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The Euro vs Dollar Debate: A Review (WP)

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Miguel Otero-Iglesias[*]

Summary
This Working Paper provides a comprehensive and multidisciplinary literature review on the euro vs dollar debate. In the first part it presents the euro-optimist and the euro-sceptical hypotheses on the euro's challenge to the dollar within Economic literature and how current data show how the euro has underperformed vis-à-vis euro-optimistic expectations. In the second part, drawing on the International Economics and International Political Economy (IPE) literature, the paper explains the euro's political flaws. It shows that a currency can only become the top international currency if there is an active political commitment by the issuing authorities to make it the leading currency. The paper shows how existing IPE literature offers a very accurate picture of the structural conditions of the international monetary system. Where it lacks nuance is in identifying the social impact of the euro. The last part of the paper focuses on these social dimensions. Following a constructivist approach, it shows how the euro has become a truly global currency in the social sense and how key financial agents are gradually seeing an evolution from a unipolar system dominated by the dollar to a bipolar system where a mildly descending senior pole (the dollar) and a mildly ascending junior pole (the euro) compete against each other.

(1) Introduction

There is hardly any other topic in the field of International Economics and International Political Economy (IPE) that has attracted more attention than the question of whether the euro will challenge the supremacy of the dollar as the leading international currency. The literature covering the debate since the late 1990s can be divided into euro-optimists, who argue in favour of this thesis, and the euro-sceptics, who point to the obstacles the European currency faces to dethrone the dollar. These two differing hypotheses have continued to the present day despite the sovereign debt crises in the Eurozone (EZ). For those who have always been sceptical about the future of the euro, the crisis has reaffirmed their conviction about the unfeasibility of the European Monetary Union (EMU) project in the long term. It confirms their assessment that the euro in its present state is structurally flawed. By contrast, in the view of the euro-optimists, the current crisis is part of the natural evolution of a currency that is still very young. This existential crisis, very common in the teenage years, might end in 'suicide' (the possibility cannot be excluded), although the most likely outcome is that European policymakers will improve

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the EMU's structural framework and that the euro will emerge from the crisis strengthened.

As in the past, the current state of affairs gives ammunition to both sides of the debate. For euro-sceptics it is difficult to see how EZ peripheral countries such as Greece, Ireland, Portugal and Spain will be able to generate growth and repay their debts within the straightjacket of monetary union. For euro-optimists, however, the crisis is a golden opportunity to establish some sort of fiscal union which will consolidate EMU. For this camp, the establishment in May 2010 of the European Financial Stability Facility (EFSF), financed through what are *de facto* Eurobonds backed by all EZ member states, is already a proto-fiscal union that will enhance the attractiveness of the euro internationally. Recent Chinese, Japanese and Middle Eastern interest in buying national debt from EZ peripheral countries, and especially Eurobonds issued by the EFSF (Mallet & Wiesmann, 2011; Milne & Oakley, 2011; Whipp, 2011), is clear proof that the euro will continue to be seen as an alternative to the greenback in the foreseeable future.

Given the importance of this debate in the past, present and future of international monetary relations, the aim of this paper is to provide a review of the state of affairs in relation to this topic. The first part of the paper presents in greater detail the two contending economic hypotheses on the euro's challenge to the dollar that have emerged since the 1990s. Subsequently, by presenting currently available economic data on the international use of the euro and the dollar, it shows how after 11 years in existence, the European currency has underperformed in relation to the euro-optimists' expectations. The economic data publicly available vindicates those who have always been sceptical about the possibility of the euro challenging the dollar. As will be shown below, roughly speaking, the dollar still accounts for 60% or more of global transactions and reserve holdings, while the euro is struggling to reach the 30% mark.

But economic data alone do not explain the whole story, especially if they are incomplete (data for international trade invoice and central bank foreign reserve allocations, for instance, are only partially available). The numbers are representative enough to prove that the euro is far from challenging the greenback, but it is also true that they do not explain in full why that should be the case. The second part of this paper looks at the IPE literature. By studying the political aspects, several IPE authors have greatly enhanced our understanding of the topic. They have been able to highlight the political weaknesses of the euro and the relative strengths of the dollar. In addition, they have also focused on geostrategic and military aspects that are vital to grasp the dollar's resilience as the leading international currency.

The last section of the paper, however, argues that these political-economic analyses, mostly based on structural tendencies, are not comprehensive enough to understand all of the inroads opened up by the euro in its challenge to the dollar. They are too structural in

scope to identify the intersubjective effects on an agential level. A more social and ideational analysis is therefore required. Drawing on a more constructivist understanding of money, the third part of the paper shows that the euro and the dollar not only compete in the economic and political spheres but rival each other in day-to-day social activities also, essentially in how financial agents interpret the euro vs dollar debate and how they believe that the debate is interpreted by other agents. The euro has developed symbolic social effects that can only be discerned by focusing on agential behaviour and understanding. In this regard, the agencies that can be considered to be in a vantage point are the chief economists and senior executives of private or state-owned commercial banks and public foreign reserve management divisions at the central banks in both developed and emerging markets. Therefore, the last part of this paper will focus on how some of these key agents intersubjectively construct the euro challenge to the dollar.

(2) The Euro vs Dollar Debate in Economics Before the Start of EMU

(2.1) The 'Euro-Optimist' Hypothesis

One of the first economists to predict the euro's ascendancy as a strong international currency was Fred Bergsten. Already in 1997, five years before the euro hit Europe's streets, he wrote that:

'The creation of a single European currency will be the most important development in the international monetary system since the adoption of flexible exchange rates in the early 1970s. The dollar will have its first real competitor since it surpassed the pound sterling as the world's dominant currency during the interwar period' (1997, p. 83).

Focusing on the economic might of the EU –with output and trade figures stronger than those for the US– and also on the strong mandate that the ECB had received from the Maastricht Treaty to ensure a strong currency, Bergsten predicted that 'there will probably be a portfolio diversification of $500 to $1 trillion into euros' and that 'most of this shift will come out of the dollar' (1997, p. 84). As a consequence of this diversification, in his calculations 'the dollar and the euro are each likely to wind up with about 40 percent of world finance, with about 20 percent remaining for the yen, the Swiss franc, and minor currencies' (1997, p. 84). For Bergsten this development would also have important political ramifications. He concluded that 'a bipolar currency regime dominated by Europe and the US, with Japan as a junior partner, will replace the dollar-centered system that has prevailed for most of this century' (1997, p. 83).

One year later, in 1998, Robert Mundell, another prominent euro-optimist, would come up with bolder predictions. For him, the historical significance of the arrival of the euro was much greater than President Nixon's decision to close the 'gold window' in 1971 or even the Bretton Woods arrangements of 1944, which created a completely new monetary

system. While those changes did not alter the power configuration in the international monetary system (IMS), he considered that:

'This is not so with the introduction of the euro. The EMU countries will eventually comprise a transactions domain that is considerably larger than the dollar area. As an economic giant, Euroland will fully be the equal of the US, and the euro will become an international currency on the same scale as the dollar. From the deeper significance of monetary power relationships, the introduction of the euro will be the most important change in the international monetary system since the transition, achieved during World War I, from the pound to the dollar as the dominant international currency' (1998, p. 227-228).

Both Bergsten's and Mundell's predictions are based on economic considerations (mainly trade and output numbers and also diversification tendencies among international investors) but the effects they envision are not limited to the economic realm, they stretch to the political field. As Mundell concludes, 'members of the EMU will get not just a currency on a par with the dollar and the right to a share in international seigniorage but will also have greater influence in running the international monetary system' (1998, p. 237). Therefore, for both these authors, issuing an international currency and acquiring greater monetary power go hand in hand: one leads to the other. The more the euro is used in the world, the greater will be European influence in shaping the governance structures of the IMS. While this relationship can be accepted, the causality effect, on the other hand, can be disputed. For these authors the greater use of an international currency provides the issuer with more international monetary power. Causality is here understood to be unidirectional and linear. As will be shown below, it can be argued that in this matter causality is relational. It is true that progressive internationalisation of a currency gives the issuing state or union of states a greater say in global economic governance, but only up to a point. After that, active political action needs to be taken to further expand monetary power and consequently promote the internationalisation process. Once this is successfully achieved, the worldwide use of the currency will increase, and this in turn will further strengthen the issuer's monetary power. The relationship is symbiotic as Mundell and Bergsten suggest, but it is not that one side determines the other, since both elements need to feed each other to maximise their performance.

Richard Portes & Hélène Rey (1998), two other economists who are also in the 'euro-optimist' camp, do consider this interactive relationship. Their analysis, based on econometric modelling, accurately established the integration of the European financial markets as the key, as it were, independent variable in determining whether the euro would topple the dollar. Inching towards the IPE terrain, they acknowledged that this variable would only be optimised by an active policy of financial market integration and international currency promotion by the European authorities. They assumed and

justified this political activism on the grounds of the benefits that derive from issuing an international currency. While they briefly covered how an international currency translates into political power and prestige (something that will be discussed in greater detail below), their attention was more directed to the economic gains, which they consider more significant and less 'nebulous'.

