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The United States and the European Monetary Union: Predictions and Reality

1. Introduction: United States, European Integration and European Monetary Union

American vision of and policy toward European integration has always had certain ambivalence to it. On the one hand, the United States can rightly be regarded as an architect of European integration at the early stage, beginning with the Marshall Plan provisions insisting on European cooperation in its implementation[1]. At the height of its power after the conclusion of WWII, America chose to realize its interests in the part of Europe it controlled through a relationship ingenuously called by one scholar as "empire by integration"[2]. Empire is understood here as a morally neutral term indicating a "hierarchical system of political relationships radiating from a center"[3]. Unlike in the Soviet imperial system, American power in Western Europe was exercised in large measure through consensus on the part of the European states, sovereignty of which was not overly compromised. At the heart of this relationship lay insistence on European integration so as to prevent the strife among European powers that had already led to two global conflicts and to the need for American military intervention on the European continent. The security and political aspect of the U.S.-European relationship was formalized in 1949 by establishing the North Atlantic Treaty Organization, while the economic plan for Europe gradually evolved into the European Economic Community in a series of treaties involving the key countries of the continent. Although the United States did not formally participate in the latter one, the process took place in the context of the U.S. security umbrella and with American backing[4].

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[1] For a new scholarly analysis of the Marshall Plan, see G. Behrman, *The Most Noble Adventure* (New York: Free Press, 2007).

[2] G. Lundestad, "*Empire" by Integration: The United States and European Integration, 1945-1997* (Oxford: Oxford University Press, 1998).

[3] G. Lundestad, *The United States and Western Europe since 1945: From "Empire" by Invitation to Transatlantic Drift* (Oxford: Oxford University Press, 2003), p.1.

[4] For an excellent history of U.S.-European relations, see for example Lundestad, *The United States and Western Europe since 1945.*

On the other hand, the United States' support for European integration should not be regarded as unconditional. Implicit in the relationship with Europe is American resolve to be the leader of the Euro-Atlantic community. It assumes American "benign hegemony" in the Euro-Atlantic security space and an informal voice in matters pertaining to European integration. At the very least, the U.S. policy makers insist that the integrated Europe "has an open architecture…that is not promoting 'fortress Europe'"—an anti-American entity in political outlook and an economically protectionist bulwark fencing its borders from free trade and investment from the outside world[5]. In short, for the United States to support European integration, the process has to develop within the "Atlantic framework" and be free of any insinuation that Europe is becoming a "counterweight" (as opposed to a "counterpart" and an ally) to American power. Resulting from this ambiguity is a certain paradox of American policies and attitudes toward European integration: disunity and conflict in Europe is bad for American interests but so is "too much" unity, which can lead to a unified Europe challenging American leadership in the Western alliance system[6]. Consequently, the European-American relationship—especially in its post-hegemonic stage—contains elements of both cooperation and competition[7]. This ambiguity of the United States policy toward Europe must be kept in mind when studying American attitudes toward the EMU.

Likewise, in analyzing American views one should not lose sight of the fact that American public opinion toward European integration—including major national media—is often colored by certain hyper-criticism and pessimism. Somewhat like anti-American opinions in Europe which are often the result of ignorance, the assessment of the European project in the U.S. is partially based on American misapprehension of both the origins and the underlying process of integration as well as the elusiveness of its intended "final product." Some of that attitude—and the refusal to consider the progress of European integration in its great complexity—does spill over into the analysis of some of the major American think tanks, and to lesser extent, government entities. There are several reasons responsible for this state of affairs. First, in its view of European integration, Americans take a lot of their cues from the British media, whose

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[5] W. Piasecki, *U.S. Policy in Europe 2004-2006: Continuity and Change*, [in:] *Stosunki ekonomiczne w rozszerzonej Unii Europejskiej*, ed. Jarosław Kundera, Wrocław: Kolonia Limited, 2007, pp. 444-45.

[6] Ibid., p. 442. For more on the U.S. policy toward Europe, see W. Piasecki, *American Policy in Europe and EU Enlargement*, [in:] *Rozszerzenie Unii Europejskiej: Korzyści i koszty dla nowych krajów członkowskich*, ed. Jarosław Kundera, Wrocław: Wydawnictwo Uniwersytetu Wrocławskiego, 2005.

[7] K. Featherstone, R. H. Ginsberg, *The United States and European Union in the 1990s*, 2nd ed., New York: St. Martin's Press, 1996, p. 121.

reporting related to the EU issues is often highly critical. Likewise, the British government outlook on European integration efforts, to whose views the United States is closely tuned, is usually cautious and far from enthusiastic. Considering that even serious American media pay scant attention to what is happening in Brussels as the seat of the EU—as opposed to the capitals of European nation-states—unawareness, criticism, and pessimism about European integration is widespread[8].

Second, the United States often sees the European Union's integration effort as a mirror of its own founding in the late 18th century, hence frequent references to the "Unites States of Europe." Needless to say, such views do not reflect the most essential differences between both processes, most importantly the fact that European integration involves historical nation-states. The tortuous pace of coming to a consensus within the heterogeneous EU is understandable from the point of view of any European insider, but incomprehensible to many American observers[9]. In consequence, American conclusions about various "inefficiencies" of the EU processes and outcomes are not far behind.

