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Paper for: SGIR 7th PAN-EUROPEAN CONFERENCE, Stockholm, Sept. 10, 2010

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Getting Real? The International Role of the Euro after the Financial Crisis

Abstract: *This article uses the global financial crisis as a case study to evaluate and apply new research on monetary power. International currencies, such as the dollar and the euro, are supposed to create substantial political and economic benefits and, occasionally, some burdens for their issuing countries (and societies). Major macro-economic shocks such as the financial crisis should magnify and illustrate at least some of these effects. The analysis focuses in particular on how the euro has fared in the past few years.*

Since at least the end of World War II, the American dollar is the world's leading international currency. This role encompasses, among others, its use as reserve instrument in almost all other countries, as anchor for a substantial number of other currencies, or as medium in which the major commodities of world trade are priced. There has been controversy ever since as to how much the US benefits from this status of its currency. Some even argue that such a distinction is actually a burden.¹ But there is little doubt that the international role of dollar is closely connected to the status of the United States as the preeminent superpower. Dollar dominance is also one of the fundamental facts of the global political economy which would start to look very different in case the dollar would be replaced by another currency. In the past couple of years, many experts have observed that since the introduction of the euro the monetary world is moving towards a more bipolar system (Cohen 2009; Eichengreen/Flandreau 2008; Goldberg 2010; Norllof 2009). There is a continuously expanding body of work which tries to quantify the reach of global currencies and offers assessments as to how far the euro has come in terms of replacing

¹ Kirshner (2008) briefly reviews the debate. See also Bergsten C.Fred, *The Dilemmas of the Dollar* (New York University Press, 2d ed., 1996).

the dollar.² Predictions diverge, though most agree that the euro is still a distant second. But the important fact is that for the first time in half a century the dollar has now a credible alternative. This alone dramatically changes the options and incentives available to official and private financial actors. The discipline is only beginning to understand the political and economic consequences of such an emerging currency duopoly. The financial crisis allows us to offer a first tentative assessment.

This paper briefly summarizes the ups and downs of dollar and euro during the crisis. It notes that not much has changed with respect to the overall ‘balance of power’ in the international monetary system. However, the crisis has underlined the advantages of owning international currencies. I identify three recent research strands which help to specify these advantages and, based on these, assess how the internationalization of the euro influenced the reaction of the Eurozone to the crisis. I argue that, in contrast to the US which heavily profits from cheap credit, the most important effect of the international role of the euro continues to be the autonomy to pursue stability-oriented policies. However, as a result of the sovereign debt crisis, the Eurozone also began to capitalize on easier access to cheaper credit.

Has the Crisis undermined the dollar’s and the euro’s role as international currencies?

To many observers, the subprime mortgage crisis initially appeared to herald the end of the dollar as undisputed global currency leader (Munchau 2008; Eichengreen 2009). The enormous accumulation of dollars in the international system since the late 1990s was seen as one of the core drivers of the global capital glut which fed the speculative excesses of the pre-crisis decade. Was now the time when the chicken finally came home to roost and US profligacy would result in a collapse of the dollar’s value? Such speculation was compounded by the huge expansionary program of the American government which was deemed necessary to counter the effects of the meltdown. Many believed that in conjunction with inflation and/or a long-lasting recession this would undermine confidence in the dollar. In addition, Wall Street’s role as center of global

² For recent assessments, see: ECB 2010; Goldberg 2010.

finance which had made investments in dollars so easy and attractive seemed to have taken a massive hit.

Dollar pessimists, however, were soon silenced by the greenback's continuing role as safe haven currency while the crisis kept rolling along. Even more importantly, the euro, as the only credible contender to the dollar, soon descended into spectacular troubles as the Greek predicament alerted markets to the serious sovereign debt problems of many Eurozone economies. Suddenly it seemed as if the European currency's survival was at stake, not to speak of any advancement towards global preeminence (Garnham 2010). Rumors spread on how official and private investors were unloading their holdings of euros. At the time of this writing, however, the shrillest alarmist voices have calmed down and some of the attention has been re-directed towards the problems of the dollar. As consequence, third currencies began to look very attractive to many investors. In mid-2010, the Japanese yen suddenly became the safe haven currency attracting record amounts of investments despite Japan's enormous debt and budget deficits (Garnham/Whipp 2010). Export-oriented Japan tried to counter the resulting appreciation with increasing desperation. Switzerland, too, invested enormous sums and lost a lot of money in an attempt to counter upward pressure of the Swiss franc caused by huge inflows in early 2010 (Garnham 2010). The reaction of both countries showed that they were not at all happy with their status as part-time substitute for the Big Two.

Overall, however, currencies such as the yen or the Swiss franc play only a rather marginal role. This is also true for the renmimbi, despite some timid steps towards a more prominent international role for the Chinese currency. The financial crisis has not fundamentally reshaped the monetary system and there is still no serious contender for the dollar and the euro. The ECB's recent report on the 'International Role of the Euro' (2010) confirms that on all indicators. The dominant positions of the dollar and the euro have not been affected substantially. The ECB concluded that shifts in global currency use obviously happen only at an extremely slow pace and that the inertia in the system was strong enough to mitigate the effects of the crisis (ECB 2010).