First of all, they highlighted the trade advantage of buying and selling products in one's own currency, thereby avoiding exchange rate risks for local companies and institutions. Secondly, they pointed to the 'exorbitant privilege' of financing one's balance of payment deficits with liabilities denominated in one's own currency, which makes one less reliant on foreign reserves, offers better protection from external shocks (price volatility) and, most importantly, reduces financing costs due to the centrality and demand-pull that the currency has in the system. Overall, then, an international currency provides the issuing country with enormous international seigniorage, defined in simple words by Portes & Rey 'as the ability to obtain real resources (net imports) in exchange for almost costless notes' (1998, p. 309). In the greenback's case, foreign residents hold approximately 60% of total outstanding US dollar stocks. In Portes & Rey's calculations this means that annual revenues of international seigniorage for the US account for around 0.1% of US GDP which, updated to 2010 GDP figures, would reach an actual sum of US$14.6 billion.[1]

Moreover, these authors identified a further source of seigniorage for the US, which they consider is often neglected. This is the one emanating from the extraordinary liquidity of the US Treasury debt market. This liquidity pushes yields down, which in their calculations brings a 'liquidity discount' that amounts to annual benefits of US$5-10 billion, a figure that must be much larger for 2010 considering that US debt issuance increased substantially as a consequence of the 'Great Recession' and that yields on US Treasury bills, notes and bonds have remained at historic lows in the past years. Finally, Portes & Rey point to the efficiency gains obtained in financial intermediation activity from the deepening of foreign exchange and financial markets. If the euro increases its share as an international currency and more international trade is invoiced in the European currency and the European debt bond markets are better integrated and converge in regulation and commissions, transaction costs will be reduced and liquidity increased, which means that less labour is necessary to deal with these activities in European companies. The material gains derived from the reduction of these transactions costs are for Portes & Rey of the same magnitude as the seigniorage gains. Therefore, in their view, they 'provide a new economic argument for policy-makers who wish to promote the international role of the euro' (1998, p. 310).

[1] The US GDP figure for 2010 (US$14.6 trillion) is taken from the IMF World Economic Outlook Database, updated in October 2010. Using a different set of calculations to those used by Portes & Rey, Cohen (2008a, p. 258) comes up with a slightly higher figure for US international segniorage revenue of US$16-22 billion. Still, he considers these calculations conservative.

By taking for granted the macroeconomic strengths of the EZ and by assuming that the European financial markets will liberalise and integrate at a rapid pace and hence soon rival the centrality of Wall Street in monetary affairs –not least because of European political determination but also because in their opinion the UK (and the City of London with its financial expertise, externalities and know-how) will very soon join the EZ– Portes & Rey concluded their analysis on a very similar vein to Bergsten and Mundell:

'Given the euro's fundamentals –the EU's economic size, the liberalization and integration of its financial markets, and confidence in its international creditor status and stability-oriented monetary policy– we find that the most likely outcome is that the dollar will have to share the number one position' (1998, p. 308).

With the benefit of hindsight, it can confidently be said today that most of the assumptions presented by Portes & Rey in their 1998 calculations have not yet materialised. While it is true that Europe's financial markets have been integrating further thanks to policy decisions like the Financial Services Action Plan (FSAP) set in motion by the European Commission in 1999 (Galati & Wooldridge, 2006), transaction costs are still higher in Europe than in the US (Grant 2010), London remains out of the EZ and, most importantly, the ECB has not shown any signs of actively promoting the internationalisation of the euro. This development has been left to market forces.

(2.2) The 'Euro-Pessimist' Hypothesis

Despite these optimistic views about the euro's rapid internationalisation, not all economists agree with these predictions. Around the same period, several authors highlighted the obstacles facing the single currency in its attempt to rival the dollar. Rudi Dornbush (1996), for instance, identified from an early stage some internal limitations that would hamper the EMU's global aspirations. His analysis is of relevance today because it predicts with great accuracy some of the difficulties experienced by peripheral EZ countries as a result of the effects of the Great Recession. Drawing on the fact that the EZ is not an Optimum Currency Area (Mundell, 1961) and considering that the Maastricht Treaty limits any transfer of funds from one country to another, Dornbush foresaw that potential asymmetric external shocks or growth disequilibria within the EMU would be extremely difficult to manage under a single monetary policy. Historically, in Europe these asymmetries would be offset by moves in the exchange rate, but lacking this mechanism and a common fiscal policy to allow transfers between EZ member states (something Dornbush does not conceive to be feasible in the European context), the adjustment costs will have to come through the labour markets. Fully aware of the troubles ahead for EMU, his overall outlook was quite pessimistic:

'The most serious criticism of EMU is that by abandoning exchange rate adjustment it transfers to the labor market the task of adjusting for competitiveness and relative prices… In backward regions unemployment will rise, as will social problems and

complaints about integration. If exchange rates are abandoned as an economic tool, something else must take their place. Maastricht promoters have carefully avoided spelling out just what that might be. Competitive labor markets is the answer, but that is a dirty word in social-welfare Europe' (1996, p. 120).

It is certainly striking how this description written 15 years ago closely resembles the current situation in countries such as Portugal, Greece, Ireland and Spain (the PIGS), which are all suffering high unemployment, massive public spending cuts and major labour reforms.

While Dornbush focused on the euro's internal problems, two other economists, Kenen (2002) and McKinnon (1998) analysed the euro challenge thesis from an international market perspective. Following a standard Economics textbook explanation of money, they stressed that in order to analyse the euro vs dollar competition it was helpful to separate the functions of any international currency into three: (1) unit of account; (2) medium of exchange; and (3) store of value. For the first two functions they argue that market actors prefer a single international currency. For the latter, though, competition between different international currencies is likely, and even desirable. The function of unit of account refers to the invoicing of contracts or pricing of commodities in one particular currency. The international pricing of oil in US dollars is a good example. The medium of exchange function, on the other hand, relates to the vehicle currency used to exchange different currencies in the foreign exchange (FX) markets. It is difficult to exchange Mexican pesos for Russian roubles. Therefore the most common strategy is to exchange the pesos for US dollars and then the dollars for roubles. Here again, there is always one particular currency that performs the function, which makes it the vehicle currency. Moreover, once this currency is consolidated 'it becomes a natural monopoly' (McKinnon, 1998, p. 33), meaning that 'it cannot readily be dislodged, even if another currency could do just as well. A synchronised switch would be needed, and it would be hard to achieve unless it would greatly enhance the efficiency of foreign-exchange trading' (Kenen, 2002, p. 348). This pattern is based on what are called network externalities. Chinn & Frankel (2008) make an analogy with languages used as a *lingua franca*. Traders use a particular currency because they know that others are likely to use it as well. This creates a historic path-dependency and inertia that is very difficult to break, and it not only holds true for the private sector: central banks normally peg (if they follow a currency peg) to this international currency to avoid price volatility from imports invoiced in that currency. They also use this currency to intervene in the markets because it is cheaper and more efficient to do so and as a result they are also likely to maintain a large part of their reserves in the same currency.

Things are different in the store-of-value function, which is normally associated to keeping wealth in a particular currency because market agents trust its long term value. In this regard, in the current system, based on fiat-money which is not backed by any

metallic asset, as was the case in the Gold Standard, it is important that the central bank issuing the international currency has credibility among market agents in controlling inflation and not monetising the countries' deficits. This is a precondition to acquiring a store-of-value status among investors. Nonetheless, in this particular function several reserve currencies with different fluctuating exchange rate trends can easily compete. As explained by Kenen, 'portfolio optimization involves the efficient management of risk and thus fosters diversification rather than dominance' (2002, p. 348). This distinction between the three functions of an international currency is important in order to analyse, for example, the behaviour of the State Administration of Foreign Exchange (SAFE), the Chinese institution responsible for managing Chinese foreign exchange reserves. China, with US$2.85 trillion[2] in foreign reserves, has far exceeded the necessary precautionary amount to maintain its peg to the dollar[3] and cope with possible external shocks. Thus its diversification incentives are undoubtedly higher.

Nonetheless, as Cooper (2000) accurately foresaw a decade ago, foreign reserve managers not only seek safe storage and high returns. They also consider the liquidity of the assets they buy, especially if they have to make use of them at unpredictable intervals. Money needs to be stored in a convenient medium, and this medium is today provided by the US Treasury debt market, where:

'Amounts measured in billions of dollars can be bought and sold readily, 24 hours a day, anonymously, without influencing the price of the outstanding bills. In effect, for large holders the US T[reasury]-bill has become interesting bearing money. It can be converted into means of payment at virtually no cost' (2000, p. 188).

The EMU does not have a deep and liquid debt market equivalent to the US Treasury market. On the contrary, debt markets in Europe until the Great Recession were relatively small (the Growth and Stability Pact only allows annual fiscal deficits of 3% of GDP in normal circumstances) and nationally fragmented (there was no pan-European debt issuance until the creation of the EFSF in May 2010). These limitations have always provided a ceiling on the projection of the euro as an international reserve currency.[4]

[2] Figure provided by the People's Bank of China as of 11/I/2011.

[3] In June 2010, the People's Bank of China, the Chinese central bank, announced that it would loosen the tight peg to the dollar and go back to a basket peg, a policy undertaken before, from 2005 until 2008, when the financial crisis in Wall Street brought great instability to the markets and the direct peg to the dollar was reintroduced.

[4] At the time writing, EZ debt issuance has increased dramatically due to the adoption of counter-cyclical fiscal policies to overcome the 2007-10 financial crisis. Almost every country in the EZ has surpassed the GSP fiscal deficit limit of 3% to GDP. The issuance of European debt is now not only limited to the national level. The European Financial Stability Facility (EFSF), set up to provide financial assistance to debt-laden countries in the EZ, started to issue Pan-European debt backed by all member states of the EZ in January 2011.

Finally, before concluding this section, it is important to highlight that the three functions of international currencies are strongly interconnected. A vehicle currency is likely to function also as a reserve currency, but it is also true that a reserve currency might gradually become a vehicle currency. This can be explained by an example. If the European debt markets were to integrate into a single one, they would acquire greater liquidity; this, in turn, would mean that China would be able to invest more of its reserves in euros and so achieve a greater diversification in its portfolio in pursuit of higher returns. Seeing the advantages of this, the Chinese authorities and institutions would be encouraged to sell more of its products in euros to the EZ and this would mean that the euro would function more as a unit of account. The euros collected through this trade pattern would then presumably return to the European financial markets for further investment and thus lower FX transaction costs for the euro, which would mean that the euro would also be increasingly attractive as a vehicle currency. Path-dependency, and especially hysteresis, might hamper this process, but theoretically it is certainly possible.