Third, the United States is used to a traditional notion of sovereignty and its own status as an independent nation state and a superpower. Therefore, the concept of "pooled sovereignty" essential to the European integration is not easily grasped. Thus, the idea that powerful countries like Germany or France would willingly give up a portion of their sovereignty in favor of some supranational entity seems incredulous[10]. In consequence, throughout most of the 1990s, the majority of American observers, including those who closely watch European affairs, were skeptical of the chances of the euro and the timely commencement of the European Monetary Union. In fact, only at the last moment, when the European consensus of the membership in the monetary union became a fact, the Americans finally realized that the euro would become a reality in 1999 as scheduled[11].

Finally, ordinary Americans tend to be disinterested in international issues—to put things mildly. In one poll taken in 1998, 42.5% of respondents in the United States stated that they heard nothing of the introduction of the single currency in Europe and 24.8% stated that they

[8] E. Pond, *The Rebirth of Europe,* 2nd ed. ,Washington, DC: Brookings Institution Press, 2002, p. 16.
[9] *Ibid*., pp. 16-17.
[10] *Ibid*.
[11] D. L. Bark, *Americans and Europeans Dancing in the Dark,* Stanford, CA: Hoover Institution Press, 2007, p. 127.

heard very little[12]. As for the consequences for the United States, 23.8% of respondents believed the effects would be good, 17.7% thought the effects would be bad, and 44.6% expected that there would be of no significance for the United States[13]. While this fact does not reflect negatively on the broadly conceived elites who are in charge of managing international affairs of the United States in both public and private sector, it does reflect on the quantity and quality of reporting of the subject in the general media.

2. American Opinions in the 1990s

For the purpose of order solely—fully realizing that they are imprecise and mutually permeating—I will divide American opinions about euro introduction into two categories according to their source and nature: academic community and official/government[14]. I will first briefly describe these two views, with particular attention given to academic accounts devoted to the issue. A special focus will then be given to the experts' views on the euro's chances of challenging the dollar as a dominant international currency. Finally, I will succinctly confront these early opinions with the reality of the several years following the introduction of the European currency.

2.1 U.S. Economists and Political Scientists Views on the Euro

In academia, both among the political scientists and the economists, views on the EMU introduction were disparate. The only point seemingly conceded by most analysts was that the primary reasons for EMU were political—with consequences both **political** and **economic** in nature. First, the introduction of the euro, one author wrote, would create a new "powerful symbol for the EU… the desire for an 'ever closer union among the peoples of Europe' expressed

[12] C. R.l Henning, P. C. Padoan, *Transatlantic Perspectives on the Euro,* Washington, DC: Brookings Institution Press / ECSA, 2000, p. 11.

[13] *Ibid*., pp. 11-12.

[14] I will not deal with American business community opinions on the euro in this article. They were quite positive, expecting that if successful, the common currency would greatly improve doing business in Europe for the American companies. Admittedly, work dealing with this topic would be interesting especially if empirical data were analyzed on the impact of the euro on U.S. business.

in the Treaty of Rome[15]. Because money has a weighty effect on how people view themselves in relation to others, the citizens of the new "eurozone" would "begin to feel themselves bound together more closely as part of the same social entity… Much like a flag or an anthem, money contributes to a sense of collective identity—of belonging to a single community"[16]. After introducing a common currency, then, "Europe's sense of identity will never be the same[17]. As a powerful measure of Europe's political will to carry on the integration efforts, euro's successful introduction was predestined to define the deepening of the process; its failure was "unthinkable" and would "set the European integration back by years"[18]. Political effects of the potential fiasco of the euro would reverberate both internally in terms of EU planned enlargement and externally in the weakened confidence of the United States in the future of the European Union[19].

Second, in addition to this internal use of the EMU—the deepening of European integration—there was its external corollary, namely the enhancement of Europe's role in the world by creating a powerful rival to the US dollar, the dominant international money of the era[20]. The introduction of the euro was thus part and parcel of Europe's attempt to advance "its capacity for independent action in both the economic and in the foreign policy and security realms"[21]. In all key measures of economic strength and trade, the EU equaled or exceeded the United States. Such was not the case in the monetary realm; the monetary power of the United States in the form of the ubiquitous dollar was clearly begrudged in Europe. The dollar's place at the top of the "currency pyramid" has long been resented as, in De Gaulle's famous phrase, "America's exorbitant privilege"[22]. Therefore, challenging the dollar as the predominant international currency and addressing the asymmetry in international monetary relations between the US and the EU constituted the "hidden agenda" of euro's introduction[23].

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[15] B. J. Cohen, *Global Currency Rivalry: Can the Euro Ever Challenge the Dollar*? Journal of Common Market Studies 41, no. 4 (September 2003): p. 575. Available: http://www.ebscohost.com/ (accessed Jan. 18, 2008).

[16] *Ibid.*

[17] *Ibid.*

[18] S. Serfaty, *Memories of Europe's Future: Farewell to Yesteryear,* Washington, DC: The CSIS Press, 2006, p. 64.

[19] *Ibid*., p. 65.

[20] Cohen, *Global Currency Rivalry*, p. 576.

[21] I. H. Daalder, *The United States and Europe: From Primacy to Partnership*?, [in:] *Eagle Rules? Foreign Policy and American Primacy in the Twenty-First Century,* ed. Robert J. Lieber, Upper Saddle River, NJ: Prentice Hall, 2002, p. 86.

[22] Charles de Gaulle quoted in Cohen, *Global Currency Rivalry*, p. 575; and B. J. Cohen, *The Future of Money*, Princeton, Princeton University Press, 2004, pp. xiv-xv.

