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A ONE-AND-A-HALF CURRENCY SYSTEM

Benjamin J. Cohen and Paola Subacchi

Even before Europe's Economic and Monetary Union (EMU) came into existence nearly a decade ago, a brilliant future was predicted for the euro as an international currency. At last, many argued, the European Union (EU) would have a monetary unit that could challenge the global dominance of the U.S. dollar. Typical was the confident assertion of two prominent European economists that "the most visible effect of EMU at the global level will be the emergence of a second global currency."¹ The conventional wisdom was clear. Leadership in monetary affairs would no longer be the privilege of the United States alone. The currency system would now rest on two pillars, not one.

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

In this essay we argue that the euro is not yet ready for prime time and, at present, can play only a subordinate role in the global system as compared to the dollar. This can be described as a one-and-a-half currency system—certainly not a two-pillar world. We address two critical questions: First, how has the global system been changed by the arrival of the euro? We elaborate on what is meant by a one-

and-a-half currency system and discuss why the euro is still not ready for prime time. Second, what can Europe do to overcome the euro's disadvantages and thus enhance the euro's role as the second pillar of the international monetary system? We argue that the main imperative is to improve the bloc's ability to project power effectively. Dual leadership at the global level is not out of reach, but will require determined reform of the EMU's governance structure.

ONE-AND-A-HALF CURRENCIES

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

Monetary Power

Briefly summarizing an argument that has been developed at greater length elsewhere, we suggest that international monetary power is comprised of two critical dimensions: autonomy and influence.² More familiar is the dimension of influence, defined as the ability to shape events or outcomes. An actor, in this sense, is powerful to the extent that it can effectively pressure or coerce others—in short, to the extent that it can exercise leverage. As a dimension of power, influence is the *sine qua non* of systemic leadership. A clear example of the power influence dynamic can be found in the United States' ability to get its way in global monetary matters during the first decades after World War II.

The second dimension, autonomy, corresponds to the dictionary definition of power as a capacity for action. An actor is also powerful to the extent that it is able to exercise operational independence or to act freely, insulated from outside pressure. In this sense, power does not mean influencing others; rather, it means not allowing others to influence you. An example of this is provided by modern-day China, which successfully continues to resist foreign appeals for a major appreciation of its currency.

The distinction between the two dimensions of power is critical. Logically, power begins with autonomy. Influence is best understood as functionally derivative, inconceivable in practical terms without first attaining and sustaining a relatively high degree of operational independence. First and foremost, actors must be free to pursue their goals without outside constraint. Only then will an actor be in a position to exercise authority elsewhere. But influence does not automatically flow from autonomy. The actor must also be in a position to actualize its potential leverage—in practical terms, to translate passive autonomy into effective control. To aspire to a leadership role, an actor must have both the will and the ability to project its power onto others. Herein lies the problem for the euro: The EMU may have succeeded in augmenting Europe's autonomy in currency affairs, but it has yet to endow its members with enough direct influence to match the degree of leverage traditionally exercised by the United States.

The EMU has yet to endow its members with enough direct influence.

Greater Autonomy...

That there has been an increase in autonomy is without question. With one joint money replacing a plethora of national currencies, the EMU's members need no longer fear the risk of exchange rate disturbances inside Europe. In the words of the European Commission, "The exchange rate realignments that periodically traumatised the European economies have become a thing of the past."³ For a continent long plagued by currency instability, this is no small accomplishment. Moreover, with the now widespread acceptability of the euro, EMU countries have come to enjoy a much improved international liquidity position. Deficits that previously had required foreign exchange may now be financed with Europe's own money. Operational independence is now greater.

However, the gain should not be exaggerated. In some respects, considerable vulnerability remains, particularly in relation to the world outside Europe. The Eurozone is largely a passive participant in global payments developments, leaving members critically exposed to fluctuations of the euro's exchange rate vis-à-vis the dollar and other major currencies. Indeed, to date, the bloc has been something of a bystander, more reactive than active. For the ECB, the highest priority has been to establish its own credentials as a champion of monetary stability consistent with its narrowly drawn mandate under the Maastricht Treaty, the EMU's founding document. Policy has been targeted almost exclusively on the domestic price level. The balance of payments and exchange rates has been left largely to their own devices.

