THE POLITICS OF THE EURO

POR

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A mi madre por su amor,
ejemplo y apoyo incondicional

A mi padre y a mis hermanos,
por su amor y cariño
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<tr>
<td>ACP</td>
<td>Africa, the Caribbean, and Pacific Countries</td>
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<td>CAP</td>
<td>Common Agricultural Policy</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>ECOFIN</td>
<td>Council of Economic and Finance Ministers</td>
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<td>ECSC</td>
<td>European Coal and Steel Community</td>
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<td>EEC</td>
<td>European Economic Community</td>
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<td>EFTA</td>
<td>European Free Trade Area</td>
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<td>EIB</td>
<td>European Investment Bank</td>
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<td>EMI</td>
<td>European Monetary Institute</td>
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<td>EMS</td>
<td>European Monetary System</td>
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<td>EMU</td>
<td>Economic and Monetary Union</td>
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<td>ERM 1</td>
<td>Exchange-Rate Mechanism (part of EMS)</td>
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<td>ERM 2</td>
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<td>ESCB</td>
<td>European System of Central Banks</td>
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<td>ESF</td>
<td>European Structural Fund</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FSAP</td>
<td>Financial Services Action Plan</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPE</td>
<td>International Political Economy</td>
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<td>MNCs</td>
<td>Multinational Corporations</td>
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<td>NCBs</td>
<td>National Central Banks</td>
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<td>OCA</td>
<td>Optimum Currency Area</td>
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<td>SMU</td>
<td>Scandinavian Monetary Union</td>
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INTRODUCTION

The creation of the euro and the establishment of the Economic and Monetary Union (EMU) raised new questions about the future of the International Monetary and Financial Systems and the predominant role of the US dollar in international transactions. Since the euro appeared in 1999, it has been considered one of the most important international currencies along with the US dollar and the yen due to the strong economic performance achieved by the European Union. The establishment of a common European currency (a crucial step for the EMU) has led scholars (see Eichengreen, 1997; Tsoukalis, 2005) and policy-makers (see Bergsten, 2005; Padoa-Schioppa, 2004) to wonder how the new currency will impact both the International Monetary System and the International Financial System, not only in the economic realm but also in the political. Considering that current relations among states and non-state actors are affected by monetary issues, the objective of this work is to answer the following question: what is the political role of the euro in the International Financial and Monetary System.

Most of the time when we talk about money we tend to make reference to the economic functions it performs, as well as the advantages and disadvantages it brings for money’s users. However, money performs non-economic functions. The political role of a currency is a particular condition of money that impacts societies inside and outside the political frontiers.

The Peace of Westphalia of 1648 established the foundations of the new world order in terms of political and territorial sovereignty. The nation state was
conceived as an independent unit playing the most important role in international relations. Along with the attributes usually attached to the nation-state, such as the creation of armies and the collection of taxes, the production and management of money within a territory has been considered one of the main roles that define a sovereign nation. The concept of One Nation/One Money, according to Benjamin J. Cohen, was born with the Peace of Westphalia. Any state in order to be considered as such had to produce its own currency not only for economic reasons, but also for the political symbolism that a currency represents, identity. Eric Helleiner (1996, 1997) highlights two key ways in which an exclusive territorial currency served to enhance a sense of national identity. First, money acted as a reminder to citizens of their connection to the state and their oneness with it. And second, everyone was part of the same social entity. In the popular mind, there is still a strong bond between money and nation (Cohen, 1998)

Although the creation of money is a responsibility of the state, the use of different currencies has not been limited by national boundaries since many of them can be used in international transactions. The international use of currencies is not restricted to the establishment of the Westphalian nation-state. Even before, almost since money was created, several currencies have been used to facilitate trade around the world. The drachma of Athens, the denarius of the Roman Empire, the bezant of Byzantium, the golden florin of Florence, and the ducat of Venice are some currencies that have dominated the international trade and currency space in one period or another. With Westphalia, the state acquired the monopoly over the production of money and the power that a monopoly brings: the ability to obtain goods and services and to manage domestic economic issues. The
nation-state had the strength to impose a specific currency within its territory and to obtain the benefits derived from it: a potent political symbol to promote a sense of national identity, a potentially powerful source of revenue to underwrite public expenditures, a possible instrument to manage macroeconomic performance, and a practical means to insulate the nation against foreign influence (Cohen, 1998). However, the acceptance of a currency also depends on the degree of social cohesion of the participants in the monetary space, where the size of an established network of relations determines how often a currency will be used inside or outside a territory.

With globalization the monetary space – where the state enjoyed a privileged position – has been transformed to open the opportunity to new actors to participate in currency affairs, particularly in the demand side of the market. Although the state still has the ability to produce money and influence the behavior of the money market, the increasing presence of non-state actors in the demand side is diminishing the monetary sovereignty that used to belong exclusively to the state. Currently, the increase of cross-border currency use and competition is reshaping the dimensions of currency space in terms of the supply and demand, leading to a *dettectorialization* of currency relations and moving from a monopoly of the state in monetary affairs to a oligopoly where the behavior and decisions of diverse agents – including governments – in the global market place of money determines who uses what money, when, and for what purpose (Cohen, 1998).

At the end of the 20th century the International Monetary and Financial Systems have showed major changes as the economies of the different countries have become more interdependent. With the end of the World War II, a new
International Monetary System was designed to avoid many of the policies that prevailed before the conflict and, because of the rise of the United States as the main superpower, the US dollar was established as the leading currency in international transactions. With the collapse of the Bretton Woods System and the consequent end of the pegged exchange rate system at the end of the 1960s, the International Monetary System lacked an established regime that could determine the way in which monetary affairs were going to be conducted and, consequently, the way in which the International Financial System was going to work to assure the transaction of capital. In this absence of a monetary regime, national governments were left with the option of managing monetary issues in a discretionary fashion. However, the US dollar preserved its status as the leading currency partly because of the lack of another superpower that could challenge to the US dominance in the political realm, and also because of the limited role that the rest of the currencies were playing within the system.

The economic instability that the collapse of Bretton Woods brought was one of the reasons that led the EEC countries to take a step forward and create a monetary alliance. However, this goal was primarily driven by a political objective: to foster political integration inside the EEC. The creations of the EMU and the euro have not only promoted the political integration of the EU, but they have also reshaped the way in which political and monetary issues take place.

The present work is divided in three chapters that offer, from an International Political Economy perspective, an explanation of how those monetary and political relations are being transformed by the presence of the European Union and, particularly, by the creation of the most successful monetary union of our time.
Chapter one offers a review on the concepts of politics and monetary power that help to explain the relationship between politics and money and its important role in the establishment of relations among states and non-state actors. From the study of classical and modern works on politics, a description and an analysis of politics and its relation to power is explained to then link it to the notion of monetary power and its impact on world politics. In order to understand that impact it is necessary to explain basic concepts related to money issues, such as, the different functions of money, its relation with the state, the international use of currencies, the current situation of the monetary scenario, and the options that states can adopt to deal with a changing currency order. Finally, the analysis of the definition of monetary union, its economic and political implications, and its benefits and costs for the states that decide to create this kind of alliance is provided in order to acquire a better understanding about the creation of the EMU and the role of the euro in the International Financial System.

Chapter two provides the historical background about the creation and development of the European Union, the Economic and Monetary Union, and the euro. It focuses on the political issues that determined the origins of the European Coal and Steel Community (ECSC) after World War II and the creation of the EU. The steps taken to establish the EU are explained from both the political as well as the economic perspective in order to analyze how a political project to enhance European security and avoid another devastating war was achieved through economic means and important doses of political will.

Chapter three analyses the main factors that determine the performance of the euro as an international currency. The economic elements are explained in terms
of trade participation, the degree of openness, population, and the geographical scope of the EU compared to the United States. Also, the development of the European financial markets contributes to understanding the role of the euro in the International Financial System; how the euro has influenced the integration process of financial markets in Europe, and what remains to be done regarding financial integration to enhance the position of the euro. The political analysis is focused on the performance of the Eurosystem and the European Central Bank, as well as in the advantages that political integration could bring to the euro. Attention is paid to the process of decision-making in determining both monetary and fiscal policies inside and outside the EU, the institutions in charge, the external representation of the EMU, and how all those elements affect the euro as an international currency. Chapter three concludes with an analysis of the political power of the euro and the challenges that it represents for the EU members in the short term and the foreseeable future.
MONETARY POWER: HOW DO CURRENCIES HAVE POLITICAL IMPACT?

Political theorists have studied politics and power by focusing on their relationship with the state, particularly since the birth of the modern state. However, the analysis of politics and power has evolved according to the changes that have occurred in the world – inside and outside the nation-states – which have helped theorists to rethink the classical conceptions of politics and power and their field of action.

This chapter explains how politics, power, and money relate to each other in order to explain those important structural changes. To understand how this evolution has taken place it is necessary to review the concepts, definitions, and theories used in the study of the subject. First, a review of the different analysis of the concepts of politics and power is offered to link them to the study of monetary power, the functions of money, the international use of currencies, and the creation of monetary alliances.
1.1 Politics and Power

The concept of politics has been particularly linked to the notion of power since the studies of the Greek philosophers, Plato and Aristotle. For Aristotle, the *polis* represented the community of the citizens and the political power is a power that is exercised over free men (Bovero, 1986). Michelangelo Bovero conceives a concept of politics as the idea of a collective order, an organization of the cohabitation through rules or norms emanated from the power that “represents” that collectivity and that prevents its disintegration, opposed to the resurgence of external conflicts (1986: 39).

The concept of politics has been defined by many authors in a variety of ways, but two main approaches can be used to regroup those definitions. On the one hand, politics has been conceived as a conflict where the plurality of interest groups and the forces they represent struggle for power and the result is the imposition of the stronger. Karl Marx and his concept of the class struggle clearly represent this idea. In the same way, Michel Foucault defines politics “as the continuation of war through other means” (in Bovero, 1986), while Max Weber affirms that it is a realm of power and violence where the state enjoys a monopoly over the legitimate use of force within its jurisdiction (Smith, 1999). On the other hand, the idea of politics as a composition or as an agreement is presented in the work of Thomas Hobbes, the first great theorist of the modern state, for whom the condition of the search of peace is the objective of politics.
In the 20th century two of the most important definitions of politics are provided by Harold D. Lasswell and David Easton. For Lasswell, politics is the process of deciding “who gets what, how, when, and where” (1936), while for Easton it involves “the authoritative allocation of social values” (1965) which can be material or spiritual qualities and that require a mechanism for their distribution due to their short supply. Politics, then, is the struggle between individuals and groups for dominion over social values (Susser, 1992).