[23] Cohen, *Global Currency Rivalry*, pp. 575-76. The agenda may not have been so disguised since in a report on EMU in 1990, the European Commission unequivocally called for "greater symmetry" in the international monetary

The idea of EMU as an essentially political project ("money as the key vehicle of political integration") leading to a substantial deepening of European integration and greater political unity of the EU was in itself uncontroversial among American observers. What indeed was controversial was whether it could succeed and whether its success or failure was good or bad for American interests. In this regard, several opinions were presented by political analysts and economists alike. First, those analysts of a neorealist persuasion regarded the EMU idea, as indeed the whole process of European integration, as a not entirely serious affair. The ill-advised monetary union in combination with the statist economies of continental Europe—eternally incapable of reforming themselves in the likeness of the US economy—would in time produce economic crisis and misery. This, as the argument went, would contribute to "subverting the political institutions of the nations in the European Union"[24]. Not unlike later neoconservative critique of European nations supposedly living in a post-historical paradise and not being earnest about fundamental issues of their own security (leaving these "historical" issues to the United States), these arguments were at the same time dismissive and distrustful of European integration. Regarding the EU as some kind of postmodern anomaly at best and a potential strategic competitor of the US at worst, the neoconservatives treated any steps toward greater European unity with suspicion and being contrary to American interests.

The doom and gloom resulting from the introduction of the euro was not the monopoly of neoconservative thinkers, however. There were other voices of those who immediately recognized the political implications of the EMU and regarded it as outright dangerous both for America and the world at large. Thus, for example, Martin Feldstein, professor of economics at Harvard University, wondered on the pages of *Foreign Affairs* whether the introduction of the euro might lead to increased tensions both among European states and between the EU and the United States[25]. His answer was affirmative, predicting conflict—or perhaps even a war—either among the hapless members of the EMU and/or between the EMU group and outside powers[26]. Negative opinions were also voiced by diplomatic analyst John Newhouse who predicted no less

system. See C. R. Henning, *Transatlantic Economic and Monetary Relations*, [in:] *Conflict and Cooperation in Transatlantic Relations*, ed. Daniel S. Hamilton, Washington, DC: Center for Transatlantic Relations, 2004, pp. 101-102.

[24] I. Kristol, *Petrified Europe*, Wall Street Journal (Europe), February 2, 1998; and W. Safire, *Alice in Euroland*, New York Times, April 30, 1998, both available: http://www.proquest.com (accessed Jan. 18, 2008).

[25] M. Feldstein, *EMU and International Conflict*, Foreign Affairs 76, no. 6 (Nov.-Dec. 1997): pp. 60-73. Available: http://www.ebcohost.com/ (accessed Jan. 18, 2008).

[26] *Ibid*., pp. 71-72.

than "economic chaos" and "massive distraction" making the EU's eastern enlargement implausible—all as a result of EMU's introduction[27].

Political analysts of the realist school of international relations held much more subdued views on the political effects of the euro introduction for the United States. Henry Kissinger regarded it as part and parcel of the political unification of the continent which had produced gradual but inevitable change in the US-European relationship. Stemming partly from fears of American hegemony brought about by its triumph in the Cold War, the introduction of the EMU was likely to loosen transatlantic cooperation[28]. In his view, this loosening was partly American fault because the US failed to conduct a serious strategic dialogue with Europe[29]. The success or failure of the new European currency was, according to Kissinger, less important for the future transatlantic cooperation than the character of the European integration itself. The "con-federal" option of the Europe of nation-states would be more preferable to the United States than the "federal" one, for the latter was "structurally" bound to undermine transatlantic ties[30].

Another set of views was put forward by American economists. As opposed to many political scientists who analyzed euro introduction from the point of view of relative power (gain for the EU mean loss for the US and *vice-versa*), economists were largely of "positive-sum game" persuasion[31.] They argued that a successful EMU would be good for **both** the European Union **and** the United States imparting similar advantages on European and American businesses[32]. However, the majority of American economists were skeptical of euro's success. As suggested by one expert:

> *If one polled the annual meeting of the American Economic Association, an overwhelming majority would probably respond that monetary union will be bad for Europe. By extension…it must also be bad for the United States*[33].

Grounds for such skepticism chiefly lay in the popularity of the theory of optimum currency areas. Deriving from the research of several prominent economists in the 1960s, the theory singled out several prerequisites to make sense for a geographic area to introduce common

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[27] J. Newhouse, *Europe Adrift*,(New York: Pantheon Books for CFR, 1997.

[28] H. Kissinger, *A New Union in Europe*, Washington Post, May 12, 1998; and H. Kissinger, *Does America Need a Foreign Policy? Toward a Diplomacy for the 21st Century*, New York: Simon and Shuster, 2002, pp. 49-52.

[29] Kissinger, *Does America Need a Foreign Policy*, p. 49.

[30] *Ibid*.; and Kissinger, *A New Union in Europe*.

[31] Henning and Padoan, *Transatlantic Perspectives on the Euro*, p. 6.

[32] *Ibid.*

[33] *Ibid.*

currency[34]. According to the majority of (though not all) economists in the United States at the time, the original euro-zone of 11 states did not satisfy these theoretical criteria. They argued that labor mobility, real wage flexibility and fiscal transfers were inadequate for the EMU to be successful as "optimum currency area[35]. In one of the sterner criticisms, the introduction of the common currency was derided as

> *an improbable and bad idea* [which became] *a bad idea that is about to come true. High unemployment, low growth, discomfort with a welfare state that is no longer affordable—all these issues have found a new hope of resolution in a desperate bid for a common currency, as if that could address the real problems of Europe. On the contrary, the hard work of attaining a common currency,…is adding to the burden of an already mismanaged Europe. The struggle to achieve monetary union under Maastricht formula may be remembered as one of the more useless battles in European history. The costs of getting there are large, the economic benefits minimal, and the prospects for disappointment major*[36].

