

12. THE POLITICAL ECONOMY OF THE EURO AS AN INTERNATIONAL CURRENCY

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Economic and Monetary Union (EMU) in Europe will have important effects on international monetary affairs. This is true on both economic and policy-making dimensions. As for the first, the euro is a major new currency whose use in international transactions will affect global monetary and financial relations in and of itself. The euro might rival the dollar as the principal international currency, which would fundamentally alter the character of other countries' exchange rate policies. Or the euro might prove a feeble currency, of little import to countries not directly tied to it. In this sense, the euro's international economic role is of interest and importance.

On the second, policy-making, dimension, the euro zone authorities are a vital new set of interlocutors in international monetary politics. This has to do not with the financial role of the euro as a currency, but rather with the involvement of the policy-making institutions of the Economic and Monetary Union in international monetary negotiations. This role, too, will have a broad impact on the international monetary system. The EMU authorities could turn inward to focus on the zone's monetary problems, even at the expense of the euro's international 'obligations'. This might imply fragmentation and conflict in international monetary relations, even a shattering into relatively self-contained currency blocs. Alternately, the euro zone might act vigorously as one of the world's principal policy-making partners, fully engaged in working out responses to global monetary problems. In this case, the result might be substantial movement toward a new international monetary architecture. Wherever reality takes us, there is no doubt that EMU brings a new monetary authority to the playing field of international monetary policy-making.

These are broad, complex, and important issues, which I do not dare address directly in this essay. Instead, I hope to provide insights into the processes and circumstances that will affect the outcomes in question. I discuss factors that I think will determine the role of the euro, and EMU

authorities, in the international monetary and financial system. I emphasize the implications of contending interests among groups in the societies that make up the euro zone. I focus on these domestic conflicts of interest both because I believe that they are important and because they have routinely been ignored in most the scholarly and popular discussions.

Determinants of the Euro's International Role

Again, there are two dimensions to the international role of the euro, that of the currency itself on international markets, and that of the EMU authorities in the corridors of international monetary and financial power. On both dimensions, we can build on substantial analyses of the sources of currency-market and policy prominence; on both dimensions, I emphasize the typically underplayed *political economy* aspects of these sources.

We can start with the international role of the euro as a currency. Most current discussions of this issue usefully dissect a variety of purely economic factors: network externalities in trade and payments, invoicing behavior, portfolio allocation decisions.¹

Yet these exclusively economic considerations are only some of the determinants of the euro's attractiveness to international users. The role of the euro will be fundamentally affected by euro zone *policy*, both short- and long-term. The desirability of a currency depends on its expected evolution, which depends in turn on the anticipated monetary policy stance of the issuing authorities. It also depends on the financial solidity of the issuing currency's 'home base', which depends in turn on the perceived depth and stability of the domestic (in this case euro zone) financial system. Both factors are determined by *policy*, both are highly *political*, and both will be decided in the cauldron of European economic policy-making, with its rich history of conflicts of interests.

The policy prerequisites of international monetary and financial leadership are generally recognized, and have been the subject of rich scholarly analysis.² Generally speaking, lasting international currency status is associated with four characteristics that are directly or indirectly dependent on national policy:

1. A generally stable currency, to reduce the risk of holding assets denominated in it.
2. A generally strong exchange rate, to avoid capital losses on the part of those who hold assets denominated in it.
3. Deep and liquid financial markets, to allow holders to diversify or liquidate their positions if necessary—that is, for example, if either of the first two conditions appear to be evolving in ways not to holders' liking.

4. Strong regulatory backing to minimize the possibility of financial difficulties and crises, so as to ensure that the third condition will hold.

The international use of a currency also typically depends on the home country having a substantial share of world trade, which of course is not directly amenable to policy. All these conditions are, however, interrelated. For example, holders of a currency are more likely to accept fluctuations in its value, the deeper and more efficient is the home financial (and forward) market. And a country's share of world trade will almost certainly have an impact on the economic and political implications of its exchange rate policies.