A near doubling of the euro's value since its lows in 2000 and 2001 has been a source of satisfaction to some, including the ECB, which initially had worried

about the effect of the currency's early depreciation on the credibility of Europe's grand monetary experiment. Many Europeans have experienced a surge of pride as their currency has left the greenback in its wake. But there is also an obvious downside: the dampening effect that an increasingly expensive euro could have on economic growth. Particularly distressing to many Europeans is the knowledge that the euro's appreciation has more to do with dollar weakness than with euro strength. The euro has been favored by currency traders because of policy failures on the U.S. side, not because of relative productivity improvements or brighter growth prospects in Europe.

Yet, 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. The bank's management knows that any attempt to reverse the rise abroad, via sales of newly issued euros, would simply undermine the battle against inflation at home. In practice, the Eurozone can do little but remain passive witnesses to its currency's appreciation. Overall, the bloc's gain of autonomy, while undeniable, remains less substantial than many had hoped.

... But Not Greater Influence

However, this is not the heart of the problem. The issue is not the scale of the gains in autonomy, but what the governments of Europe have been able to do with it. In fact, they have been able to do little. Slight or not, greater autonomy has not translated into more effective influence. Though freer now to pursue internal objectives without outside constraint, the Eurozone has yet to realize its potential for overt leverage over others.

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

In practice, however, Europe's voice has remained muted. A comparison with the United States is telling. Even without the participation of Britain and some other EU countries, the euro constitutes one of the largest economic units in the world—rivaling the United States in terms of output, population and share of foreign trade. Yet despite the dollar's recent tribulations, Washington still speaks with a much louder voice in global forums such as the International Monetary Fund (IMF) or Group of Seven (G-7). As the European Commission unhappily acknowledges, Europe "still punches below its economic weight in international fora."⁴ Europe has

proved no match for the American heavyweight.

The reason for this lies in the governance structure of EMU, the constellation of rules and institutions that constitute the framework for Eurozone economic policy. Under the terms established by the Maastricht Treaty, no one knows who, precisely, speaks for the EMU. No single body is formally designated to represent the bloc in international discussions. As a result, Europe is at a permanent disadvantage in any effort to exert influence. The Eurozone, laments euro enthusiast Fred Bergsten, “still speaks with a multiplicity, even a cacophony, of voices.... Hence it dissipates much of the potential for realizing a key international role.”⁵

For example, the IMF bloc’s fifteen present members are split up among no fewer than eight different constituencies. France and Germany each have a single chair on the Fund’s twenty-four-member Executive Board. The other thirteen 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. Collectively, the EMU’s membership accounts for some 23 percent of total voting power at the IMF. But, because representation is so fragmented, it is difficult for Europe to exercise a commensurate influence on decision-making or even to develop common policy positions.

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

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

WHAT CAN EUROPE DO?

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

Building a Credible Currency

Addressing the structure of governance in this context is critical because of the institutional complexity of a monetary union established by a group of states that retain their sovereignty in most economic matters other than monetary policy. In the EMU, governance broadly covers four policy areas: monetary policy, fiscal policy, market structure and exchange rates. All of these aspire to the same goals of promoting economic growth and employment. However, not all policy areas are addressed at all levels of policymaking. Monetary policy is a matter for the ECB, while fiscal policy and strategic exchange rate policy remain in the hands of EMU member states—the latter through the EU's Economic and Financial Affairs Council (Ecofin). The locus of responsibility for the external value of the euro is divided ambiguously.

The EMU's governance structure, not surprisingly, reflects issues that were embedded in the circumstances of the 1990s. In the process of building the EMU's institutional framework, the establishment of an independent central bank with a mandate over monetary policy for the currency union as a whole took priority. Using the DM as a template, the main concern was to ensure a smooth functioning of the single monetary area in order to create a strong and credible currency. It was correctly thought that confidence in the euro could only be established with the backing of a central bank firmly committed to price stability, on the model of the Deutsche Bundesbank, together with a set of rather stringent criteria to smooth the convergence process and ease adjustments to asymmetric shocks. The goal was to give credibility to the new currency by ensuring lasting macroeconomic stability across Europe's internal market. Besides appeasing German concerns about scrapping the DM, macroeconomic stability promised to protect the EMU's members from unnecessary volatility, to lower the cost of capital and to encourage investment across Europe as a whole.