Not surprisingly, the unenthusiastic or downright disapproving opinions of the majority of American economists about the plans for EMU were offset by the minority view of those who thought the idea exceptionally suitable for the times. One prominent supporter of the EMU turned out to be Robert Mundell, Canadian-born professor of economics at Columbia University who pioneered research on the optimal currency areas in 1961[37]. A laureate of the Nobel Prize in Economics of 1999, Mundell wrote a lucid 2-piece story on the euro introduction for the *Wall Street Journal* in March 1998[38]. In recording the reasons for having to make another case for the euro, Mundell listed, among others, "a considerable academic opposition to the idea of monetary union":

> *It comes not just from Keynesians but from monetarists such as Milton Friedman, Henry Kaufman and Martin Feldstein, and even—surprise—a supply-sider, Arthur Laffer. The Keynesians fear the removal of devaluation as a weapon of policy. The monetarists' reasons*

[34] *Ibid*., pp. 6-7.
[35] *Ibid*., p. 7.
[36] R. Dornbusch, *Euro Fantasies*, Foreign Affairs 75, no. 5 (Sept.-Oct.1996): p. 113, available: http://www.ebscohost.com/ (accessed Jan. 18, 2008).
[37] R. Mundell, *A Theory of Optimum Currency Areas*, American Economic Review 51, no. 3 (September 1961): pp. 657-65.
[38] R. Mundell, *The Case for the Euro—I*, Wall Street Journal (Eastern ed.), March 24, 1998; and R. Mundell, *The Case for the Euro—II*, Wall Street Journal (Eastern ed.), March 25, 1998, available: http://www.proquest.com/ (accessed Jan. 12, 2008).

range all the way from the threat that the euro might bring the dollar to its knees to the political possibility that it will create civil war in Europe! By contrast, Mr. Laffer thinks that a European currency might be a good idea in principle but the Europeans will make a botch of it[39].

Mundell also noted that even economists form Europe were not immune to the apprehension of discarding the exchange rate policy from the arsenal of weapons at the disposal of policy makers to battle unemployment[40]. Taking part of the blame for the argument that monetary union in Europe may result in some countries' or regions' burdened with high unemployment—because it had constituted his own line of reasoning in the optimal currency area concept—Mundell nonetheless argued that devaluation and inflation were illusory medicines to cure unemployment. Both morally suspect and impractical in the long haul, the ability to be in command of the exchange rate was not worth clinging on to compared with the advantages of the monetary union[41]. The benefits of the latter were manifold despite the complexity and difficulty of the process of its introduction:

Europeans will gain a currency that spans a continent. The benefits will derive from transparency of pricing, stability of expectations and lower transaction costs, as well as common monetary policy run by the best minds that Europe can muster…Monetary union will do much to integrate Europe's commodity, factor and capital markets. It will increase Europe-wide competition and revolutionize financial markets. It will spur rationalization, mergers and takeovers in the European banking industry and commercial firms. Perhaps most important of all, EMU will change the way Europeans think about themselves and about a multiregional continental market that has become the largest in the world[42].

Mundell was equally optimistic about EMU's international implications. The introduction of the euro, in his view, would constitute "the most important event in the history of the international monetary system since the dollar took over from the pound the role of dominant currency in WWI"[43]. The euro was bound to become the challenger of the dollar in its uses as

[39] Mundell, *The Case for the Euro—I*, p. 1.
[40] *Ibid*., pp. 1-2.
[41] *Ibid*., p. 2.
[42] *Ibid*., p. 3.
[43] Mundell, *The Case for the Euro—II*, p. 1.

the international currency—as unit of account, reserve currency and intervention currency[44]. Long disagreeable to European states, the dollar's use as international currency gave the United States the monetary power to practice monetary statecraft at the expense of its major economic partners[45]. It allowed the U.S. to obtain gains from seigniorage (all the greater with the dollar inflation) and run "deficits without tears"—making the country the "biggest international debtor in world history"[46]. Although inevitable and beneficial in the immediate years after WWII, the virtual monopoly of the dollar as the only truly global currency was neither necessary nor practical in view of the economic rise of Europe. Moreover, it was fraught with unwarranted risks for both the United States and the rest of the world[47].

The introduction of the euro, in Mundell's view, would create a much needed alternative to the dollar. The Euro would become an alternative reserve currency of choice especially for those countries whose trade with the EU is significant. It would deprive the United States of part of the monetary muscle it had enjoyed and perhaps force it to become a more fiscally responsible power. In short, it would contribute to the stability of the international monetary system whose robustness was endangered by the dollar monopoly and not always sensible behavior of the United States government in the realm of monetary policy[48]. A successful monetary union, in Mundell's words:

> *will be of enormous benefit to the people of Europe and to the rest of the world, including the U.S. Members of the EMU will get not just a currency on a par with the dollar and the right to a share in international segniorage but also greater influence in the running of the international monetary system. The rest of the world will get an alternative asset to the dollar to use in international reserves and a new and stable currency that could be used as the focus for stable exchange rates or currency boards. The U.S. will get a needed relief from the eventually debilitating overuse of the dollar as an international currency, a single-currency*

[44] *Ibid*., p. 2.