This makes clear how important the policy stance of the home government of such a currency is to its standing. And it is worth noting that these policies—toward the exchange rate and financial regulation—are often politically contentious.

The reason for the general politicization of these policies is that they involve trade-offs, on which important socio-economic groups typically have very different interests and views. J. Lawrence Broz (1997) tells the fascinating story of how attempts to establish the US dollar as an international currency after the turn of the 20th century led to substantial political conflict. An international position for the dollar required major monetary and financial policy shifts—such as the establishment of a central bank and of new financial instruments and regulations. These changes were strongly supported by the major American banks and firms that expected to gain from the 'internationalization' of the dollar, but were just as strongly opposed by other interests in the United States. This and other historical and contemporary experiences demonstrate clearly how a currency's international status often implicates powerful interests on different sides of relevant issues.³

In addition to the international role of the euro as a currency, we are interested in the role EMU policy-making authorities might play in international monetary and financial relations. Certainly there is no technical barrier to the ECB becoming the principal interlocutor of other national macroeconomic authorities in international monetary and financial affairs.

The determinants of such a role—and, potentially, the barriers to such an evolution—will be political. Substantial international involvement of EMU policy-makers in the corridors of international monetary and financial diplomacy requires these authorities to be able to speak and act as one. This in turn requires that whatever conflicts of interest may persist among members of the EMU are resolved before the ECB and other euro-authorities project their influence outside the borders of the European Union. This, too, requires agreement among EMU members to subordinate their particularistic

concerns to the evolution of a common policy aimed at addressing global issues.

Whether the issue in question has to do with the position of the euro or of the EMU authorities, the governments, policy-makers, and peoples of the euro zone face potential conflicts. At the core of these expected conflicts is a crucial issue: the potential trade-off between the pursuit of international and domestic (in this case, EMU-specific) objectives. Policies aimed to ensure the euro's international role, or to secure EMU policy-makers' international bargaining influence, require reducing the priority placed on some domestic targets. For example, a strong euro may conflict with the desire of European exporters for a 'competitive' currency; and the development of a consistent EMU-area international economic negotiating position may have to ignore the concerns of a troubled region. All this is complicated by the institutional complexity—and confusion—of current EMU arrangements. Such potential conflicts of interests and institutions will have a powerful effect on the constraints imposed on euro policy-makers, and it is important to understand what conflicts may develop and whom they may implicate.

Anticipated Conflicts of Interest Over Euro Policy

At the core of the controversies that will shape euro policy are the complex of interests and institutions that will determine the willingness of the EMU to make domestic sacrifices for international goals. This is true whether the goal in question is to make the euro a leading international currency, or to catapult EMU authorities into a position as one of two leaders in 'bipolar' monetary system (Fratianne and Hauskrecht 1998). Three sets of potential areas of conflict can be anticipated: short-term exchange rate policy, the longer-term monetary stance of the euro authorities, and the character of the EMU financial system. In all three cases, there are substantial differences among powerful groups in the EU, as well as substantial institutional ambiguities and complications.

Immediate exchange rate policy. By this I have in mind the euro's value over the short or medium term, whether it has been relatively strong or relatively weak. A weak euro—and one expected to weaken further—is not very likely to attract substantial international use. By the same token, policies oriented toward a weak exchange rate are not generally associated with attempts to coordinate macroeconomic policies with other countries—such international cooperation is typically the result of attempts to join forces to stabilize and defend, not drive down, currencies.

The exchange rate excites powerful interests, with diametrically opposed inclinations. Those concerned with their competitive position at home or

abroad want a relatively weak currency to raise the price of foreign goods on home markets and reduce the price of home goods on foreign markets. But a depreciated exchange rate is typically unpopular with monetary hard-liners, especially in the financial community. This is because it tends to be inflationary, and because assets denominated in a weak currency tend to be less attractive to investors.⁴

The trade-off here is an age-old one in exchange rate policy, usually thought of as the choice between competitiveness and credibility. There is no clear economic argument for one or the other—too strong an exchange rate can wreak havoc with the payments balance, too weak a one can ignite inflationary embers. The issue is, however, highly political, as it implicates powerful opposing interests.