Along with the idea of politics, the concepts of power and state have played a key role in the studies made by political scientists. For Bovero, power and politics are inseparable, because power is the substance of politics (1986: 37). At the same time, the relation power-state has been present in the political analysis due to the complex political organization that the state possesses (Mariñez Navarro, 2001), particularly since the creation of the modern state with the Peace of Westphalia. The clearest analysis of power has been that of Max Weber for whom there are three types of power: 1) political power, where the state possesses the legitimate monopoly for the use of violent means of coercion; 2) economic power, characterized by the possession of goods and wealth; and, 3) ideological power, based on the control of persuasive methods such as knowledge, doctrines, or religions where the influence is exercised over the members of a group in order to affect their behavior. For Weber, the transfer of power is made by three different ways: 1) traditional power, where the importance of traditions and history permit one or few people to inherit the authority, like in monarchies; 2) charismatic power, where the leader exercises authority not by the use of violence, but by a privileged revelation or investiture that legitimizes his behavior and will; and, 3) rational
power, which bases its legitimacy on the exercise of power itself according to the established rules (Châtelet and Pisier-Kouchner, 1986; Bobbio, 1989) or what Kelsen calls “the political power as an authorized power” (Bovero, 1986).

Different approaches have been used by different authors to analyze the concept of power, its sources, its typology, and its scope. Bobbio presents three theories about power: 1) the substantialist theory argues that power can be conceived as a thing that can be used as any other good; 2) the subjective theory explains power as a capacity to obtain certain effects, not as a thing that helps to reach an objective, as defined by Locke; and, 3) the relational theory establishes a relation between two subjects where the first one obtains a specific behavior from the second (1989: 84-87).

On the other hand, but very related to Bobbio’s typology of power theories, Rojo (2005) classifies the definitions of power in the voluntarist, the systemic, and the critical approaches. The voluntarist approach considers power in a relational fashion where one actor has the possibility to impose his will over another actor to obtain certain objectives. Hobbes, Russell, Weber, Dahl, Lasswell, and Wrong are some of the authors that conceive power as the possession of the means to produce desired effects. To define political power as the power whose specific means is the use of force helps to understand why it has been considered the ultimate power that characterizes the dominant group in every society (Bobbio, 1989) and has been usually identified with the state. Hobbes argues that, in order to finish with the use of force by single centers of power, it is necessary to concentrate all its sources in one point: to establish the sovereign power as a political power that becomes the only legitimate one based on the authorization
obtained by social pact (Bovero, 1986). For him, this sovereign power can be represented by one person—a king—or by a group of people—like a legislature—where the ruler is the power. The same author states that power is a “man’s present means to any future good” even when he is not engaged in employing them to that end, while Bertrand Russell defines it as “the production of intended effects” (Wrong, 2000). For Weber, power means the probability to impose one’s will within a social relation against any resistance (Rojo, 2005). Robert Dahl, in his work *Who Governs?*, acknowledges the notion of influence and defines power as the influence of A over B to the extent that he can get B to do something that B would not otherwise do concluding that “the making of governmental decisions is not a majestic march of great majorities united upon certain matters...it is the steady appeasement of relatively small groups” (Dahl, 1957).

The pluralist approach used by Dahl focuses on observable behavior and the study of decision-making where subjective interests are seen as policy preferences revealed by political participation (Lukes, 2005). In the same way, Lasswell affirms that the function of government is power. Power is the making of important decisions, and the importance of the decisions is measured by their effect on the distribution of values and the degree of participation of individuals and groups in the decision-making process. To him, politics and power is the study of influence and the influential (Smith, 1999).

The systemic approach, on the other hand, takes into account the voluntarist feature of who holds power and his willingness to use it. It also considers a perspective related to the social system and the searching for collective objectives that result in the proper functioning of that social system (Rojo, 2005). Among the
authors that represent this view are Talcott Parsons, Niklas Luhmann, and David Easton. For Parsons, power is the "generalized capacity to secure the performance of binding obligations by units in a system of collective organization when the obligations are legitimized with reference to their bearing on collective goals, and where in case of recalcitrance there is a presumption of enforcement by negative situational sanctions whatever the actual agency of that enforcement" (Parsons, 1969).

The critical approach is represented by Bachrach and Baratz, Michel Foucault, and Steven Lukes. Bachrach and Baratz maintain that power is part of what Elmer E. Schattschneider (1960) had called “the mobilization of bias”, it is, “a group of values, beliefs, rituals, and institutional procedures (“rules of the game”) that operate systematically and consistently to the benefit of certain persons and groups at the expense of other (Bachrach and Baratz, 1970). For them, those who operate in this system are also able to limit the scope of the decisions within the boundaries where they can make sure that their interests will be defended. This perspective is focused on decision-making, as well as, nondecision-making where observable (overt or covert) conflict is considered and where objective interests are seen as policy preferences (Lukes, 2005). In the same critical approach, Steven Lukes goes beyond Bachrach and Baratz’s studies when he proposes a three dimensional view of power where he criticizes the behavioral perspective, and thinks that it is almost impossible to accomplish a universal definition of power. He argues that all those different definitions must be considered because each one of them provides a vision of society. Lukes considers that the supreme exercise of power is to get another to have the desires one want him to have. For this author it
is not only important to focus on the decision-making process, as the behavioralists argue, but also on the control over the political agenda, on issues and potential issues, on observable (overt or covert) and latent conflict, and on subjective and real interests (Lukes, 2005).

According to the definitions already described, the concepts of politics and power have been particularly studied from a state-centric perspective beginning with the studies of the Greek philosophers in relation to the city state of their time. With the Peace of Westphalia and the establishment of the modern state, power was mostly assumed as a characteristic belonging exclusively to this entity, where not only political but also economic power – in the form of a monetary monopoly where the state has the ability to produce its own money and manage the economic performance – was exercised by this predominant actor of society. However, with the changes that occurred in the last century, one must note that both political and economic power have suffered a transformation related to who holds it. This has led theorists to rethink the conceptions of power and politics to include not only the state but also other participants in the policy-making process.

With the increasing participation of non-state actors in the political and economic realms and the constant changes occurring in technology, the power exercised by the state over the economy and the society has been greatly transformed. The state no longer holds the dominant power in the implementation of economic policies, and in particular, those related to monetary and financial issues. For some authors (see Strange, 1996) this situation reveals an erosion of the state where market actors have taken a predominant role in the management of international finance. This new distribution of power among diverse actors has affected not only
the way in which economic relations take place, but also how political relations are conducted since it is impossible to deny that politics and economics share a strong bond in the creation and implementation of policies.

1.2 Money and Power

* A theoretical approach to monetary power: the International Political Economy perspective

The rapid changes that have taken place in the global system in the last four decades have led many scholars and politicians to develop explanations about the factors that have contributed to those changes (see Strange, 1998; Underhill, 2000). Production processes, technological innovations, trade patterns, financial flows, social and political concerns, health issues, and environmental problems are some of the fields that have showed dramatic changes in the last forty years of the 20th century and the first four of the 21st.

Explanations from the main ideological camps of International Relations – realism, pluralism, and globalism – have dominated the debate about the way the international system works. Major attention has been paid to the neorealist and the neoliberal schools – represented by Kenneth Waltz and Robert O. Keohane respectively – when trying to explain the functioning of this system. The neorealist approach is particularly concerned with the distribution of power as a determinant of outcomes and with the constraints imposed on and incentives provided to states.
by the international system, where states act according to their self-interest in
deciding whether or not to participate in international alliances (Lawton et al.,
2000). This approach considers the state as a rational actor whose major concern
is high politics of national security and political issues, while economic and social
issues are relegated to low politics. On the other hand, neoliberal theorists argue
that states are not entirely autonomous and that decisions should be made to
achieve inter-state cooperation based on agreements that can be used to obtain
national objectives. Even though both approaches differ in the way the actors make
decisions in the international system, they keep a state-centric position where non-
state actors play an almost nonexisting role in the international system.

A different position is adopted by the globalist approach of the Marxist school
developed during the 1960s and 1970s in the work of I. Wallerstein whose basic
premise is that the proliferation of transnational culture and economic interactions
has led to the development of a global system. However, the classical Marxist
approach has underestimated the role that states play within the world system
(Lawton et al., 2000).

Although these three ideologies have had a great impact on the study of the
International Relations, they have failed to explain the changes that occurred in the
last forty years. The emergence of international actors different from states, such
as Multinational Corporations, international organizations, non-governmental
organizations, trade blocks, and individuals have reshaped the way in which
international relations take place in every field, economic, social, political,
environmental, technological, and health issues and have redistributed the power
that used to belong exclusively to states.
After World War I, International Political Economy (IPE) emerged as a subset of International Relations (IR) and focused on international economic affairs, such as trade negotiations and economic transactions. The central study of IPE was the international economic activities of nation states. But it is in the latter part of the 20th century that IPE changed its orientation from state-state economic relations to an approach where markets and firms begin to take major importance in the world system and to share power in international fields (Lawton et al., 2000). This discipline opened new possibilities to the study of the international system that considered not only the international relations ideologies but also the incorporation of other social sciences such as international economics, and sociology.

The British scholar Susan Strange was one of the first to recognize that “international relations theorists suffered a myopia derived from their obsession with the problematic of war and peace and conflict between states that equals the myopia of western political theorists derived from a similar obsession with values of political liberalism” (Strange, 1998). For her, political relations cannot be explained without considering economic implications, and vice versa. To Strange, the defining characteristic of the late 20th century was that humanity was undergoing major structural change, and that conventional frameworks of analysis failed to take these dynamics into account making it necessary to develop a theory that could bring politics and economics together to guide policy in a dynamic world system (Story, 2000). Such transformations relate to four main issues that emerged in the contemporary world system: first, the rise of the United States as the only superpower after the end of the Cold War; second, the change of the government influenced by a monetarist ideology based on a “market democracy”
(Story, 2000) where the role of the state was much more limited in economic issues; third, the development of the world market, especially the financial market by the western powers; and fourth, the increase in the industrial and service sectors through MNCs.