[45] On *monetary power* (a relational property—when one state's behavior changes because of its monetary relationship with another state) and *monetary statecraft* (conscious manipulation of monetary relations in order to influence the policies of other states), see D. M. Andrews, *Monetary Power and Monetary Statecraft*, [in:] *International Monetary Power*, ed. D. M. Andrews, Ithaca: Cornell University Press, 2006, pp. 7-28.

[46] Mundell, *Case for the Euro—II*, p. 2.

[47] *Ibid*., p. 3.

[48] *Ibid*., p. 4.

continent that vastly simplifies trade and investment, and a strong partner in Europe with an equal stake in constructing an international monetary system suitable for the 21st century[49].

Similar views about a gradual rise of the euro as an international currency on par with the dollar were held by C. Fred Bergsten, the director of the Institute for International Economics, an influential Washington think-tank. In a major article published by *Foreign Affairs* in 1997, Bergsten envisaged a measured end to the dollar monopoly and an eventual bi-polar international monetary system with the American and European currencies playing equal parts[50]. He suggested that this process would proceed in three phases: the period up to 1999; the transition period lasting up to 10 years during which the euro would achieve its new standing in the international financial system; the post-transition stage when all the structural changes had taken place and the new bi-polar stability is instituted[51]. Bergsten was so confident in the euro success in 1997 that he did not exclude a scenario in which a more rapid change took place. There is historical evidence, he maintained, that a major shock could generate a faster transformation of the international monetary system. Alluding to the devaluation of pound sterling in 1931 which boosted the dollar in its role as global money, he mused whether such thing might not happen to the euro—in case the United States seriously mismanaged its monetary and economic policies[52].

In either case, Bergsten concluded that EMU introduction would create a new "balance of power" in the international monetary system in which the United States would be forced to be more cooperative than before. He argued that the euro's introduction would strengthen Europe both economically and politically. Yet, eschewing the zero-sum-game logic, Bergsten was adamant that this was in America's best interest[53]. In the long run, he asserted:

The existence of a real rival will generate healthy competition for the United States across the world economy. The euro, however, also may make it costlier for the United States to borrow huge amounts of foreign capital needed to finance our chronic external imbalances. It could even trigger a dollar crisis if we fail to keep our house in order. Creation of the euro means that Europe will become a full equal of the United States, at least in economic terms. The two economic superpowers will have to learn to function as partners…to exercise their joint

[49] *Ibid*.
[50] C. F. Bergsten, *The Dollar and the Euro*, Foreign Affairs 76, no. 4 (July-Aug. 1997): p. 83.
[51] *Ibid*., p. 86.
[52] *Ibid*., p. 91.
[53] C. F. Bergsten, *Year of the Euro: A Real Rival Will Generate Healthy Competition for the U.S*, Washington Post, January 3, 1999, available: http://www.washingtonpost.com/ (accessed April 1, 2008).

responsibility for the world economy. New mechanism will be needed to maintain currency stability, keep trade and investment open and sustain economic progress[54].

2.2 Official Views: Government and Central Bankers

Although at the time of these writings Bergsten was an academic and no longer a government bureaucrat, his optimism in many ways resembled the official U.S. government position on EMU[55]. In an extensive report on the EMU implications for the United States written for the relevant Congressional Committee, its authors took a rather sanguine view of the issue[56]. In the key concern of the likelihood of the euro's imperiling the dollar as the dominant international currency, the authors agreed that any such challenge, if it did in fact take place, would be gradual[57]. In another report, its author similarly discounted the possibility that the common European currency would adversely affect the dollar's international functions. If the euro would indeed **partially** replace the dollar as an international reserve and payment currency, the gradualness of such change would not "cause a sudden decline in the dollar in the near future"[58].

This benign view reflected the long-time American preoccupation with geo-strategic interests in Europe which put priority on broadly conceived "security and stability" in this part of the world. The steps taken toward European economic integration has generally figured positively in this regard on the proviso that it did not **excessively** harm American economic interests. Such was also the case with EMU which was not enthusiastically encouraged but neither was it contested by the United States[59]. Indeed, official comments on the subject were scarce throughout the beginning of the 1990s.[60] It was only after 1996 that American officials

[54] *Ibid.*

[55] C. F. Bergsten was Assistant to the National Security Council for International Economic Affairs in 1969-1971, and Assistant Secretary of the Treasury for International Affairs in 1977-1981.

[56] *The Euro: Implications for the United States—Answers to Key Questions*, Report to the Chairman, Subcommittee on Domestic and International Monetary Policy, Committee on Banking and Financial Services, House of Representatives (Washington, DC: United States General Accounting Office, March 2000), available: http://www.gao.gov/archive/2000/g400105.pdf (accessed April 10, 2008).

[57] *Ibid.*, pp. 26-27.

[58] A. Wilson, *European Monetary Union and the United States: An Overview*, CRS Report for Congress, June 8, 1998, Summary, available: http://www.lexis-nexis.com/ (accessed Jan. 18, 2008).

[59] Henning and Padoan, *Transatlantic Perspectives on the Euro,* p. 12.

[60] *Ibid*., pp. 12-13; and "U.S. Backs Preparation for European Currency," *Wall Street Journal*, October 22, 1997, Eastern ed., available: htt://www.proquest.com/ (accessed Jan. 12, 2008).

went out of their way to sound a positive note on the EMU introduction lest their lack of commentary were interpreted as hidden opposition or worse[61]. The then Secretary of Treasury Robert Rubin restated American interest in a stable and prosperous Europe:

It is in the interest of the United States for Europe to prosper. We've always said that we think European unification serves that purpose and therefore if it's good for them, it's also good for us[62].