And this sort of conflict of interest can only be ignored at the peril of serious miscalculations, as in fact early experience with EMU demonstrates. Initial expectations were for a rising euro, based on expectations that the ECB would focus on proving its inflation-fighting mettle. These expectations ignored the powerful lobbies for a depreciated exchange rate, especially among Europe's exporters and import-competers. In fact, at the time of the introduction of the single currency, European manufacturers were extremely concerned about export and import competition, in the face of a wave of Asian and Brazilian devaluations and continued attempts by Eastern and Central European producers to increase their sales in Western Europe. The reality of and potential for surging imports led European manufacturers to exert powerful pressures against an appreciation of the euro, and their views seem to have carried the day—much to the surprise of many euro-watchers in early 1999.

General exchange rate policy orientation. Here I have in mind the broad character of the monetary stance of the authorities. In the case of the euro, as for all international currencies, the principal question is how the authorities weight international and domestic (euro zone) concerns. This tension is commonly expressed as being between international and domestic stability, that is, emphasis on the stability of the exchange rate as opposed to the use of monetary policy for domestic purposes. Monetary authorities, of course, are concerned about both international and domestic dimensions of their policy choices, and cannot always achieve their goals on both dimensions simultaneously—domestic stabilization may destabilize currency markets, while defending the exchange rate may weaken the domestic economy.

Over the course of time, countries' macroeconomic authorities develop a reputation with regard to the international or domestic bias of their overall monetary stance. Economic agents have long expected the Swiss government to give pride of place to the international position of the franc; before 1990 the Swedish authorities had a well-deserved reputation for using the exchange

rate as an active instrument of domestic macroeconomic (especially employment and wages) policy. This reputation reflects the society's underlying socio-political and economic character. Visceral German aversion to inflation, for example, meant that no amount of concern about the strength of the Deutschmark would lead the Bundesbank to countenance a substantial increase in inflation.

In the case of the euro, it is a matter of great uncertainty what the relative importance of domestic and international goals will be to the EMU authorities. And these goals implicate contending interests. As with the shorter-term exchange rate, many in the financial community are eager to ensure that the euro challenge the dollar for use as an international vehicle, which would require clear commitments by the ECB to avoid policy changes motivated solely by domestic considerations.

Yet much of the support for EMU came precisely from groups in the European Union who wanted a zone of monetary stability—*domestic* monetary stability. The larger currency area would allow more effective attention to EU economic needs, and avoid the whipsawing of macroeconomic policy by global forces. And European labor movements and small businesses, many of which were ambivalent about EMU in any event, are intent on making sure that it does not subordinate European to international considerations. The commonly expressed view that EMU must help reduce unemployment—unrealistic as it may be, given the powerful structural factors that are the principal determinants of the region's joblessness—is emblematic of a general desire on the part of labor and others that the EMU authorities act more forcefully on the 'domestic' (European) economic front than has been possible in the contentious transition to EMU.

There are political bases for both domestic and international orientations. This is reflected in the divergences of opinion among informed analysts. Some observers, emphasizing powerful domestic factors, have argued that the transition from eleven small open economies to one large closed economy will allow (or lead) the ECB to focus on internal concerns. Others, noting the greater potential for a single currency to affect international developments, stress the prospects for a more concerted global role for the EMU authorities. Each possibility finds strong support in Europe; both cannot be pursued simultaneously.

Not only are there powerful conflicts of interest over the general course of European monetary policy, there are major institutional complications. The international position of the euro depends at least in some measure on the stance of EMU authorities in international monetary and financial forums. Yet it is very unclear who the relevant authorities are, and how they will be represented. Representatives of the European Union are often included in international meetings, but not all members of the EU are in EMU, and in any

case their statutory authority over monetary policy is very limited (indeed, at least in principle, they have none). The member states of the Economic and Monetary Union are of course members of the IMF, and several are in the Group of Seven; yet, again, they are not formally (or informally) capable of making monetary or financial commitments on behalf of the euro.