Based on the Marxist structuralist approach which argues that the international system should not be viewed as a one-dimensional, monolithic entity, but rather as a system containing numerous interlinked power structures, Strange redefined the structure of the world economy based on the power to make decisions on four basic societal needs or interlocking structures: security, knowledge, finance, and production (Lawton et al., 2000; Strange, 1988). This notion of structural change enables us to understand why and how the power of firms has increased relative to governments and changed the nature of international relations (Story, 2000). In this case, technology (an essential part of knowledge) is the central feature of the structure that allows gaining power and strengthens the other three pillars of the systemic power (Lawton et al., 2000). In addition, technology serves as a catalyst in the transformation of the relations between governments and firms (Story, 2000). Along with the rapid changes in technology, the financial realm has showed remarkable transformations as well. The financial markets have taken advantage of those technological innovations to increase their size and the number of operations that take place within. Hence, it is the financial structure – the creation and allocation of credit and the international monetary order – what has driven many IPE scholars’ work when trying to explain those changes in the international system by showing the many times denied link between politics, money, and power.
International disagreements over monetary matters run deep (Andrews, 2004a). The relation between money and power has been neglected particularly by the realist approach to which the state is the central player in international affairs considering politics as the determining element of economics, and also by the liberal approach which emphasizes that economics and politics are separate realms. Although both approaches consider power as a key element in international relations, they relate it more to the traditional view of power as the ability of one state to influence the behavior of other states, or what can be called “relational power”, as was mentioned above. For the realist school, power is based on capabilities – military, natural, and economic resources – that can give a state the strength to affect another state’s behavior even if the other state does not want to do it. The realist approach was very useful to explain many of the issues that happened until the end of the Cold War, but with all the changes in the international system especially in the financial structure and in technology a new view was needed. States were no longer fighting for territories or natural resources, but for attracting capital to their industries, for opening their economies to the rest of the world, for selling their products and services abroad while letting other non-state actors to become part of the international bargaining. In this context, the innovations in technology and financial products have made possible the expansion of a global market where money plays a central role in the relations among states and states and non-states actors.

For Strange, money is inherently political and cannot be relegated to the “low politics” of technical economics alone (Cohen, 2000). Because of the political nature of money, the concept of power in monetary affairs has a particular meaning
at the international level. A state is powerful if it can influence the behavior of other states. The author noted that what really matters is not physical endowments – like the realist theory argues - but rather structures and relationships: who depends on whom and for what. Strange explains the difference between relational power – widely used by the realist approach – and structural power. On the one hand, relational power is the ability of A to get B to do something it would not otherwise do, it means to gain under the prevailing rules of the game (Strange, 1994). On the other hand, structural power is the ability to shape and determine the structures of the global political economy: the power to decide how things will be done, the power to shape frameworks within which states relate to each other (Strange, 1994), a definition that follows very closely the one provided by Lukes and his three-dimensional view of power. In this way, the notion of structural power in world politics, society and economy has liberated the study of international political economy from the realist tradition (Lawton et al., 2000).

*Power and the international use of currencies*

Although a general theory on money does not exist, scholars have approached to the study of money (Cohen, 1998; Strange, 1998). To begin with, it is important to understand how currencies can be used at the international level in order to analyze the relationship between money and power.

Economists define money as anything that serves the following three functions: a unit of account when prices are set in terms of money; a store of value for
maintaining the purchasing power of the money; and a medium of exchange when money is used for the purchasing of goods and services (Pollard, 2001). In a single economy where the state enjoys the monopoly of managing monetary issues, the use of a currency is imposed by the government within a specific territory, while the use of a currency at the international level responds to market forces whose consequences are ratified more than guided by international agreements (Tavlas, 1998). In the case of a particular state, this monopoly brings some benefits that derive from a territorial currency. According to Cohen (2004), four advantages are considered under this situation: 1) a potent political symbol to promote a sense of national identity; 2) a potentially powerful source of revenue to underwrite public expenditures – or seigniorage\(^1\); 3) a possible instrument to manage macroeconomic performance; and, 4) a practical means to insulate the nation against foreign influence or constraint.

Following the three functions of money, the international use of a currency can be considered under two perspectives: by private agents and by official agents. Internationally, a currency is used: 1) as a medium of exchange, used by private agents both in direct exchange of currencies, and as a vehicle currency in carrying out indirect exchanges between two other currencies in foreign trade and capital transactions, while official agents use it as a vehicle for exchange market intervention and for balance of payments financing; 2) as a unit of account to invoice merchandise trade, to denominate financial transactions, and to define exchange rate parities; and, 3) as a store of value used by private agents when

\(^1\) Seigniorage: technically, it refers to the excess of the nominal value of a currency over its cost of production. Seigniorage can be understood as an alternative source of revenue for the state, beyond what can be raised via taxation or by borrowing from financial markets (Cohen, 2004)
they are choosing financial assets, while official agents may hold both an international currency and financial assets denominated in it as reserve assets (Tavlas, 1998; Pollard, 2001).

In order to consider a currency international, Tavlas (1998) mentions several factors that must be accomplished. First, an international currency should have a stable value relative to other currencies in order to provide confidence derived from its inflation performance. Second, the issuing country requires a stable political system. Third, the issuing country should possess financial markets that are substantially free of controls with a wide variety of financial instruments and well-developed secondary markets that contribute to the international demand for a country’s currency, reflecting central bank’s and other investors preferences for safe, liquid financial instruments. Fourth, the larger the country’s share of world trade, the more likely its currency is to be familiar to traders and the most useful is that currency as a unit of account and a medium of exchange.

The use of an international currency depends on how many private and official agents use it. This means, how well its transactional network is developed. It can bring certain benefits to the issuing country as well as some costs. First, it derives seigniorage internally, and externally it can create extra seigniorage when the issuing country inflates the currency. Second, the earnings of its financial sector will increase due to the increase of loans, investments, and purchases of goods and services through the financial institutions. And third, the issuing country becomes less vulnerable to changes in the value of its currency than other economies. The costs of having an international currency depend on the exchange rate mechanism the issuing country uses. Under pegged exchange rates, a shift in
preferences by foreigners can cause large capital flows and undermine the
capacity of the monetary authorities to control the monetary base and influence
domestic economic activity. Under floating rates, such a shift can lead to large
variations in the exchange rate, which could also limit the degree of influence
exerted by the authorities over the domestic economy (Tavlas, 1998).

The use of international currencies is linked not only to economic factors, but
also to political issues related to power. Since the international use of currencies is
not determined exclusively by states, but also by the use of the currencies by
market actors, the *deterritorialization* of the use of money has been a remarkable
phenomenon in recent years. Under the Westphalian model, monetary authority is
exercised by the state, but in an even more globalized economy monetary authority
has been changing to include the more active participation of market agents. This
situation has changed the monopoly once enjoyed by the state into an oligopoly,
where states compete against each other to preserve or promote market share and
obtain the benefits derived from the use of their currency in the international
market.

Kirshner, in his work *Currency and Coercion* (Kirshner, 1995), claims to present
a general theory of monetary power. However, his book offers less a theory than a
handy taxonomy of the many ways that money can be used in inter-state relations
(Cohen, 2000). The same author distinguishes among three categories of
monetary power: *currency manipulation*, referring to initiatives taken to affect the
value and stability of target currencies; *monetary dependence*, involving efforts to
create and exploit a sphere of influence; and *systemic disruption*, encompassing
actions directed at specific international monetary systems or subsystems (Cohen, 2000).

Cohen (1998, 2004) states that governments have a limited number of strategies to defend their money’s market position, which include: 1) *market leadership*, an aggressive unilateralist policy intended to promote use of the national money; 2) *market preservation*, an unilateralist status-quo policy intended to defend, rather than augment, a previously acquired market position for the home currency; 3) *market followership*, an acquiescent policy of subordinating monetary sovereignty to a stronger foreign currency; and, 4) *market alliance*, a collusive policy of sharing monetary sovereignty in an exchange-rate union or monetary union of some kind.

The same author explains that there are two ways in which a state can enforce the demand side of the market both at home and abroad and these include persuasion and coercion. Persuasion consists of an intensive campaign to enhance a money’s reputation, its usefulness and reliability through several tactics such as higher interest rates, convertibility guarantees, special tax advantages, and selected liquid assets. It basically consists on expanding a money’s transactional network by sponsoring development of debt markets denominated in a specific currency, in order to enhance its exchange convenience and capital certainty (Cohen, 2004). Coercion, on the other hand, make use of high-pressure tactics, such as compulsory tying arrangements or exclusive marketing schemes, but only as the law allows – considering that the law-making attribute is a unique privilege of sovereign governments – and never backed by a legitimate use of force (Cohen, 2004).
The analysis of monetary relations has also helped to develop different classifications of currencies in order to explain why and how international currencies are used by all the different actors in the monetary market. Susan Strange explained a taxonomy of currencies based on the states’ power: 1) a top currency is that of the dominant state in the system; 2) a master currency is the one that is imposed by an imperial power, and creates political dependencies; 3) a negotiated currency emerges when a master currency begins to lose its power because the imperial power begins to decline; and 4) a neutral currency is the one whose use originated in the strong economic position of the issuing state (Strange, 1971).

According to Strange, the distribution of power in the world system is not equal. First, because some states possess the dominant currencies – or top currencies – which give them the ability to decide on the establishment of the structure of the financial system, and second, because power has been dispersed among different actors – like firms and international organizations – which means that authority is exercised not only by the state, but by non-state actors as well. The relationship between money and power is important in order to explain how the global order is structured. As mentioned above, Strange argued that there are four key structures in the global order: security, production, finance, and knowledge. But from all of them, the financial structure is the one that defines the shape the other three are going to take. The international monetary system is shaped by the power [shared by governments and banks] to create and allocate credit (Strange, 1988) on which trade and production depend. Production processes and trade patterns have changed, increasing intra-firm and intra-industry trade, and fragmenting production
processes through MNCs which are located closer to markets. As capital has become more mobile, firms and markets have become more transnational, enhancing their power in relation to governments, which remain territorially based (Underhill, 2000). This situation gave rise to what the author called “triangular diplomacy” which relates to state to state relations, state to firm relations, and firm to firm relations, as opposed to the classical state to state relations of the realist theories.

