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The euro as a challenge to the dollar in international monetary relations?[1]

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1. Introductory remarks

The significance of the euro as an international currency comprises a number of aspects. It is worthwhile emphasizing at least the following five aspects:

Firstly an increased use of the euro as an international currency – or as an international reserve currency – may contribute to an easing of the international monetary and financial imbalances and disequilibria linked to the highly unstable status of the current international reserve currency: the dollar. The is nothing new in the unstable nature of the dollar - it dates back to the early 70ies and may still last for pretty long; however it is also appropriate to note that the present situation of the American economy characterized by among other things highly significant balance-of-payments as well as budgetary deficits may prove problematic to the continued international role of the dollar. It may also be not that while the instability of the dollar is far from new, we are presently for the first time witnessing a situation in which some kind of an alternative to the dollar – the euro – exists. Compared to the situation in the previous decades of dollar instability this is a radically new situation.

Secondly the issue of an international reserve currency is far from limited to its monetary and financial dimensions. It is intimately linked to questions of international power and to the political ruling of the international economy. US global dominance and hegemony rest among other things on the international role of its currency. Therefore an increased use of the euro as an international currency may also pose a challenge to US global supremacy.

Thirdly the international position of the euro could be an important instrument for the strengthening of the international position of the EU. An increased role for the EU in global governance and a relative strengthening of the position of the EU with respect to other international actors may develop not only via e.g. the creation of common foreign and security policies (CFSP) but also via a

[1] The present paper is a revised version of a paper prepared for the Nordic Political Science Association's XV Conference, University of Tromsø, August 2008.

greater European monetary and financial autonomy. A stronger international position of the euro and a lesser degree of dependence on the dollar would appear to be crucial in this respect.

Fourthly an increased international role of the euro can hardly be realized without a significant impact on internal European political and economic structures and processes. A greater international role of the euro is hardly thinkable without a clearer political decision making structure with regard to economic policies and without a stronger institutional representation in international institutions linked to international economic policymaking (e.g. in the IMF, the G8 and the G20). Currently the EU more often than not speaks with more than one voice – not only in e.g. CFSP matters – but also in issues of international economic policymaking[2]. Similarly a stronger international role of the euro may have a significant economic impact on the European economy: some sort of domestic stability (whose form is to be discussed further) could perhaps be seen as a precondition for the internationalization of the euro and furthermore the latter may have important impacts e.g. on financial markets and public debt. While the cross-border and European dimension of financial markets has been developing drastically, public debts remain fragmented along national lines and the increasing spreads over rates on government bonds testifies to the fact that markets operators assess the qualities of national public debts in an increasingly diversified way. Currently there is no such thing as a European public debt and it is questionable to what extent the euro may internationalize without a common European public debt.

Fifthly it seems rather clear that the strengthening of the international role of the euro is a political objective for some member states of the EU. E.g. for France an increased role of the euro has often been seen as a means to (counter)balance the dominating position of the dollar and of the USA in the international system – politically and economically. However, hardly all member states share this objective. The aim of strengthening the international role of the euro seems is shared by the Commission while the ECB is much more reluctant in this regard. In this area as well as in others (e.g. the Common Foreign and Security Policy, the CFSP) governments as well as other social and economic actors diverge in their conception of European versus American interests. Thus a strengthening of the international role of the euro is far from politically neutral – neither in global nor in internal European terms.

[2] In economic policy-making the EU essentially speaks with one voice only in the area of international trade.

Since the creation of the euro in 1999 the question of the international status of the euro has been widely discussed and for several years the quantitative role of the euro as an international reserve currency seemed to be increasing. Naturally one reason for this development was that the euro took over the role of the previously existing national currencies - in particular that of the German mark. A number of observers have been led to rather optimistic predictions regarding the potential of the euro in the international economy[3] while others took a more cautious or pessimistic position[4]. The optimistic positions have been echoed by more official writings from e.g. the Commission (2008) while other official bodies – in particular the ECB and the BIS (Bank for International Settlements), as we shall discuss it in a moment - have taken a more balanced view.