In short, the focus was placed single-mindedly on the EMU's internal conditions. The development of the euro as an international currency was not identified as an explicit policy goal. In the words of the ECB:

From a policy perspective, the Eurosystem has adopted a neutral stance on the international use of its currency. It does not pursue the internationalisation of the euro as a policy goal.... The currency's use outside the euro area's borders is and should remain the outcome of economic and financial developments.... In any case, in a globalised world with deeply integrated and market-based financial systems, policymakers have limited scope to influence the internationalisation of a currency, even if they want to do so.⁶

Over the last ten years, the ECB has managed to build a solid reputation for independence by firmly sticking to its mandate of price stability. Even during the recent credit crisis, Jean-Claude Trichet, the ECB's president, maintained that price stability was the ECB's sole priority, reinforcing the bank's inflation-fighting credentials. The ECB, he declared, would not bow to political pressures to ease monetary policy in order to promote economic growth.⁷ In other words, the ECB has played the "confidence game" well.⁸ It has successfully established a track record of preserving market confidence in the value and usability of Europe's money.

After ten years, however, it is becoming clear that a single-minded focus on internal conditions is no longer enough if Europe is to be able to project power in monetary affairs to an extent commensurate with the growing international role of the euro.⁹ While sound domestic policy and a credible central bank are integral to the successful exercise of monetary influence, they are not sufficient. Closer attention should also be paid both to the euro exchange rate and to the role of the Eurozone in international monetary forums.

The External Dimension of the Euro

A decade after the EMU's birth, the international role of the euro has grown well beyond the legacy of the eleven currencies that joined together at the outset. For example, the share of the euro in global central bank reserves is now some 26 percent—higher than the share of the sum of all its legacy currencies (including, most notably, the DM) at the end of 1998, which was about 18 percent.¹⁰ The euro has also become the most popular currency in the world for international bond issues.¹¹

During the same decade, the dynamics of the world economy have changed as well. Ten years ago, when Europe's EMU was established, the emergence of China was more a possibility than a reality, while the "Asian Tigers" were still coming to terms with a devastating financial crisis. Now the rise of the emerging market economies and the enlargement of the global economy's playing field pose significant challenges to the competitiveness of advanced economies such as Europe and the United States. These challenges particularly affect the labor market and the international division of labor as well as income distribution, inflation, financial volatility and the sustainability of current account imbalances. They also affect the way the Eurozone's adjustment process operates by altering both the typology of shocks and the available adjustment mechanisms.

The external dimension of a popular currency like the euro has two main components—one is its international use; the other, its external value. Though often conflated, the two components are not necessarily related. An international currency is the one that central banks and private-market actors are happy to use for trans-

action purposes and to hold in their portfolios. On the other hand, the external value of a currency is related to a number of factors that surely include economic fundamentals and may also reflect transient trading conditions in foreign exchange markets. An international currency may not always have a stable or rising external value. A strong or appreciating currency may not be widely used for international purposes.

The distinction is important to any discussion of reform of the EMU's governance structure. Too often in the past, debate about the role of the euro in the global system has been muddled by issues related to the currency's exchange rate rather than to its international use. In fact, the two issues are institutionally and logically distinct and therefore need to be addressed separately.

Exchange Rates and EMU Member States

Given the strengthening of the euro's external value since 2001—coupled with the persistently weak performance of the Eurozone's real economy—it is hardly surprising that the exchange rate issue has, by now, become central to EMU policy discussions.¹² The question for policymakers is whether exchange rate management and coordinated currency interventions should play a more prominent role in the bloc's macro-policy tool kit.

Modern economic theory contends that a floating exchange rate is best understood as a forward-looking asset price determined at a level that induces market agents to willingly hold the outstanding stock of a currency. This contrasts with the older view—no longer endorsed by most economists—that the exchange rate is determined by the flow demand and supply of foreign exchange.¹³ The exchange rate, accordingly, may be assumed to depend on expectations of future events rather than just on what is happening in the present or has happened in the past.¹⁴ Given this theoretical framework, along with abundant empirical evidence, direct intervention in currency markets can be expected to have little scope and effect.¹⁵ It may also risk sending wrong signals to the markets and setting unmanageable expectations. Central banks can still play a useful role, but mainly by helping market actors locate long-term equilibrium by signaling future changes in monetary policy and/or by changing the relative supplies of different assets.