The really interesting question is, however, whether the effects of the crisis might have underlined the advantages and disadvantages of having a global currency, and thus shed new light on an issue which fascinates IPE scholars since the late 1960s. Obviously, a crisis of this magnitude provides an ideal real-time experiment in this respect. Such macroeconomic shocks can lead to enormous losses of wealth, and the question of distributing these losses across countries is among the core issues of the global political economy. It will be argued that the international role of the euro has helped Eurozone governments to weather the crisis.

What are the distributive and political benefits of global currencies? Some recent research

The fluctuations in the presumed global importance of the dollar and the euro are among the most closely watched phenomena in the global economy. This includes not only the world's most important exchange rate, but also the ups and downs in the various functions and uses of global currencies (for a standard classification, see table 1). Only a currency which is used to a significant extent by market participants for one of these functions can be called a truly international currency. The dollar and the euro are the only currencies of major importance in each of these areas.

Table 1: Functions of International Currencies

<i>Function of Money</i>	<i>Official Use</i>	<i>Private Use</i>
Store of Value	Official currency reserves (Reserve Currency Role)	Deposits, Loans, Bonds denominated in international currency
Medium of Exchange	Vehicle Currency for Foreign Exchange Intervention	Vehicle Currency in Foreign Exchange Markets
Unit of Account	Anchor Currency	Invoicing or Quotation currency for trade and financial transactions

Source: Adapted from Cohen (1971); Kenen (1983); Galati/Wooldridge (2006).

In most op-ed articles, blogs and many more general texts touching upon the issue of the euro's future as global currency, it is simply assumed that 'the euro gives European policy makers both global influence and responsibilities which, prior to its introduction, were the preserve of the United States' (Thom 2000: 179). Many political scientists, following the footsteps of Susan

Strange, assume that the dollar has been and still is an indispensable bedrock of American global influence by giving it enormous structural power, in particular the power to create credit (Strange 1988). This has been taken up by a large number of critical analyses which argue that a Dollar-Wall Street Regime dominates the global economy, perpetuating US hegemony (Gowan 1999). Even analyses by economists are informed by the underlying theme that a potential redistribution of wealth effects caused by currency shifts is closely related to the global balance of power. The fascination derived from the euro-dollar comparison ultimately rests on the idea that the status of global currencies indicates or causes global power shifts.

However, it is not so easy to substantiate in what sense the possession of a global currency actually bestows power on the issuing country. There are enough voices who indicate that the supposed exorbitant privilege might actually be a 'burden' in some respects (Bergsten 2008). Countries such as Germany and Japan have successfully tried to stop an expansion of the role of their currencies, and the ECB in its public statements has made clear that the internationalization of the euro is a process it sees not necessarily as desirable though it would not actively resist it. The advantages of international currencies are not as straightforward as the phrase 'dollar hegemony' suggests. Contrary to international trade, gains and losses in international monetary affairs are much harder to identify or, for that matter, to quantify. Trade is more institutionalized, nationally and internationally. Trade lobbying is mostly direct and observable, as is the distribution of political power depending on various types of resources (political, financial, reputational, etc.). In addition, the advent of flexible exchange rates, the spreading of a global paradigm of anti-inflationary policies, and the supposed ineffectiveness of currency interventions and exchange rate manipulation seemed to reduce the salience of monetary policy and its investigation to a rather low place. Hence, the strong focus of mainstream IPE on trade and other themes rather than on international monetary affairs.³ The imagined (huge) importance of global currency shifts and the quantity of actual analytical research have diverged sharply.

In recent years, however, there has been a lot of new research which moved beyond earlier rather unspecified assertions of monetary power. This work allows a much better appreciation of the political and economic consequences of shifts in global currency patterns. It is possible to

³ For example: IO has only 5 articles on monetary policies since 2005.

discern three different strands of this research. A first group of analyses, often pursued by economists and frequently sponsored by official financial institutions, looks at the different functions of global currencies which I have outlined above, assesses quantitative changes using them as indicators for global currency usage and, sometimes, tries to calculate the consequences of these changes in terms of financial gains or losses. A second research focus, pioneered by American and European IPE scholars, concentrates on the political consequences of monetary power and stresses above all the political leverage gained by the possession of a global currency. A third and still very recent research area involves the attempt to disaggregate the political and economic consequences and to look at how different groups within currency areas that owe a global currency or that are affected by global currencies profit or lose from the effects of monetary power. The argument here is that an international currency conveys advantages to specific groups, and these groups are not the same in different countries (or currency areas). Instead they reflect the respective variety of capitalism.

I will briefly summarize these three research strands, lay out in what sense they identify the advantages of global currencies and assess how the financial crisis has substantiated or disproved these claims.

What are the economic gains from having an international currency?

The next paragraphs will scrutinize indicators quantifying the various functions of global currencies with respect to potential economic advantages. It will be argued that the figures themselves are ambiguous as to positive (or negative) effects of owing a global currency; however, they provide important indications towards an analysis of the two other concepts which will be discussed in this paper: autonomy and differential accumulation.

The factor which is quoted most often in serious assessments of shifts in global currency usage is *the share of currencies in total official reserves*.⁴ According to the IMF, the dollar share shrank from 71.5% in 2001 to 64% in 2008. The share of the euro meanwhile rose from 19.2% to 26.5%, though in the past few years this trend has slowed down almost to zero, despite a gigantic growth of global reserves (IMF 2009).⁵ The most recent preliminary data from the IMF COFER database suggest that the dollar's share has declined to 61.55%, whereas the euro share increased slightly to 27.2%.⁶ This confirms that the crisis has not led to large-scale shifts.

