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**THE EURO
AND TRANSATLANTIC RELATIONS**

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How will the euro affect transatlantic relations? Even while partners in a political and military alliance, Europe and the United States have long been rivals in monetary affairs. Until recently, however, it was a rather one-sided contest, since Europe had no currency – not even the fabled Deutsche mark (DM) – that could effectively match the U.S. dollar as international money. Now Europe has the euro, which many have predicted will quickly emerge as a potent competitor to America’s greenback. Could growing rivalry between the dollar and the euro endanger the historic European-American partnership?

The dollar today is the only truly global currency, used for all the familiar purposes of money – medium of exchange, unit of account, store of value -- in virtually every corner of the world. Resentment has long simmered among Europeans sensitive to the inordinate power that the greenback gives the United States – America’s “exorbitant privilege,” in Charles De Gaulle’s memorable phrase. The European Union (EU) is the equal of the United States in economic output and trade. Why should it not be America’s equal in monetary matters, too? For many Europeans, this is the “hidden agenda” of Economic and Monetary Union (EMU). Some degree of monetary conflict, therefore, would seem inevitable. Worse, in turn, monetary conflict could conceivably spill over into broader geopolitical confrontation.

The critical question is: Can the dominance of the dollar be challenged? The answer comes in two parts – first, if we look to the logic of market competition; and second, if we factor in government preferences as well.

Looking to the logic of market competition alone, the answer is clear. Despite its recent travails in the exchange markets, the dollar will continue to prevail as the world’s only truly global currency. The euro will of course dominate monetary relations within the European region and may even extend its influence to some neighboring areas, such as the Mediterranean littoral or sub-Saharan Africa. But elsewhere, for the foreseeable future, Europe’s new money is fated to remain a distant second to the greenback, however much many Europeans would prefer otherwise.

Once we factor in government preferences, however, the outlook becomes cloudier. The Europeans can be expected to make every effort to promote the market appeal of their new currency. The greenback’s global dominance will not go unchallenged. But will Europe go further, to seek formation of an organized monetary bloc with foreign governments? That is less certain. In fact, there seems little reason to believe that Europeans are prepared to carry currency confrontation with the United States to the point where it might jeopardize more vital political and security interests. The risk of a serious collision, accordingly, appears low. Mutual restraint, I argue, is the much more likely scenario.

I. THE STAKES

What is at stake? Broadly speaking, currencies may be employed outside their country of origin for either of two purposes – for transactions either between nations or within foreign states. The former is conventionally referred to as international currency use or currency internationalization; the latter goes under the label currency substitution and can be referred to as foreign-domestic use. For both purposes America’s greenback today is indisputably the global leader, privileging the United States both economically and politically. The stakes, in fact, are considerable. Four distinct benefits may be cited.

Most familiar is the potential for seigniorage. International use of a national money generates the equivalent of a subsidized or interest-free loan -- an implicit transfer that represents a real-resource gain for the issuing economy. Consider, for example, the widespread foreign circulation of Federal Reserve notes, which are a form of non-interest bearing liability. Authoritative studies (Porter and Judson 1996; U.S. Treasury 2000) put the value of all Federal Reserve notes in circulation abroad at between 50 and 70 percent of the total outstanding stock -- equivalent at the turn of the century to roughly \$275 billion to \$375 billion in all. Estimates also suggest that as much as three-quarters of the annual increase of U.S. notes now goes directly abroad, up from less than one-half in the 1980s and under one-third in the 1970s. Updating earlier estimates (Frankel 1995; Blinder 1996), current interest savings from foreign circulation of the greenback may be conservatively calculated at some \$16-22 billion a year. To this may be added a saving of interest payments on U.S. government securities, which are uniquely attractive to foreign holders because of their greater liquidity. Economists Richard Portes and H el ene Rey (1998: 309) call this an "often neglected source of seigniorage to the issuer of the international currency." In their words (1998: 309): "This international currency effect reduces the real yields that the United States government has to pay" -- a "liquidity discount" that they suggest could amount to at least \$5-10 billion a year. Put these numbers together and, paraphrasing former Republican Senator Everett Dirksen's celebrated remark about the Federal budget, we are beginning to talk about real money.

A second gain is the increased flexibility of macroeconomic policy that is afforded by the privilege of being able to rely on one's own currency to help finance foreign deficits. Expanded cross-border circulation reduces the real cost of adjustment to payments imbalances by internalizing through credit what otherwise would be external transactions requiring scarce foreign exchange. In effect, it reduces the role of the balance of payments as a constraint on policy formulation and implementation. How else could the United States have run current-account deficits for so long without any noticeable impact on domestic monetary or fiscal policy? Increased macroeconomic flexibility makes it easier for Washington to pursue strategic goals abroad, whether economic or political, without worrying about where the money is coming from.