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

Effective exchange rate management will also require a concerted parallel effort by the EMU's member governments. Monetary policy alone cannot carry the load. Equally important is the role of fiscal policy as exercised by individual states, which can have a significant impact not only on the euro's external value but also on real rates of exchange within the EMU. Empirical evidence points to growing divergences of real exchange rates within the Eurozone.¹⁶ At the root of these divergences are differences in national inflation rates. These are not only a function of cyclical positions, but are also determined by the shape of national institutions—above all, labor markets. Sound national policies aimed at strong productivity growth can help real exchange rate readjustment for converging economies with a fixed nominal exchange rate, and therefore improve competitiveness. Better coordination and surveillance of policies, in turn, would ensure that separate national targets and instruments are consistent with each other and are integrated into a non-conflicting framework in order to avoid negative spillovers. This is one of the three pillars of the European Commission's policy agenda.¹⁷

The function of coordination would be best undertaken by the Eurogroup, the Eurozone's informal committee of finance ministers which, according to the European Commission, has become "a key body in the present EMU's system of economic governance."¹⁸ The main strength of the Eurogroup is its relatively small size and cohesiveness, which enables it to debate issues thoroughly and with candor. Currently, it is charged with the surveillance of public finance and macroeconomic developments. Additionally, in recent years, it has increasingly discussed microeconomic issues relevant for a better functioning of the EMU. The Eurogroup can play a bigger role in overseeing structural reforms and policy linkages among its members.¹⁹

Speaking with One Voice?

Even with more effective exchange rate management, the Eurozone will remain a political dwarf on the global stage so long as it continues to speak as it currently does with a so-called cacophony of voices. The disadvantages of the EMU's lack of coherence are by now well understood. In a report marking the ECB's tenth anniversary, the European Commission explicitly identified the consolidation of the bloc's external representation as a policy target: "To be able to speak with a more coherent voice in global fora, the euro area needs to consolidate its external representation....[T]he time is ripe for launching this process of consolidation."²⁰

One possibility mooted by the Commission as a long-term objective would be the establishment of a single seat for all EMU members in relevant international bodies and forums such as the IMF and the G-7. Such a goal is easier to enunciate than to implement since those member states that now occupy individual seats are

unlikely to relinquish their privileged positions without a struggle. Given the diffuse skepticism and increasing disillusionment toward the European project that seems rampant across Europe today—well demonstrated by the Irish public's rejection of the Lisbon Treaty in a referendum this past June—there is little appetite in Brussels for any move now that might seem to threaten such a key element of national sovereignty. Consolidation of representation in a single seat for the Eurozone is simply not politically realistic under present circumstances.

More plausible is the possibility that a single EMU representative might be added to the EU's existing cast of characters to speak specifically for the Eurozone on matters of critical interest to its members. Who might provide that representative? One possible candidate is the ECB. As the Eurozone's only truly collective institution, the ECB seems to be the most natural candidate to speak for the EMU on global monetary issues. But that choice runs up against the tradition that, in most such settings, countries are usually represented not by central banks

Member states must pursue their own goals without conflicting with EMU interests.

but by finance ministers with the political clout to speak for their respective governments. But the ECB cannot claim that kind of authority. Indeed, it is difficult to imagine the elected governments of Europe ever delegating such a fundamental power to an institution that was deliberately designed to be as free from political influence as possible.

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

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

muffled by policy differences among governments. Given the EMU's present governance structure, a single official cannot ignore or override the preferences of diverse sovereign states.

Can the voice of the president be strengthened? It would help if the role of the Eurogroup were to be formally institutionalized within the EU's complex governance structure. Likewise, the president's legitimacy and credibility could be enhanced by the grant of an official mandate to represent the EMU in all international organizations and forums. There would also be great benefit if the finance ministers of the Eurogroup could be persuaded to look more often at the bigger picture, reflecting a genuine sense of community and common identity.

However, herein lies a difficult balancing act between the interests of the euro area as whole and those of member states. The euro's external representation and governance must fit within a framework in which member states pursue their own goals without conflicting with the EMU's overall interests.²¹


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

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

CONCLUSION

Throughout the decade since its birth, the euro has clearly established itself as the second most important international currency in the world. Nevertheless,

contrary to expectations, the euro has not become a second pillar of the system on par with the U.S. dollar. Though an economic giant, the EMU remains a political dwarf, unable to punch its weight in monetary affairs. The outcome can best be described as a one-and-a-half currency system—certainly not the two-pillar world that many anticipated.