What are the associated advantages? On a purely economic level, the importance of the indicator of reserve composition lays in the notion of seigniorage. As other nations and their citizens hold the global currency at no or low interest, they effectively extend a loan to the issuing country. However, in terms of global financial power this effect is generally assumed to be relatively small (Kenen 2003: 265). Estimated figures are in the order of 0,05% GDP (Bini-Smaghi 2009).

A more important facet of the seigniorage effect is that the country issuing the dominant currency also benefits from a liquidity premium (Portes/Rey 1998). High demand for the bonds of this country due to accumulation by foreign entities reduces the real yield which has to be paid to investors. The country thus benefits from cheaper borrowing costs. Estimating the corresponding gain is hard. Under scenario in which most investments switch from dollar to euro the premium might amount to 0.5% of GDP for the Eurozone (Papaioannou/Portes 2008: 23). Breuss, Roeger and in t'Veld (2008) who model a shift in global reserve composition towards equality between dollars and euros arrive at similar figures which derive from a lowering of real interest rates as a consequence of higher demand. But these figures are highly speculative and depend on the substitutability of assets. Overall, the direct wealth effect of seigniorage is limited.

⁴ Countries hold foreign exchange reserve to finance international transactions, to insure against currency crises or to simply neutralize trade surpluses. Currently, China holds the largest reserves, a whopping 2.5 trillion, followed by Japan with 1 trillion (July 2010).

⁵ One might argue that much of the rise of the euro in official reserves is due to the effects of the fall of the dollar over the past few years and thus purely temporary, but that presupposes that there is some hypothetical fixed value for a currency. This makes little sense. A major problem of this indicator is, however, that the IMF data on which it is based are very incomplete since many official reserve holders treat the composition of their reserves as confidential. About 63% of all official reserves are reported.

⁶ <http://www.imf.org/external/np/sta/cofer/eng/> (last accessed: Aug. 18, 2010).

Given the high symbolic value of the indicator of reserve composition it also has political effects since changes might send a powerful signal to the markets. States which reduce the share of certain currencies in the composition of their reserves signal mistrust and thus may drive up the interest the states issuing these currencies will have to pay on their bonds. This became an important issue during the second stage of the financial crisis, the sovereign debt crisis, as we shall see later.

The use of the euro as *vehicle currency* is concentrated in the regional proximity of EMU (Papaioannou/Portes 2008: 41-44). This has not changed during the crisis (ECB 2010). The dollar thus remains the world's leading vehicle currency, being part of 86.3% (out of 200% because two currencies are involved) of global foreign exchange transactions in 2007, whereas the euro share is 37% (BIS 2007). The principal advantage accruing to global vehicle currencies is the lower exchange rate risk for companies located in the core country. Though hard to quantify, this benefit can be considerable, particularly at times of volatile exchange rates. Export dependent countries, such as most members of the Eurozone, are particularly interested in a stable trading environment. Through currency hedging and out-sourcing, however, firms can limit these risks and they do so to an ever-growing extent. Additionally, countries with global currencies tend to generate most of their wealth in their huge domestic markets.

Related to this role is the so-called 'exorbitant privilege' of financing deficits with liabilities denominated in the home currency (De Beaufort Wijnholds/McKay 2007: 61). Since – allegedly – de Gaulle or his finance minister Giscard d'Estaing coined the term, this phrase has been employed to mean quite a lot of different things. French politicians in the 1960s claimed that an over-valued dollar helped US businesses to cheaply buy up European industries. Critics of US global policy use it to claim that the US is able to finance its global strategies with cheap credit without ever having to fear bankruptcy. This conveys the impression that international investors just throw valuable money at the US which the Americans then use for consumption or global expansion. But of course this money is invested in treasury bonds which eventually mature and pay interest.

A more precise and nuanced meaning of the exorbitant privilege is that the US all through the post-war period was able to borrow short and lend long, continuously earning a higher income on its liabilities abroad than foreigners earned on their generally low-yielding dollar assets. As Gourinchas and Rey (2005) in a well-known paper demonstrated: even when US liabilities exceeded its assets by a considerable margin, the US recorded a substantial net income. In case of a dollar devaluation, the US also profited from an exchange rate effect as dollar-holders' reserves shrank whereas US investments abroad rose in value. Basically, the US is at the center of a system of global arbitrage: it issues safe low-yield liabilities, mainly Treasury bonds, to risk-averse investors across the globe and invests these funds in riskier assets abroad which provide a higher return (Schwartz 2009). Habib (2009) shows that 1/3 of this is due to the yield differential⁷ and 2/3 to capital gains⁸. The Eurozone does not benefit from such an 'exorbitant privilege', reflecting the high risk premium some Eurozone countries have to pay. At least, the negative yield differential which existed prior to EMU has vanished (Habib 2009:).

It is not entirely clear whether the 'higher return' is due to international role of the dollar. It might as well be the case that the American variety of capitalism privileges high-risk short-term strategies whereas savers in most foreign societies prefer safe long-term assets. A December 2009 Study by the McKinsey Global Institute (McKinsey 2009) found that the net benefit of the exorbitant privilege to the US in 2007/8 might have been 0.3-0.5% of U.S. GDP (between about \$40-70bn). This is not enough to make the preservation of this privilege a policy-relevant consideration of US decision-makers. However, it is undeniable that the capacity of international currencies to attract investors which are risk-averse and therefore willing to receive a low interest on their investments is a major advantage. Bonds issued in truly international currencies rarely face a buyer's strike.

