

Back to Basics

State Power in a Contemporary World

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*For Stephen Krasner, whose intellectual integrity, clarity of mind,
and fearless curiosity have made us all better scholars*

Currency and State Power

BENJAMIN J. COHEN

The modern field of international political economy has had remarkably little to say about the concept of power in monetary relations. Well into the 1990s—apart from some early discussions by Charles Kindleberger,¹ Susan Strange,² and myself³—the theory of monetary power remained, in the words of Jonathan Kirshner, “a neglected area of study.”⁴ Much has been written about the instrumental use of power in monetary relations. But only recently have scholars begun to explore the concept of monetary power itself, its nature and sources, in formal theoretical terms,⁵ including two previous efforts of my own.⁶ Many questions, however, still remain unanswered.

The aim of this chapter, building on my previous efforts, is to address one issue in particular: the effect of an international currency on state power. We know that at any given time, a few national moneys play important international roles. We also know—or, at least, assume—there must be some connection between currency and state power, though it is not always obvious which way the arrow of causation runs. To some extent, clearly, power plays the role of independent variable, driving currency choice. A money will not come to be used internationally if its issuing state does not already enjoy a significant measure of economic and political standing in the world. For the purposes of this essay, however, the emphasis will be on the reverse causal relationship—power as a dependent variable, driven by currency choice. A state’s initial endowment of power will be assumed to be given. The question is: What will happen to that endowment of power once the national money comes to play an important international role? In short, what value is added by currency internationalization?

In conceptual terms, we really know very little about the specific causal pathways that run from cross-border use of a money to the capabilities of its home government. To set the issue within a firm analytical framework, this chapter disaggregates the concept of currency internationalization into the separate roles that an international money may play. Attention is then focused on three specific questions: What is the effect on state power of each specific role, considered on its own? Are there interdependencies among the various roles? And are what are their relative or cumulative impacts?

In the end, three roles appear to be of paramount importance: a money's role in financial markets, trade, and central-bank reserves. The roles in financial markets and reserves enhance the issuing state's monetary autonomy, making it easier to delay or deflect adjustment costs. Autonomy in turn creates a capacity for influence, though whether that capacity can be actualized will depend on ancillary conditions that may vary considerably over time. A currency's role in trade is important, above all, because of its impact on central-bank reserve preferences. The more a currency dominates in each of these three roles, the greater is the issuing state's monetary power.

Framing the Issue

The concept of state power is not simple, as the editors of this volume remind us. In the context of international monetary relations, most power analyses tend to focus on overt manifestations of influence at a micro or macro level—the ability of a government to play an authoritative role in, say, crisis management or financial regulatory politics or the supply of payments financing. But to truly understand monetary power, we have to go behind these manifestations to see where such abilities come from. That demands clarification of two key analytical issues: the relevant definition of power and the nature of the environment in which states operate.

For most scholars of world politics, including most of the contributors to this volume, power tends to be equated simply with influence—“letting others have your way,” as diplomacy has jokingly been defined. But in monetary relations a second dimension of power must also be emphasized—the dimension of *autonomy*, understood as an ability to act freely, without external constraint (in effect, others letting *you* have your way). The relevant definition of power encompasses both autonomy and influence.

In the monetary domain, autonomy is important because, as I have argued elsewhere, it is the essential prerequisite for influence.⁷ The starting point is the balance of payments—the flows of money in and out of a country generated by international trade and investment. Through the balance of payments, with its inevitable surpluses and deficits, national economies are inescapably linked. The ever-present risk of unsustainable imbalance poses a persistent threat to policy independence. For most states, therefore, the foundation of monetary power is the capacity to avoid the burden of adjustment required by payments disequilibrium—an ability to delay adjustment or deflect its costs onto others. Only once autonomy is established might a government then be able to turn its thoughts to the possibility of influencing others as well.

In a real sense, of course, influence is inherent in autonomy. Because monetary relations are inherently reciprocal, a potential for leverage is created automatically whenever policy independence is attained. By definition, a capacity to

avoid adjustment costs implies that if payments equilibrium is to be restored, others must adjust instead. At least part of the burden will be diverted elsewhere. Hence a measure of influence is necessarily generated as an inescapable corollary of the process. But what kind of influence? The influence that derives automatically from a capacity to avoid adjustment costs is *passive*, representing at best a contingent aspect of power since it can be said to exist at all only because of the core dimension of autonomy. Moreover, the impacts involved are diffuse and undirected. This kind of passive power is very different from what is conventionally meant by influence, which normally is understood to imply some degree of deliberate targeting or intent—“purposeful acts,” in the words of David Andrews.⁸ Monetary autonomy translates into influence in the accepted sense of the term—a dimension of power aiming to shape the actions of others—only when the potential for leverage is *actualized*, self-consciously applied to attain economic or political goals.