Third, more psychological in nature, is the gain of status and prestige that goes with market dominance. Money, as I have written elsewhere (Cohen 1998), has long played a key symbolic role for governments, useful -- like flags, anthems, and postage stamps -- as a means to cultivate a unique sense of national identity. But that critical role is eroded to the extent that a local currency is displaced by a more popular foreign money, especially a money like the greenback that is so widely used on a daily basis. Foreign publics are constantly reminded of America's elevated rank in the community of nations. "Great powers have great currencies," Nobel laureate Robert Mundell once wrote (1993: 10). In effect, the dollar has become a potent symbol of American primacy -- an example of what Joe Nye calls "soft power," the ability to exercise influence by shaping beliefs and perceptions. Though obviously difficult to quantify, the role of reputation in geopolitics should not be underestimated.

Finally, there is the gain of "hard" power that derives from the monetary dependence of others. On the one hand, an issuing country is better insulated from outside influence in the domestic arena. On the other hand, it is also better positioned to pursue foreign objectives without constraint or even to exercise a degree of coercion internationally. As political scientist

Jonathan Kirshner reminds us (1995: 29, 31): “Monetary power is a remarkably efficient component of state power... the most potent instrument of economic coercion available to states in a position to exercise it.” Money, after all, is simply command over real resources. If a country can be denied access to the means needed to purchase vital goods and services, it is clearly vulnerable in political terms. Kirshner lists four ways in which currency dependence can be exploited: (1) enforcement – manipulation of standing rules or threats of sanctions; (2) expulsion – suspension or termination of privileges; (3) extraction – use of the relationship to extract real resources; and (4) entrapment – transformation of a dependent state’s interests. The dollar’s widespread use puts all of these possibilities in the hands of Washington policymakers.

Admittedly there are limits to these benefits, as the United States has lately been reminded. Swelling U.S. payments deficits have put the greenback under great strain, risking an erosion of America’s privileges – a risk that is all the greater now that the euro has come on the scene, making it easier for market actors to switch allegiance. In the first years of the new millennium, the greenback has lost roughly a quarter of its overall value in exchange markets; against the euro alone, the drop has been closer to half. The longer the dollar’s depreciation goes on, the greater will be the pressure on Washington to do something about it. In economic terms, this could mean higher interest rates, reducing both seigniorage income, on a net basis, and macroeconomic flexibility. In political terms, both the prestige the dollar and America’s hard power abroad could gradually suffer. But even admitting such limits, there seems little doubt that on balance there are advantages here of considerable significance. The stakes are indeed high.

II. THE LOGIC OF MARKET COMPETITION

Can the euro challenge the dominance of the dollar? Many have predicted that Europe’s new currency will quickly match, and perhaps even surpass, the dollar’s global popularity. But the logic of market competition, I contend, suggests otherwise. Left to their own devices market actors will continue to give a distinct preference to the dollar, current strains notwithstanding.

Barriers to displacement

Displacement of a dominant international money is not easy, for two reasons – first, because the qualities required for competitive success tend to be highly demanding; and second, because of inertia, which is a characteristic inherent in all monetary behavior.

Fundamentally, currency choice in the global marketplace is shaped by three essential attributes. First, at least during the initial stages of a money’s cross-border use, is widespread confidence in its future value backed by political stability in the country of origin. Second are the qualities of “exchange convenience” and “capital certainty” -- a high degree of transactional liquidity and reasonable predictability of asset value. The key to both qualities is a set of well developed financial markets, sufficiently open to ensure full access by non-residents. Markets must not be encumbered by high transactions costs or formal or informal barriers to entry. They must also be broad, with a large assortment of instruments available for temporary or longer-term forms of investment, and resilient, with fully operating secondary markets for most if not all financial claims. And third, a money must promise a broad transactional network, since nothing

enhances a currency's acceptability more than the prospect of acceptability by others. Historically, this factor has usually meant an economy that is large in absolute size and well integrated into world markets. The greater the volume of transactions conducted in or with a country, the greater are the potential network externalities to be derived from use of its money. Not many currencies can meet all these demanding conditions.

Moreover, even with the requisite attributes, displacement is difficult because of inertia in currency choice. The principle source of inertia is the pre-existence of already well established transactional networks, which generate a well documented stickiness in user preferences – what specialists call hysteresis or ratchet effects. In effect, prior use confers a certain natural advantage of incumbency. Switching from one money to another is costly, involving an expensive process of financial adaptation. Considerable effort must be invested in creating and learning to use new instruments and institutions, with much riding on what other market agents may be expected to do at the same time. Hence as attractive as a given money may seem, adoption will not prove cost-effective unless others appear likely to make extensive use of it, too.