Benjamin J. Cohen presents a different categorization of currencies called “the currency pyramid” and classifies monies as: top currencies, whose use dominates almost all types of cross-border purposes and enjoy certain popularity not restricted to any particular geographic region – like the US dollar; patrician currencies, which possess an important popularity for cross-border purposes, but not equal to that of the top currencies – like the Deutschemark before the appearance of the euro or the yen; elite currencies are described as those with a significant international use but of insufficient weight to carry much direct influence beyond their national frontiers- like the British pound; plebeian currencies have a very limited international use whose substantive authority is even more seriously compromised from abroad like the case of the smaller industrial states of Australia, Norway and Sweden or the wealthier oil-exporters of Kuwait, Saudi Arabia, and the United Arab Emirates; permeated currencies are those whose authoritative domain is compromised even at home, mainly through the market-driven process of currency substitution where nominal monetary sovereignty continues to reside with the issuing government, and a foreign currency supplants the domestic alternative for some monetary purposes; quasi-currencies are supplanted not only as a store of
value but as a unit of account and a medium of exchange as well, like it happened in the less stable economies of Latin America and the former Soviet bloc; and, *pseudo-currencies*, which possess a legal status but no significant economic impact and are subordinated partners of relatively asymmetric alliances like the balboa of Panama (Cohen, 1998).

Although different authors present different classification of currencies, it is important to note that, when it comes to the international use of a currency, *top currencies* are those that play a major role in the structure of the international financial system. But, what determines which international currency can reach the top of the pyramid? The characteristics, according to Cohen (2004) and very close to Tavlas argument, are three: 1) a proven track record of relatively low inflation and inflation variability which provides confidence in a money’s future value, backed by political stability in the country of origin; 2) a high degree of transactional liquidity (“exchange convenience”) and reasonable predictability of asset value (“capital certainty”), backed by a set of well developed financial markets, sufficiently open to ensure full access by nonresidents; and, 3) a broad transactional network provided by a great volume of transactions conducted in or with a country that can be enhanced if that country is also a major player in world trade.

Currently, the currencies considered to be at the top internationally are three: the American dollar, the euro, and the yen. All of them offer an example of achieving the three attributes required to be on the top to. It is important to add, that there is no other potential rival that could challenge them. However, among the
three the most remarkable difference is the euro is not a single-country’s currency, but that of twelve and a growing number of countries willing to adopt it.

**Monetary alliance: sharing or giving up monetary sovereignty?**

In recent years the issue of monetary sovereignty has been put on the table by several states when trying to develop strategies to enhance economic activity and power. Countries, like Argentina, have attempted to *dollarize* their economy. El Salvador and Ecuador have already done it. The members of the European Union have created a monetary union replacing their national currencies for a new one, the euro. The *deterritorialization* of money has lead many states to reconsider different strategies to make their currencies more competitive in the market which can assure them an important participation in the sharing of benefits while allowing them to enhance economic activity.

For currency leaders, the benefits derived from seigniorage, the status and insulation from outside pressures, allow them to adopt an independent position to acquire political power, exercise influence, and achieve foreign objectives (Cohen, 2004). For the rest of the currencies three strategies can be followed, like Cohen has mentioned: market preservation, market followership, and market alliance. The last two imply a degree of regionalization that is determined by several factors: 1) decision making authority; 2) transactions costs; 2) macroeconomic management; 3) distribution of seigniorage; 4) political symbolism; and, 5) diplomatic influence.
Regionalization also implies four conditions: country size, economic linkages between nations, political linkages, and domestic politics.

Market followership is achieved through vertical regionalization, where a country subordinates its monetary sovereignty to a stronger currency. Dollarization implies giving up a national currency with its respective benefits and costs. It is often argued, that dollarization is most likely when the cost of defending an existing national currency has become intolerably high, mainly at the microeconomic level where a switch to a leader’s money is bound to reduce transactions costs, lower interest rates, and increase benefits at the macroeconomic level for countries with a long history of high inflation (Cohen, 2004). However, the costs of surrendering monetary sovereignty can be very high: the loss of seigniorage, the ability to manage macroeconomic performance, the increasing dependency on the leader, and the loss of an important symbol of political sovereignty.

On the other hand, the third strategy – market alliance – implies a different vision of how to deal with monetary sovereignty through horizontal regionalization. The reasons that motivate states to get involved in a monetary alliance depend on the benefits and costs it entails. According to the Optimum Currency Area (OCA) theory, the economic benefits derived from a monetary alliance stress the importance of the three basic functions of money. As medium of exchange, transactions costs are lowered as the currency conversions decreases; as store of value, the exchange risk is lowered along with the reduction in the number of currencies; and, as unit of account, information saving accompanies a decrease in the number of required price quotations. Besides, a broadening of the foreign-
exchange market vis-à-vis third countries may decrease currency volatility (Cohen, 1998; Mundell, 1973).

Although economic factors are important for establishing a monetary alliance, political issues are critical to its sustainability over time. Two characteristics can mark the fate of a monetary alliance. The first, suggested by the realist approach, is the presence or absence of a dominant state – an hegemon – willing to keep such an arrangement functioning effectively on terms agreeable to all. The second, suggested by institutional approaches, is the presence or absence of a broad group of related ties and commitments sufficient to make the loss of policy autonomy acceptable to each partner through a well-developed set of institutional linkages (Cohen, 1998).

Monetary alliances can take two different forms. One, through a full monetary union where a group of national currencies is substituted by a common currency and a supranational institution exercises monetary authority instead of individual national governments. Two, through an exchange-rate union where there is not an adoption of a common currency, but currency values are set according to national governments’ discretion in order to maintain the control of that currency’s value and its participation in the union.

*Monetary union: pooling monetary sovereignty*

As was mentioned above, monetary union requires a full commitment by states to delegate national monetary sovereignty to a supranational authority that will be
managing currency affairs on behalf of all the members of the union, when a common currency is adopted. But, what can motivate a state to “renounce” its monetary sovereignty to become part of a monetary union? Do states surrender all their monetary independence when they form part of a monetary union?

Monetary unions are not new. For example, the Scandinavian Monetary Union (SMU) was established in 1873 among Sweden, Denmark, and Norway, adopting a common currency, the krone, but allowing the free circulation of national currencies. However, the agreement was abandoned as a consequence of the disruption in the financial market when World War I began, and finally, with the international financial crisis of 1931. In the 20th century some attempts to create a monetary union among different countries were not successful, except for the Economic and Monetary Union of the European Union which can be considered the most advanced of its type.

Participating in a monetary union offers different benefits as well as costs, both economically and politically. On the one hand, the economic benefits represent a reduction of transactions costs among the members of the union, once the costs of the exchange-rate are eliminated. This gain increases as more countries enter into the monetary union, creating economies of scale. On the other hand, the distribution of seigniorage, the ability to manage macroeconomic performance, the political symbolism, and the diplomatic influence are seriously affected, since each government suffers an erosion of these attributes in favor of the supranational institution. However, authority is not surrendered but pooled – delegated to joint institutions of the currency partnership to be shared and, in some manner, collectively managed by all the countries involved. Authority may be diluted at the
national level, but it is reconstructed at the group level where each government retains a voice in decision-making for the group as a whole (Cohen, 2004).

The adoption of a common currency provides more strength and power to the entire group, instead of maintaining weak national currencies which, contrary to conventional wisdom, can cost more to the issuing country in its attempt to defend its national money. By acting as a group, the global market position of the members can be improved; policy makers will be better positioned to resist market pressures and better able to guide macroeconomic performance, generate seigniorage revenue, promote a sense of community, and avoid external dependence (Cohen, 2004).

However, achieving a monetary union is not that simple. Political issues matter, even more than economic factors. First, it is difficult to find partners willing to commit their national interests in favor of a common project. Second, negotiations to establish the proper institutions and the beginning of a monetary union require time, money, and big efforts from the future members. These kinds of obstacles require a linkage that can merge all those national interests into a preference for establishing a monetary union. As previously mentioned, the presence of a leader and a set of developed institutional connections are necessary elements for the success of a monetary union.
1.3 Conclusion

The study of politics, money, and power through the lens of International Political Economy allows us to rethink the definition and use of those concepts in today’s global relations. Although the state continues to play a decisive role in global affairs, it would be incorrect to deny the presence of other actors in reshaping of global relations. The case of the International Monetary System offers a perfect example. It has been transformed in such a manner that the state is no longer the only actor that defines monetary relations through a single currency for its territory and the control of that money’s supply. The state forms part of an oligopoly where it has to compete against other currencies in order to get a bigger share of the global market. This situation drives states to implement strategies that allow them to gain power in the monetary market by becoming the market’s leader, preserving the status-quo, substituting its national money for a stronger currency, or by creating alliances with other states.

If the management of money is no longer the exclusive attribute of states, it is important to ask Who governs monetary affairs? Monetary governance can take less formal forms. Money power has also been transferred to the other side of the market, the demand. As Benjamin J. Cohen has argued: “Governance is provided by whatever may influence market confidence in individual currencies” (Cohen, 1998). Monetary issues are gaining greater importance as the world becomes more interdependent, and as global relations are defined not only in terms of security and political concerns, but also in terms of the structuring and management of currency affairs.
THE EUROPEAN UNION

The EMU is the most successful case of a monetary alliance. The EU members that take part in this agreement share a common history of culture, trade, religion, and conflict. Chapter two focuses on the process of creation and development of the EU, and how the differences among EU members became the cornerstone of the most advanced case of economic integration. The first part describes the origins of the ECSC up to the establishment of the EU. The second part explains the main economic and political issues that led to the creation of the EMU and the euro.