In a recent paper, Papaioannou and Portes (2007: 16) argued that it is the *anchor currency role* (unit of account) which in the end determines the other indicators. Currency pegs are a very potent incentive for a country to hold reserves in the currency to which it is pegged. Recent data

⁷ As explained above, the yield differential results from other countries having to pay a higher risk premium on their bonds.

⁸ Capital gains abroad are increases in the value of a capital asset, such as investment in foreign bonds, equity or real estate. The gain is not realized until the asset is sold.

suggests that the role of the euro as anchor is growing, though it is still mostly confined to areas in geographic proximity (Galati/Wooldridge 2006: 12). The policies of anchor currencies obviously have a huge impact on countries which peg their currencies to them. However, the impact is less felt by the powerful but rather by the anchored country since it loses autonomy to move according to its own whims. The financial crisis has underlined this. A vivid example is provided by the Danish experience after Lehman. When the ECB loosened monetary policy and flooded the markets with liquidity, the Danish had to raise interest rates to defend their currency (Eichengreen 2009). They also had to approach the ECB for a currency swap. Another example was provided by Switzerland. The Swiss franc became a safe haven currency during the Greek crisis. Its rise threatened Swiss exporters which are overwhelmingly dependent on European markets, forcing massive adjustment measures. The effort to limit the appreciation of the franc cost the Swiss national bank enormous sums (Ewing 2010). Switzerland had to adjust to the crisis of the euro and lost part of the autonomy to tailor its monetary policy to domestic objectives.

What are the political gains? The Notion of Autonomy

A path-breaking recent volume on monetary power edited by D. Andrews (2006) introduced exactly this notion of policy autonomy as the fundamental base of monetary power. On a systemic level this entails autonomy in policy choices, i.e. the pursuit of fundamental preferences of states, their leaders and their societies without constraints deriving from exchange rate considerations, currency crises, imported inflation, etc. On a subsystemic level, autonomy entails the avoidance of costs for domestic groups and the autonomy to choose economic strategies for state actors. In the volume, B. Cohen defined the essence of monetary power as ‘the relative capacity to avoid the burden of payments adjustment, making others pay instead’ (Cohen 2006: 50). The ultimate measure of monetary power is therefore to be able to pursue one’s goals without regard to the effects on others (‘influence’, the second dimension of power identified by Cohen, ultimately derives from autonomy). Potential adjustment costs will fall on other participants, since opting out of the monetary system is impossible for practically all market participants. The one red thread running through any analysis of US monetary policy since the ascendancy of the dollar is the America’s unwillingness to subject domestic economic strategies to movements on global currency markets, and, more importantly, its capacity to do so. There

have been exceptions, notably during the 1960s when, for reasons related to the cohesion of Cold War alliances, the US implemented various restrictions on its international monetary transactions, negotiated deals with allies, and participated in a series of international mechanisms, all designed to bolster the dollar (Zimmermann 2002). The US was also somewhat constrained by the existence of gold as alternative reserve asset, at least until 1973. Essentially, however, the US didn't have to adjust, most notably, of course, to the massive current account deficits of the past decades. Nixon's Secretary of the Treasury, John Connally, was certainly not a great economic thinker. But he captured this fundamental truth very well in his famous quip to a group of Europeans: "The dollar is our currency, but your problem". In words that created a huge buzz in the blogosphere, a high Chinese official recently pronounced the same thought: "Once you start issuing \$ 1 - \$ 2 trillion (of US government bonds)... we know the dollar is going to depreciate, so we hate you guys, but there is nothing much we can do" (Sender 2009). The capacity of the US to spend its way out of the crisis by creating massive amounts of additional debt at low yields illustrates this (Vermeiren 2010).

US autonomy for the most part was not based on a conscious strategy, or, in the language of the Andrews volume on 'influence' or 'statecraft'. Despite some conspiracy theories, there are few indications that the US actively tried to promote or preserve the status of the dollar after the 1970s.⁹ This is not surprising given the diffuse economic benefits. It was much more important that other countries had to react to the effects created by various policy choices in the center country, whether that suited their preferences or not. Europe with its integrating markets, which necessitate a high level of exchange rate stability, suffered particularly from these fluctuations. The consequence were acrimonious struggles within the Common Market concerning adjustment measures and the distribution of serious losses to European producers which resulted from the exchange rate risk vis-à-vis the dollar zone (Zimmermann 2008). Frequently, the very survival of European cooperation seemed at stake when supposedly strong currencies appreciated against the dollar and weak currencies came under pressure.

⁹ The most frequently cited episode is described by David Spiro who maintains that US protection of the oil-rich gulf countries such as Saudi Arabia hinges on a quid-pro-quo of these countries to support the dollar and American consumption (Spiro 1999). But even if such a straight-forward deal actually exists, such arrangements seem to be clearly an exception.