Inertia is also promoted by the exceptionally high level of uncertainty that is inherent in any choice between alternative moneys. Uncertainty encourages a tendency toward what psychologists call “mimesis”: the rational impulse of risk-averse actors, in conditions of contingency, to minimize anxiety by imitative behavior based on past experience. Once a currency gains a degree of acceptance, its use is apt to be perpetuated -- even after the appearance of powerful new competitors -- simply by regular repetition of previous practice. In effect, a conservative bias is inherent in the dynamics of the marketplace.

The salience of inertia in this context is well illustrated by the dollar's own experience when it first began to rival the pound sterling, the dominant currency of the nineteenth century. Even after America's emergence as the world's richest economy, it took literally decades for the greenback to ascend to top rank among currencies. As Paul Krugman has commented (1992: 173): “The impressive fact here is surely the inertia; sterling remained the first-ranked currency for half a century after Britain had ceased to be the first-ranked economic power”. Similar inertias have been evident for millennia in the prolonged use of such international moneys as the Byzantine solidus (otherwise known as the bezant) or the Spanish silver peso (later known as the Mexican silver dollar) long after the decline of the imperial powers that first coined them (Cohen 1998: ch. 2). In fact, such inertias are very much the rule, not the exception, in global currency relations.

Exceptional or not, even the most stubborn inertias can in time be overcome, as these historical examples also illustrate. But to defeat the conservative bias in market behavior, a new contender must do more than merely *match* the attributes of the existing incumbent. It must be able to offer substantial *advantages* over its established rival. The dollar was able to do that in relation to sterling once New York overtook London as the world's pre-eminent source of investment capital. The problem for the euro is that for the foreseeable future it cannot realistically hope to offer comparable advantages in relation to the greenback.

In principle, prospects for the euro should be bright, particularly following its rapid recent appreciation in exchange markets.. Europe's new currency started life in January 1999 with many of the attributes necessary for competitive success already well in evidence. Together, the twelve present members of the Economic and Monetary Union – familiarly known as the euro area or euro zone -- constitute an economy nearly as large as that of the United States,

with extensive trade relations not only in the European region but around the world. The potential for network externalities is considerable. Likewise, the euro zone started with both unquestioned political stability and an enviably low rate of inflation, backed by a joint monetary authority, the European Central Bank (ECB), that is fully committed to preserving confidence in the euro's future value. Much room exists, therefore, for a quick ascendancy, as frequently predicted. Typical is the attitude of Robert Mundell, who expresses no doubt that the euro "will challenge the status of the dollar and alter the power configuration of the system" (2000: 57). In the oft-quoted words of Jacques Delors, former head of the European Commission, "*le petit euro deviendra grand.*"

In practice, however, the outlook for the euro is anything but rosy, despite the currency's recent appreciation. Short-term movements of exchange rates should not be confused with longer-term trends in use for investment or transactional purposes. In fact, with each passing year it becomes increasingly clear that serious obstacles lie in the path of the euro's ascent as international money. Within the European region, of course, the euro will dominate easily; and its influence may even be extended as well to some neighboring areas, such as the Mediterranean littoral or sub-Saharan Africa. In these nearby locales the euro is the natural currency of choice. As one European economist remarks: "This is the euro's turf" (Wyplosz 1999: 89). But that appears to be as far as the new money's domain will expand as a result of market forces alone. Virtually all the growth of cross-border use of the euro since its introduction has occurred within the euro's immediate neighborhood (ECB 2003). Elsewhere, left to the logic of market competition, the currency seems fated to remain a distant second to the greenback. In a recent analysis (Cohen 2003b), I spell out three critical reasons for this negative assessment.

Transactions costs. First is the cost of doing business in euros, which directly affects the currency's attractiveness as a vehicle for foreign-exchange transactions or international trade. Euro transactions costs, as measured by bid-ask spreads, are historically higher than those on the more widely traded dollar. Whether they can be lowered to more competitive levels will depend directly on what happens to the structural efficiency of Europe's financial markets. On the face of it, prospects for euro transactions costs look good. In purely quantitative terms, introduction of the euro promises to create the largest single-currency capital market in the world; and that expansion, in turn, should trigger major qualitative improvements in depth and liquidity as previously segmented national markets are gradually knitted together into an integrated whole. As a practical matter, however, progress to date has been disappointing, owing to stubborn resistance to many market-opening measures; and as a result is not at all clear that the euro's promise in this respect can ever be converted fully into performance. As a recent EU report on Europe's financial markets – the so-called Lamfalussy Report – firmly insisted (European Union 2001: 8): "The European Union has no divine right to the benefits of an integrated financial market. It has to *capture* those benefits" – and so far, at least, the EU has not done a very good job at doing so.