It would probably be somewhat premature to draw any final conclusions as regards the present status and potentials of the euro, we may at least note that recent developments seem to indicate that this initial international growth of the euro has come to an end or at least to have lost its vigour - particularly since 2003. To some extent these developments have been blurred by the appreciation of the euro against the dollar: if we focus on substitution between the euro and the dollar – excluding valuation effects – the share of the euro is no more increasing. If we exclude valuation effects the share of the euro in international reserves is presently below the share of the currencies presently constituting the euro in the 1980s and early 1990s[5]. Similarly we may note that in political terms the development of the euro hardly seems to have stimulated any form of political actorness from the European side: thus when speaking with the experience of an insider Padoa-Schioppa[6] (2004, p. 176) talks about “a reluctant global actor” and notes that is “somewhat paradoxical that, in the process of stipulating ad hoc arrangements on who should speak or act on behalf of euroland, the main advocates of a minimalized role were the Europeans themselves. There were more divisions among them than between them and the Americans” (2004, p. 177). Similarly the Commission (2008) has noted that the international role of the euro is limited by both the lack of an international strategy of the euro and by the lack of an international political representation.

We may thus point to a number of limits to the extent of the internationalisation of the euro – economical as well as political limits. Can these limits be overcome? In a short-time perspective

[3] See e.g. Chinn & Frankel (2008) for a recent example.
[4] See e.g. Cohen (2003; 2007) and Posen (2008).
[5] For comprehensive surveys of recent developments in this field see Galati & Wooldridge (2006), as well as the reports of the ECB on the international role of the euro, e.g. ECB (2007, 2008)
[6] Padoa-Schioppa was a member of the ECB’s executive board until 2005.

there is hardly any reason to believe in any significant strengthening of the international role of the euro. In a long-term perspective various things may obviously change and I shall also attempt to touch some possible factors conducive to change – even if no attempt to make any long-term predictions regarding the future international role of the euro will be made.

2. Tales of the euro – valuation effects and regional dynamics

There is no simple way of defining and measuring the international role of a currency – and hence of the euro. Both for conceptual and statistical reasons it is difficult to get a comprehensive picture of the role of different international currencies. These questions will not be dealt with any further in the present paper[7]. However a few remarks do seem necessary.

It is current in monetary analysis to distinguish between three different functions of a monetary unit: (1) As a medium of exchange, (2) as a unit of account; and (3) as a store of value. Furthermore these three different functions exist both at the level of states and public actors (including central banks) and at the level of private actors (firms, banks, funds, investment companies etc.). These three functions are interlinked and they cannot be seen in isolation from each other. On the other hand they may – but they need not - coincide. Thus actors may choose e.g. one currency for savings (i.e. as a store of value) and another currency for payments (i.e. as a medium of exchange and/or as a unit of account), and public and private actors may use different currencies for the same purposes. Similarly it may also be noted that the international role of the euro develops in differentiated ways when we look at its three different functions[8]. As these points have been carefully discussed in the previously quoted papers I shall not pursue them any further here. In the following discussion I shall focus on the role of the euro in the foreign exchange reserves of central banks – an indicator frequently used e.g. in publications from the ECB, BIS and the IMF and where comparatively good empirical material is available. Special attention, however, will be given to an aspect mentioned e.g. by both the ECB and the BIS but whose importance remains underrated, i.e. the significance of valuation effects and composition effects and their relative role in explaining the use of different currencies e.g. as part of international currency reserves.

[7] See Galati & Wooldridge (2006), for a useful discussion.
[8] See the surveys provided by Galati & Wooldridge (2006, p. 11-15) and Papaioannou & Portes (2008).

In order to clarify the significance of this point let me start by a quote from the most recent ECB report on the international role of the euro:

“the share of the euro [in the foreign exchange reserves of Central Banks] increased by around 1.5 percentage points between December 2006 and December 2007 when measured at current exchange rates. Corrected for exchange rate fluctuations, however, the share of the euro actually declined by around 1.5 percentage points” (ECB 2008a, p. 9).

Elsewhere in the same report it is noted that:

“the share of the euro in international reserves rose gradually from 18% in 1999 to around 25% in 2003. Since then, the share of the euro has remained relatively stable, hovering around 24-25% and reaching 26.5% in December 2007… this recent increase occurred almost entirely as a result of positive valuation effects. The gradual rise in the share of the euro since its launch in 1999 has been most pronounced in developing countries, where it increased from 18% to 29% in 2007. Among the industrialised countries, the share of the euro in foreign exchange reserves rose gradually in line with the aggregate trend until early 2003. Thereafter, the share of the euro in industrialised countries declined somewhat until early 2004 and has remained broadly stable at around 20% since then.