Isolation from the effects of dollar fluctuations was a major reason for creating EMU. Doubtlessly, the introduction of the euro has made the Eurozone much more autonomous in this sense. Exchange rate fluctuations such as the fall of the dollar since early 2002 would have led to incessant asymmetric adjustment pressure on European currencies in earlier times, whereas in the current situation Europe has suffered remarkably little impact, apart from some losses on exports to the dollar area. The Eurozone was also able to set its interest rates independently even when the Federal Reserves slashed its rates massively and embarked on quantitative easing as response to the subprime disaster. Just as the US was able to pursue a major objective, that is, to ascertain a continuous inflow of capital without inflation or other adjustment pressures, the Eurozone has been able to pursue its preferences, such as price stability and reduced exchange rate volatility.

The concept of preferences introduces a new layer and leads us to the third strand of research which asks: whose preferences? Talking about US or Eurozone preferences aggregates a huge diversity of policy objectives and obscures important differences of opinion inside those actors.

Differential Accumulation as a Consequence of International Currencies: Who Gains?

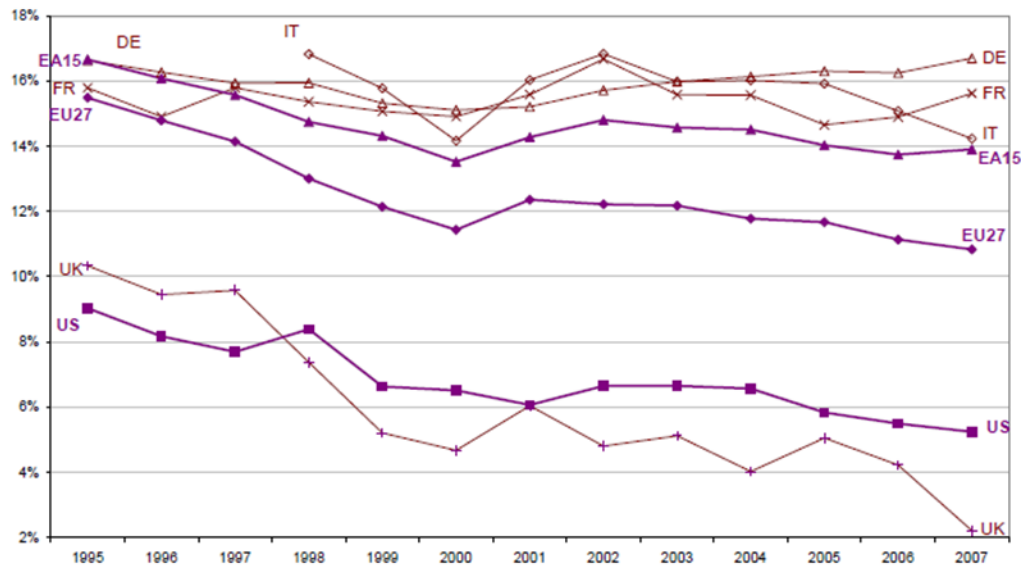
Herman Schwartz' 2009 volume 'Subprime Nation' on the origins of the financial crisis offers an alternative account of the advantages of having a reserve currency. He focuses on the wealth effect and claims that the global role of the dollar permitted differential accumulation, allowing the US to grow quicker than its competitors (Schwartz 2009: 1). He shows how foreign lending to the US kept interest rates in the American economy low, feeding a housing boom in a market which permits easy refinancing. Expanding home-ownership was one of the core domestic economic goals of the Clinton and Bush jr. administrations, substituting for the lack of an effective welfare state (Kapner 2010). This led to a prolonged Keynesian stimulus, pushing American growth rates above those of most OECD countries, and consequentially bolstering the global role of the dollar. This global role in turn gave the US access to abundant and cheap capital, permitting a system of global arbitrage which benefitted internationally mobile American investors. According to Schwartz, most Eurozone countries do not have the flexible market

structures allowing them to profit from cheap credit as a result of the possession of a global currency.

However, it is doubtful whether the Eurozone is so keen on this attribute. More demand for a global currency can drive up the exchange rate, threatening exporters. In addition, it is very likely that the ECB would regard an abundance of cheap credit as eminent inflationary threat. Incontrollable currency holdings by foreigners can make the control of the money supply difficult, especially in the case of sudden swings in market sentiment. Recent examples show that Eurozone authorities are very alert to this danger. In 2006, the government of Montenegro decided to unilaterally adopt the euro without worrying about whether its economy actually fulfilled the EMU convergence criteria. EU representatives, while not actively trying to discourage Montenegro, clearly expressed their disapproval (IHT 2007). When the Icelandic krona collapsed in the wake of the global financial crisis in 2007/08, Iceland began to contemplate the idea of a Euroisation of its economy. Both the ECB and EU institutions reacted very negatively, to the point of threatening sanctions (SZ 2008). In fact, if the ECB had to tighten its policy in response to external influences, this might create enormous strains in some Eurozone countries (Tilford 2006). However, given the economic weight of potential 'euroizers', their potential to disrupt the Eurozone is limited, similar to the minuscule impact of dollarizing countries on US monetary policy (Cohen 2002). It is interesting, though, to note that the US has reacted to dollarization with neutrality (Helleiner 2003), while the Eurozone has been quite explicit in its resistance. The autonomy to control the money supply emerges as the key preference of the Eurozone, at least as long as the ECB dominates external decision-making.