In a hearing before the US Senate, the deputy Secretary of Treasury Lawrence Summers echoed a similar tone,

If the European Monetary Union works for Europe, it will work for the United States.…We are well served when the region is vibrant economically, and is working to open its markets and strengthen its ties with the global economy.…When Europe is growing rapidly it is a more dynamic market for our exports, and a stronger partner for us around the world"[63].

These views were generally shared by American central bankers. During his official trip to Europe New York Fed Chairman William J. McDonough denied press speculation that the United States considered EMU as a menace to American monetary policy or the dollar's position as international currency[64]. In his opinion the euro, if successful, would rather "foster deeper global trade and financial markets and a more efficient monetary system [from which] all countries stand to benefit"[65]. McDonough concurred with the preponderant view that any change in the dollar's global role would "occur only gradually… and in a manner that could be easily coped with"[66]. As far as a more immediate effect on the United States, he pointed out that as a serious competitor to the dollar, the euro could compel the Americans to "address the country's chronic low-savings problem and consequent reliance on foreign capital to finance its current account deficit[67].

Similar opinion was voiced by Federal Reserve Chairman, Alan Greenspan. In a Senate Banking Committee hearing, he reiterated the positive effect the introduction of the euro would have for the global economy. In his view, the euro would improve Europe's competitive position

[61] Henning and Padoan, *Transatlantic Perspectives on the Euro*, p. 13.
[62] *Ibid*.
[63] *U.S. Backs Preparations for European Currency*.
[64] M. R. Sesit, *New York Fed's McDonough Says U.S. Doesn't Look Upon the Euro as a Threat*, Wall Street Journal, November 19, 1997, Eastern ed., available: http://www.proquest.com/ (accessed Jan. 12, 2008).
[65] *Ibid*.
[66] *Ibid*.
[67] *Ibid*.

in the world which in turn would be a constructive development for the United States and the world:

> *All of post-World War II evidence…clearly suggests…that the greater the real growth in trade, the greater the ability of globalization and integration of the various major elements within the international system, the better it is for everybody*[68].

If generally positive regarding the effect of the EMU introduction on the United States, American officials were ambivalent whether they thought the euro would indeed prove a success. These doubts—usually deep seated and often not expressed publicly—were partially the result of an enduring attachment to the optimum-currency-area theory since many present-day government officials had their roots in the academia. In addition, political difficulties to reach a consensus among the European governments involved were thought to be enormous because the extent of the needed reforms was massive and went "to the heart of the social democratic consensus in Europe"[69]. Predictably, these opinions reflected a rather limited faith on the part of the United States in the ability of the European governments to sustain the political will necessary to conclude the process of the launch of the EMU on time.

Another caveat to the by and large positive official response to the EMU was American concern that the EU might get overly preoccupied with the process of introducing the common currency at the expense of other pressing international matters. American officials were eager to emphasize that the EU should "continue to open its markets to the global economy" and design a "decision-making process that permits quick and effective action on the international stage"[70]. In this regard, of particular strategic interest to the United States was the fate of the so-called eastern enlargement of the EU—"an ambitious undertaking and one which the U.S. government hope[d] [would] succeed"[71]. Predictably, geopolitical considerations—especially moving the border of the "democratic space" to the East— seemed to overshadow lesser economic interests which could be sacrificed on the altar of the primary goal of stability and security on the European continent.

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[68] Chairman Alan Greenspan before Senate Banking Committee, July 23, 1997, quoted in Henning and Padoan, *Transatlantic Perspectives on the Euro*, p. 15.

[69] L.H. Summers, *EMU: An American View of Europe*, remarks delivered at the Euromoney Conference, April 30, 1997, quoted in Henning and Padoan, *Transatlantic Perspectives on the Euro*, p. 14.

[70] Summers quoted in *Ibid*., p. 15.

[71] *Ibid.*

On the whole, the actual policies of the successive American administrations were by and large supportive of the subsequent steps of the European integration including that of the establishment of the EMU. They mostly followed the middle-of-the-road approach designed to encourage the kind of integration that was not directly at odds with American interests. When, on the contrary, the U.S. felt that the EU encroached upon its leadership in the Euro-Atlantic alliance—such as some aspects of the EDSP—it compellingly let its views be known and consequent negotiations followed[72]. However, despite frequently alarmist views expressed in the European and American media alike, the U.S. never—even at the most critical junctures of the relationship—pursued policies designed to undermine European integration, rightly assuming they would be counterproductive[73]. Such was also the rationale in the case of the EMU introduction.

2.3 Euro's Challenge to the Dollar as International Currency

Of particular interest is the rather sanguine and relaxed official approach to the euro's potential challenge to the dollar's position as international currency. Although the status of the dollar as the unquestioned "global currency" has provided considerable benefits to the United States both symbolically and materially, the U.S. did not seem to be overly concerned about the prospective threat that the euro might pose to the dollar's dominance[74]. In the initial studies assessing the chances of the euro to become a viable alternative to the dollar in its international currency functions, most analysts were cautious in their assessments. Although opinions ranged from optimistic (implying that the euro might replace the dollar soon after its successful introduction) to subdued (implying that the new currency had regional rather than global future), the majority opinion held the view that the euro might **gradually** rise to **share** global currency status with the dollar[75]. However, as the prevailing argument went, in the years to come, the

[72] For American attitudes toward EDSP, see R. Hunter, *The European Security and Defense Policy: NATO's Companion—or Competitor?,* Santa Monica: RAND, 2002.