These trends are partly driven by valuation effects, notably by the impact of exchange rate changes on the value of euro-denominated reserves. When currency shares in international reserves are measured at constant exchange rates, the overall trends are less pronounced. Developing countries are seen to have increased their holdings of euro-denominated assets relative to other assets until mid-2005 ... Since then, they have somewhat reduced their relative exposure to euro-denominated assets. Constant exchange rate shares for the euro in the reserves held by industrialised countries suggest that these countries, after a period of increasing their exposure to euro-denominated assets, decreased euro-denominated assets relative to other currencies in the first quarter of 2003 and the first quarter of 2004.” (2008a, pp. 60-1)[9].

[9] It may be added that these observations are similar to points made in previous reports of the ECB as well as to the points made by Galati & Wooldridge (2006).

What is then the significance of these observations? It is a well-known fact that the international role of the euro has increased significantly – it is often noted that the euro today is the world's second international currency[10] - but it is not so often noted that this significant increase is quite simply due to the increased value of the euro in relation to the dollar. This point is for instance not emphasized - or even noted - by the Commission in spite of its crucial importance. Let us try to reformulate the significance of this point:

If we were living a process in which the euro was gradually gaining ground with regard to the dollar – the euro slowly catching up with the role of the dollar as the dominating international reserve currency – shouldn't we then witness a process in which market actors (including central banks) buying and selling international currencies were gradually acquiring more and more euros and getting less and less dollars in quantitative terms (i.e. corrected for exchange rate fluctuations)? And when the exchange rate of the euro is persistently appreciating shouldn't market actors be responding by acquiring more and more euros in quantitative terms (i.e. corrected for exchange rate fluctuations)? But this is seemingly not what is happening. Market actors are in relative terms acquiring less and less euros – even if these still fewer euros are worth more and more e.g. when measured in dollars.

This point could also be formulated in terms of transaction versus portfolio objectives in the composition of the currency reserves of central banks. The relative variation in the shares of different currencies in the reserves of central banks is significantly higher when measured in current than when measured at constant exchange rates. This point on the one hand indicates that variations in exchange rates explain a significant part of the changes in the relative share of different currencies and on the other hand that transaction motives could be more important than portfolio motives in explaining choices regarding the composition of currency reserves[11].

This is the significance of what was noted above in the first quote from the ECB: the share of the euro in the foreign exchange reserves increased by around 1.5 percentage points when measured at current exchange rates while the share declined by around 1.5 percentage points when corrected for exchange rate fluctuations.

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[10] E.g. by the Commission (2008).
[11] Cf. ECB (2008a, pp. 63-64).

Let us close this point by underlining that the fact that the increasing role of the euro essentially reflects valuation effects – the increasing value of the euro exchange rate – does not imply that the process is of no significance. The value – or purchasing power – of a basket of currency reserves may obviously be rather crucial. If, however, we are interested in investigating whether the euro is developing into a new international reserve currency the share of the euro as measured at current exchange rates constitutes a rather poor – not to say misleading – indicator. This seems to be the position of the ECB also[12]. Is it perhaps because the promotion of the euro as an international currency is not on the agenda of the ECB[13]? In this regard the publications of the Commission – another official body – appear somewhat differently with their somewhat superficial analysis based on current exchange rate measurements[14]. Perhaps the political agenda of the Commission is different in that respect?

We shall return to the question of how to interpret the role of valuation and composition effects and their relative significance below. However, let us first add a few comments on another issue in measurement: the regional dimension of the international use of the euro. We shall close the present section with a couple of remarks in this regard.

Until now the discussion has focused on global developments and aggregate figures. However, as underlined by e.g. the ECB the internationalisation of the euro is "characterised by a strong institutional and regional pattern" (ECB 2007. p. 74). The crucial point is that the international spread of the use of the euro is to a significant degree confined to countries having close links to the EU: either in terms of geographical neighbourhood or in terms of political and/or institutional links (e.g. EU member-states not being part of the Eurozone and candidate countries). The ECB summarizes this point in the following way: "One of the most prominent factors remains geographical, economic, financial and institutional proximity to the euro area." (ECB 2008a, p. 9).