(3) The Euro vs Dollar Debate in Economics Today

(3.1) The Euro Challenge Hypothesis Reinvigorated

More than 10 years after these opposing hypotheses on the euro challenge to the dollar were first laid out, the debate in the Economics field is still dominated by these two contending analyses. This was the case up to the current sovereign debt crisis in the EZ and presumably, if the euro does not break up, it will continue into the future. Chinn & Frankel represent the 'euro-optimist' camp. After predicting in 2005 that the euro would possibly surpass the dollar in 2022 as the leading reserve currency, their latest econometric calculations in 2008 pushed the tipping-point even closer to 2015. Their predictions are based on the main factors that economists generally consider are determinant to gain international currency status: (1) economic size measured in output and trade; (2) deep, liquid and well-developed financial markets; (3) confidence in the value of the currency; and (4) network externalities. In their view, while in the first two the EZ is catching up with the US (new members will make EZ GDP higher than US GDP and the City of London is becoming the *de facto* financial hub for euro-denominated financial instruments), the dollar is bound to underperform *vis-à-vis* the euro in the third factor. As they put it: 'the US current account deficit is always a likely source of downward pressure on the dollar' (2008, p. 58). Given this outlook and focusing on central bank foreign reserve management in their calculations because of its importance to fund US external debt, Chinn & Frankel answer the question of whether the dollar might lose its predominant role as the leading world currency with:

'The answer is may be 'yes. The primary reason is that the euro now exists as a more serious potential rival than the mark and yen were. A secondary reason is that the United States by now has a 25-year history of chronic current account deficits and the dollar has a 35-year history of trend depreciation' (2008, p. 51).

In Chinn & Frankel's analysis therefore there will be a moment when dollar inertia will be broken and a new equilibrium will be found. This is the tipping-point that will catapult the euro to a top international currency status. This is a similar conclusion to that reached by other euro-optimist economists, such as Papaioannou & Portes (2008). As explained above, for these authors the increased reserve role of the euro will affect the other two functions performed by an international currency: the vehicle-currency role and the trade-invoicing role. In other words, the former will stimulate the latter.

(3.2) The Euro Challenge to the Dollar Measured in Quantitative Terms

Figure 1. Euro-dollar exchange rate, 1999-2Q2010

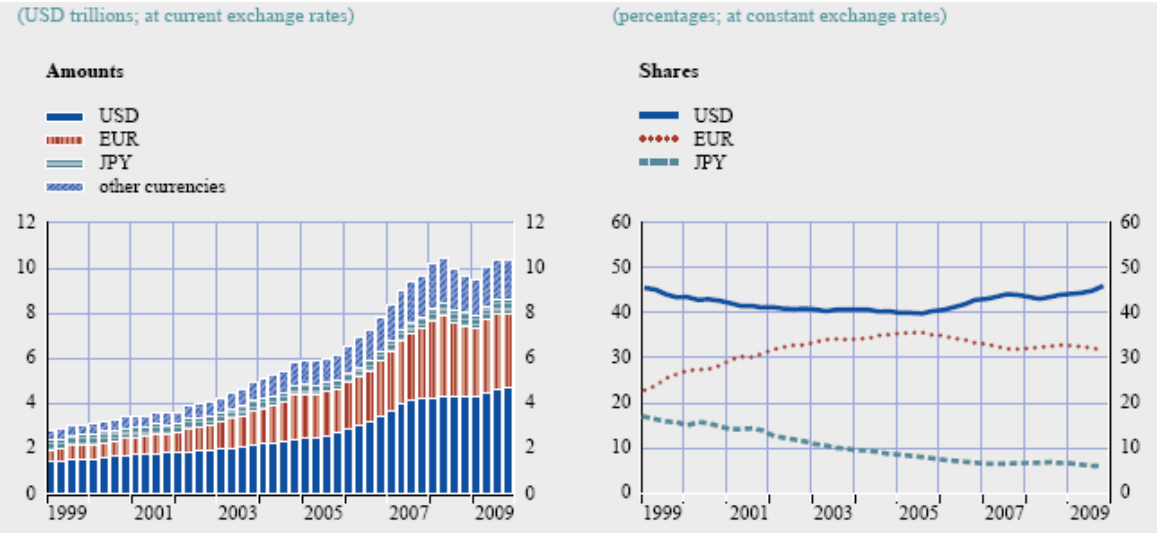
Source: ECB.

The presentation of Chinn & Frankel's econometric calculations in 2008 was timely as the dollar was depreciating rapidly *vis-à-vis* the euro (see Figure 1) and triggered a rapid reaction by economists that were more sceptical about this outcome. It is worthwhile presenting the response of De la De la Dehesa (2009), who provides a good summary of the international use of the euro to underscore his claim that the euro is still far from posing a challenge to the greenback. Where possible, De la De la Dehesa's comprehensive data sample is updated with the latest figures as of the time of writing. De la De la Dehesa assesses the euro challenge to the dollar through its relative weight in three different international markets: (a) the international liability management market; (b) the international asset management market; and (c) the foreign exchange market.

(a) International Liability Management: the issuing of euro-denominated securities around the world has increased substantially since the creation of the single currency. 'According to the ECB, in a narrow sense –excluding domestic issuance of debt securities at constant exchange rates, ie, adjusted by valuation effects–, the share of euro-

denominated debt securities of the total stock grew from 20% at the start of EMU in 1998 to a peak of 33.8% in mid 2005' (De la De la Dehesa, 2009, p. 7). This amount has dropped slightly in recent years, hovering just above the 30% mark. In 2009 the actual figure was 31.4% of total issuance (ECB, 2010). Dollar-denominated debt securities, by contrast, experienced a decline from 49% of total stock at the start of EMU in 1998 to a low of 41% in 2005, when the euro peaked. Since then, however, dollar-denominated issuance has increased and in 2009 (the latest figure to date) it stands at 46%. The data show a rapid growth for the euro in the first years, with a plateau at around 30%. The dollar remains robust at around 45% while the biggest loser is the yen, still the third most used currency, but in a continuous downward trend. In 1998 it represented 18% of total issued debt, while today its share is below 6% (ECB, 2010, p. 17-18).

Figure 2. Stock of international debt securities (narrow measure): outstanding amounts and currency shares

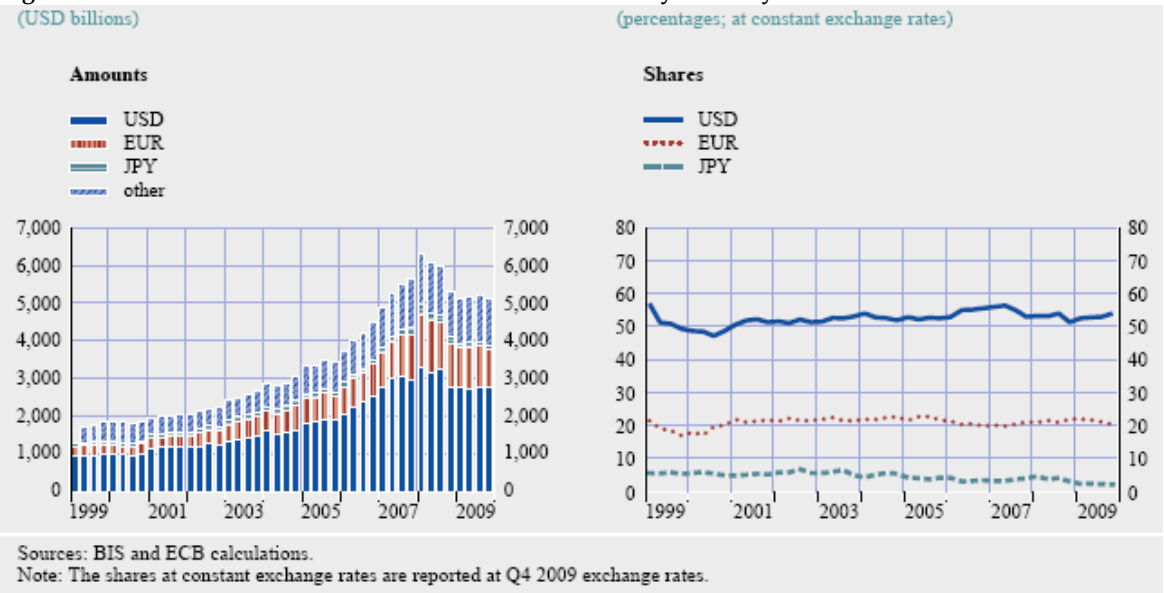


Source: ECB (2010).

De la Dehesa observes that most of euro-denominated issuance is in fixed income and not in equity markets. Equity markets in the EZ, despite efforts to integrate them, are still nationally divided and hence present a considerable 'home bias'. This makes them much smaller than their US equivalents. In De la Dehesa's (2009) calculations, at the end of 2008, the market capitalisation of the US equity market was US$9.4 trillion (35.2% of the world total and 67% of US GDP), while the EZ's was only US$5.8 trillion (21.7% of the world total and 46% of EZ GDP). Things are a bit different in fixed income debt, despite the aforementioned deficit of not having an integrated pan-European government debt market. Here the creation of a single currency has eliminated exchange rate risk, improving overall demand. Bond and note issuers, both from the public and the private sector, have greatly benefited from this development. Financial institutions, predominantly in the UK and the US, for instance, have been particularly keen to borrow

in euros. Overall, euro-denominated debt is prevailing in Central and Eastern Europe (80% of total issuance), the UK, Sweden and Denmark (58%) and North America (53%). In Africa the euro and the dollar are very close (the euro share is 41%), while in Asia (20%), Latin America (14%) and the Middle East (11%) dollar-denominated debt is still predominant (ECB, 2010, p. 20). The same can also be said in relation to the international loan markets. Here too the dollar is strongly favoured. As of 2009 only 20.3% of cross-border loans from banks to non-financial firms and households were denominated in euros. In the case of the dollar the share was close to 54%. This has remained so for the last decade, with the euro making no significant advance.