The European Central Bank, the monetary authority *per se*, is a central bank without a country, and international monetary and financial politics are still organized around countries. To make matters even more complicated, the Maastricht Treaty appears to reserve the making of explicit exchange rate agreements on the part of the Economic and Monetary Union to the Council of Ministers and not the ECB. It is unthinkable that such exchange rate agreements could be made and sustained without the cooperation of the ECB, but the nature of collaboration between the ECB and other EU policy-making institutions is still being developed.

For all these reasons, there remains a great deal of uncertainty about the overall bias to be expected from ECB monetary policy. This uncertainty was, again, much in evidence in the first months of the euro. Much of the early discussion of the ECB's expected stance focused on the bank's need to establish its reputation as a tough successor to the Bundesbank. This ignored the political environment within which the ECB operates, in which member governments and their constituents are keen to ensure that monetary policy takes full account of their domestic concerns. The importance of this political environment was reinforced by the French government's willingness and ability to block the appointment of Wim Duisenberg to head the Bank until receiving an informal commitment that he would step down early in favor of a Frenchman. The centrality of the political setting was also hammered home when the new Social Democratic government in Germany began, in the person of Finance Minister Oskar Lafontaine, to exert very public pressure on the ECB to loosen monetary policy. What followed was a delicate dance in which the Bank did not want to be seen as responding too blatantly to political pressure, but also did not want to be too far from the desires of its constituents. The result was a substantially looser ECB stance than many scholars had anticipated, and a generally revised expectation that ECB policy would have to take careful account of both domestic and international pressures.

The 'home' financial system. The status of a currency on international markets, and the status of macroeconomic policy-making authorities in international negotiations, depend importantly on the breadth, depth, and reliability of the relevant financial system. The financial sources of negotiating influence are straightforward: the prominence of a nation's government in discussions of international macroeconomic concerns depends on the importance of its financial markets to the global economy. No matter

how large the nation's economy may be, if it is of trivial importance to world financial and macroeconomic conditions, it will have a limited role in international macroeconomic policy forums.

Domestic financial circumstances also have a powerful impact on the international role of national currencies. Where the local financial market is underdeveloped, foreigners will be less willing to hold assets denominated in the currency. This is true both about the size of the market, and about the range of instruments available in it.

In a way, the solidity of the home financial market can substitute for other concomitants of international-currency status. For example, extremely well-developed forward markets can reduce the expected cost of the currency's volatility to potential users and holders. In the case of the United States, there is little question that the monetary authorities privilege domestic macroeconomic concerns over international ones, but American financial markets are so broad and deep that few users of dollars are particularly concerned. Of course, the longer the time horizon of the investor, the harder it is to protect against adverse policy trends, but in the short and medium run well-developed financial markets provide important reassurances to potential users of an international currency.

This also affects the use of the currency in debt and equity contracts. The fact that the dollar-based stock and bond markets are extremely well developed gives investors strong incentives to invest in dollar-denominated assets. Thin capital markets mean that potential investors take additional risks, such as finding themselves illiquid in the event of inauspicious conditions.

An important component of the financial stability that can reinforce currency use is the home regulatory environment. If investors regard the home authorities as reliable guarantors of the stability of local financial conditions, they will be more likely to hold assets in the currency. This is true both of the general regulatory setting—how financial markets are organized—and of the specific expectations that financial regulators will be able to deal effectively with a crisis, whether with lender of last resort facilities or some other similar crisis management initiatives. Inefficient and cumbersome financial regulations, and inadequate provisions for crisis containment, will reduce interest in the local markets and the local currency.

The depth and breadth of financial markets attracts further investors and borrowers, and the process is self-reinforcing. The more reliable the markets, the more they will be used; and the more they are used, the deeper and broader they become. There may also be feedback to financial regulation, as better developed markets increase the pressures on regulators to improve both general financial regulation and crisis management policies.