This argument makes clear that different groups in different countries might have contrasting ideas about the advantages and disadvantages of global currencies. The well-known Bretton Woods II argument which stresses the influence of export industries in emerging economies leading these countries to prefer undervalued currencies and to neutralize trade surpluses by accumulating foreign exchange reserves, also illustrates that there is no unique advantage to global currencies: it all depends on whether the dominant societal preference is served. The US uses its structural power to get cheap credit, the Eurozone to preserve monetary stability. A look at the respective savings rates shows that this reflects different varieties of financial capitalism.

Figure 1: Gross household saving rates in the four largest EU economies and the US, 1995-2007



Source: Eurostat and OECD

The dynamics of savers and investors is a core determinant of the future of international currencies. Policies regarding the internationalization of the euro and the dollar reflect this. But preferences are not fixed forever: particularly during major upheavals they might shift. In addition, the Eurozone is a rather internally divided actor. Countries with excess savings such as Germany confront big spenders such as the Mediterranean countries and Ireland. The financial crisis is a vivid illustration.

How has the Euro as International Currency helped Europe during the Financial Crisis?

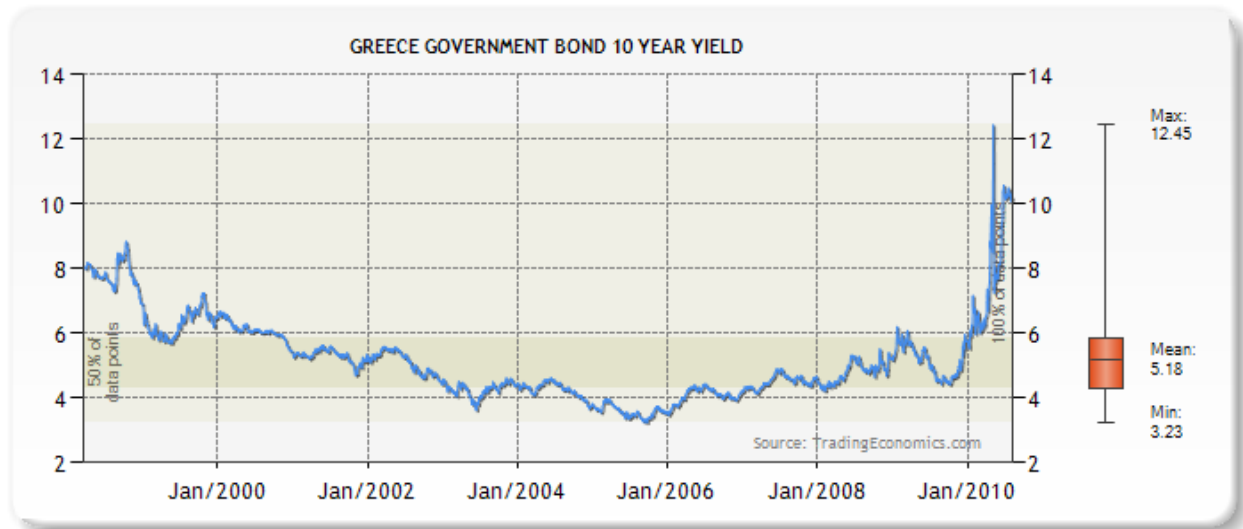
As stated at the outset, the financial crisis has not led to significant shifts in the relative importance of global currencies. Has the internationalization of their currencies helped their issuing countries to weather the storm? To answer this question I will consider the crisis as two related but separate phenomena: a banking crisis and a sovereign debt crisis. Potential positive or negative effects of the internationalization of the euro on these two types of crises are obviously different. Since our understanding of the crisis is still evolving, I can present here only some preliminary and suggestive evidence which, however, points towards very promising research directions for future investigations on the effects of global currencies.

There is as yet little research into how the fact that they were located in currency areas with internationalized currencies helped or damaged financial institutions in the US and Europe. For sure, institutions outside the dollar-area and the Eurozone were faced with serious exchange rate risk as these currencies became safe havens (as the East European example showed). But the Eurozone emerged not unscathed. A recent BIS study seems to point to privileges of American banks vis-à-vis their European counterparts. McGuire and von Peter (2009) show how large net US dollar position by European banks prior to the crisis exposed these banks to serious funding risks once liquidity dried up after Lehman. European banks built up these positions to finance the expansion of their investment bank activities (ibid.: 52). Only rapid agreements on unlimited swap lines between the Fed and the ECB helped to overcome the dollar shortage. This episode indicates the dollar's continued dominance as safe asset and the additional risk which foreign institutions face during situations of stress (Kaminski 2009).

The dollar shortage was overcome quite quickly by the unprecedented expansion of liquidity in the system. More serious was the ensuing sovereign debt crisis. It demonstrated that the capacity to raise funds and sustain debts is probably the most important attribute of currency power (Helleiner 2006). The major weapon of the US against the crisis was sharply increased government spending, raising public debt levels to enormous heights. Despite that, risk-averse markets have continued to accumulate US bonds. The experience of the past years suggests that the Eurozone starts to benefit from a similar privilege. Bolstered by the credibility of the euro, many members of the Eurozone embarked on a credit-fuelled expansion which came to a screeching halt when liquidity dried up in Western economies and massive bail-outs inflated the debt of most OECD countries. The euro had permitted the weaker members to ride on the coattails of stronger nations, as it compressed yield differentials between weaker and stronger countries. The risk premium that certain countries had to offer to the markets to sell their debt decreased rapidly once these countries were about to or had become Eurozone members.