In turn, whether we are talking of autonomy or influence, it is evident that the key to analysis lies in the nature of the environment within which states operate. Currency internationalization is largely a market phenomenon, reflecting the preferences of diverse agents in global trade and financial markets. But since moneys tend to be issued by states (or, as in Europe, by a group of states), the power derived from currency internationalization is generally manifested in state-to-state relations. Most salient, therefore, is the structure of transactional relationships among states, as emphasized in the so-called “relational power” approach (or “social power” approach) that has dominated power analysis since the mid-twentieth century.⁹ What matters is who depends on whom and for what. How asymmetrical are prevailing relationships among states, and how centrally located is a country in the global network of interactions? Relational asymmetries manifestly lie at the root of monetary autonomy and therefore may be said to be the source of a state's influence as well. The connections run from (1) mutual dependence to (2) a capacity to avoid the burden of adjustment to (3) passive or actualized influence.

Framing the central issue for this essay then is relatively straightforward. A framework for analysis can be outlined in the form of a series of four interrelated sets of questions:

1. What is the effect of an international currency on the issuing state's position within the global monetary network? In particular, is dependence reduced or centrality of position enhanced?
2. What is the effect of an international currency on the state's monetary autonomy?
3. What is the effect of an international currency on the state's capacity for influence?
4. What is the likelihood that influence will be actualized?

Money and Power

Few knowledgeable observers doubt that currency internationalization can add to the power of the state that issues it. As Strange put it long ago: "It is highly probable that any state economically strong enough to possess [an international money] will also exert substantial power and influence. The rich usually do."¹⁰ Remarkably, however, the conventional wisdom has never been put to a serious test. A broad causal relationship is assumed, linking currency to power, and much has been written about how the resulting capabilities might be used as an instrument of statecraft.¹¹ But no one has ever tried to spell out the connections in detail, to see just how or why any of the diverse cross-border uses of a national money might actually affect the autonomy or influence of its issuer. International currencies play many roles, and not all of those roles may have the same impact on state power. We need to take a closer look to see what specific characteristics of international money make the most difference.

The Conventional Wisdom

The logic of the conventional wisdom is impeccable. From the days of the earliest coins in ancient Greece, a pronounced hierarchy has always tended to exist among the world's diverse moneys in what I have previously characterized as the currency pyramid.¹² Competition among currencies has thrown up one or a few market favorites that, for shorter or longer periods of time, predominate in cross-border use and set a standard for all other moneys. Not insignificant is the fact that in every case the dominant currency's issuer—at least at the start—was also a major, if not dominant, economic and political power.

It hardly seems implausible, therefore, to assume that there might be a connection between currency and power. The very notion of hierarchy, after all, is inherently political, suggesting degrees of reciprocal influence—differential impacts on the ability of governments to achieve goals at home or abroad. So why not just connect the dots? The stronger the currency, the stronger the country. As Nobel laureate Robert Mundell once wrote, "Great powers have great currencies."¹³

In the extant literature, however, we find only the vaguest clues to how the dots might in fact be connected. Most observers, including myself, have tended to limit themselves simply to enumerating the benefits that can accrue to the issuer of an international money. Standard analysis identifies four main gains—two economic and two political. These are:

1. **Seigniorage.** Technically defined as the excess of the nominal value of a currency over its cost of production, seigniorage at the international level

is generated whenever foreigners acquire and hold significant amounts of domestic money, or financial claims denominated in the domestic money, in exchange for traded goods and services. Cross-border accumulations represent the equivalent of a subsidized or interest-free loan from abroad—an implicit economic transfer that constitutes a real-resource gain for the economy at home. Included as well is the benefit of any reduction of overall interest rates generated by the extra demand for home-country assets.

2. **Macroeconomic flexibility.** Cross-border use can also relax the constraint of the balance of payments on domestic monetary and fiscal policy. The greater the ability to finance payments deficits with the country's own currency, the easier it is for policy makers to pursue public spending objectives, both internally and externally. Macroeconomic flexibility may be considered another way of expressing the autonomy dimension of monetary power.
3. **Reputation.** At the symbolic level, a position of prominence in the hierarchy of currencies can promote the issuing state's overall reputation in world affairs—a form of what political scientists today call soft power. Broad international circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations.
4. **Leverage.** Finally, in more tangible terms, prominence in the hierarchy of currencies may promote the issuing state's capacity to exercise leverage over others through its control of access to financial resources—a form of hard power. This benefit, obviously, corresponds to the influence dimension of monetary power.

