as a whole.

The underlying obstacle is of course the lingering influence of national allegiance. Though EMU members share a joint money, their interests are hardly identical. Thus, however advantageous a single voice might be for the group, any effort to consolidate the Euro Area's institutional participation is bound to run into resistance from at least some individual participants. As Jeffry Frieden (2004: 262) observed, any such reform 'requires that member states weigh the potential benefits of a common policy against the potential costs of a policy that is not to their liking.... There is a clear trade-off between the advantages of scale and the disadvantages of overriding heterogeneous preferences.' Divergent preferences make members reluctant to give up the right to speak for themselves. Even after a decade of living with the euro, national identity still trumps collective interest.

Conclusion

Overall, the conclusion seems clear. For all its undoubted success in other respects, EMU has failed to improve the power of participating states to cope with external challenges. Neither the autonomy nor the influence of the bloc has been significantly enhanced. The reason seems equally clear. Based as it is on an agreement among sovereign states—what one scholar calls a 'sovereignty bargain' (Litfin 1997)—the Euro Area lacks the clean lines of authority traditionally associated with the management of money

by individual states. Its founding document, the Maastricht Treaty, is full of artful compromises and deliberate obfuscations, reflecting unresolved disagreements among governments at the time of negotiation (Dyson and Featherstone 1999). In the decade since the euro's birth, the Treaty's ambiguities have persistently clouded understandings about decision-making and the distribution of competences and responsibilities. As long as it remains a sovereignty bargain rather than a genuine federal union, EMU will always be at a structural disadvantage in the geopolitics of finance.