This is a remarkable observation: why should proximity play such a crucial role in a world where distance and borders are supposed to be of next to no importance? In the world of money and

[12] It is in any case striking that the ECB so often notes the fact the changes in the composition of currency reserves are mainly or to a large extent due to valuation effects while the Commission is more discreet in this respect.

[13] "From a policy perspective, the Eurosystem has adopted a neutral stance on the international use of its currency. It does not pursue the internationalisation of the euro as a policy goal and neither fosters nor discourages its use by non-residents of the euro area" ECB (2008b, p. 89).

[14] Or as noted by the European Parliament (2008: 60): the European Parliament "regrets that in its Communication on EMU @ 10 the Commission has not conducted a more detailed and precise analysis of the euro's international role…"

finance which supposedly is highly globalized? Let me simply conclude this point by noting that it seems more appropriate to talk about a *regionalisation* than about an internationalisation of the euro[15]. The euro is increasingly taking the character of a regionally dominating currency while it remains subordinate to the dollar in global terms. In regional terms the increasing role of the euro may be characterized as institutionally rather than market-driven while the somewhat more modest development of the euro in global terms may be seen as market rather than institutionally driven. More comments on this point will be given later.

3. Learning from theory?

A number of attempts to identify the factors leading a national currency to acquire the status of an international currency have been made in the area of international economics[16]. Thus Chinn & Frankel (2008, pp. 56-59) summarize these factors under the following headings: (1) the relative size of national economies (in terms of output and trade), (2) the organisation of national financial markets (e.g. size and depth of financial markets), (3) the degree of confidence in the value of the currency, and (4) the phenomena of network externalities (economies of scale and economies of scope). The list of factors suggested by Papaioannou & Portes (2008, p. 19-20) is roughly similar to that of Chinn & Portes but it has the advantage of focusing more explicitly on economic strength as measured by growth rates. It also explicitly includes a political dimension by its emphasis on political stability and geopolitical strength. It is often pointed out that the above-mentioned factors present a relatively high degree of inertia: they are likely to change only in the long run.

It is hardly questionable that such factors do play a crucial role in promoting the internationalisation of national currencies[17]. The problem, however, is whether this list of economic factors can be considered exhaustive. The factors identified above essentially focus on a state of affairs – i.e. what characterises an international currency *once it is established* as such – and not on the *processes* that may be implied in a perhaps contradictory and open-ended process of transition and competition between currencies and their states. They tend to paint a static rather than a dynamic picture.

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[15] This observation raises a number of issues which shall not be pursued any further in the present context such as the meaning of the very concept of a regional currency, the relationship and/or co-existence between regional and global currencies, whether the position of a regional currency is a step towards a global currency etc.

[16] Useful summaries of this literature are provided by Chinn & Frankel (2008, pp. 56-59) and Papaioannou & Portes (2008).

[17] Even if a number of formulations and specifications may be subject to controversy. I shall not pursue these issues further here although a few comments will be added below.

A more dynamic vision would possibly require a more explicit taking into account of political and other social factors and their impact on the international status of national currencies[18]. Similarly more attention to the potential political and economic contradictions linked to the situation of an international currency might also be relevant: factors such as the (lack of) compatibility between the national and the international roles of a national currency[19], the relationships between the financial system of a country issuing an international currency and its long-term process of economic growth and transformation[20], as well as the relations between on the one hand exchange rate and monetary stability and on the other hand growth and structural change[21], are all factors that may merit further attention in this context.

It is, however, beyond the ambitions of the present paper to suggest a general systemic theoretical analysis of the mechanisms involved in the development of international currencies. We do not have many historical examples of transitions involving the rise and fall of national currencies as international currencies, and generalisations are hence not readily available. On the other hand when faced with the task of understanding the processes involved in the internationalisation of the euro there is hardly any reason not to take inspiration from the theoretical clues briefly surveyed above – supplemented by various critical points alluded to in the previous discussion. These points, however, need further development.