Standard analysis of course also identifies potential costs, mostly associated with the risks posed by an excessive accumulation of foreign liabilities. The benefits of currency internationalization, as I have previously suggested,¹⁴ are most likely to accrue at the earliest stages of cross-border use, when a money is most popular. Later on, gains may well be eroded by a growing "overhang" of debt that could erode confidence in the currency's future value or usefulness. To persuade foreigners to hold on to their accumulated balances, interest rates may have to be raised, reducing or even eliminating seigniorage gains,¹⁵ and compromising macroeconomic flexibility. Eventually both reputation and leverage could also be adversely affected. In a very real sense, therefore, an international currency can be regarded as a two-edged sword, potentially valuable as a means to shape the behavior of others but, in time, possibly also dangerous to its issuer.

Time in this context, however, is likely to be quite lengthy, measured not in years but decades, given the well-known inertias in international currency choice.¹⁶ Consider how long it took the US dollar, despite its many attractions, to displace Britain's pound sterling at the top of the currency pyramid in the last century. 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.¹⁷ As a practical matter, the costs of currency internationalization are likely to assert themselves only in the very long term. In the shorter term, accordingly, policy makers understandably may be inclined to discount the potential risks involved, focusing on the benefits instead.

But beyond enumerating these potential gains and risks, the extant literature has put remarkably little effort into analyzing the specifics of causation. Currency internationalization, typically, is treated more or less holistically, with little regard for the distinctively separate roles that an international money may play. Apart from a few casual comments here or there, the possibility that these separate roles might have differential impacts on the power of issuing states has never been formally addressed.

The Roles of Money

Impeccable as the logic of the conventional wisdom may be, therefore, it still leaves critical gaps in our understanding. We know that international currencies play many roles, to a greater or lesser extent. But we know little about how each of these roles separately may (or may not) connect to state power. To improve understanding, we need to systematically disaggregate the concept of currency internationalization in order to isolate the impact of each individual role.

The standard taxonomy for characterizing the roles of international money, which I can take pride in originating,¹⁸ separates out the three familiar functions of money—medium of exchange, unit of account, store of value—at two levels of analysis: the private market and official policy, adding up to six roles in all. Specialists today generally speak of the separate roles of an international currency at the private level in foreign-exchange trading (medium of exchange), trade invoicing and settlement (unit of account and medium of exchange), and financial markets (store of value). At the official level, we speak of a money's roles as an exchange-rate anchor (unit of account), intervention currency (medium of exchange), or reserve currency (store of value). Each of the six roles is distinct in practical as well as analytical terms. The taxonomy is summarized in Figure 8.1.

At any given moment, only one or two currencies are ever likely to be of significance for all these diverse functions. These are what, with a nod to Strange,¹⁹ I have called “top currencies”—moneys whose scope and domain are more or less universal. Top currencies are what an economist would call full-bodied money, generally accepted for all purposes. Today the only true top currency is the US dollar, which for all its tribulations still dominates for most cross-border uses and in most regions.²⁰ Not even the gale-force winds of the recent global financial crisis could topple America's greenback from its perch at the peak of the currency pyramid, though debate about its future continues.²¹

Levels of analysis	Functions		
	Medium of exchange	Unit of account	Store of value
Private	Foreign exchange trading, trade settlement	Trade invoicing	Investment
Official	Intervention	Anchor	Reserve

Figure 8.1 The Roles of International Money

Just below are what I call patrician currencies—moneys whose use for various cross-border purposes, while substantial, is something less than dominant and whose popularity, while widespread, is something less than global. Most prominent among these is of course the euro, the joint money of the European Union (EU), which is already second to the greenback in most categories of use. Though many observers have predicted that the euro is destined soon to achieve parity with or even surpass the greenback as international money,²² the evidence suggests otherwise.²³ In reality, after a fast start, cross-border use of the euro appears to have leveled off and, especially after Europe's sovereign-debt problems that began in the spring of 2010, has come to be largely confined to the EU's immediate hinterland around the European periphery and in parts of the Mediterranean littoral and Africa. The only other patrician currency of note today, despite some recent loss of popularity, is the Japanese yen. Many expect the euro and yen to be joined eventually, though not anytime soon, by China's yuan, otherwise known as the renminbi (“people's currency”).

And below the patrician currencies come what I call elite currencies—moneys of sufficient attractiveness to qualify for some degree of cross-border use but with only limited scope or domain. These are the minor international currencies, a list that today would include, *inter alia*, Britain's pound sterling (sadly no longer a top currency or even a patrician currency), the Swiss franc, the Canadian and Australian dollars, and a small handful of others.