2.1 The creation and development of the European Union

The creation of the EU\(^2\) was a consequence of two wars between the two main European enemies: France and Germany. The French-German conflict has its origins in the dispute of the territory of the Saar. This unique place – characterized by its richness in coal – acquired a major importance in the end of the 19\(^{th}\) century at a time when coal was the main source used by industrialized states. After several unsuccessful attempts to solve the conflict, World War II put the issue in

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\(^2\) The EU is a treaty-based, institutional framework that defines and manages economic and political cooperation among its 25 member states (Archick, 2005) which includes: Austria, Belgium, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.
the spotlight again, but in 1946 a referendum gave France the opportunity to get it back. Although France had tried to insert the Saar into the French administration and culture, Germany was still fighting in the ideological realm for the territory.

The solution to this situation was the main objective of the Schuman Plan launched in 1951 which was also focused on reinserting a divided Germany into the western world. In order to avoid more conflicts over the property of sources, the European Coal and Steel Community (ECSC) was created with the participation of France, Germany, Belgium, Italy, Luxembourg and Netherlands, leaving the management of these resources to a supranational entity instead of the national governments. By subordinating the basic German industries, France won; by making France subject to the same authority, Germany recovered a state of equality, establishing the foundations of the European Union (Strange, 1998).

Along with the conflict over the Saar, the Marshall Plan – launched by the United States after World War II – played a major role in the development of the European Union. It required cooperation among Western European governments as a condition for the use of resources to rebuild their damaged countries through the progressive liberalization of intra-European trade and payments (Tsoukalis, 1997), based on a continental basis (Arestis et al., 1999). By assisting integration, the United States hoped to create a stable and reliable partner (Arestis et al., 1999) and to gain future influence in the zone as a response to the Soviet Union.

With the Korean War in the 1950s, the United States attempted to rearm Western Europe with the purpose of pushing the European allies to participate in it. The fear of rearming Germany led to a conflict when the European Defense Community Treaty was debated in the national assemblies. As a result of the
French National Assembly’s rejection of the treaty, the European leaders decided to take the economic path to achieve a union (Arestis et al., 1999). The six members of the ECSC pushed on with other aspects of integration, and the Treaty of Rome was signed in 1957 and ratified in 1958 bringing into being a common market and an atomic energy community - the European Economic Community (EEC) and Euratom. The EEC Treaty was a commitment to economic integration over a period of 12 years (Garden, 2001). Euratom was focused on the research and proper use of nuclear energy. The common market established the free movement of goods, services, and people through the elimination of trade barriers and the adoption of common policies such as the Common Agricultural Policy (CAP) which allowed the EEC to protect its products from foreign competition, particularly from the cheap American goods.

With the Treaty of Rome, a wider framework for the integration of Europe was set instead of the ECSC which was only focused on the regulation of two resources. Also, four institutions were created: a High Authority that worked as an executive branch responsible for the implementation of the treaty, the making of legally binding decisions, and the fixing of Community price stability. It was integrated by nine members and it was later replaced by the European Commission; a Council with legislative functions composed by representatives from member states charged with the task of ensuring that the actions of the High Authority were consistent with the wishes of the national governments; a Parliamentary Assembly composed by delegates of the member states that played a consultative role; and a Court of Justice in charge of the judicial check on the
actions of the High Authority, the national governments, and individual firms (Arestis et al., 1999).

At the same time that the members of the Treaty of Rome were moving forward on the integration process, another group of countries including the United Kingdom, Norway, Denmark, Sweden, Austria, and Switzerland, were creating the European Free Trade Area (EFTA). The number of members increased to ten when Portugal, Finland, Iceland, and Liechtenstein also joined. The rules of EFTA suited its members very well since they were free to deal externally how they wished, and the basis of the internal free market was industrial with hardly any agricultural trade included. This meant that they could continue their own agricultural systems unlike the members of the EEC who were under remit to harmonize arrangements under the common agricultural policy (Garden, 2001). While pushing for the creation of the EFTA, the United Kingdom began to reconsider joining the EEC and began negotiations to be part of the Community. By 1973 the first enlargement of the EEC took place when Denmark, Ireland and the United Kingdom were accepted, and De Gaulle was not able to block the entry of the United Kingdom as he did before.

The second and third enlargements of the EEC allowed the entry of Greece in 1981 and Spain and Portugal in 1986. These enlargements gave the Community the opportunity to play a more important role in the international system, particularly in trade. The EEC members became aware that working in a higher profile as a unit on the international stage could result in the development of a common foreign and security policy and acting as one European voice (Arestis et al., 1999)
The EEC was clear about achieving several monetary objectives that could foster economic integration: first, pursue an equilibrium in the balance of payments; second, maintain confidence in currency, high employment, and stable prices by coordinating economic policy through the central bank and government collaboration; and third, stabilize exchange rates. But the Treaty of Rome did not specify the measures the members had to take in monetary issues to achieve those objectives, and the EEC focused on trade issues such as the elimination of custom duties and quantitative restrictions on intra-EEC trade; the establishment of a common commercial policy towards third countries; the movement of goods, services, persons, and capital; the common policies in agriculture and transport; the establishment of mechanisms to promote fair competition in the common market; and the creation of laws and institutions such as the European Structural Fund (ESF) and the European Investment Bank (EIB) to enable the proper function of the common market (Arestis et al., 1999).

With the increase in the economic scope of the EEC, monetary integration was seen as a fundamental element to continue with the trade expansion and the enforcement of the Single Market. It was not until the 1990s when, after many attempts to achieve a monetary union, the EEC members agreed on a new treaty to establish the European Union. The Maastricht Treaty, which was signed in 1992 and came into force on 1 January 1993, was followed by two more enlargements. In 1995, the fourth enlargement included three former EFTA members: Austria, Finland, and Sweden; while in 2004, the fifth open the door of the European Union to eastern countries: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. In addition, two more
treaties have been signed according to the terms of the Maastricht Treaty: the Amsterdam Treaty in 1997 and the Nice Treaty in 2000. The first relates to issues such as security, environment, jobs, terrorism, citizenship, and public health. The second is focused on the preparation of the EU institutions for future enlargements, like the one of 2004.

2.2 The origins of the Economic and Monetary Union (EMU)

Since the establishment of the EEC two main approaches have been taken by political leaders in order to achieve European integration. On the one hand, there is the federalist approach, which highlights the cooperation of local, regional, national and European authorities to complement each other in the process of integration. On the other hand, there is the functionalist approach which favors a gradual transfer of sovereignty from the national to the Community level in the form of supranational institutions. These two views have been present in the whole process of development of the EU: national and regional authorities need to be matched by independent institutions in areas such as the single market, monetary policy, economic and social cohesion, security policy, employment policy, environmental protection, foreign and defense policy, and freedom and justice (Andrews, 2002b).

With the establishment of the EEC in 1957 by the Treaty of Rome, monetary integration was one of the central objectives to pursue, but the road taken to achieve it has been full of ups and downs, of fast and incredible progress as well
as of long periods of stagnation. If there is something that characterizes the creation of the EMU is the way the EEC members responded to economic crises: when a financial crisis was threatening the growth of the EEC, authorities pushed for the establishment of mechanisms to achieve monetary cooperation, but once the crisis had receded the monetary union became a secondary objective.

The European Commission, founded in 1958, played an active role in promoting European monetary cooperation with the objective of establishing a monetary union (Andrews, 2002b). By order of the European Commission, two bodies were created to provide support for the development of the EMU: the Committee of Governors of the Central Banks of the EEC, established in 1964, and the Council of Economic and Finance Ministers (ECOFIN). Both of these institutions were in charge of facilitating cooperative monetary relations among the central banks of the EEC members through specific activities and the exchange of information.

The EMU was born as a result of two different interests: a) a concern about a customs union and the CAP threatened by exchange rate fluctuations, and b) by the need to adopt a common policy vis-à-vis the dollar. In 1962, a peg exchange rate system and a reserve currency was launched, working in a smooth way until the collapse of the Bretton Woods System (Arestis et al., 1999). The uncertainty in the international monetary system before the end of Bretton Woods led the European authorities to take two critical steps: a) the creation of the First Barré Plan during a meeting in The Hague in 1969; and b) the creation of the Second Barré Plan, where the European Commission proposed the coordination of monetary policies to provide currency stability.
Once the American government decided to stop the convertibility of the dollar to gold the French government started to question the privileges of the dollar. The result was the Werner Plan which was launched in 1970 and proposed the pursuit of monetary integration through a mechanism of peg exchange rates in a three stages process in a ten years period. This was also accompanied by the free movement of goods, services, persons, and capital. However, it was not clear how the EEC members were going to achieve it (Strange, 1998). Again, two approaches on monetary issues were taken: 1) the monetarists, led by France, were in favor of the peg exchange rate system; and, 2) the economists, led by Germany, supported the economic convergence based on anti-inflation policies (Strange, 1998).

In the debates on an international monetary reform, Germany did not support France’s wishes to reduce the dollar’s power. This partly because Germany’s security was still depending on American military capabilities against any possible threat from the USSR, and also because American economic assistance had helped Germany to achieve economic growth during the 1950s and 1960s (Strange, 1998).

The imminent end of the Bretton Woods System was the cause of the failure of the Werner Plan. This event promoted the creation and function of the Exchange Rate Mechanism (ERM 1). The debate between monetarists and economists also played and important role in the failure of the Werner Plan once the EEC members realized that the pegged exchange rate system did not allow them to have margins of fluctuation (Arestis et al., 1999). Instead of following the proposals of the Werner Plan, a new system was adopted in 1972. The ERM 1 established parities that
could move through narrow margins of fluctuation ("the snake in the tunnel") and whose movements were permitted in respect of EEC countries against the dollar (Strange, 1998; Arestis et al., 1999). But the ERM 1 did not last enough to accomplish its goal of EMU. Soon, the United Kingdom, Ireland, and Denmark abandoned the project, and were followed by Italy and France, who were not able to support the pressure over their national currencies. This led to the creation of a Deutschmark zone leaving the weaker currencies out of the mechanism (Tsoukalis, 1997). One of the reasons that can explain the origin of the Deutschmark zone was the fact that in the mid-1970s the logic of the market, which was facing a weak dollar, led to change dollars into German marks, instead of liras or French francs (Strange, 1998).