Figure 3. International loan markets: all cross-border loans by currency

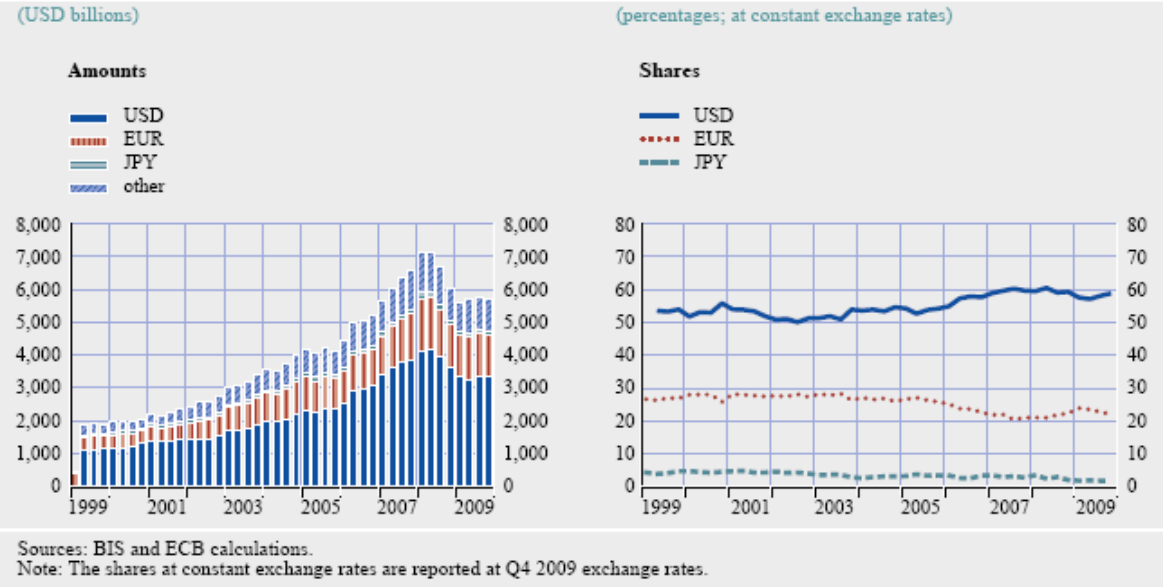


Source: ECB (2010).

(b) International Asset Management: in this section De la Dehesa (2009) provides very interesting 2006 data on the currency composition of managed investment funds worldwide. Here the share of the euro accounts for only 0.7% of total assets owned by investment funds allocated in the US and Canada and for 27.8% for those in Western European non-EZ countries (the UK, Denmark, Sweden, Switzerland, Norway, Monaco and Lichtenstein). In contrast, the dollar's share totals 97.1% in the former and 14.4% in the latter. The euro has achieved some gains since 1999 (the numbers were 0.2% and 26.8%, respectively), but these are still minor. Average euro shares in investment portfolios in Central and Eastern Europe are around 50%. However, in other parts of the world the dollar is clearly dominant. In Japan the dollar's portfolio share is 44% compared with 20% for the euro, while in the rest of Asia, Latin America and Russia the dollar accounts for 80%, 95% and 92%, respectively, with only 4% for the euro. Nonetheless, De la Dehesa suggests that diversification into euros is rapidly increasing in these emerging markets. In cross-border deposit markets the euro is also well behind the dollar. In 2009 the euro share was 22%, while that of dollars was almost at the 60% mark (ECB, 2010, p.

21-22). As an example, De la Dehesa (2009) indicates that in 2008 the euro's share of deposits held by OPEC countries was 18%, compared with the dollar's 77% share.

Figure 4. International deposit markets: all cross-border deposits by currency



Source: ECB (2010).

(c) Foreign Exchange Markets: in the foreign exchange markets, where the euro and the dollar compete for international vehicle currency in the function of medium of exchange, the euro's share has not gained much ground either. The latest Triennial BIS Survey on foreign exchange turnover released in December 2010 shows how in 2001 the shares were 89.9% for the dollar and 37.9% for the euro, while now they are 84.9% and 39.1% out of 200%,[5] respectively (BIS, 2010, see Figure 5).

[5] The 200% figure is due to the fact that in every transaction there are two currencies involved.

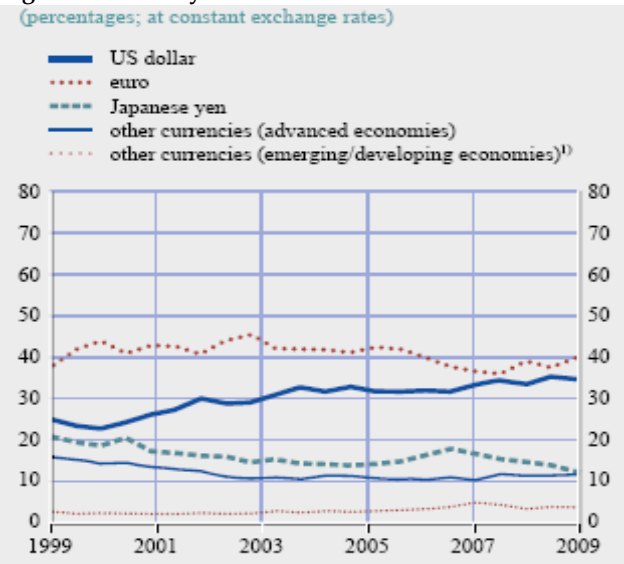
Figure 5. Currency distribution of global foreign exchange market turnover

Currency	1998	2001	2004	2007	2010
US dollar	86.8	89.9	88.0	85.6	84.9
Euro	...	37.9	37.4	37.0	39.1
Japanese yen	21.7	23.5	20.8	17.2	19.0
Pound sterling	11.0	13.0	16.5	14.9	12.9
Australian dollar	3.0	4.3	6.0	6.6	7.6
Swiss franc	7.1	6.0	6.0	6.8	6.4
Canadian dollar	3.5	4.5	4.2	4.3	5.3
Hong Kong dollar	1.0	2.2	1.8	2.7	2.4
Swedish krona	0.3	2.5	2.2	2.7	2.2
New Zealand dollar	0.2	0.6	1.1	1.9	1.6
Korean won	0.2	0.8	1.1	1.2	1.5
Singapore dollar	1.1	1.1	0.9	1.2	1.4
Norwegian krone	0.2	1.5	1.4	2.1	1.3
Mexican peso	0.5	0.8	1.1	1.3	1.3
Indian rupee	0.1	0.2	0.3	0.7	0.9
Russian rouble	0.3	0.3	0.6	0.7	0.9
Chinese renminbi	0.0	0.0	0.1	0.5	0.9

Source: BIS (2010).

Where the euro beats the dollar is in over-the-counter (OTC) interest rate derivatives. Here the share of the euro is 39% out of 100%, while the dollar accounts for only 34%.

Figure 6. Currency breakdown of OTC interest rate derivatives



Source: ECB (2010).

However, the euro is actually losing ground in this market against the greenback. In 1999 the euro's share was very similar, while the dollar's was around 25%. In foreign exchange derivatives the dollar has, by contrast, maintained over the decade its 80% out of 200% share, while the euro has remained stuck at 40%. Not surprisingly the greenback is also overwhelmingly dominant in the issuance of more synthesised derivatives such as asset-

backed securities (ABS) and credit default swaps (CDS). In these markets the US accounts for 67.9% of total issuance, followed far behind by the EZ with 10.6% and the UK with 9.6%. The largest proportion of this issuance, 85%, is in the issuer's currency, making the dollar by far the leading currency (De la Dehesa, 2009).

Nonetheless, where the European currency has made more inroads into its competition with the dollar is in the invoicing and settlement of international trade, a predictable evolution considering the trade might of the EZ. In its latest report the ECB writes that 'since the launch of the single currency in 1999, the prominence of trade conducted in euro has increased steadily' (2010, p. 25). On this same issue De la Dehesa (2009) states that the euro's average invoice share for global merchandise trade has increased from 18.2% in 2001 to 28.9% in 2007. EZ companies seem increasingly able 'to impose their domestic currency both on their trading partners in the EU and on non-EU countries, pointing towards non-negligible producer currency pricing power' (ECB, 2010, p. 26-27). Yet the ECB report also acknowledges that this power diminishes as the geographical distance from the EZ increases. ECB figures released in 2008 by the European Commission (2008) show that only 5.3% of EZ trade with Asian countries such as Indonesia, Japan and South Korea is invoiced in euros, versus 80.1% in dollars (2008, p. 120). Nevertheless, it is important to highlight that these figures are mostly estimates. As recognised by the ECB in its 2009 report on the international role of the euro:

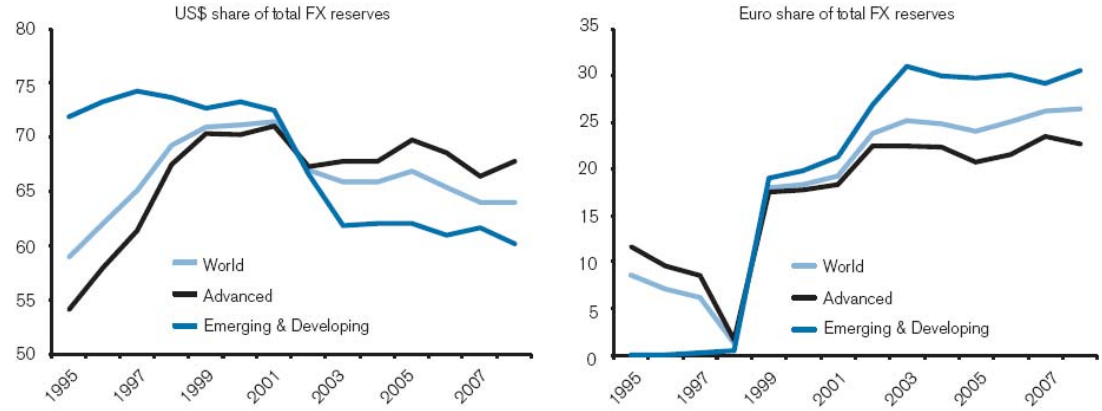
'Ten years after the introduction of the euro, information about the currency denomination of invoicing or settlement of international trade flows continues to be scarce, considerable data collection efforts by the ESCB [European System of Central Banks] notwithstanding. In fact, data are obtainable for less than a third of global merchandise transactions in 2007' (2009, p. 36).