The challenge is to look carefully at each of the principal roles of an international currency and, using the framework suggested in this essay, ask: What is the effect on state power of each specific role, considered on its own? Are there interdependencies among the various roles? And what are their relative or cumulative impacts? Only then can we begin to get a real handle on the specifics of causation in the currency-power relationship.

The Private Level

In international markets, selected national currencies—whether top, patrician, or elite—may play any of three roles: in foreign-exchange trading, trade invoicing

and settlement, or financial markets. Examining each role on its own, it becomes evident that their respective implications for state power differ noticeably. All three may generate economic dividends, but only the role in financial markets, where currencies serve as an investment medium, can prove advantageous in political terms as well. The big dividing line is between the medium-of-exchange and unit-of-account functions of money, on the one hand, and the store-of-value function on the other.

Foreign-Exchange Trading

Nothing better illustrates the network-like quality of international monetary relations than the foreign-exchange market—that vast agglomeration of banks and other financial institutions around the world where national currencies are actively traded for one another. Given the more than 150 distinct state moneys now in existence, it is evident that the total of bilateral relationships numbers in the thousands, constituting a gigantic web of interactions. The metric for all of these relationships is of course the rate of exchange between each pair of currencies.

Not all relationships are of equal importance, however. In most cases, the direct connections between pairs of currencies are weak at best, meaning that the expense of direct purchases is likely to be high, if not prohibitive. Most wholesale trades therefore tend to go through a more widely used intermediary, a “vehicle” currency, in order to minimize transaction costs. The idea is to take advantage of scale economies or what economists call “network externalities.” One peripheral currency is used to buy the vehicle currency; the vehicle currency is then used to buy another money. In the exchange market today, according to the most recent survey by the Bank for International Settlements,²⁴ the US dollar is by far the most dominant vehicle currency, appearing on one side or the other of some 86 percent of all market transactions. (Percentages add up to 200 percent because every transaction involves two currencies.) Trailing far behind are the euro (37 percent), yen (16.5 percent), and a small handful of elite currencies.

Vehicle currencies clearly enjoy a position of centrality in the global currency network, since so many exchanges pass through them. For issuing states, this almost certainly translates into economic benefit. Transactions costs are likely to be reduced for local enterprises; financial institutions may gain some competitive advantage from the volume of business done in their own home currency. Political benefits, on the other hand, seem slight, since the role appears to have little impact on monetary autonomy. Widespread use as an intermediary for currency trading in no way affects a state’s ability to delay or deflect adjustment costs. No constraint on state action is removed or alleviated. The vehicle role is a purely mechanical one and can be easily replaced.

Trade Invoicing and Settlement

Much the same can also be said of a currency’s role in trade invoicing and settlement. Whenever goods or services are bought and sold internationally, the parties to the transaction must agree on the monetary unit to be used to denominate contracts and effectuate payments. And here too scale economies dictate a dominant role for a small handful of currencies at the center of the global monetary network. Available data suggest that roughly half of all world exports today are invoiced and settled in US dollars. Partly this is because of America’s large market size and still predominant place as an importer and exporter, all providing a large transactional network that enhances scale economies. And partly it is because of the greenback’s central role in the markets for virtually all reference-priced and organized exchange-traded commodities—including, most notably, the global market for oil, the world’s most widely traded product. Next in importance is the euro, which accounts for perhaps 15–20 percent of exports, mainly in and around the European region. Most other moneys play a marginal role at best.

The benefits of the trade role too appear to be largely economic rather than political. On the economic side, local enterprises need worry less about the issue of exchange risk; financial institutions may enjoy a competitive edge in providing commercial credit or other trade-related services in their own home currency. These are definite advantages. But on the political side gains again seem slight, and for much the same reason. The market’s choice of a national currency for invoicing and settlement, on its own, adds nothing directly to the issuing government’s ability to delay or deflect adjustment costs. Again, no constraint is removed or alleviated. Bills must still be paid on time, whatever the currency used.