I would thus suggest an added emphasis on (1) a more explicitly institutionalist approach to monetary theory and analysis, (2) processes rather than states of affairs, (3) the role of political and ideological factors, (4) the role of ideas and interpretation, and (5) the possible tensions between

[18] This point is also mentioned by Papaioannou & Portes (2008) even if they do not discuss it in a very systematic way. A recent attempt to do deal with the political determinants of international currencies is Helleiner (2008).
[19] The occasionally somewhat uneasy relation between the domestic and the international roles of the dollar should at least provide an illustration of this point. I shall return to it later in connection with the international role of the euro.
[20] While a well functioning financial system indeed appears to be a necessary condition for economic growth, it may also be argued that finance-driven economic systems may imply a problematic focus on short-term profits and speculative gains to the detriment of economic growth and employment as argued in recent research on finance-driven growth and "financialisation", e.g. Palley (2007), Stockhammer (2007), Toporowski (2008).
[21] The relationship between monetary stability and economic growth is indeed far from simple. Firstly the very notion of stability is far from unambiguous as witnessed e.g. by the problematic relationship between consumer price inflation and asset price inflation. Secondly it seems obvious that while excessive instability (e.g. of the exchange rate or of the inflation rate) is likely to be incompatible with long-term economic growth, it is far more complicated to establish any sort of general linkage between e.g. inflation rates and economic growth. In general terms we cannot claim that monetary stability is a necessary condition for economic growth and under certain circumstances it may equally be claimed that a trade-off between monetary stability and economic growth is likely to exist. See also the survey by Bruno & Easterly (1996).

some of the above-mentioned economic factors – in particular related to the relationship between stability and growth.

Institutionalist economists such as e.g. Keynes and Polanyi have pointed to the social and institutional side of money. Keynes considered money as "a subtle device for linking the present to the future" (1973[1936], p. 294) and Polanyi (1957[1944]) considered money – along with labour and land - as a fictitious commodity. We may also refer to money as a public good – a point which also emphasizes the non-commodity and institutional nature of money. Political scientists such as Ruggie (1982) and Helleiner (1994) among others have also stressed the social and political nature of international monetary regimes, and recently Widmaier (2003, 2004) has suggested a constructivist institutionalist approach to the analysis of international monetary affairs. Where do these points lead us in understanding the nature of international currencies?

Several points should be emphasized here: firstly it is a striking that international currencies are usually *national* currencies circulating internationally. In other words we may speak of *national* international currencies rather than of *international* international currencies[22]. International currencies have always been economically and politically backed by their states of origin. Secondly the fact that international currencies are national, involve a potential contradiction between the domestic political-economic priorities of the state issuing the international currency and the perceived needs of the global economic system (or other states) in terms of e.g. liquidity and stability. Thirdly the question of international currency inevitably has a crucial *political* dimension – it is subject to interests, actors and strategies, and links to other political items may exist and/or develop - whether functionally or politically. Hence not only market competition (liquidity, stability, economies of scale etc.) but also political interests and strategies may shape and influence the role and status of different currencies. Obviously factors emanating from market competition and factors of a more political nature may interact. Market competition – and for that matter currency competition - does not unfold in a political and institutional vacuum. It is shaped and influenced by politics, institutions, ideology and culture.

[22] At the Bretton Woods Keynes and the British delegation suggested a plan for an international international currency, i.e. the bancor. The plan, however, was never accepted by the USA. The IMF issues another sort of international international currency, the Special Drawing Rights (SDR) but it is only available in rather limited quantities.

Let me – in order to simplify matters – distinguish between two different modes of internationalizing a currency[23]. On the one hand a mode based on competition and market selection and on the other hand a way a mode based on institutional and political arrangements. These two modes may be combined and they may also reinforce each other mutually. Nevertheless it is important to distinguish between these two modes.

The market mode implies that market operators should select the currencies to be used internationally. Hence a competitive principle will be involved – the availability of liquidity (e.g. for transaction motives) and stability (e.g. for portfolio motives) are likely to be the decisive factors. For reasons of stability the market selection principle is likely to favour the choice of scarce currencies emanating from countries enjoying balance-of-payments surpluses. If not compensated by other means[24] this, however, will imply a deflationary constraint on the international economy as was the case in Western Europe of the late 70s and 80s where the German Mark as a consequence of substantial German balance-of-payments surpluses to a certain extent was selected by market actors as an international currency with no the support of the German monetary and political authorities. This resulted in strong deflationary consequences on "non-German" Europe – and in the last instance also in the strategy of Europeanizing German monetary policies by the creation of a common currency.