[73] J. Bugajski, I.Teleki, *Atlantic Bridges: America's New European Allies*, New York: Rowman and Littlefield Publishers / The CSIS, 2007, pp. 73-75; and J. Van Oudenaren, *Containing Europe*, National Interest, no. 80 (Summer 2005): pp. 58-59, available: http://www.ebscohost.com/ (accessed Jan. 18, 2008).

[74] T. D. Lairson, D. Skidmore, *International Political Economy: The Struggle for Power and Wealth*, 3rd ed., Belmont, CA: Thomson, Wadsworth, 2003, p. 176.

[75] Ewe-Ghee Lim, *The Euro's Challenge to the Dollar: Different Views from Economists and Evidence from COFER (Currency Composition of Foreign Exchange Reserves) and other Data*, IMF Working Paper WP/06/153, June 2006, pp. 10-16, available: www.imf.org/; and M. Chinn and J. A. Frankel, *Will the Euro Eventually Surpass*

dollar would continue to play dominant role for several reasons: strong inertial bias; the size of the US economy; deep, well developed and liquid financial markets; and confidence in the value of currency[76]. Although the euro area could boast an economy similar in size to the United States, the other conditions necessary for the euro to become a serious contender for an eminent place in the "currency pyramid" would take time to pertain.

Admittedly, the success of the euro as an international currency should be but one aspect of measuring its international political success. However, it is an important one, for although somewhat ill-defined, there are significant gains from having a currency used internationally. From simple—though hard to measure in material terms—advantage to consumers, financial institutions and businesses to be dealing in their own currency which is internationally accepted, to the more quantifiable gains from seigniorage (which was estimated in the late 1990s at $15-20 billion annually for the United States) and to increased flexibility of macroeconomic policy that is provided by the reliance of one's own currency to finance external deficits [77]. In addition, there are purely political benefits related to power and prestige that go with market domination. Global money becomes a "potent symbol of primacy", an illustration of "soft power—the ability to exercise influence by shaping beliefs and perceptions"[78]. There are also more direct political benefits. The issuer of international currency is not only better removed from outside pressures but it is also better situated to "pursue foreign objectives without constraint, or even to exercise a degree of influence or coercion internationally"[79].

The Euro international advances at the expense of the dollar can be most easily and conveniently assessed by looking at its role as the reserve currency in the last few years. Although admittedly only one out of the several possible gauges of international use, the data on reserve currency holdings of governments is the one most easily available over a period of time[80]. Recently, several studies were published on the topic, evaluating the international use of the euro in this regard. The three traditional functions of currency— as medium of exchange, store of value and unit of account are used by central banks for their needs in foreign exchange

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the Dollar as Leading International Reserve Currency? [in:] *G7 Current Account Imbalances: Sustainability and Adjustment*, ed. Richard H. Clarida, Chicago: The University of Chicago Press, 2007, pp. 283-335.

[76] J. A. Frankel, *Still the Lingua Franca: the Exaggerated Death of the Dollar*, Foreign Affairs 74, no. 4 (July-Aug.1995): p. 13, available: http://www.ebscohost.com/ (accessed Jan. 18, 2008).

[77] Cohen, *Global Currency Rivalry*, p. 578.

[78] J. S. Nye, Jr., *Soft Power,* Foreign Policy*,* no. 80 (Fall 1990), available: http://www.ebscohost.com/ (accessed April 2, 2008); and Cohen, *The Future of Money,* p. 80.

[79] Cohen, *Global Currency Rivalry*, p. 578.

[80] Chinn and Frankel, *Will the Euro Eventually Surpass the Dollar*, p. 287.

intervention, reserve accumulation and anchor for pegging local currency[81]. Although the IMF's COFER (*composition of foreign exchange reserves*) data is far from perfect, it shows the essential movement of dollar and euro holdings in the official reserves of the reporting countries[82]. The dollar share of total official reserves was the lowest in the early 1990s—around 45%, rose to 72% in 2001 and dropped to around 66% in 2003, remaining unchanged at this level in 2006. The euro share was about 18% in 1999, rose to 25% in 2003 remaining unchanged in 2006. Interestingly, the principal origin of change in both the amount and the allocation of official reserves was the result of the increase of official reserves in developing countries. They accounted for 58% of the growth of total holdings, reducing their share of dollar holdings from 70% to 60% and expanding their euro holdings from 19% to 30%[83].

In the medium of exchange function, in 2004 the euro entered on one side of 37% of all foreign exchange transactions compared with the dollar's 89% (drop from 94% in 1998). The appeal of the euro was also boosted by the increasing depth of the government securities markets which increased to \$4.7 trillion[84]. In its unit of account function, the euro's attractiveness was evidenced by the growing "gravitational pull" of the new currency in comparison with the dollar—not only in the European countries outside of the EMU, but also some Latin American states as well as Canada, Australia and New Zealand. The dollar, however, retained a dominant role as monetary anchor for most of Asia[85]. Perhaps the biggest challenge for the dollar has been to continue maintaining its role as a store of value. The currency's continuous slide since 2002, especially against the euro, has put the American currency under great pressure. So far, the superior liquidity of dollar assets and the fear that any talk of diversification would put additional strain on the beleaguered currency inhibited central banks from taking any far-reaching adjustments in their holdings. Considering, however, that the official reserves of many developing countries go beyond of what is needed for intervention purposes and that central bankers may want to concentrate more on the performance of their assets, analysts expect the euro to be a more and more viable challenger to the dollar in this regard[86].