This statement effectively indicates that there is insufficient data available to measure accurately the euro challenge in the key realm of international trade invoicing, perhaps one of the most important domains in assessing the performance of an international currency in the function of unit of account. The ECB provides only 39.2% of currency denomination trade data for EZ countries (having only estimates for France and no export data for Germany, the two biggest economies of the EZ). Furthermore, for non-EZ countries the share falls to 32.6% and for other regions of the world it drops to 5.4% (even though these account for 60% of global trade). This caveat is not acknowledged by many authors who rely on the same data (Cohen, 2009a) to assess the performance of the euro, nor is it highlighted by De la Dehesa.

What is widely acknowledged in the literature is the lack of reliable data on the currency composition of foreign exchange reserves in central banks. The most used data set in this regard remains the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER), which, as recognised by the ECB (2010), only covers around 60% of global

reserves. Important foreign reserve holders such as China do not disclose their foreign exchange composition. Here again the performance of the euro as an international currency in the function of store-of-value is not quantifiable. COFER data, as of September 2010, show that the euro has steadily increased its share from 18% to 26.9% of total known reserves since 1999, versus a steady decline in dollar reserves from 71% to 61.3% in the same period (IMF, 2010). This indicates almost a 10% swing but, as mentioned, these numbers should be interpreted with caution because they miss around 40% of the total stock.

Figure 7. Global distribution of foreign exchange reserves



Source: IMF, COFER (reproduced in Benigno, 2010).

More interesting are the figures that the ECB (2010, p. 35) gives for other important nations, which do disclose to some degree their reserve composition. These estimates indicate that as of the end of 2009 the euro represented over 60% of UK, more than 40% of Canadian and close to 50% of US reserves. The ECB also gives 2008 figures for Russia, showing that the euro share was very close to 50%. This is in line with the 2009 report of the Russian Central Bank (RCB) which showed that the euro had surpassed the dollar as the main Russian reserve currency. The European currency now accounts for 47.5% of the share of total reserves, while the greenback accounts for 41.5% (*Pravda*, 2009).

It is useful to finish this section with the Russian central bank's move to diversify out of dollars and into euros because it clearly shows what this quantitative overview can and cannot tell about the euro's challenge to the dollar. Where the amount of data is representative, the challenge is easily measurable. The figures show that while the euro has increased its share in debt-issuance, investment management and foreign exchange (FX) activity to around 30% on average, the dollar is still clearly dominant in roughly two thirds of activity. Because of the lack of reliable data, the evidence is not as clear cut in the invoice of international trade and foreign reserve management of central banks. Thus, Chinn & Frankel's euro challenge hypothesis is not totally disproved. Moreover, even if Chinn & Frankel are considered to be wrong on the basis of factual evidence, as De la

Dehesa assumes, the question that still remains is, why is that not the case? Why is the euro unable to de-throne the dollar? For De la Dehesa, the answer is simple. The euro's market performance as an international currency has been remarkable. However, 'unless the EU can construct a political governance system similar to that of a federal state it will be very difficult for the euro to overtake the dollar as the world's dominant currency' (2009, p. 18). Therefore, the answer to the question lies not exclusively in Economics. It hinges on both economic and political factors combined, which is essentially the field of study of IPE.

(4) The Euro vs Dollar Debate in International Political Economy

(4.1) The Political Determinants of International Currencies

As summarised in the previous section, the Economics literature agrees broadly on four main facilitating factors to achieve international currency status: (1) large economic size; (2) broad and deep financial markets; (3) confidence in the currency's value; and (4) network externalities (Lim, 2006).[6] Taking an IPE approach that engages with this same framework, Helleiner (2008) reduces these economic factors to three: (1) confidence; (2) liquidity; and (3) transactional networks. However, he also argues that politics have both an indirect and a direct influence on these areas. Indirectly, politics can affect the main economic determinants through several channels. Confidence in a currency can be sustained by economic factors but also by 'the broader international security power of the issuing state' or by 'a consistent conservative monetary policy that is credibly embedded within domestic politics and institutions' (Helleiner, 2008, p. 358). The former is epitomised by US military power, while the latter by the ECB's anti-inflation stand, which is widely believed to have inherited the monetary conservatism of the German Bundesbank. Politics also matter in the integration and sophistication of the financial markets. With the launch in 1999 of the Financial Services Action Plan (FSAP), which began its implementation phase in 2004, the European Commission (EC), for instance, has shown great commitment in creating a more integrated pan-European financial market. Finally, transactional networking can also be enhanced indirectly by the political behaviour of governmental authorities. These public institutions can help to open up new markets through diplomatic negotiations, they can increase governmental aid to key regions and they can spread their own clearing and payments systems to further encourage the use of their respective currencies. As Helleiner suggests, 'in the current age, European political initiatives to make euro-based clearing and payments systems as attractive as their dollar counterparts will play a significant role in influencing the euro's ability to challenge the dollar's international position' (Helleiner, 2008, p. 359). The EC's

[6] In his review of the literature, Lim (2006) adds a fifth facilitating factor, 'political stability', which as he recognises is only highlighted by economists 'taking a more historical perspective' (2006, p. 7) on the feasibility of monetary unions without fiscal union. Presumably, this fifth factor is for many mainstream economists included in the third factor, focused on 'confidence in the currency's value'. As seen recently with the Greek sovereign debt crisis, when the institutional edifice of a monetary union starts to be in doubt, the currency normally tends to depreciate.

and the ECB's recent efforts to establish derivative clearing houses based in the EZ go precisely in that direction (Grant, 2009; Tait & Grant, 2009).

However, politics also have a direct influence on the use of an international currency. To clarify this point, Helleiner turns to Strange's seminal 1971 taxonomy of international currencies, which is deliberately both political and economic, 'consciously regarding the two as inextricably intermixed' (Strange, 1971, p. 217). Strange identifies four types of international currencies: (1) top currency; (2) master currency; (3) neutral currency; and (4) negotiated currency. The direct influence of politics on the master currency is clear because Strange in this respect meant a *de facto* territorial domination of one state by the issuer state of the master currency. Today master currencies are in disuse (with some exceptions, such as Ecuador and Panama). A top currency, in contrast, acquires this privileged status mainly because of economic factors. It can be defined as 'the currency that has world economic leadership, the currency of the predominant state in the international economy' (Strange, 1971, p. 221). The dollar has certainly deserved this status in the decades up to the recent financial crisis, but it remains to be seen whether it can retain it. The best example of neutral currency –or passive currency, as it is also called– is the Swiss franc, which is a stable currency with its own attractiveness but which has neither the means nor aspirations to become the top international currency. The euro is also currently no more than a strong 'neutral' international currency in most parts of the world, while it can be considered a 'top' currency in its own regional sphere of influence. In this regard, it is important to note that Strange's currency types are not rigid but fluid: 'any international currency can assume different roles *simultaneously* in different contexts' (Helleiner 2008, p. 360).

Finally, the last type of international currency is the negotiated or political one. In this case, the issuer of the master/top currency loses political or economic might, as is the case today with the US in the aftermath of the financial crisis, and hence some of the follower countries might start doubting about its anchor role in the system. The issuer, in turn, might need to offer certain financial (ie, market access) or political (ie, military protection) inducements in order to persuade them to continue to use his currency. As Helleiner points out, these concessions might not be explicitly negotiated at a table, they might just be implicitly shared by the issuer and followers. In today's context, however, this negotiated framework is both implicit and explicit. It is implicit because the US needs, for instance, to keep its market open to Chinese goods and to militarily protect the GCC countries in order to maintain the status of the dollar as the main international currency. And it is also explicit, because the governments of the BRIC countries have openly said that they want to see the end of dollar dominance in the IMS and that they would like to start negotiating this topic in multilateral forums (Parker *et al*., 2009; Kim, 2010). Given this context, Helleiner's typology is the most appropriate one to understand the current positions of the euro and the dollar in the system. While the dollar is increasingly sliding from top to negotiated currency, supported by politically-motivated financial and

military inducements, it is precisely the willingness of the US to maintain this support which is allowing the dollar, at least for the time being, to retain its edge *vis-à-vis* the euro, which remains mainly an international passive/neutral currency due to its political under-achievement.

(4.2) The Euro's Political Shortcomings

Once political determinants are included in the picture, as the IPE literature does, the euro-optimist hypothesis loses strength. There are very few authors that see the euro as the next global currency (De Cecco, 2009, is perhaps the exception), while there are many more who think otherwise (Cohen, 2010; Plaschke, 2010; Cafruny & Ryner, 2007). One IPE author who has over the years pinpointed the political weaknesses of the European currency in its struggle to rival the greenback is Cohen (2010). A review of his work on this topic over the last decade provides an accurate summary of the euro's shortcomings, and also reflects how the dollar has slowly weakened in its role as top international currency. Cohen's intense study of the euro's challenge to the dollar reaches two noteworthy conclusions. First, the euro is not yet a threat to the dollar. Secondly, the dollar is increasingly malfunctioning as the main anchor of the IMS. In other words, what Cohen says is that the euro might be catching up with the dollar, but that this is not so much a consequence of the euro's strengths, but that it has more to do with the dollar's weaknesses.