An institutional and/or political mode implies some sort of a shared vision and agreement on matters like the rules and regulations of the international monetary and financial system regarding the creation of liquidity, the financing of deficits, the fixing of exchange rates, and the balancing between domestic and international needs and priorities. Obviously these different elements may be combined in numerous ways. Among the precondition for an institutional solution to be realised at least the following need to be singled out:
i) A sufficient economic strength to supply the international economic system with adequate liquidity or means of payment; this point constitutes a link to the competition based selection principle discussed above. A currency with insufficient economic strength is unlikely to be able to function as an international currency.
ii) The existence of a political structure governing monetary decisions and policies and facilitating the existence of actorness in the area of monetary policies; and

[23] Such a distinction is also suggested by Arestis & Bain (1995, p. 212).
[24] E.g. by outflows of foreign direct investment or other ways of creating credits to deficit countries.

iii) The existence of some sort of a shared vision regarding policies, priorities and economic understandings.

The Bretton Woods system as founded in 1944 may be seen as an example of an institutional solution based on asymmetry, American hegemony and a Keynesian inspired vision of “embedded liberalism” (Ruggie 1982). It is well known fact from analyses of the Bretton Woods Agreements that the post WWII international monetary system was the result not only of economic balances of power but also of e.g. negotiations, clashes of visions, diverging political-economic interests and negotiated compromises[25]. Furthermore the selection of a strong national currency (the dollar) as the international reserve currency was linked to the establishing of a set of institutional mechanisms facilitating the functioning of the Bretton Woods and partly compensating the asymmetries between Europe and the USA. The deflationary effects of the dollar-scarcity until 1958 was compensated by the European Payments Union, the Americas accepted limits on short-run capital movements etc.

There is no reason to recall the history of the Bretton Woods system in further details here. We may just note that the Bretton Woods system defined a framework for a compromise between domestic American needs and the needs of (parts of) the international economic system for a couple of decades. The compromise broke down when domestic American needs could no more be reconciled with the needs of the international economic system – the dollar based Bretton Woods system was based on a *national* international currency and not on an *international* international currency and the abundance of dollars emanating from US deficits provided plenty of liquidity but also increasing instability.

Rather than attempting to draw parallels or precise lessons from the two – very different - cases briefly surveyed above I shall now discuss the question of the internationalisation of the euro in the light of the factors discussed until now. The emphasis of the ECB on the institutional determinants of the internationalisation of the euro that we have alluded to above may also be recalled.

4. Characterising the present European situation.

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[25] E.g. De Cecco (1979), Ikenberry (1993), and Ruggie (1982).

In the discussion above I have distinguished between two different modes of internationalising a currency: a market selection based mode and an institutionally based mode. It has also been noted that the institutionally based mode is unlikely to work unless it is supported by a sufficiently strong economic foundation. If we use this distinction to characterize the present form of internationalisation of the euro we may argue that the euro is essentially internationalised via the market selection mode – at least when we refer to internationalisation in general[26].

If we look at the political and institutional mechanisms framing the internationalisation of the euro the following three points should be underlined:

i) The ECB is favouring a market selection of international currencies. It has no policy or declared priorities in this regard and wishes neither to promote nor to hinder a possible internationalisation of the euro[27]. This attitude may reflect the underlying idea that "developments in the international use of the euro are the outcome of decisions taken by market participants" as it is formulated by the President of the ECB (ECB 2007, p. 7). It may be discussed whether this idea is supposed to reflect the underlying realities of the international economy, whether it is supposed to represent an underlying normative ideal vision, or whether the two (realities and ideals) are supposed to coincide. In practice the implications of the viewpoint of the ECB is that the trajectory of the euro is left in the hands not only of market participants but also of other actors in the international economy, including other central banks with a more activist and/or offensive attitudes as well as various forms of investment funds[28].