However, the ERM 1 was not completely abandoned. In 1979 the ERM1 was replaced by the creation of the European Monetary System (EMS), after a meeting in Copenhagen in 1978. The new face of the ERM 1 was in track supported by a stronger dollar, as a result of the new policies adopted by the Fed (a reduction of the national money supply, restrictions to credits, and an increase in the interest rates). The crisis was over and the markets were working again without any serious threat in the short term.

During the 1980s, and in the first years of the 1990s, Spain, Britain, Austria, and Portugal also joined the ERM 1 increasing the area of influence of the Deutschmark and made Germany the leader of the EEC. This leadership was reinforced by the Basel-Nyborg Agreement in 1987. The Basel Agreement was used to link the exchange rates to those of the Bundesbank in order to maintain the ERM 1 on track. This new optimism over the creation of a future monetary union
was reinforced by facts such as the launch of the Single Market, the improvement of the relationship between France and the European Commission\(^3\) due to the designation of Jacques Delors as the new Commission’s President which gave France the opportunity to control the influence of Germany on monetary issues in the Deutschmark zone, and the fall of the Berlin Wall and the end of the Cold War that gave Germany independence from the United States in the defense field. But this optimism about the future of the EMU was going to be transformed very soon in a widespread pessimism due to the changes in the international context as well as in the internal environment.

The financial crisis in the 1980s preceded by the rise in oil prices created a new uncertainty for the EMU leading EEC members to take unilateral decisions to keep their currencies stable. Internally, the German government supported the exchange of western and eastern marks in a 1 to 1 parity. Despite opposition from the Bundesbank, the government of Chancellor Helmut Kohl approved the use of extensive finance measures\(^4\) which resulted in high inflation rates, increases in the interest rate, and in the strengthening of the Deutschmark, while added pressure on the other EEC member’s currencies (Strange, 1998). Between 1992 and 1993, Britain—who had been accepted in the EMS again in 1990—, Italy, Ireland, and Denmark devaluated their currencies forcing them to withdraw from the EMS once again. France was saved due to a massive intervention by the government to keep the French franc in the system.

\(^3\) France was very skeptic on the role of the Commission during the De Gaulle’s Administration

\(^4\) This finance measures were primarily focused on rebuilding the obsolete infrastructure of Eastern Germany through government spending, which resulted in high budget deficits
In 1988, the European Council asked Commission President Jacques Delors to head a committee to develop a technical framework for achieving monetary union. In 1989, Delors Report was published and it stressed the importance of three major areas where the EEC members had to reach a consensus: employment, inflation, and exchange rates (Andrews, 2002). The European countries were facing troubles due to the financial crisis of the 1980s and they were losing competitiveness against American firms (Arestis et al., 1999). The Report helped to put the EMU issue again on the table, arguing that since the common market established in the Treaty of Rome had helped the original EEC countries to achieve economic growth, the completion of a single market would do the same now, if it could have a mechanism for improving decision-making and for strengthening the market mechanism. It recommended a three stage approach to monetary union and a single currency (Arestis et al., 1999):

1) The convergence of performance and cooperation in monetary and fiscal policies. To complete the common market, all restrictions to the movement of capital should be removed; all countries should enter the ERM 2 at the narrow band and take measures to encourage the convergence of key macroeconomic indicators. In this case, the Committee of Governors was given the task of coordinating policy;

2) A transition stage was set to consolidate the procedures established in stage one and to create the institutional framework. A European System of Central Banks (ESCB) would coordinate the independent monetary policies of member states and would also seek to achieve harmonization of supervisory and regulatory functions;
3) The irrevocable fixing of participating states’ exchange rates while national central banks would relinquish control of domestic money supply to the EC institutions. Eventually national currencies would be replaced by a single currency: the Euro.

The first stage started on July 1, 1990. All the restrictions to the movement of capital were abolished and the Treaty of Rome was revised in order to establish the required institutional structure. An intergovernmental conference on EMU was convened which resulted in the Treaty of the European Union (Maastricht Treaty) on February 7, 1992, coming into force on November 1, 1993. It introduced the Protocol on the Statute of the European System of Central Banks and of the European Central Bank, and the Protocol on the Statute of the European Monetary Institute (EMI). The second stage began on January 1 1994 and the Committee of Governors ceased to exist to join the Council of the EMI. The ERM 2 was adopted to prepare the work on the future monetary and exchange rate relationships between the euro and the other EU currencies through the establishment of irrevocable conversion rates. On June 1, 1998 the EMI ceased to exist to establish the European Central Bank (ECB). Finally, the third stage started on January 1, 1999 with the introduction of a single monetary policy under the responsibility of the ECB (European Central Bank, 2005).

With the third stage the Economic and Monetary Union was formally established in the form of the Eurosystem, integrated by the ECB with its six-member Executive Board, and the twelve National Central Banks (NCBs) with its Governing Council of the European System of Central Banks. The ESCB Council would
determine the broad lines of monetary policy and the Board (of the Central Institution) would be responsible for its day-to-day execution (Heinsohn and Steiger, 2002). The euro came into theoretical operation on January 1999 between the eleven members of the EU (Greece joined in 2001; Britain, Denmark, and Sweden remain out of the Euro zone), while its physical operation began on January 1, 2002. The experience acquired in the last four decades – characterized by external and internal crises that made attempts for a monetary union fail – motivated the EU authorities to implement new and strict measures to be part of the EMU. As a consequence, a convergence criterion was established for those EU members that wanted to participate in the Eurosystem which consisted of:

1. Inflation rate not to exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5%;
2. Average exchange rate not to deviate by more than 2.25% from its central rate for the two years prior to membership;
3. Long-term interest rates no to exceed the average interest rate of the three countries with the lowest inflation rate by 2%;
4. Budget deficit not to exceed 3% of its GDP; and,
5. Government debt not to exceed 60% of its GDP

However, the convergence criterion has raised many questions about its effectiveness and flexibility, particularly because of the low growth rates shown by the EU members in recent years, characterized by the low creation of jobs. The important feature about the convergence criterion is that it has helped to reduce
the asymmetries of the different members of the EMU to achieve a smoother insertion into the Eurosystem.

2.3 Conclusion

The creation and development of the European Union has been driven by the achievement of a political objective through economic means. It began with the regulation of certain key resources to then move to the creation of a single market for goods, services, capitals, and people. In this process of economic integration, the EU members realized that monetary integration was a crucial step to reinforce economic development. But the establishment of the EMU had not only economic purposes. Many policy-makers and scholars also see it as a means to foster political integration as long as the benefits derived from it can reach the European population in the form of jobs, economic growth, and social development.

Although the road taken by EU members to achieve the high level of integration they enjoy today has not been easy, it is important to highlight the political will they have shown to their national sovereignty in the pursuit of the creation of an entity that has helped them to strengthen Europe as a region, not only in the economic field but also in the political realm. This is evident in the Maastricht Treaty which can be considered a political compromise where each country gave some ground in order to gain some movement on an objective: the single currency and foreign policy arrangements satisfied France’s ambitions while the increase in the power of the European Parliament and the direction of the money policy met German
interests (Arestis et al., 1999). The EMU was not considered an end for itself, but as a mean to achieve social and economic progress.

The EMU has a political dimension: it entails the transfer of national monetary policy decision-making powers to a supranational entity – the ECB -. This transfer of sovereignty shows a convergence of political will, where EU members have achieved a high degree of harmony in monetary attitudes and preferences. The introduction of the single currency has helped to foster the completion of the single market where the costs and risks of currency exchange are eliminated. And finally, it was a political decision to start a monetary union between a group of countries which did not form a political union (Issing, 2001).

However, the EU and EMU are far from being a completed task. Too much remains to be done, analyzed, and improved in the development of the monetary union established so far. It is important to recognize that the EU is a major player in the international arena and the further it moves toward economic and political integration, the bigger and stronger it becomes as a key actor in the global politics. Although a single currency is already circulating in the EU economies, there are many key issues that require a deep revision in order to continue with the process of integration. In this respect, the creation of the Euro has raised many questions of how it will impact the current international monetary and political relations, and how the EU will face and handle the challenge of having one of the top international currencies.
THE INTERNATIONAL ROLE OF THE EURO

After the U.S. dollar, the euro is considered the second most important international currency, followed by the Japanese yen. The creation of the EMU in the form of the Eurosystem and the launch of the euro in 1999, according to the established by the Maastricht Treaty, raised some questions about the performance of the common currency and its relation to the U.S dollar. The expectations it raised led to speculations if the new currency could become a major rival to the US dollar’s supremacy in the International Monetary System and, eventually, even replace the greenback as the top currency.

With the appearance of money as the main vehicle for transactions, several currencies have been considered international in their use in different historical periods. What determines the replacement of one currency for another has depended on the international conditions of a particular time, as well as, the internal situation of the issuing countries. The most recent case is that of the rise of the US dollar to replace the British pound in the 20th century when British power was reduced by two World Wars and the United States established itself as a superpower both in the political as well as in the economic fields.

The second part of the 20th century witnessed the creation and development of what is considered the most successful case of economic regionalization. Several
European states decided to avoid more wars through economic means, which eventually led them to achieve both commercial and monetary integration in the form of a common currency, the euro. In the process, the EU has not only solved the inter-state conflicts that had characterized European history, but it has also helped to make the EU and its members major players in the global arena once again.

In the present study the focus is on the performance of the euro and the Eurosystem in the International Monetary System, the way European authorities face the challenge of having a single currency, the position the international financial actors adopt in respect to the euro, and the future of the euro as an international currency.

3.1 The euro as an international currency

There is no doubt that the euro had shown a rapid growth as an important currency in the International Monetary and Financial Systems even before its physical appearance in 2002. Although the euro has been in use for a short period, it has been set in the second place of the top currencies. But, what has made it possible for the European currency to become such an important player in monetary affairs? The use of the euro as an international currency is determined by three main factors: 1) the demographic and economic importance of the euro area and the degree of openness of the EU economy in relation to the rest of the world economy; 2) the rate of development and level of activity of the European
financial markets and institutions; and, 3) the stability of the currency and the credibility of the ECB to guarantee the maintenance of the purchasing power of savings (Solana, 1999).