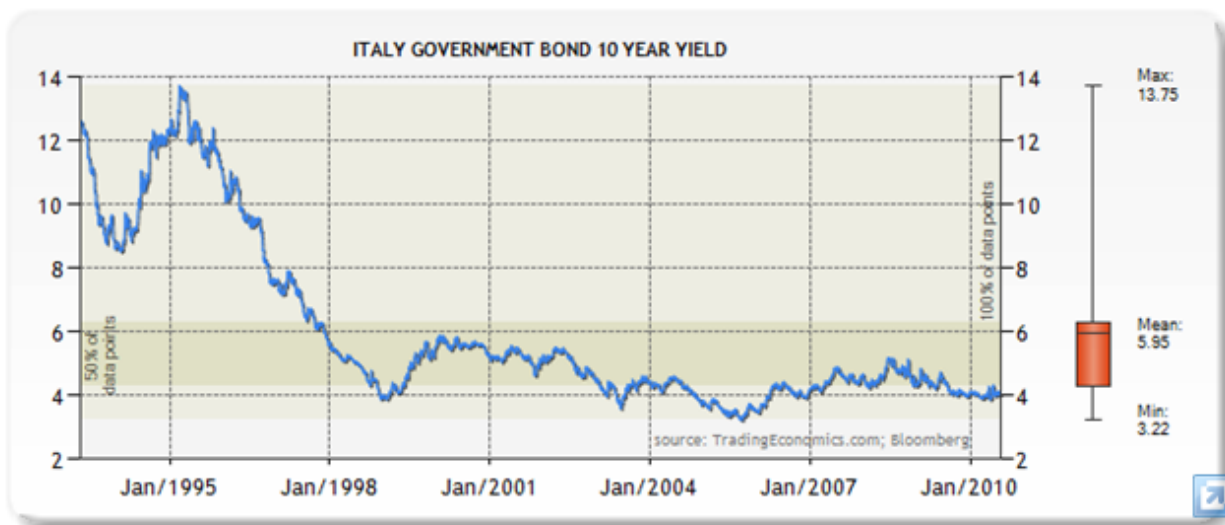
The following graph shows the development of the yield of Greek government bonds since 1998. The country entered the euro in January 2001. With the increasing likelihood of its eventual entry, Greek yields declined significantly prior to that date and continued to do so until the end

of 2005. Afterwards they rose slowly, but not dramatically until the eruption of the Greek sovereign debt crisis in 2010. The trajectory was basically stable. Between 2000 and June 2008, when the financial crisis began, inflation-adjusted annual GDP growth was about 1% which was hardly enough to inspire confidence. Nonetheless, Greece enjoyed a long period of cheap credit.



Source: www.tradingeconomics.com/Economics/Government-Bond-Yield.aspx?Symbol=GR (acc. Aug 12, 2010)

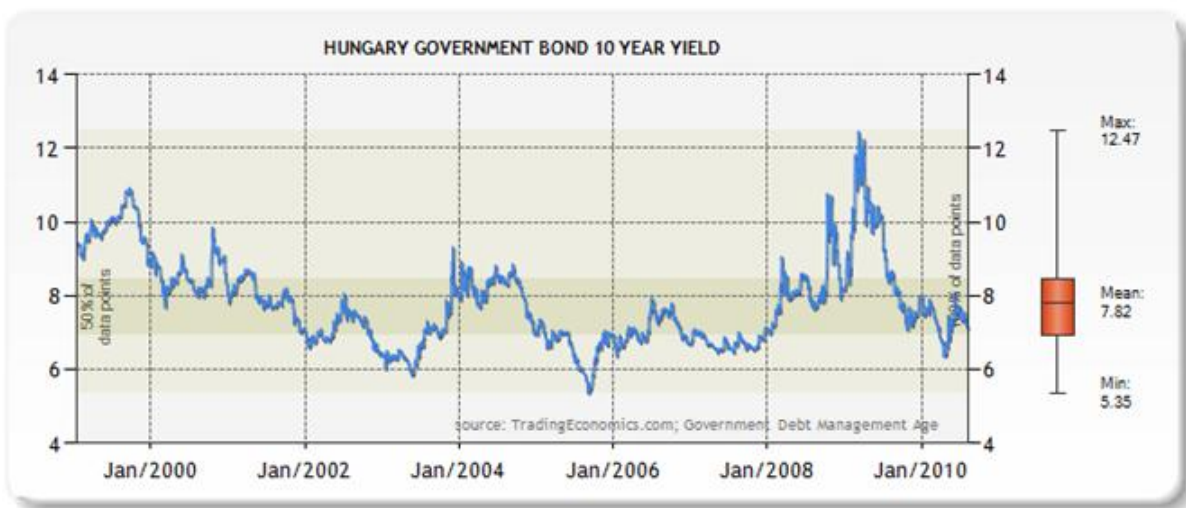
We see a similar logic at work in the case of Italy. In May 1998, the decision on the eleven original members of the Eurozone was taken, after a long period of uncertainty about whether Italy would make it. Borrowing costs briefly rose after the decision to admit Italy, but thereafter they remained at a fairly low and stable level, even during the crisis. GDP growth between 1998



and mid-2008 was a paltry 0.33%. Participation in the euro significantly depresses the yield that has to be paid on sovereign debt (Hallerberg and Wolff 2008).