ii) Similarly the EU as such has no international strategy for the euro. This fact is openly regretted by the Commission in its status report on the euro after 10 years: "the euro area must therefore **build an international strategy** commensurate with the international status of its currency. Following a successful first decade, the euro area … is now called upon to develop a clear and all encompassing strategy on international economic and financial affairs." (Commission 2008, p. 11, emphasis in the original). Even if this remark is highly pertinent if it remains somewhat obscure how an international strategy is to be developed when the ECB explicitly refuses to develop a

[26] At the regional level institutional mechanisms seem to be of greater significance as briefly touched upon earlier in the present text. This point, however, will not be addressed any further here.
[27] Cf. also footnote 13.
[28] We may of course also choose to characterise central banks, hedge funds, sovereign wealth funds etc. as market participants. And in a certain sense they certainly are. However, possibly not in the textbook version of competitive markets.

policy in this regard. It is striking that the Commission strongly emphasises the need for an international strategy for the euro in the preface to its status report with so little discussion of this matter elsewhere in the very same report.

iii) The euro area has no common external representation in international financial and monetary fora such as the IMF – a fact which is equally noted with regrets by the Commission in its status report (Commission 2008, pp. 6 & 11). The euro speaks with several voices in international monetary and financial matters – a point which complicates the development of common policies and strategies and blocks the euro area in exercising an influence "commensurate with the international status of its currency" on international monetary and financial issues[29].

An emphasis on market selection for the international use of the euro, the lack of a strategy for the euro, and the lack of an external representation for the euro area – these three factors all point in the same direction: the euro as a passive tool with regard to issues in the governance of international financial and monetary affairs. To a certain extent these three factors derive from the same fundamental point: the euro is not issued and backed by a state but by a somewhat heterogeneous collection of individual states sharing preferences some regards but not in others. But the problem also has another dimension: the predominance and institutionalisation of a monetary doctrine favouring the defensive adaptation of the monetary system rather than its active use for framing priorities of global financial and monetary governance. The status report of the Commission (2008) shows an awareness of this problem. On the other hand the timidity and discretion of the report also show that there is still a long way to go[30]

[29] The euro area "has to play a more active and assertive role both in multilateral fora and through its bilateral dialogues with strategic partners. It has to improve coordination and define common positions and – when appropriate – common terms of reference on all these issues. It has to speak with a single voice on exchange rate policies and assume its responsibilities in financial stability and macroeconomic surveillance issues. The risk that the unwinding of global imbalances disproportionately harms the competitiveness of the euro area and its members is adding to these needs." (Commission 2008, p. 11, see also pp. , 23, 248-49 and 282). The need for of a common external representation and for speaking with one voice is an important strategic element when discussing the international role of the euro. It is parallel to the debates on how to represent the Union and to speak with one voice in other policy areas, including foreign and security policies. But it is perhaps not enough in such a context simply to note such a need. A common voice would be a good thing, but what is the common voice going to say? How are its underlying political and strategic choices and ideas going to be formed? Perhaps there is a need for more daring and bold propositions? See also McNamara & Meunier (2002) as well as Bini Smaghi (2006).

[30] In this regard one may speculate about the possible impact on the global financial crises on the political and institutional architecture of the EMU. This point, however, will not be developed any further in the present paper.

Let us now focus on some of the “domestic” economic and political mechanisms framing the internationalisation of the euro.

While it is on the one hand clear that the euro financial markets have developed quite substantially (e.g. in terms of depth and liquidity) since the introduction of the euro facilitating the international use of the euro, it also seems relevant to point to a couple of important limits to the generalisation of the internationalisation of the euro. However, the economic policy architecture of the EU is not properly equipped to supply adequate liquidity to the international economy denominated in euros.

As noted by many observers the economic policy formation of the Eurozone is characterized by a centralisation of monetary policies and a decentralisation of other economic policies, in particular fiscal policies. Thus there are e.g. only week compensatory transfer mechanisms between the different member states of the Euro zone; the absence of compensatory mechanisms need not be a problem for the cohesiveness of the Euro zone but if we are facing a situation combining significantly differentiated developments of labour costs and a high or appreciating exchange of the euro, this absence may indeed constitute a problem. I shall return to this point shortly.