The problem lies in the governance of the EMU, which structurally constrains the role that the bloc can play in monetary governance. Therefore, the solution lies in a reform of the bloc's rules and institutions that would put greater emphasis on the euro's external dimension. On one hand, this calls for more proactive management of the currency's exchange rate by the ECB in conjunction with an explicit commitment by the Eurogroup to undertake effective coordination of national fiscal policies. On the other hand, it would mean designating a single representative of the EMU with real authority to speak on behalf of members in international councils. Unless the Eurozone can learn how to project power more successfully, dual leadership of monetary affairs at the global level will remain out of reach. 

NOTES

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¹ Daniel Gros and Niels Thygesen, *European Monetary Integration: From the European Monetary System to European Monetary Union* (London: Longman, 1998), 373.

² Benjamin J. Cohen, "The Macrofoundations of Monetary Power," in *International Monetary Power*, ed. David M. Andrews (Ithaca, NY: Cornell University Press, 2006), 31-50.

³ "EMU@10: successes and challenges after 10 years of Economic and Monetary Union" (Brussels: European Commission, 2008), 4.

⁴ *Ibid.*, 11.

⁵ C. Fred Bergsten, "The Euro and the Dollar: Toward a 'Finance G-2'?" in *The Euro at Five: Ready for a Global Role?* ed. Adam Posen (Washington, DC: Peterson Institute for International Economics, 2005), 33.

⁶ "The Euro's Impact on Trade and Capital Flows and its International Role," *Monthly Bulletin: 10th Anniversary of the ECB* (European Central Bank: Germany, May 2008), 96.

⁷ Jean-Claude Trichet, "Hearing at the Economic and Monetary Affairs Committee of the European Parliament" (speech, European Parliament, Brussels: 26 March 2008). This point was echoed by the

Bundesbank President and ECB Council member Axel Weber: "Given our mandate of price stability and the identified upside risks especially in the medium-term we have today re-iterated and emphasised our commitment to maintaining price stability as our primary objective in accordance with our mandate." Axel Weber, "Globalisation, Monetary Policy and the Euro" (speech, Norges Bank Conference on Monetary Policy, Jarle Berge Colloquium: *Globalization and Monetary Policy*, Oslo, 7 March 2008).

⁸ Paul R. Krugman, "The confidence game," *New Republic*, (5 October 1998), 24.

⁹ Benjamin J. Cohen, "The Euro in a Global Context: Challenges and Capacities," in *The Euro at Ten: Europeanization, Power, and Convergence*, ed. Kenneth Dyson (Oxford: Oxford University Press, 2008), 37-53. See also Paola Subacchi, Benedicita Marzinotto, and Vanessa Rossi, "Exploiting Europe's Strong Potential: Governance, Institutions and Policies" (briefing paper, *Chatham House*, January 2008) 1-6.

¹⁰ European Central Bank, 97.

¹¹ *Ibid.*

¹² "We believe the euro will not survive in the long run in the absence of some kind of political support.... Otherwise you'll see the euro at \$1.80 and no action." Tony Barber, "Business chiefs warn of dangers to currency," *Financial Times*, (7 March 2008).

¹³ John Williamson, "Exchange Rate Economics" (Working Paper No. 2, Commission on Growth and Development, Washington, DC, 2008), 2-3.

¹⁴ Current account outcomes also depend on saving and investment, with income flows and exchange rates both determined simultaneously in a general equilibrium setting. For a discussion of exchange rate economics, see Williamson, 1-24.

¹⁵ For a contrary view see Williamson, 15-16.

¹⁶ Subacchi et al. (2008).

¹⁷ European Commission, 3.

¹⁸ *Ibid.*, 287

¹⁹ "Germany's 3 percent value-added tax increase in January 2007 was, apparently, not discussed by the Eurogroup, even though such a move by so big a country was likely to have a spillover effect for its neighbours." Stuart Fleming, "Europe must shape debate on global issues," *European Voice*, 14, no. 8 (28 February 2008).

²⁰ European Commission, 279.

²¹ Jean Pisani-Ferry et al., "Coming of Age: Report on the Euro Area," Bruegel Blueprint Series IV, (Bruegel, Brussels: 2008).