Compare this with the data of Hungary which is not a member of the Eurozone. The Hungarian graph shows a significantly higher volatility, despite an average GDP growth from January 1999 to June 2008 of almost 4%. That is, the Hungarian economy performed much better than Greek or Italian. Nonetheless, it had to offer a significantly higher risk premium.

Once the crisis struck, Hungary experienced the massive drawbacks of not being part of an international currency. The attractive rates offered by the euro had led many Hungarians to borrow in euros. The depreciation of the Hungarian forint against the euro during the crisis proved disastrous for many borrowers (Bohle 2010).



* The table above displays the monthly average.

As painful as the debt crisis was for Greece, at least it did not suffer from the crippling effects of currency volatility with its major markets. In addition, very soon after the extreme focus on Greece and other Eurozone countries receded, bond yields went back to normal pre-crisis levels. Currently, Ireland, Spain and Portugal borrow cheaper than in the 1990s (Oakley 2010). What has in effect widened is the spread to Germany which benefits from record lows in the yields on its bonds – a typical effect of the safe haven status of an international currency. This, of course, creates the opportunity for arbitrage inside the currency area.

Greece can live off the rescue program for the next couple of years. For sure, it had lost the option of devaluation to restore its competitiveness. Yet, this option has its drawbacks, potentially delaying necessary adjustment. Furthermore, it is fundamentally incompatible with adherence to the Common Market. It is debatable whether this would indeed have made life easier for Greece. Adherence to the Eurozone and to an international currency carries further advantages. Even in a situation of extreme market distrust, Greece was able to tap more resources than other countries in less serious situations. During a July 2010 state visit of German Chancellor Merkel to China, the Chinese Premier confirmed that Europe would remain one of the main investment markets for China's huge surplus. Just prior to the visit, the Chinese had bought several million euros of Spanish bonds (Dyer 2010). China had also invested into Greece at moments of direst need. Such moves were essential to restore faith in Europe's public debt and reduced the yield that had to be paid by European governments considerably. Many have interpreted China's surprising interventions as political ploy, for example, to get access to Greek ports (source). In a column in the Financial Times, Gillian Tett maintained the European U-turn on the issue of stress tests for their banks was due to pressure from official and private Asian investors who threatened to stop their accumulation of European bonds (Tett 2010). Despite US pressure, the Eurozone had refused to submit their banks to the rigorous stress tests which had been employed so successfully by the Americans in 2009. After a G-20 meeting in Busan, South Korea, in June 2010, they had a change of heart, supposedly because of Asian interventions. But there are also few alternatives for the Chinese, given the longstanding problems of the dollar. In fact, most surplus nations had continued to invest in Euro bonds, for example India, Kuwait, and South Korea (Shellock 2010). One Japanese government official was quoted by Reuters with the words: "Even if the dollar or the euro is in trouble, is there anywhere else to invest? Not really. There needs to be a certain degree of liquidity. Currencies of countries with capital controls won't work, too. That leaves us with very few options" (Kihara/da Costa 2010). The continued accumulation of euro bonds throughout the crisis shows that the currency had maintained its safe haven status. The crisis thus demonstrates that the Eurozone can already capitalize on one of the major advantages of international currencies: access to credit despite unfavorable economic circumstances.

The Eurozone faces one essential weakness, however. There is no Eurobond. Investors can choose among the bonds of different governments, some of them risky, some considered ultra-safe, some of them offering a high return, some a very low one. This was no problem as long as stable economic conditions and rapid growth in the Eurozone's peripheral economies created sufficient demand for the bonds of these countries. But the crisis has exposed the troubles of countries such as Greece glaringly. The absence of a Eurobond has long been considered an essential weakness: "Only when a homogeneous debt instrument with a euro-wide market comes into existence, when it is backed by the full faith and credit of euro area governments as a group, and only when it is backstopped by the ECB will the euro be in a position to seriously rival the dollar as a reserve currency" (Eichengreen 2009).

The Eurobond would signal to markets that there is a near-zero default risk. The essential attribute of global currencies of cheap credit creation has been shunned by the creators of the Eurozone due to its inflationary implications. But confronted with the Greek disaster they needed it. The result was the creation of a functional equivalent to the Eurobond. When the ECB announced its decision to buy up the debt of member countries it effectively gave a (albeit silent) guarantee on the bonds of weaker Eurozone members. The €750bn EU/IMF financial aid package of May 2010 has a similar effect. Significantly, auction of Spanish and Greek government bonds met with success in the months after this pledge. The Greek crisis thus introduced a Eurobond through the backdoors – despite the resistance of stability oriented Eurozone members.

Conclusion

The financial crisis demonstrated the many faces of monetary power. In the end, the question of monetary power resides in its link with societal preferences, in particular the dominant preference. Arguments which assume that the Eurozone because of its neoliberal policy regime has forfeited the power potential of its currency have to take this into account. Certain groups, such as savers, are advantaged under the current philosophy and institutional biases of the Eurozone. Those who designed the Eurozone and are influential enough to resist changes, also profit from the international role of the euro as it lends them the means to push through their preferences without interference from abroad. The financial crisis made clear, however, that

when push comes to shove, even the ECB feels compelled to ‘abuse’ the hegemonic privilege of cheap credit creation – a privilege of international currencies which French proponents of a common currency had craved for a long time.

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