Mechanisms to facilitate a supply of liquidity in euros remain poorly developed weak. The common EU-budget remains very modest and furthermore no deficit-financing is allowed. The common budget has to be balanced. Whatever one may think about this it has a clear-cut implication of relevance in the present context: deficit-financing via the presently non-existing European bonds (in addition to national bonds) could enhance the internationalisation of the euro but this possibility is excluded. Similarly we may note the national segmentation of public debts among the Eurozone countries (we are yet to see the slogan of “*One Money – One Debt*” as a follow-up to the “*One Market – One Money*” slogan introduced in the context of the single market project of the early 1990s), and the relatively balanced current account position of the Eurozone. Again both a Europeanisation of national public debts and the development of a European current account deficit could stimulate the international use of the euro. Inadequate supply of liquidity may explain why periods of dollar instability leading to an increased demand for euros, translates into an appreciation of the euro exchange rate rather than into an increased supply of euros.

Let us now briefly recall some of the most significant characteristics of the present international role of the euro as discussed above: its international share has been growing significantly when measured in current exchange rates while it has been falling when measured in fixed exchange rates. How can we interpret these tendencies in view of the arguments developed above?

The starting point (whose origins we do not need to trace in the present context) is the instability of the dollar following from domestic developments in the US economy and rivalry and competition from other economic powers in the global economy. The instability of the dollar leads market actors to search for alternatives to the dollar. Up to a point alternatives to the dollar do exist but none of them constitute serious alternatives for the present moment. At some remote later stage the Chinese renminbi may become an alternative candidate and if we try to be creative we could perhaps also imagine an increased role for some sort of Special Drawing Rights from the IMF. Market actors may also choose e.g. gold or oil as investment objects. However, at the end of the day – and in view of the size and relative strength of the Euro zone - market actors can hardly avoid focussing on the euro as *the* main alternative to the dollar.

However the combination of dollar instability and the limited availability of euros for external purposes – limited by the factors indicated above - inevitably leads to an appreciation of the exchange rate of the euro as demonstrated by the experience of recent years. Hence it would appear that the form of internationalisation of the euro that we are witnessing is the passive consequence of the instability of the dollar rather than anything else[31]. In this regard the Euro zone is passively subjected to rather than actively shaping the globalisation of financial and monetary affairs.

Among the consequences of this we may simply note the fact that different member-states of the Eurozone are affected in quite different ways by these processes. Due to a number of factors that I shall not deal with here (including the nature of national productive specialisation, market structures, and trends in labour costs) the impact of the appreciation of the euro varies between the member states of the EU. And – as mentioned before – this differentiated impact cannot be counterbalanced by a common budget.

[31] Thus it is not surprising that the December 2008 figures (http://www.imf.org/external/np/sta/cofer/eng/index.htm) for the share of different currencies in the official foreign exchange reserves (measured in current exchange rates) after a long period of falling dollar shares and increasing euro shares show a rise in the share of the dollar and a decline in the share of the euro in the 3rd quarter of 2008, i.e. in a period where the dollar after a long period of depreciation started appreciating towards the euro. This is at least what we might have expected from the argument developed in the text.

5. Concluding remarks

The international role of the euro has increased considerably in the ten years following its introduction. The euro constitutes the second most important international currency. A closer study of the mechanisms involved in the internationalisation of the euro, however, reveals a number of limits to the international role of the euro. Thus the potentials of the euro for rivalling the dollar as *the* main international reserve currency remain quite limited.

However, the future prospects of the US economy and its currency – the dollar – have not been discussed. For this (and other) reasons it is beyond the ambitions of the present paper to assess the prospect of the future international monetary system. I do, however, wish to point to a number of limits to the potential of the euro in this context – limits that have been surveyed above.

A priori nothing precludes these limits from being removed in a mid- or longer term perspectives. Major factors of change such as e.g. a possible British participation in the euro, a further break-down of the global economic system, and a strengthening of reform thinking within European political-economic policy-thinking could modify the political agenda as well as the mechanisms and frames within which the international dimension of the euro is developing. On the other hand in view of the rather timid analysis of the Commission regarding the lack of an international strategy for the euro (as discussed above) we may also note that we may still have a long way to go.

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