Financial Markets

Effects are quite different, however, in financial markets, where currencies play a role as an investment medium. One of the principal functions of financial markets is to facilitate the management of investor risk by creating opportunities for portfolio diversification. At the international level this means widening the range of currency choice. To spread risk, global portfolio managers typically invest across a variety of currencies, including all the familiar moneys near the peak of the currency pyramid. Most popular here too is the US dollar, though by a declining margin. Representative are the figures for the outstanding stock of international debt instruments (defined as securities issued in a currency other than that of the borrower’s home country). At the end of 2008, the greenback’s share of the global bond market stood at 45 percent, down from about 50 percent in 1999. The euro’s share, by contrast, was up noticeably, from just 19 percent in 1999 to roughly one-third in 2008. At least a half-dozen other moneys, including the yen and a number of elite currencies, account for the remainder.²⁵

Like the vehicle and trade roles, the investment role clearly yields economic benefits. Most significant is the seigniorage gain that automatically results from the willingness of market actors to hold a currency that is not their own. Additional benefits may also accrue to local banks or other financial institutions that generate, trade, or manage the claims owned by foreigners. But unlike the vehicle and trade roles, the investment role also yields political benefits insofar as it relaxes traditional balance-of-payments constraints on domestic macroeconomic policy. Autonomy is enhanced when it becomes possible to finance external deficits with the state's own currency. Adjustment costs can more easily be delayed or deflected.

Is influence enhanced as well? We know that a *capacity* to exercise leverage emerges automatically as a corollary of enhanced autonomy in the adjustment process. But can that potential be *actualized*? That depends greatly on two ancillary conditions: (1) the availability of alternatives to the state's currency as an investment medium, and (2) the magnitude of existing foreign holdings of the currency. The former variable is important because it determines the issuing state's ability to control the *supply* of investment opportunities; the latter, because it helps shape market sentiment regarding the attractiveness of those opportunities, thus affecting *demand*. At one extreme would be a situation like that enjoyed by the United States after World War II, when market actors had few alternatives to the US dollar, and greenback holdings were low. America had a virtual monopoly on quality outlets for savings, and few feared for the dollar's future value. As a result, Washington was in a position to make access to its financial markets an explicit instrument of foreign policy, welcoming friends or barring adversaries. At the other extreme would be a situation like the present, when alternatives to the greenback are more plentiful and the accumulated overhang of foreign dollar claims has grown alarmingly. Any attempt today to actualize the potential for leverage might be met simply by a flight from the dollar, which almost certainly would be more disadvantageous than advantageous from America's point of view.

On balance, therefore, the power implications of the investment role are ambiguous. Autonomy is initially increased as a result of the greater degree of macroeconomic flexibility. But influence in the active mode may or may not be facilitated, depending as it does on ancillary conditions that can vary considerably over time. Gains in the shorter term might well eventually be reversed in the longer term. If an international currency can be regarded as a two-edged sword, the investment role is one reason why.

The Official Level

At the official level, involving relations between governments, national currencies may also play any of three roles, as an exchange-rate anchor, intervention

currency, or reserve currency. Here too each role, considered separately, has its own implications for state power. Likewise, here too the biggest difference is between the medium-of-exchange and unit-of-account functions, on the one hand, and the store-of-value function on the other.

Exchange-Rate Anchor

Since the breakdown of the Bretton Woods pegged-rate system in the early 1970s, governments have been free to choose whatever exchange-rate regime they desire, from various versions of a "hard" or "soft" peg to managed flexibility or an independent ("clean") float. States that prefer to retain some form of peg have a wide range of units of account to choose from. In practice, only a few currencies figure prominently as exchange-rate anchors, either for single-currency pegs or as a prominent part of basket pegs. Most dominant, once again, are the US dollar and euro. About sixty states now align their exchange-rate policy, wholly or in part, with the greenback, ranging in size from tiny islands in the Pacific to China. Close to forty countries, including four European mini-states (Andorra, Monaco, San Marino, and the Vatican), six current members of the EU, and several more candidates for EU membership, rely solely or mainly on the euro.

As with trade invoicing at the private level, the anchor role at the official level appears to produce gains that are largely economic rather than political. The relative stability of a peg is likely to reduce the cost of doing business with aligned countries, as compared with economies with more flexible or freely floating rates. Power implications, by contrast, appear to be as ambiguous as with the investment role. An anchor role certainly enhances the centrality of a currency, putting it at the core of a formal or informal monetary bloc. That may help promote the issuing state's soft power, by adding to the country's global prestige and reputation. But hard power benefits little, since on its own the pegging function, understood simply as a currency *numéraire*, does nothing to augment monetary autonomy. Indeed the net impact on the issuing state's power position could even turn out to be negative, to the extent that use as an anchor constrains the government's ability to resort to exchange-rate shifts as part of the adjustment process. Its power to delay or deflect might actually be eroded. This role too may be a two-edged sword.