[81] Ibid., p. 286; and Craig K. Elwell, "The Dollar's Future as the World's Reserve Currency: The Challenge of the Euro," CRS Report for Congress, July 10, 2007, pp. 2-3, available: http://www.lexis-nexis.com/ (accessed Jan. 18, 2008).

[82] Elwell, "The Dollar's Future as the World's Reserve Currency," p. 4.

[83] Ibid., pp. 4-5.

[84] Ibid., p. 5.

[85] Ibid., p. 6.

[86] Ibid.

The death of the dollar was pronounced so many times after periods of its protracted weakness that it would be foolish to draw any definitive conclusions from the current figures. That is even more so since the statistics supports the thesis forecasting only a gradual change in the dollar's international position. Indeed, the dollar denominated assets as a share of total official reserves rose from their lows in the early 1990s and changed little during 2003-2006, a period which corresponded with its steep decline against the European currency[87]. Nonetheless, some analysts concluded that despite the dollar's important advantages stemming from being the **incumbent** global currency, supported by a huge economy, liquid financial markets and a stable central government, the challenge of the euro is real. Although gradual, the euro's equaling or surpassing the dollar as international reserve currency was inevitable and only the pace of its rise may vary dependent on two major issues:

1. *Whether enough other EU members join euro-land so that it becomes larger than the U.S. economy, and, in particular, whether the United Kingdom comes in with its large financial markets.*
2. *Whether U.S. macroeconomic policies eventually undermine confidence in the value of the dollar through inflation and depreciation*[88].

Even if such scenarios are overly optimistic for the euro, nearly every observer agrees that significant changes in the international position of the dollar and the euro were to be expected[89].

Conclusions

Judging from its performance in the past several years, the euro seems to have lived up to the expectations of its founders. Internally, in addition to the beneficial economic effects, it constituted an important step in the process of integration. Its success was a stimulus to continue the course in the direction of greater political unity and coherence of the EU. Internationally, in terms of relative power, it strengthened the position of the EMU members, and the EU as a whole, *vis a vis* the other economic powers, including the United States. In particular, it diminished the ability of the U.S.—with its globally dominant currency—to unilaterally use monetary statecraft to

[87] Ibid., pp. 4-8.
[88] Chinn and Frankel, "Will the Euro Eventually Surpass the Dollar," p. 317.
[89] Peter B. Kenen and Ellen E. Meade, *Regional Monetary Integration* (Cambridge: Cambridge University Press, 2008), pp. 188-189.

achieve its interests at the expense of its economic and trade partners. In addition, thus far it has arguably helped the euro area to confront the subprime financial crisis of 2007-2008 better than it would have been possible to do by individual countries and their national currencies.

The international assertiveness of the euro area ultimately depends on the political leadership of the EU, whose political coherence must be enhanced for the EMU to play a greater leadership role in the international monetary affairs. Indeed, such steps were taken in the provisions of the Lisbon treaty, which gave the EU and the EMU a stronger "external face" with the new posts of President and High Representative for Foreign and Security Affairs. Likewise, the existence of the Eurogroup was officially established, which may strengthen the political standing of its Chairman. The effects of these changes can be assessed after they take effect but they augur well for the increased weight of the euro area in the international monetary system.

The euro, however, has not been free of vulnerabilities. It is not backed by a strong central government, like the U.S. dollar, which makes it exposed to disunity among the EMU members. Depending whether or not the subprime financial crisis of 2007-2008 has reached its bottom yet, the euro may be headed toward its most severe test to date. If the economic slowdown in the euro-area members were prove to be differential, as it appears at this point, political pressures from the worse affected states on the ECB to "do something" about the strength of the euro might dramatically increase. If this indeed were the case, as *The Economist* wrote recently, "the euro is about to show the world that it is not yet an optimal currency area—and the demonstration may not be a pretty one"[90].

Both for the United States and the EU, the question of sound money and a reliable monetary system go beyond narrow economics and encroach upon political and security affairs. This was demonstrated in a recent testimony in the U.S. Senate Select Committee on Intelligence. In addition to the usual list of global terrorism, nuclear proliferation and regional conflicts, the chief of the U.S. Intelligence Michael McConnell added the falling dollar as a major threat to the U.S. security. He specifically admitted "concerns about the financial capabilities of Russia, China and OPEC countries and the potential use of their market access to exert financial leverage to achieve political ends"[91]. He warned of the impact of the weak dollar on national security and cautioned that it can transform "into a full-blown currency crisis with damaging geopolitical consequences."

[90] *Danger Ahead for the Mighty Euro*, The Economist, April12, 2008.
[91] J. Shelton, *Security and the Falling Dollar,* Wall Street Journal, February 15, 2008.

The current administration policy of “weak dollar”, “plays directly into fears about a weakening U.S. economy and gives credence to self-serving pronouncements [of foreign leaders] about America’s weakening role in the world arena” [92].

Characteristically, nowhere in the testimony the existence of EMU is mentioned as a risk to a stable international monetary system or, indirectly, a threat to U.S. security. In American official pronouncements, past or present, the introduction of the euro or the existence of the EMU has never been treated with excessive apprehension. Although diplomatic jargon full of good wishes for the success of the EMU has never sounded sincere to an anti-American ear, this should not blind us to the simple truth that successful and stable EU **is in fact** in American vital interest. For all the talk about the euro as a **rival** to the dollar, the United States and the European Union are strategic partners and their relations are characterized mostly by cooperation, sometimes by competition and only rarely by conflict. This fundamental fact should always be kept in mind.

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[92] *Ibid*.

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