Cohen divides the euro's political shortcomings in three: (1) the fragmentation of the European financial markets; (2) the anti-growth bias entrenched in the Maastricht Treaty; and (3) the governance difficulties associated with a decentralised monetary union. The first weakness has been explained before. It relates to how European policymakers have certainly achieved some progress in stimulating the integration process of the European financial markets (Galati & Wooldridge, 2006), the creation of the pan-European Euronext stock exchange being a good example, although this has only been achieved through indirect political intervention, following Helleiner's political determinants framework. Direct political commitment to merge sovereign debt markets in one pan-European issuance or to establish a pan-European public financial markets regulator and supervisor is still absent.[7] This limitation in the regulatory structure of the EZ's financial markets prevents the euro from competing with the dollar.

The second shortcoming exposed by Cohen refers both to the sole mandate of price stability given to the ECB, which is banned by law to perform the task of lender-of-last-

[7] The current financial crisis has made evident the need for greater pan-European coordination in financial market regulation and supervision. The emergency reaction to the crisis in 2008 was uncoordinated and nationally fragmented. Since then and on the basis of the Larosière Report (2009) it was agreed to establish a European Systemic Risk Council (ESRC), bringing together all EU member states' financial market supervisors. Nonetheless, the ESRC and its three agencies –focused on banking, securities and insurance supervision and based in London, Paris and Frankfurt, respectively– have only a consultative character. Day-to-day financial regulation and supervision –and, of course, fiscal responsibility– will still be national responsibilities.

resort to its member states,[8] but also to the controversial Growth and Stability Pact (GSP) embedded in the Maastricht Treaty. As De Grauwe (2006) criticises, by capping the fiscal deficits of member states to an annual 3% of GDP, the possibility of using expansive, Keynesian style, fiscal policies to spur growth at times of declining activity is essentially undermined. This might be convenient for Germany, which relies heavily on export-led growth, but for the EZ's Mediterranean economies, that are more dependent on domestic demand, this monetarist straightjacket is difficult to bear, especially if they are confronted with a major financial crisis, as in recent times. It is no surprise, therefore, to hear the former EC President and Italian Prime Minister, Romano Prodi (2010), continuously referring to the GSP as 'stupid' and calling for a more federal EZ.

This second weakness can structurally be linked to Cohen's first. Both point to the fact that the EZ is a monetary union without a 'federal' fiscal structure that can support it. By rejecting the possibility of creating a pan-European public debt market able to channel funds to a centralised budget, charged with overcoming asymmetric shocks, the EZ rules out the option of developing a macroeconomic strategy for growth at times of depressed demand.[9] As De Grauwe (2006) explains, monetarists in Brussels and Frankfurt would argue that it is precisely this rigid framework, designed to avoid moral hazard among member states, that will eventually promote labour flexibility and make the EZ an optimum currency area able to increase its growth potential. But even under this assumption, there is only a degree of flexibility that can be enforced in the EZ before labour discontent, caused by diminishing welfare and protection, degenerates into social unrest, as Cafruny and Ryner (2007) convincingly point out.

Overall, the effects of this conservative monetary framework for the euro's international trajectory are mixed. On the one hand, investors around the world might be attracted by the political commitment to price stability of the ECB and the GSP, especially if they see unsustainable profligacy in the US (De Cecco, 2009). On the other hand, they might be disappointed by the lack of political zeal to foster higher growth in the EZ.

These two weaknesses converge in Cohen's third one, which can be summarised in a simple question: who's in charge of Euroland? Again, as with the previous weaknesses, these shortcomings point to the fact that there is an asymmetry between monetary policy

[8] The so called 'no bail-out' clause of the ECB entrenched in the Maastricht Treaty has been partially broken in practice during the ongoing sovereign debt financial crisis when the ECB decided from May 2010 onwards to buy government bonds of member states in financing difficulties (Greece, Ireland, Portugal and Spain).

[9] The current financial crisis has brought to the fore the limitations of the GSP when confronted with major external shocks. The lack of macroeconomic coordination has produced unsustainable internal imbalances in the EZ which have brought Greece and Ireland to the brink of default due to their deficits. Lacking the mechanisms to deal with this situation, European policymakers had to come up in a matter of months with a European Financial Stability Facility (EFSF) of €750 billion to save the integrity of the EMU. They also decided to set up a Task Force to improve macroeconomic coordination within the EZ. However, some commentators have already indicated that the new GSP framework might again be heavily focused on promoting stability and not on fostering growth (Münchau, 2010).

being decided at a supranational level and fiscal and macroeconomic policies being designed and implemented at a national level. Moreover, there is no single voice for the euro, as repeatedly denounced by the EC (2008). Technically it is the President of the Eurogroup, but in practice there is a cacophony of uncoordinated authorities that speak for the euro. This cacophony is especially evident at the IMF. Thus, the EZ lacks a federal authority equivalent to the US Treasury. In moments of turmoil, there is no pan-European Ministry of Finance that can act rapidly internally, within the EZ, and externally, in the EZ's relations with the US, Japan or China, in order to mitigate the effects of external shocks. The recent financial crisis has been a clear example of this. While the ECB has been able to react quickly to the shortage of credit that started in 2007 with massive liquidity injection, member states had to negotiate during months a combined fiscal approach on the matter (Pisani-Ferry & Sapir, 2009). This has 'left investors with an important question: how much trust should they put in the euro and European financial markets when fiscal cooperation has failed to keep pace with financial and monetary integration?' (Helleiner, 2009, p. 75). As the Italian politician La Malfa (2002) put it some time ago, without political unity matching monetary union, the euro will essentially remain an 'orphan currency'.

This shortcoming is evident in international foreign exchange coordination, a strategic realm in relation to unwinding existing global imbalances. If the Europeans want to negotiate any deal on a global level, it remains unclear who will be sitting in front of the US Secretary of the Treasury and the Ministers of Finance of China and Japan. Article 219 of the Lisbon Treaty establishes that foreign exchange agreements between the EZ and third states need to be decided unanimously by the Council (in this case the EcoFin) on the recommendation of either the ECB or the EC and only after consulting both the ECB and the European Parliament, and always without prejudice to price stability. As Cohen puts it, this is a 'recipe for political deadlock and drift' (2003, p. 590). This structural weakness of the EZ is not only apparent in exchange rate policy, it transcends to every issue linked to global monetary and internal financial affairs, and consequently also to the euro's role as an international currency. The lack of political unity prevents the EZ from influencing, in a *politically direct* way, global monetary governance, and as a result it prevents it from actively using the full potential of its international monetary power, as Mundell and Bergsten would have expected considering only economic variables.

(4.3) From Dollar Uni-Polarity to a One-And-a-Half System

Notwithstanding the shortcomings in the EZ's political structure, in recent years Cohen has started to recognise that with the introduction of the single currency 'some measure of power has indeed shifted across the Atlantic' (2008b, p. 459). Where before there was dollar uni-polarity, today there is a 'one-and-a-half' monetary system (Cohen, 2010). EMU has provided the Europeans with more protection to resist external shocks emanating from the US. Following Cohen's (2006) conceptualisation of international monetary power, more than *influence*, the euro has given the EZ increased *autonomy* in monetary

affairs *vis-à-vis* the US. While before the euro the US was able to individually bully different European states and force them to follow its monetary guidelines (Henning, 1998, 2006), this is not as straightforward today. Recent tensions within the G20 forum between the US and the EZ in relation to implementing expansionary or restrictive fiscal policies to overcome the Great Recession after the financial crisis of 2007-08 are proof of this (Beattie & Peel, 2010; Rove, 2010).

During the recent financial crisis, the euro has also avoided exchange rate disturbances and speculative foreign exchange attacks within the EZ, a common feature in previous crises (Wyplosz, 2009). Here again, the euro has brought advantages and benefits for EZ member countries. Overall, Cohen acknowledges that in the last decade the EZ has gained greater monetary independence while the dollar and the US have seen their leadership role put in question, especially in the aftermath of the recent financial crisis which originated in the US. In line with many other analysts (Bergsten, 2009; Obstfeld, & Rogoff, 2009; Eichengreen, 2007; Roubini, 2006, Duncan, 2005 [2003]), Cohen thinks that the chronic US balance of payment deficits are unsustainable in the long run and that eventually they will undermine the world's faith in the dollar. Sceptical with the possibility of policymakers in Washington addressing this trend with unpopular austerity reforms, Cohen's predictions point to a transition between the current 'one-and-a-half' to a leaderless currency system with different currencies (probably the dollar, the euro and the Chinese yuan) in competition for international use and recognition:

'A weakening dollar is unlikely to be replaced by any other single currency. The outlook, rather, is for a more fragmented currency system, with three or four monies in direct competition in different parts of the world. Sustained cooperation among the major players is unlikely… Much more probable is a prolonged leadership struggle, particularly in such contested regions as the Middle East and East Asia' (2009b, p. 163).

(4.4) The Euro's Geopolitical Limitations

Pointing to this leadership struggle and making a corollary between monetary power and consequent political and even military power, several authors in the wider field of International Relations (IR) saw in the creation of the euro the first step in the creation of a European superpower (McCormick, 2007; Reid, 2004; Haseler, 2004; Kupchan, 2002; Calleo, 1999). Bellicose analogies to describe the birth of the euro were not lacking among these euro-optimists in IR theory. Reid wrote that 'for the Europeans, the dreams of grandeur, the hope of creating "the weapon with which to fight back" against the might of the US dollar, are likely to come true' (2004, p. 85). In a similar vein, Haseler (2004, p. 76) said that 'so integrated and centralised is the money of the EU that on monetary policy the Union speaks "with one voice", and with a vengeance!'. Calleo, 1999, p. 6, for his part, said that the euro's 'success will push the EU towards rounding out its commercial and financial power with more effective and autonomous collective diplomatic and military power'. Finally, for Kupchan the creation of the euro is a stepping stone to establishing a

European federal state more independent from the US economically and militarily, probably leading to friction between the two blocs in the future. While these IR analyses can be dismissed for overlooking some of the fundamental economic variables explained above, fears about the euro provoking military tension between the US and the EZ have not been limited to the field of IR. Economists such as Feldstein (1997) have expressed similar worries since the start of EMU. Feldstein even went so far as to argue that the euro could be the seed for a future war between Europeans (as in the American civil war) or even a war between the EU and the US, due to differing world views. Highlighting the political consequences of the creation of the euro, which for him would eventually lead to political union, Feldstein would warn about the potential military might that such a union could gather:

'The creation of a political union based on the EMU with explicit authority to develop a common foreign and defense policy would accelerate the development of an independent European military structure capable of projecting force outside Western Europe' (1997, p. 70).