However, the euro is still far from replacing the US dollar as the first international currency. In the same way that the factors mentioned above have contributed to strengthen the position of the euro, it is important to note that there are also certain weaknesses within those factors which are provoking a slow adoption of the euro in particular areas. When the euro appeared, it generated great expectations about if it will replace the US dollar in a short period of time. But those expectations have been replaced by more cautious analysis and arguments about the rise of the euro as the top global currency and the persistence of the US dollar in the privileged place. What are the conditions that have been determining the performance of the euro in the International Monetary System? We can analyze those factors from both an economic and a political perspective.

The demographic and economic importance of the Eurozone

According to Tavlas (1998), the larger the country’s share of world trade, the more likely its currency is to be familiar to traders and the most useful is that currency as a unit of account and a medium of exchange. The size of a country’s transactional network determines, in an important manner, the degree a currency is used in international transactions. A country’s share of world trade is determined by two main quantitative factors: the demographic constitution of a country,
particularly the number of inhabitants, and its economic position, that is its GDP participation and the degree of openness.

General data shows that:

- **Population:** In the case of population in the EU – 385 million inhabitants in 2005 for the 25 countries and 310 million for the euro area which represent the 7.2% of the world population– it exceeds the population of the United States – 295 million inhabitants in 2005 which represent the 4.6% of world population\(^5\);

- **Gross Domestic Product (GDP):** in 2005 the EU’s GDP was of $11 billion dollars while that of the United States was $10.9 billion dollars;

- **Degree of openness:** The degree of openness of an economic area is also a relevant factor as regards the international impact of its currency. In this respect the euro area is more open than the United States, with a percentage of external trade of around 14.6% of GDP, as compared with 8.8% for the United States\(^6\). In 2005 the percentages of FDI for the EU and the United States were of 25.7 and 31.3 respectively; while the percentages of investment that European and American companies made overseas were of 46.1 and 24.8 respectively.

The considerable participation of the EU in world trade and the increasing population derived from the most recent enlargement have given a bigger projection

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\(^5\) Sources: Eurostat, European Union official website, and INEGI.

of the euro in the international arena. The future adoption of the currency by the new members has already amplified the area of influence of the EU, since they have been linking their monetary activities around the euro even before they were fully accepted. The opposite case is that of Sweden, Denmark, and the United Kingdom, who have chosen to stay out of the EMU and whose future adoption of the euro still remains in doubt. The entrance of these three countries in the EMU could increase the weight of the euro in the international financial system, particularly with the participation of London, one of the most important financial centers.

The influence of the euro is not only constraint to the borders of the member-states. The Euro-time zone integrates those countries and regions that could experience an influence of the euro in areas such as trade, finance, and development aid. In general, the Euro-time zone is formed by countries physically located in the periphery of the EU such as the Eastern European countries, many of which have applied for EU’s membership, and Mediterranean and Middle East states; it also includes those regions with particular links to European states like countries that were part of the former European colonies in Africa, the Caribbean, and the Pacific (ACP).

The importance of expanding the transactional network of a currency implies developments in different economic, demographic, and geographic factors as it has been seen. All those elements help to promote the use of a currency beyond the borders of the region and, consequently, to enhance the position of the euro.

The progress achieved by the EU in the internal liberalization of trade due to the creation of a single market and the important presence it has gained in the
international trade system, have made the EU a major player in trade negotiations and forums, equalizing the weight of the United States and acting sometimes as a partner and sometimes as a powerful challenger of American decisions.

The financial dimension: the European Financial Markets

The International Financial System has been considered one of the most important elements of the global economy. Susan Strange recognized this feature when she explained that finance was one of the four pillars of the world economy because of its fundamental function in the creation and allocation of credit and the international monetary order. The International Financial System has shown a rapid evolution both in the products and benefits it provides as well as in the volume of transactions that take place around the world, all of that derived from the changes in technology and the deregulation of financial markets.

The case of the European Financial System can be differentiated from other financial centers like the United States or Japan. The European Financial System – in particular the continental European model – is characterized by the dominant role of banks in channeling savings toward investment opportunities, engaging directly in the full range of securities activities, and establishing linkages between banks and insurance companies. In addition, in many European countries the widespread presence of central or regional governments in the ownership structure of banks has been seen as a way to alleviate the risk of systemic instability in the financial system (Padoa-Schioppa, 2004).
The creation of the euro has fostered the integration of the European financial markets. The transaction costs have shown an important decrease since the euro appeared, facilitating and expanding the transactional network of financial assets, especially because of the elimination of exchange-rate uncertainty. We have to remember that the establishment of well developed financial markets provides a fundamental ground for the international use of a currency. Financial markets must have particular characteristics such as the freedom from controls, a wide variety of financial instruments, and the development of secondary markets.

However, the European financial markets are still far from achieving a total integration that could improve the performance of the euro. The Euro area financial markets remain far less liquid, less diverse and less integrated that the US markets, all of which have made investors reluctant to switch from dollar-into euro-denominated assets (Sapir, 2006). One of the reasons for the lack of total integration of the Euro-area financial markets is the considerable participation of banks in financial transactions, contrary to the case of the United States where most of them are conducted by individuals, corporations, pension funds, or other institutions.

The remarkable element in the process of integration of the European financial markets is that it has not been the same for the different market segments, nor for all the countries:

— The foreign exchange markets saw the most tremendous changes, but also the least spectacular ones, because it is evident that the introduction of the euro stopped all trading between the Euro-area currencies (Lederer, 2003)
Another market that shows an almost complete integration is that of the money markets characterized by their high liquidity and the creation of the Euribor – the deposit rate used in European interbank market and which forms a common form of pricing within the Euro area (Lederer, 2003). However, the Repo-market segment has shown a slower development due to differences in the regulatory, legal, and tax environment as well as to differing markets practices (Galati and Tsatsaronis, 2003).

The opposite case is that of the loan markets where – as it was already mentioned – most of the loans are acquired through banks and not through wholesale markets. These markets are furthermore still domestically dominated, because in the Euro-area banks give still 90 per cent of their loans to domestic customers and receive 91 per cent of their deposits from the same nationals where they headquarter is located (Lederer, 2003).

The bond market has been the financial market segment where the influence of the single currency has been the quickest and most pronounced. In part this reflects the fact that the European bond market, in both its government and private components, had a fairly international character even before introduction of the euro (Galati and Tsatsaronis, 2003). The case of the bond market integration is due to the decision of market actors in diversifying their portfolios by investing on sectors instead of a country’s preference. Among all the
capital markets, the **equity and derivative markets** are considered to be the less integrated, partly because they started to integrate recently.

Although financial exchange has been extensively deregulated, the process of financial integration has also been considered one of the most important issues on the policy agenda of the EU. In 1998, the European Commission proposed a Financial Services Action Plan (FSAP) to establish deep and liquid markets in Europe and to broaden consumer choice (Freixas *et al.*, 2004). These policy actions are particularly relevant if we consider that by making European financial markets more efficient and transactions costs cheaper, the emergence of the euro as an international currency will be strengthened. So far, the euro is being more used as a store of value than as unit of account and medium of exchange. The dollar remains the first choice for commercial transactions and as a vehicle for other currencies’ trade.

The inertia in monetary practices is one of the key factors that keep the US dollar as the main top currency. This inertia is caused by the uncertainty a change in a new currency can bring. So far, the European currency has had a relatively good performance, but, because of its short age, many doubts still remain about its improvement as unit of account and medium of exchange. The clearest indicator of a money’s international status is the amplitude of its use as a medium of exchange in the foreign exchange market; top currencies are bought and sold not only for direct use in trade and investment, but also as a low-cost intermediary – a “vehicle” – for the trading of other currencies (Cohen, 2003).
In conclusion, a deeper and wider development of the European financial markets is needed to strengthen the international status of the euro which, at the same time, will bring the benefits of certainty for investors when trading with assets denominated in a strong currency backed by well-established financial markets.

*The Eurosystem, the ECB, and the euro: who makes policy?*

The Maastricht Treaty established the Eurosystem as the central institution in charge of conducting the single monetary policy in the EU. The Eurosystem consists of the European Central Bank (ECB) as the head of the system, and the European System of Central Banks (ESCB). The ECB Executive Board is in charge of the day-to-day business of the ECB and the execution of the decisions taken by the ECB Governing Council; the Executive Board is composed of the President of the ECB, the Vice-President, and other four members designated by the European Council. The ECB Governing Council is the body in charge of decision-making in monetary affairs and it is integrated by the Executive Board and the governors of the Central Banks that participate in the EMU. In total, the Governing Council is formed by eighteen members that decide the guidelines for the Eurosystem and the single monetary policy.

The primary objective of the Eurosystem is maintaining price stability, while economic growth and employment are second objectives. In order to achieve this goal, the ECB has been granted a high degree of independence from political interference by national governments. The Eurosystem combines a federal with a
national role in the working process of policy-making: decisions are taken by the Governing Council of the ECB; implementation of decisions is made by the Executive Board; while the execution is done by the NCBs and the ECB (Padoa-Schioppa, 2004). However, it is not as clear as it may sound. Certain tasks are assigned to national central banks, while others are exclusive matter of the supranational institution. Besides, the Maastricht Treaty establishes the participation of the Council of Economics and Finance (ECOFIN) in the determination of the exchange rate policy. This situation make us think about the specific functions that each actor has to play in the determination of the EU monetary policy, where the only clear point is that functions are particularly unclear about who is in charge of conducting and representing that single monetary policy.

There is also the problem of a “crowded” Governing Council in the short term, when the new members of the EU become part of the EMU. The decision-making process will face a bigger challenge when this body grows from its 18 members to more than 30. A solution will have to be found in order to make the decision process more effective and to provide more credibility to the ECB.

The confusion that the policy-making process creates is not only restricted to Europe. The lack of formal representation for the euro in the international forums creates an image of a multiplicity of positions in monetary affairs, particularly in the IMF where there is not a single body that represents the interests of the whole EU. This case has been extensively criticized by scholars (see Bergsten, 2005; Cohen, 2004; and Eichengreen, 1997), international organizations, and governments. The situation of the EU in the IMF has been attributed to the fact that the IMF “is a country-based institution that then will have to require an amendment of the
Articles of the Agreement before other international entities such as the EU could become members” (Kiekens, 2002). To “solve” the case, the EU members have adopted common positions when it comes to their participation in the IMF, but this coordination has been entirely informal, which makes more evident the need for deeper integration on issues related to the external development of the EU.