On the other hand, poorly developed and regulated financial systems, and uncertain lender of last resort facilities, dampen interest in a currency and assets denominated in it. And there remains great uncertainty about the future of Europe's financial systems. Certainly there has been important movement in the direction of a more consolidated and efficient financial market, and more reliable regulation. However, some of the national financial systems of the Economic and Monetary Union are still quite backward, and the euro zone as a whole is far from being a serious competitor to the United States as a major financial market. Much of the problem is regulatory: there is no single set of European financial regulations, and it is not clear how the regulatory environment for European finance will evolve over the coming decade.

At the same time, the division of authority for lender of last resort facilities in EMU is extremely ambiguous. Officially, national governments retain sole responsibility for 'their' financial institutions. Unofficially, it is widely recognized that serious financial problems in one EMU member would spill over to the rest of the members, to one degree or another. In this context, the ECB would probably be required to adjust policy to take a local financial crisis into account; and, *in extremis*, it might be called upon to act as an unofficial lender of last resort.

The problem is that both financial regulation and crisis facilities are potentially controversial. Financial market regulation has been a political minefield in the United States for decades, for it implicates extremely powerful interests, such as financial institutions with lucrative local monopolies or segmented markets. Some European countries have faced similar political obstacles to financial de-regulation and re-regulation. And while in principle few oppose lender of last resort facilities, if the issue is whether Dutch taxpayers should participate in a bailout of Spanish banks, thorny political problems are likely to arise.

In addition, neither Europe's central bankers nor other national policy-makers are eager to be explicit about how they see the evolution of the regulatory and crisis-management functions of the euro zone. Too direct a definition of expected policies would create powerful incentives for perverse behavior by investors and others. Weak banks in a weak national system could exploit a hypothetical stated willingness of the ECB to act as ultimate lender of last resort for all of the EMU by taking unwarranted risks in the knowledge that they would eventually be bailed out. This sort of moral hazard problem, and related possibilities to exploit inside regulatory information, make it difficult to make credible commitments that the euro authorities are 'in control' of European finance.

Yet this ambiguity and uncertainty contributes to nervousness in the financial markets, and to a reluctance to increase exposure to financial

markets and instruments that depend on the European regulatory environment. Until these issues are resolved, the global reach of European financial markets will be hamstrung. And resolving these issues requires confronting some potentially serious disagreements among countries, and among groups within and across countries.

On all three of these dimensions, there is likely to be continuing conflict. The short-term direction of exchange rate policy; the longer-term general stance of the monetary authorities, whether they look primarily inward or outward; and the depth and regulation of European financial markets, are all crucial determinants of the euro's international role. And all will in turn be determined in large part by the pulling and hauling of powerful interests in the member states of the euro zone, in a context of great institutional complexity and ambiguity.

Conclusion

I do not mean to imply that these conflicts cannot be overcome, or that EMU will necessarily founder on the shoals of these controversies. There are powerful pressures for European governments and EU institutions to resolve the problems that stand in the way of the euro's realization of its global potential.

However, the euro, like all currencies, is a creature of its society. Domestic—that is, euro zone—political forces will be brought to bear on the EMU policy-making authorities. The future of the euro is complicated by the fact that these political forces, and indeed these policy-making authorities, operate in an environment of great institutional novelty and uncertainty, in which it is not always clear who the relevant forces and authorities are.

Nonetheless, a full understanding of the euro's role in international monetary and financial relations—whether it will act as leader, challenger, partner, or obstacle—depends on the domestic context within which the policies of the ECB and other euro authorities are made. A central task for scholars and observers is to clarify the nature of the conflicting interests and institutions that make up the Economic and Monetary Union, and to understand how they interact in the formation of EMU macroeconomic policy.

Notes

1. An excellent introduction to the issues is Fratianni, Hauskrecht and Maccario (1998).
2. Broz (1997), Krugman (1984), and Tavlas (1991) include excellent surveys and/or examples of this sort of analysis.
3. Another fascinating recent example is the yen, discussed in Rosenbluth (1993).
4. One approach to understanding these conflicts is in Frieden (1994).

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