Feldstein has not been the only economist who has warned about the negative political and military consequences of an increased competition between the dollar and the euro. International monies can be seen as the projection of statecraft overseas (Kirshner, 1995) and this might trigger tensions and conflict. The incumbent hegemon might not be willing to share some of its privileges with the new challengers. Kindleberger (1986 [1973]), for instance, the father of hegemonic stability theory, has persistently warned about leaderless transition periods. In his opinion, which contrasts with that of those that have criticised his determinism and advocated the possibility of a more cooperative international order after US hegemony (Keohane, 2005 [1984]), 'for the world economy to be stabilised, there has to be a stabiliser – one stabiliser' (Kindleberger, 1986, p. 304). For Kindleberger, 'a world in which one nation is in the decline and no other has risen to take its place in ensuring peace and stability is likely to encounter trouble' (Kindleberger, 2000, p. 17).

The US is today without doubt the main military stabiliser of the world. Its military might is uncontested. This is partly why the dollar remains the main international currency. Its durability relies heavily on the negotiated framework explained above in which the US offers military protection to different parts of the world and, in exchange, these regions (this is especially the case for East Asia, except China, and the GCC) keep trading in dollars. Does the EZ have the capabilities or willingness to change this? The answer for now is a categorical no. The EU can be seen as a normative power, a civilian power, a soft power and a market power, but it is certainly not a hard power (Laïdi, 2008). Therefore, in this realm the euro is also far away to compete with the greenback. As Posen (2009) rightly explains, geostrategic dimensions are generally overlooked in the euro vs dollar debate because monetary officials are keen in avoiding them for diplomatic reasons and

because economists see them as too 'nebulous' or 'conspiratorial', nonetheless 'national security capabilities and foreign policy projection more broadly of the government behind a potentially global currency do heavily influence the extent to which other countries take up that currency' (Posen, 2009, p. 86). In this regard, some moves by France in the GCC region with a new military base in Abu Dhabi and future potential moves by China in East Asia might change this situation in the long term, but in the short term the dominance of the dollar is assured.

(5) The Euro vs Dollar Debate from a Social Perspective

(5.1) International Currencies as a Social Phenomenon

As should be clear by now, to understand international currencies in their full complexity it is necessary to consider both economic variables and political factors. As Kirshner (2003, p. 647) states, it would be a mistake to overlook the 'inescapable politics of money'. However, as Kirshner also hints, this is not comprehensive enough. There is more to money than just economics and politics. Money is socially constructed in everyday interactions. There is an inherent cultural symbolism in currencies that transcends narrow economic and political considerations. As Kindleberger once wrote, 'a country's exchange rate is more than a number. It is an emblem of its importance to the world, a sort of international status symbol' (1970, p. 198). In line with this, Zelizer (1999) argued that money is not a culturally neutral or socially anonymous object, its value and reputation being profoundly shaped by cultural and social phenomena. Thus, for a full study of the euro challenge to the dollar it is necessary to explore this social context and attempt to grasp how this challenge is socially and culturally perceived worldwide. Most of the analyses presented so far are overly material and structural in their approach, treating agency in an abstract sense. Consequently, they are not as well suited to fully apprehend the social impact and social change triggered by the euro. Key economic agents, such as sovereign and private wealth fund managers, think and act within a specific social environment. To understand what they think about the euro and how they might change their behaviour in reaction to it, it might be a good starting point to analyse how the euro has changed the social context in which they are embedded, and then see how they relate to it both ideationally and materially. There is certainly a vast constructivist literature in IPE which has broadly analysed the interconnection between ideas and money (Helleiner, 2006; Kirshner, 2003; Seabrooke, 2001; Gilbert & Helleiner, 1999; McNamara, 1998). However, so far there are only a few works that have tried to apply this approach to the euro vs dollar debate (Otero-Iglesias, 2011; McNamara, 2008).

(5.2) The Euro's Socio-Cultural Impact

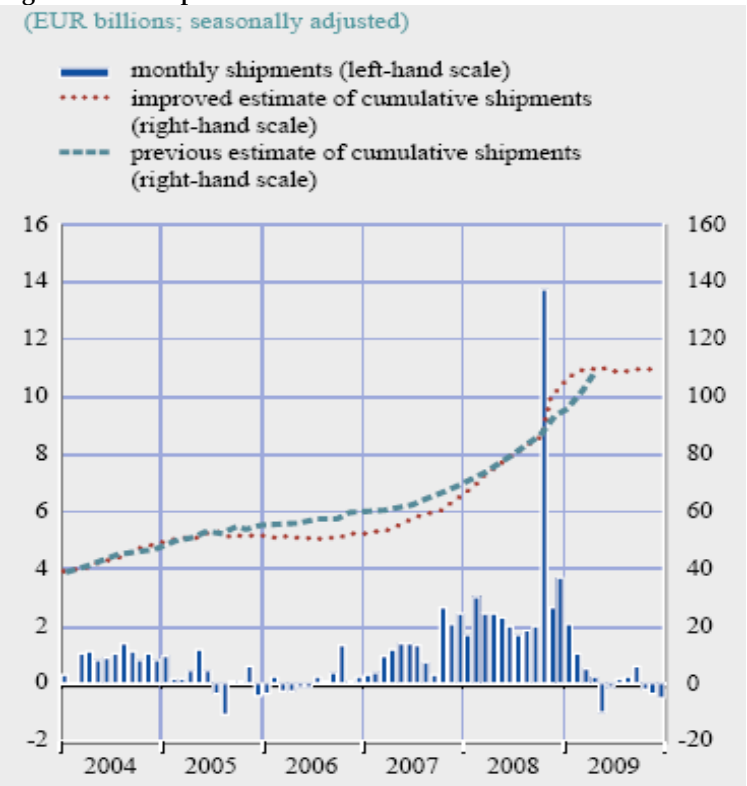
It is generally accepted in the literature that the euro is the first real global competitor to the dollar since WWII. It poses a much greater challenge to the greenback than the Deutsche Mark and the Japanese Yen did in the 1970s and 1980s. This is acknowledged by respected economic historians who have studied the evolution of the IMS in depth

(Eichengreen, 2008), by financial elites, as will be shown below, and also in a wider social context, by the general public. The increased global impact of the European currency is noticeable in the economic field: in the invoicing of trade transactions, the foreign exchange and debt markets and the coffers of the central banks; but it is also observable in popular music, Hollywood movies, the fashion world and every tourist destination around the world. Seen from the cultural viewpoint, the euro has certainly penetrated most social layers on a global scale. A few recent examples suffice to illustrate this point. In his video for the song *Blue Magic,* the popular US rapper Jay-Z is one of the first US rappers to use a suitcase full of €500 notes instead of the ubiquitous dollar wads and dollar-symbol neck chains traditionally wedded to American rappers. The Brazilian supermodel Gisele Bündchen recently surprised public opinion by asking to be paid in euros and not in dollars (BBC, 2007). Confirming the global appeal of the euro, viewers all around the world can hear one of the villains in the latest James Bond film –*Quantum of Solace* (2008)– saying 'the US dollar isn't what it used to be', before handing over a suitcase full of euros to a corrupt Latin American general (Rojanaphruk, 2008). The euro is not only identified and accepted as an international currency in every corner of the world, it has even reached the streets of the US. As *Reuters* informed a couple of years ago, some shops in New York's East Village have started to accept euros. A historic event since 'the acceptance of foreign money in Manhattan was unheard of until recently' (Reuters, 2008). These might be considered impressionistic examples with no real economic significance. Jay-Z, Gisele Bündchen, James Bond and shop owners in Manhattan will hardly decide the international currency of the moment. Nonetheless, they suggest a global cultural impact of the euro that needs to be included in a comprehensive review such as the present. The quote from *Quantum of Solace*, for instance, was not taken from the film. It appeared in a report by an ASEAN journalist writing about EMU as a role model for regional cooperation (Rojanaphruk, 2008).

Much more significant than these examples is the fact that in value terms, with a total amount issued of over €800 billion, there are now more euros in circulation in the world than US dollars. The overseas demand for European bills has increased steadily since its inception (ECB, 2010). Several economists (Posen, 2005; Rogoff, 1998) have associated this trend with gangsters and money-launderers preferring for their illegal activities the higher denominated €200 and €500 notes than the US$100 bill, which is the highest-denomination note in the US, but this is only one part of the story. Looking at ECB data on the increased circulation of euro notes, it turns out that over the years there has been a significantly greater issuance of €100 notes than of €500 notes, while the issuance of €200 notes has remained almost unchanged (ECB, 2011). Whatever the 'overground' or 'underground' economic activity that is carried out with these notes, what is unquestionable is that this high issuance represents a proportionately higher source of seigniorage. Willem Buiter, currently Citigroup's Chief Economist, calculates that with so much issuance, seigniorage returns to the ECB could average at least €50 billion per year (Fidler, 2010). This is certainly not a negligible sum (roughly half of the Greek rescue

package), as it is very close –if not higher– than US seigniorage intakes, and has already triggered complaints from policymakers in Washington.[10] This more micro-level analysis highlights another curiosity. While it is widely believed that the dollar was the 'haven currency', and therefore uncontested top international currency (Cohen, 2009a), right after the collapse of the investment bank Lehman Brothers (the sudden surge of the dollar in the exchange rate provides evidence to support this), shipment data from the ECB show that there was also a huge demand for euro notes outside the EZ. In an average month, the ECB barely sends more than €2 billion in banknotes to overseas banks (see Figure 8); in the month after the collapse of Lehman Brothers the overseas shipment reached almost €14 billion (ECB, 2010), proportionately increasing the seigniorage gains for the EZ.