A possible solution to the external representation of the EU is the formal establishment of the Euro Group – an informal body integrated by the eurozone finance ministers – as the institution in charge of this task. A single body that represents the EU’s position on monetary and financial matters could provide a negotiating authority compared to that achieved in international trade negotiations. The risk of maintaining separate representations for the EU members, as Benjamin Cohen has expressed, is a disincentive for market actors: “…fragmented decision making might fail to provide a clear indication of official intentions…” (Cohen, 2004)

The euro as a key element for political integration

The euro does not have behind it a political power as strong and as cohesive as that of the dollar or other currencies. The euro is issued by a union made up of multiple jurisdictions, not by a single political jurisdiction as in the case of the US dollar. The euro has given a tremendous impulse to the process of integration not only in the economic aspect, but also in the political one. The common currency has led to the convergence of policies in monetary and financial issues. It has proved that it is possible for a currency to perform as one of the most important
international currencies without being backed by a single political power. So far, the credibility achieved by the ECB has been one of the key elements that support the euro in the international currencies market. The question is up to what point the lack of a strong political power will foster or diminish the international power of the euro?

The value of a currency is no longer determined by an intrinsic feature as it used to be in the times of the gold standard. Currently, the use and value of a currency depend on its purchasing power, based on the trust that like-minded transactors have in a currency’s general use and acceptability (Cohen, 1998; Padoa-Schioppa, 2004). Public and market actors may be more confident in a currency which, in addition to the guarantee of an independent central bank, has the support of a strong political power. This is an assertion in favor of continuing with the decision to build a European political structure.

Monetary integration has been considered a fundamental piece in the search for political integration. However, it is also considered that political integration will follow quickly if monetary integration entails significant fiscal centralization, but slowly if it does not (Eichengreen, 1996). Fiscal policy remains at a national level; the power to tax and spend depends on the national governments wishes to distribute income and wealth. The importance of fiscal policy decentralization lies in the fact that large budget deficits – beyond those established in the Maastricht Treaty – can undermine the credibility of the euro (Tsoukalis, 2005). According to Eichengreen (1996), monetary integration would involve fiscal restrictions, and fiscal restrictions would lead to the centralization of fiscal functions, prompting the move to political union.
Also, the issue of accountability in monetary and fiscal matters remains a central factor that determines the political credibility of the euro and the ECB. Accountability is required to grant transparency in conducting monetary policy. Contrary to the US Congress ability to supervise monetary policy, the European Parliament lacks the authority to change the charter and mandate of the ECB (Padoa-Schioppa, 2004). This lack of accountability is a clear sign of the limited political integration of the EU.

The EU is a “polity in the making” (Padoa-Schioppa, 2004). The creation of a common currency is one step in the process of integration, not an ultimate goal. However, reinforcing the euro and the monetary and fiscal policies may help to foster political integration in the EU which, at the same time, will strengthen the power of the euro.

3.2 The political power of the euro

The euro will make an attractive alternative to the dollar as a safe haven in the event of shocks to the world economy. It is very clear that the internationalization of a currency depends basically on the demand side of the market. Although the ECB has stated that it does not intentionally foster the euro as an international currency, it cannot be denied that the currency has been gaining more power in the international scene.

The economic objective of creating a single currency is to complement the single market established long time ago in order to maintain price stability inside
the euro area. The political objective is to promote political integration of the EU members. The question is, then, how will the EMU authorities deal with the internationalization of their currency even if it is not a goal? More important, why the EU authorities would not like to take advantage of the benefits that a powerful currency brings with it?

The economic size of the EU makes impossible to limit the use of the euro as a regional currency only. Its transactional network, the importance of its financial markets, and the evolving process of political integration strengthen the power of the euro as an international currency. However, the Eurosystem is, or at least it officially seems, focused on working on its main task of maintaining price stability.

It has been seen in chapter one that a powerful currency brings advantages to the issuing country—in this case the issuing bloc: a potent political symbol to promote a sense of national identity; a potentially powerful source of revenue to underwrite public expenditures— or seigniorage; a possible instrument to manage macroeconomic performance; and a practical means to insulate the nation against foreign influence or constraint. In the case of top currencies extra seigniorage is created, financial institutions provide earnings derived from loans and investments, and the vulnerability to changes in the value of the currency is lowered. But a powerful currency also comes with political advantages: adoption of independent positions to acquire political power, exercise influence, and achieve foreign objectives. For the particular case of monetary union, the common currency strengthens the power of the entire group of member-states to act in the market, to avoid external dependence, to guide macroeconomic performance, and promote a sense on community.
It is clear that the EMU purpose is basically to insulate the Union against changes in the value of the currency. It was one of the driving forces in the creation of the euro. The multiplicity of national currencies inside the EEC members and their dependence on the US dollar under the Bretton Woods System, made it evident that the instability of the currency leader could provoke a serious damage to their economies, by raising inflation and transactions costs. With the euro that risk has almost disappeared.

Also, the euro has helped to promote the sense of European national identity that characterizes sovereign states. The political symbolism of the currency is creating a new vision of the European identity, while it reinforces the support for political integration.

But when it comes to the creation of extra seigniorage, the management of macroeconomic performance, and the exercising influence and political power to achieve foreign objectives the EU remains silent. In fact, it seems evident that in the case of macroeconomic performance and participation in the international forums, where it can actually exercise the power and influence such a union, the EU retreats to the national ground where a multiplicity of voices and interests reflects the lack of harmonization and agreement on crucial issues such as the improvement of the International Financial and Monetary Systems. The monetary union is supposed to pursue the power of a group of states, but the EU is still speaking separately at the international level.

The case of creating extra seigniorage to underwrite public expenditures is definitively not a purpose of the EMU. Fiscal policy is determined according to national guidelines; the ECB has been granted independence to avoid political
pressures and avoid price instability derived from a wrong spending performance. However, sooner or later the decision-making of fiscal policy will have to be assumed by the European authorities in order to promote economic growth needed in the EU in the form of the creation of jobs to reduce the increasing rate of unemployment. More important, the centralization of fiscal policy at the European level will promote the creation of the political structure of the EU.

**3.3 Conclusion**

In its short time of life, the euro has been rapidly placed among the three most important international currencies along with the US dollar and the yen. Although it raised many expectations about the challenging role of the euro for the US dollar, it has been evident that the newly created currency is still far from replacing the greenback as the top currency, at least in the foreseeable future. So far, the most important factors that have helped to promote the euro’s position are those related to the economic weight of the EU in trade, first, and in the financial markets, second. The potential of the euro to challenge the dollar as the top international currency will depend on several factors:

1. The growth of the EU’s transactional network outside the Euro-time zone, to include those countries to which the EU does not have strong economic ties;
2. The implementation of mechanisms and policies to develop deeper and wider European financial markets in order to enhance the participation of the euro in international financial transactions;

3. The promotion of structural changes to improve the performance and accountability of the proper bodies required in the creation of the single monetary policy to assure the effective implementation and supervision of the designated tasks, all of which will derive in the strengthening of the EMU credibility;

4. The centralization of fiscal policy in the European authorities to implement monetary policy and integrate all the central economic decision at the European level;

5. The creation of a formal institution that represents the EMU at the international level in forums and organizations, where it can exert the powerful influence obtained by achieving monetary union;

6. The building of a European political structure that could bring a strong support to the euro. The value of a currency does not exclusively depend on the performance of the central bank, but also on the social, economic, and political attributes of the issuing entity.
CONCLUSION

The establishment and development of the EU, the EMU, and the euro are the perfect example of the relation between politics, power, and money. The EU was conceived as a common project to achieve political stability through economic means in a continent characterized by a long history full of periods of wars and peace.

The EMU is not the final goal. The EMU and the euro are two of the most important steps in the process of European integration. The road walked by the EU members has been full of obstacles and opportunities, of up's and down's that have made possible the achievement of such an important objective.

The advent of the euro raised many expectations. Most of them tended to consider the common currency as a potential challenger of the US dollar. The euro is the second most important international currency and it definitively has many of the attributes to become the number-one top currency. However, there are also remarkable factors that lie behind the slow ascent of the euro to the first place in the 'currency pyramid'. To begin with, the euro and the Eurosystem are too young. As they grow up, experience will be acquired and improvements in the decision-making process and the operational tasks will be made. Besides, inertia in monetary affairs plays a determinant role; new participants have not gained enough credibility for market actors when they make monetary choices.

To gain such credibility and trust, a currency must be backed by a stable social, cultural, economic, and political system. For the people money has to do with the
perception of the society to which they belong and, ultimately, with their culture (Padoa-Schioppa, 2004). Benjamin Cohen (1998) has argued that a territorial currency helps to homogenize diverse and often antagonistic social groups. But this idea can also be applied for the EU. The creation of the euro has not only helped to reinforce economic integration, but also to establish the notion of a European identity. The adoption of this European identity is a central factor that will strengthen the support for political integration and the establishment of a European political system. In this context, the relationship between politics, power, and money lies in the fact that the three terms are related in a way that they reinforce each other: political stability is key to economic growth and vice versa. Political stability and economic growth reinforce the structural power of an international entity, in the case of the EU, to reshape the structure of the world economy.

Although the euro has acquired more structural power, the EU is cautious about strengthening its presence in the international arena. The arguments the EU offers to explain such attitude refer, first, to the primary objective of the EMU to maintain price stability inside the region; and second, to avoid a rush to the euro, on the grounds that participation without adequate preparation could prove unmanageable, straitjacketing governments at just the time when flexibility will be most needed (Cohen, 2004).

The monetary alliance of the EU represents many challenges not only to the EU members, but to other states and market participants. For the EU, it entails structural reforms in the fiscal policy, the further integration of European financial markets, the coordination of European monetary authorities, the creation of a
formal body that represents the EMU and the euro at the international level, and – above all – the creation of a political structure.

Finally, it is important to say that the euro and the Eurosystem have contributed to transform the way to think about money and its deterritorialization, and to reinforce the power the EU has acquired to reshape the relations among states and non-state actors in the structure of the world economy.
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