Intervention Currency

Except for an absolutely clean float—rare in practice—all exchange-rate regimes involve some degree of government intervention in the exchange market, whether modest or substantial. But what foreign currency should be bought or sold in order to manage an exchange rate? Here too, as in foreign-exchange

trading, scale economies matter. Efficiency criteria dictate choosing a currency that is as widely traded as possible, to ensure that the effects of intervention will be quickly and smoothly generalized. That means relying on one of the most popular international moneys, such as the US dollar, euro, or yen. Use for intervention purposes generally tends to mirror a money's prominence as a vehicle currency.

Effects of the intervention role, for the issuing state, appear to parallel those of the anchor role. On the one hand, there is likely to be some economic benefit, insofar as widespread use of the currency advantages home financial institutions. On the other hand, power implications are ambiguous. There is nothing in the intervention role, considered separately, that augments monetary autonomy. There is, however, a risk of loss of influence over the exchange rate in the adjustment process to the extent that bilateral rates are controlled by the intervention practices of others. Once again, we find a two-edged sword.

Reserve Currency

Finally, we come to the role of reserve currency—the function that most readily comes to mind when we think about international currencies. For central banks, reserve assets serve as a store of value that can be used directly for intervention purposes or else can be more or less quickly converted into a usable intervention medium. For historical reasons gold is still included in the reserve stockpiles of many countries, despite the fact that it is no longer directly employable as a means of exchange. So too are Special Drawing Rights, which like gold must be exchanged for a more usable instrument when the need for financing arises. But the great bulk of reserves is held in the form of liquid assets denominated in one of the small handful of moneys at the peak of the currency pyramid. Once again the US dollar predominates, accounting at end-2009 for some 62 percent of global reserves, according to the IMF's public database on the Currency Composition of Official Foreign Exchange Reserves (COFER). This was down from 71.5 percent in 1999 but well up from a low of around 45 percent in 1990. And once again the euro is second, with a share of 27 percent at end-2009, up from 18 percent in 1999.

Effects of the reserve-currency role most closely resemble those of the investment role. On the one hand there are clear economic benefits, including a gain of seigniorage for the economy as a whole, as well as heightened profit opportunities for local financial institutions that are in a position to assist foreign central banks in the management of their reserves. On the other hand, power implications are ambiguous and highly dependent on ancillary conditions that can vary over time.

Here too autonomy is increased initially as a result of a greater degree of macroeconomic flexibility. The more foreign central banks are willing to add to

their reserve holdings, in effect extending credit to the issuing state, the easier it is for the issuer to delay or deflect adjustment costs. A capacity to exercise leverage emerges. But whether that potential can be actualized is another matter entirely—once again, the two-edged sword. Much depends on the same ancillary economic considerations that make the investment role so contingent: the availability of alternatives and the magnitude of existing holdings. Because here we are speaking of official state institutions, and not just private market actors, much also depends on political considerations, including especially the nature of the issuing state's diplomatic and security relations with reserve holders. Possibilities vary enormously, from a condition of potentially great strength early on to, later, a position of decided weakness.

Interdependencies

Overall, a distinctive pattern emerges. All six roles generate economic benefits of some magnitude. Political effects, however, tend to be more concentrated. Only the two store-of-value roles—the investment role at the private level and the reserve role at the official level—seem able to add directly to the issuing state's monetary autonomy, creating a potential for effective leverage (though in time this advantage may be eroded by an accumulation of foreign debt). In this respect, there is a clear dividing line between the store-of-value function and the other two functions of international money (medium of exchange, unit of account).

That does not mean, however, that the two store-of-value roles are the only ones that matter. Analysis cannot stop with a consideration of each role on its own. The possibility of interdependencies among the various roles must also be considered. For example, we know that the intervention role of an international money is closely tied to its importance as a vehicle currency. As indicated, scale economies matter in exchange-rate management. Likewise, it is evident that a close link exists between the invoicing role of a currency in international trade (a unit-of-account function) and its settlement role (a medium-of-exchange function). It is no accident that typically these are spoken of, as I have done here, in tandem: the trade role. Most parties to international trade find it convenient to use the same currency for both purposes.

The real question, however, concerns the two store-of-value roles and the dividing line between them, on the one hand, and the other two functions of international money on the other. Is either the investment role or the reserve role in any way dependent on a currency's use as a medium of exchange or unit of account at either the private or official level?

At the private level, the answer is clear: no. For most portfolio managers, seeking diversification to manage risk, use of any given currency as an investment

medium is most closely tied to the critical qualities of “exchange convenience” and “capital certainty”—a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a set of broad and well-developed financial markets for claims denominated in the issuing country’s currency, sufficiently open to ensure full access by investors of all kinds. Neither exchange convenience nor capital certainty appears to depend in any way on how much a money may or may not be used as a vehicle in currency markets or for trade invoicing and settlement. In currency markets the vehicle is not held as a store of value at all. In trade, a species of investment instrument is created in the form of commercial paper, but the claims involved are very short-term and effectively self-liquidating.