Figure 8. Net shipments of euro banknotes to destinations outside the euro area



Source: ECB (2010).

[10] Lawrence H. Summers, former US Treasury Secretary and former director of the National Economic Council advising the Obama Administration, makes explicit these complaints at a conference on the euro organised by the Peterson Institute for International Economics in 2008. He calls the issuance of €500 notes an "internationally uncivil act" and proceeds by saying: "If you calculate the seigniorage gain that results from the European act – it is essentially an interest-free loan forever of that amount of money – $50 to $100 billion can plausibly be attributed to it" (Summers 2009: 196).

Here again we can see that the socially perceived value of the euro as a reserve currency and 'safe haven' among non-EZ residents in times of systemic market strain might be greater than mainstream economic indicators like the foreign exchange (FX) market might indicate. This is of course especially true in countries neighbouring the EU.

(5.3) Euro-Optimism seen from the Perspective of Key Financial Actors

This wider global social context, which impacts on the 'social mood' of market investors, as the socionomics literature has investigated (Prechter & Parker, 2007),[11] is mirrored in the narratives and behaviour of key private and public financial market actors and institutions, for whom the euro is also increasingly playing a bigger international role despite not being a challenge to the dollar. Goldman Sachs, for example, one of the most influential financial institutions of the world, considers EMU 'as a remarkable success so far, weathering widespread original scepticism, as well as a series of shocks –including 9/11 and the present market dislocations– while contributing to good and relatively stable growth throughout the Euro-zone' over the past decade (Goldman Sachs, 2008, p. 7). Contrary to the mainstream perception and most IPE literature (especially the euro-sceptical one) which sees the EZ underperforming economically against the US, Goldman Sachs calculates that in the decade between 1998 and 2008 the EZ has had higher per capita and job creation growth than the US and this despite European workers working considerably less hours per year than their American counterparts. By contrast, the long-term outlook on the dollar is generally bleak according to Goldman Sachs. This makes its Chief Economist, Jim O'Neill, believe that 'we are emerging into this very hazy and slightly worrying state of affairs where there isn't going to be any single country leading the world in the way the US has done and with it no single currency either' (Woods, 2008). Interestingly, these remarks of one of the most influential actors in the markets coincide closely with Cohen's assessment on the relative weakening of the dollar and the future of the IMS.

The head of the FX Division at HSBC, one of the leading foreign exchange trading desks in the world, David Bloom, is also seeing a gradual shift out of dollar unipolarity. He compares the foreign exchange world to a cosmos and says that while before there was only one big currency sun, the dollar, there are now two suns. One bigger, the dollar, and one smaller, the euro, but both with different satellite currencies linked to them.[12] Bloom

[11] Prechter & Parker (2007) state that unlike in the economic sphere, most activity in finance is not based on rational calculations, as the Efficient Market Hypothesis (EMH) predicts, but rather on social moods and herding. This is especially the case at times of market uncertainty such as the present.

[12] The 'euro sun' has around 40 'satellite currencies' that either follow a strict peg or have the euro in their currency basket (ECB, 2010). The dollar has around 60 of these satellite currencies, some of them shared with the euro. While the dollar dominates in Asia and Latin America, the euro is increasingly gaining satellites in neighbouring regions such as Eastern Europe (Russian Federation), Africa (Morocco and the CFA Franc Zone) and the Middle East (Iran and Kuwait). Despite this trend in favour of the euro, Cohen (2009) points out that some of the pegs to the dollar are more important because of their GDP weight. This is the case for China (since 2010 de-pegged, following a basket), Hong Kong, Saudi Arabia and the UAE. However, outside the *de jure* pegs, the gravitational role of the euro, identified through correlation in exchange rate movements, has

summarises the short history of the euro in the metaphor of a baby that at the beginning needed to be nurtured and taken care off (referring to combined ECB and FED intervention in 2000 to stop euro depreciation) but that gradually has grown up and is now a youngster with its own evolving history, who can compete against the senior currency. On this note, and contrary to Kindleberger and others who worry about potential conflict and instabilities, he believes that euro-dollar competition will be good. It will bring more diversification and therefore more options for global investors. For him, 'the world prefers a euro that is a big, strong currency, which gives a choice out of the dollar' (Bloom, 2008).[13] This view is shared by the analysts at Deutsche Bank, another of the global heavyweights in the FX market. They calculate a further increase of the international role for the euro to between 30%-40% of the global share in the medium to long term. The view at Deutsche is that 'a bipolar system is not per se unstable… competition between the dollar and the euro regarding the international role is basically a good thing. Such a permanent beauty parade is expected to provide a big incentive for policymakers on both sides of the Atlantic to pursue sound economic and fiscal policies' (Deutsche Bank, 2008, p. 11).

Following this rationale, in recent years central banks around the world appear to have actively embraced the option of diversifying out of dollar unipolarity. This diversification does not occur in existing stocks. The dollar there is still dominant. It rather affects new foreign reserve entries. In the second quarter of 2009, for instance, central banks reporting currency breakdown in their reserves 'put 63 percent of the new cash into euros and yen', prompting Steven Englander, a former FED researcher and now Chief US FX Strategist at Barclays, another important financial institution, to conclude that 'global central banks are getting more serious about diversification, whereas in the past they used to just talk about it' (Ye & Worrachate, 2009). The winner in this diversification trend seems to be mainly the euro. A survey conducted by Central Banking Publication and sponsored by the Royal Bank of Scotland among central bank reserve managers between October 2009 and January 2010 shows that the European currency gained increased attractiveness in the aftermath of the financial crisis *vis-à-vis* the dollar (Pringle & Carver, 2010). Not even the EZ debt crisis in mid-2010 seems to have changed the trend. At the peak of the crisis, with the euro depreciating fast and with continuous talk in the markets of the EMU possibly breaking up, official sources at the central banks in Brazil, India, Russia, Japan and South Korea assured that 'their reserve currency portfolios were too big to change without affecting the markets, and there were no alternatives in the near term to the liquidity of the euro and the US dollar' (Kihara & Nicolaci da Costa, 2010). Here again, as in the case

also increased in recent years. Galati & Wooldrige (2006) say that this gravitational pull of the euro has increased *vis-à-vis* the dollar for the pound sterling, the Australian, Canadian and New Zealand dollars and even for the South African rand and the Brazilian real and Chilean peso.

[13] Bloom has not changed his bullish long-term outlook for the euro and his bearish views on the dollar despite the ongoing sovereign debt crisis in Europe. A recent interview published in *Handelsblatt* confirms this (Hackhausen & Panster, 2010).

of private banks, the *idea* of an emerging bipolar system (with a senior and a junior pole) seems to be gaining favour.

(6) Conclusion

This paper has attempted to provide a comprehensive and multidisciplinary literature review on the euro vs dollar debate. It is a summary of what its author sees as the key economic, political and social variables that need to be considered to fully apprehend the euro's challenge to the dollar in all its dimensions. In the first part it has presented the euro-optimist and euro-sceptical hypotheses on the subject within the Economics literature and their underlying arguments focused on economic size, financial market sophistication, confidence in the value of the currency and network externalities. Current data on the international use of the dollar and the euro show that the euro-optimists were too optimistic about the European currency. The dollar dominates roughly two-thirds of global activity versus the euro's less than one-third. However, these numbers alone do not explain why the euro has underperformed.

The IPE literature provides this explanation. It shows that a currency can only become the top international currency if there is an active political commitment by the issuing authorities to make this currency the leading currency, an aspect that the Economics literature has not explored with sufficient rigour. This political commitment is non-existent within the EMU at present. The EMU is politically too fragmented to allow the euro to challenge the dollar's predominance. Nonetheless, the euro has offered its member states more protection from dollar dominance, and this newly-acquired autonomy has in turn aggravated the dollar's weaknesses. Up to this point the existing IPE literature offers a very accurate picture of the structural conditions of the international monetary system. Where it lacks nuance is in identifying the social impact of the euro. Using structural and material analyses it asserts that the euro, while on the rise, is unable to reach the dollar, while, the dollar, despite descending in absolute terms, is still dominant. However, this macro approach does not discern how these relative ascents and descents are socially constructed by key agencies at the micro level. This can only be done through a constructivist approach which focuses on how the impact of the euro in the IMS has been intersubjectively constructed. The last part of the paper focuses on these social dimensions. It shows how the euro has become a truly global currency in the social sense with great symbolic effects and how key agents in private banking and public foreign reserve management institutions are gradually seeing the development from a unipolar system dominated by the dollar to a bipolar system where a mildly descending senior pole (the dollar) and a mildly ascending junior pole (the euro) compete against each other. The current sovereign debt crisis in the EZ and the willingness of key players such as China and Japan to invest further in euro-denominated debt in order to diversify away from the dollar just shows how systemically important the European currency has become. In this regard, subjective interpretations of the reality are very different

depending on the vantage point. While from the point of view of the US, the dollar is still dominant, with everyone else far behind, as has been the case over the past five decades, from the point of view of the policymakers and financial elites of key emerging markets there is now the dollar *and the euro*, midway, far behind the dollar, but also far ahead of their own currencies. This change in the framework has incentivised them to develop their own monies as international currencies, as seen in recent times in China with the renmimbi's internationalisation. Now, from the perspective of the Chinese and others, there is one currency still far ahead in the race, though losing ground, and another that is gradually leaving the pack behind, which is good because it reduces the difference with the leader, but is also a wake-up call. From the point of view of perspectives, the current IMS is very different from having one currency ahead and all the rest more or less at the same distance. No wonder then that the Chinese want to catch up by promoting the renminbi. Their idea is that in the future there might be room for more suns than just the current two.

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