At the official level, the answer is trickier. In principle central banks are no less free than market investors to diversify the currency composition of their holdings, so long as the assets they hold can be quickly converted when needed into a medium useful for intervention purposes. To that extent, the qualities they seek are the same as those valued by private actors: exchange convenience and capital certainty. In practice, however, reserve preferences in most countries tend to be distinctly skewed, favoring one currency in particular. In Latin America, the Middle East, and much of Asia, the US dollar typically predominates, while around Europe and in parts of Africa the euro is more popular. Why is that?

Superficially, it might appear to have something to do with the anchor and intervention roles. If a country’s money is formally or informally aligned with one anchor currency in particular, it makes sense to intervene in that currency as well; and that in turn would logically encourage concentrated holdings of the currency, to facilitate easy entry or exit in the exchange market. But that fails to explain why we also see the same kind of skewed preferences in states with floating currencies, which may not actively manage their exchange rate on a regular basis. Nor, for states that do intervene frequently, does it account for the choice of anchor to start with. Such decisions are not made arbitrarily.

Looking deeper, it seems evident that the really crucial link lies elsewhere—in the trade role. Politics aside, reserve preferences are most likely to reflect the pattern of currency choice in a country’s foreign commercial relationships. The popularity of the US dollar in Latin America, the Middle East, and Asia is a direct reflection of either or both of two considerations: the importance of the United States as a market or supplier; or the importance of reference-priced and organized exchange-traded commodities in each country’s exports. Since the greenback is the main monetary unit used for invoicing and settlement in both bilateral trade with the United States and global commodity trade, it is hardly surprising to find it dominant in the reserves of these countries as well. Conversely, the euro naturally dominates in the European region, where trade relations are focused more toward members of the EU.

Plainly, therefore, the investment and reserve roles are not the only ones that matter. In terms of direct implications for state power, the dividing line between the two store-of-value roles, on the one hand, and money’s other two functions (medium of exchange and unit of account), on the other hand, remains essential. But indirectly, the role of a currency in private trade can be seen to play a vital part, too, insofar as it helps to shape government reserve preferences. Overall, three of an international money’s six possible roles—specifically, the trade, investment, and reserve-currency roles—are critically involved, not just the two store-of-value roles.

Relative and Cumulative Impacts

What are the relative or cumulative impacts of these three roles? Ultimately, it seems not unreasonable to conclude that a currency’s reserve role has the greatest effect on state power, owing to the enhanced capacity that emerges for direct leverage on governments. By comparison, the investment and trade roles would appear to be of secondary importance. Their relevance derives mainly from the part they play in making the reserve role possible.

There are two reasons for discounting the relative impact of the investment role considered on its own. First, as compared with the reserve-currency role, it is clearly more difficult to actualize any potential for influence. We know that both store-of-value roles enhance autonomy, by relaxing traditional balance-of-payments constraints on domestic macroeconomic policy. A capacity for leverage is the automatic corollary of any increase in the power to delay or deflect adjustment costs. But when the enhanced autonomy results from decentralized investment decisions in the open marketplace rather than from centralized government choices, impacts are bound to be more dispersed and diffuse, making it harder to target specific actors with self-conscious intent. When a currency is held just by private investors, pressures can be brought to bear on other states only indirectly. When the same currency is held by public agencies, pressures on foreign governments can be applied directly, to much better effect.

Second, the investment role also offers a lower degree of control over supply, again as compared with the reserve-currency role. That is evident from the differing degrees of diversification in private markets and official reserves. At the private level, as indicated, as many as eight to ten currencies figure prominently in global finance. It is not like the immediate aftermath of World War II when just one country, the United States, could enjoy anything like a monopoly over available alternatives. Given the higher level of competition today, few issuing states are in a position even to try to exercise deliberate leverage through the role of their currency as an investment medium. Assets denominated in the monetary units of countries like Australia, Canada, and Switzerland are all actively traded

in global markets, but no one would claim that this translates into any kind of power for their issuing governments. At the official level, by contrast, where just two currencies dominate, an effective duopoly prevails. More room, accordingly, is offered for actualizing influence.

On the other hand, it is clear that an investment role is essential if a currency is ever to rise to the status of a reserve currency. While a given money can play an investment role even if never used as a reserve currency, the reverse is unlikely ever to happen in a market-based currency system. Monetary history suggests that the investment role comes first and then is followed by a reserve role *in addition*. Certainly that was the pattern followed in the nineteenth century by the pound sterling, which first found an international role as a consequence of London's preeminence as a financial center, and only later began to be held by central banks as well. Likewise, it was true of the US dollar, which first rode the rise of New York as a rival to London for foreign lending, well before it surpassed sterling as a reserve asset. It is necessary to think in terms of cumulative effects. A state whose currency is used as a store of value in private markets alone gains only the influence created by that role. But a state whose currency is used as a store of value by central banks too gains the cumulative effect of both roles.

The link, of course, is the trade role, which plays a critical part in determining which among several investment currencies will emerge as a favored reserve asset as well. The issuer of an international money that is used only as investment medium can aspire at best to just some modest modicum of power. But add widespread use for trade invoicing and settlement leading to a reserve role, and soon the issuing state becomes much more centrally placed in the global monetary network, enhancing its influence considerably. Combined dominance in all three—financial markets, trade, and reserves—produces the “exorbitant privilege,” as Charles de Gaulle put it, of a true top currency.

Conclusion

The practical implications of all this are clear. Several states around the world today are thought to harbor ambitions to amplify their monetary power—including, most prominently, the four BRIC countries (Brazil, Russia, India, and above all China). One way to do this is to promote a reserve role for their currency, discounting the longer-term risks of currency internationalization. How can that be done? The analysis suggests two crucial imperatives. One is a commitment to broad financial-market development, building up the exchange convenience and capital certainty of their currency, in order to attract the interest of private investors and portfolio managers. The other is a commitment to wider use of their currency in trade invoicing and settlement, reshaping commercial relationships,

in order to attract the interest of foreign central banks. Neither path is easy, of course, and success is by no means guaranteed. But the consequences could be significant, even profound. As Steve Krasner has long reminded us, any change in the distribution of state power in the world economy is bound to have impacts that can be ignored only at our peril.

Notes

1. Kindleberger 1970.
2. Strange 1971a, 1971b.
3. Cohen 1971a, 1977.
4. Kirshner 1995, 3.
5. Kirshner 1995; Lawton, Rosenau, and Verdun 2000; Andrews 2006a.
6. Cohen 2000, 2006.
7. Cohen 2006.
8. Andrews 2006b, 17.
9. Baldwin 2002.
10. Strange 1971a, 222.
11. Kirshner 1995; Andrews 2006a.
12. Cohen 1998, 2004.
13. Mundell 1993, 10.
14. Cohen 1998, 129.
15. Cohen 1971b.
16. Cohen 1998, 136–137.
17. Krugman 1992, 173.
18. Cohen 1971a.
19. Strange 1971a, 1971b.
20. Cohen 2009.
21. Helleiner and Kirshner 2009.
22. Chinn and Frankel 2008.
23. Cohen 2011.
24. Bank for International Settlements 2007.
25. European Central Bank 2009.

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International Trade Law as a Mechanism for State Transformation

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Famously, "structural realist" regimes theory depicted international law as epiphenomenal: international law merely reflected the interests of powerful states, and weaker states were compelled to follow international law, so international law had no independent effect on outcomes.¹ Scores of commentators subsequently simplified that into a claim that international law does not matter—and many of them confounded "structural realism" with "realism." Hence, "realism" became a straw man that enabled commentators to show how international law matters.² "Realism" became international law's whipping boy.

Yet at the time when the "structural realist" regimes theory straw man was created, only one commentator was cited for the claim that regimes have no effect on behavior or outcomes.³ Not even Ken Waltz, the father of structural realism, had argued that; structural realists focus on structure, so the structural realist deduction about regimes should have been that they have no independent effect on system structure—not that they don't have any effect on behavior or nonstructural outcomes.⁴

In fact, the history of realist thought consistently embraces the notion that international law is consequential, even if in limited ways. Thucydides showed that some treaties of alliance advanced states interests, while treaties concluded because countries were "sister democracies" sometimes harmed their state interests, as did the failure to conclude treaties because of religious beliefs.⁵ Machiavelli made similar arguments.⁶ Morgenthau argued that power configurations, shared interests, or shared norms could be a basis for international law, and that rules backed by both interests and norms are most likely to enjoy compliance.⁷ In the same piece in which Krasner (who is generally regarded as a realist) distilled the claim that international law is epiphenomenal, he distanced himself from that claim by identifying himself as a "modified structural realist," taking the stance that international regimes may enable cooperation that otherwise would be impossible. Hence, contrary to the tenor of the discourse in the past three decades, the realist tradition has long attended to international law and its consequences.