In certain key respects the dollar's advantages will persist no matter what the EU does. Most important is the lack of a universal financial instrument in Europe to rival the U.S. Treasury bill for liquidity and convenience – a deficiency that will be difficult, if not impossible, to rectify so long as the Europeans, with their separate national governments, lack a counterpart to the Federal Government in Washington. Full consolidation of the euro zone's markets for public debt is stymied by the persistence of differential credit and liquidity risk premiums among

participating countries as well as by variations in legal traditions, procedures, issuance calendars, and primary dealer systems. Market segmentation has also been prolonged by intense competition among governments to establish their own issues as EMU benchmarks.

On balance, therefore, it seems unlikely that anticipated efficiency gains, though substantial, will soon suffice on their own to displace the greenback from top rank. To date, there is little evidence of reduced transactions costs for Europe's new money. Indeed, for some types of transactions bid-ask spreads actually increased after introduction of the euro, relative to earlier spreads for the DM, Europe's most widely traded currency prior to EMU (Detken and Hartmann 2002; Hau *et al.* 2002a, 2002b). In reality, no one expects that euro transactions costs will ever decline to a level substantially below those presently quoted for the dollar.

Anti-growth bias. A second critical factor is a serious anti-growth bias that appears to be built into the institutional structure of EMU. By impacting negatively on yields on euro-denominated assets, this structural bias directly affects the currency's attractiveness as a long-term investment medium. When EMU first came into existence, eliminating exchange risk within the European region, a massive shift was predicted in the allocation of global savings as compared with holdings of European assets in the past. In fact, however, international portfolio managers have been slow to move into the euro (ECB 2003; Geis *et al.* 2004). Liquid funds have been attracted, of course, by the prospect of short-term appreciation. But underlying investor preferences have barely budged, in good part because of doubts about prospects for longer-term growth. In turn, one of the main cause for such doubts seems to lie in the core institutional provisions of EMU governing monetary and fiscal policy, the key determinants of macroeconomic performance. In neither policy domain is priority attached to promoting real production. Rather, in each, the main emphasis is on other considerations that can be expected to limit opportunities for future expansion – imparting a distinct anti-growth bias to the economy of the euro zone as a whole.

On the monetary policy side, the European Central Bank, unlike many other monetary authorities, was created with just a single policy mandate – to maintain price stability. Moreover, the ECB is formally endowed with absolute independence, largely insulating it from political influence. Legally, the ECB is free to focus exclusively on fighting inflation, even if over time this might be at the cost of stunting real growth. In practice, naturally, the ECB is not wholly insensitive to growth concerns. Nonetheless, the overall orientation of ECB priorities is clear. Since EMU's start, the bias of monetary policy has plainly been toward restraint, not expansion.

Likewise, on the side of fiscal policy, euro-zone governments have formally tied their own hands with their controversial Stability and Growth Pact (SGP), which mandates a medium-term objective of fiscal balance in all participating economies as well as a strict cap on annual budget deficits. These fiscal restraints make it exceedingly difficult for elected officials to use budgetary policy for contracyclical purposes, to offset the anti-growth bias of monetary policy. Here too, we know, practice has increasingly diverged from principle; and many specialist in Europe have called for revision or repeal of the Pact's principle provisions. Until now, however, such appeals have made little headway. So long as the SGP remains officially binding on all euro-zone governments, an anti-growth bias will be perpetuated in fiscal policy, too.

Governance. Finally, there is the governance structure of EMU, which for the euro's prospects as an international currency may be the biggest obstacle of all. The basic question is:

Who is in charge? The answer, regrettably, has never been clear. From the start, much confusion has reigned concerning the delegation of authority among governments and EU institutions. The Maastricht Treaty, which brought EMU into existence, embodies a variety of artful compromises and deliberate obfuscations in provisions for the political management of the euro, resulting in a high level of ambiguity. Prospective users of the new currency, therefore, may be excused for hesitating to commit themselves to what seemingly amounts to a pig in a poke -- even if in fact transactions costs could be lowered to competitive levels and rewards to European capital could be significantly improved.

Three key provisions are at issue. First is the governance of EMU's core institution, the European Central Bank itself. Immediate operational control of monetary policy lies in the hands of the ECB's Executive Board, made up of the President, Vice-President, and four other members. Ultimate authority, however, is formally lodged in the Governing Council, which in addition to the six-member Executive Board include heads of central banks of the participating states -- a number seemingly greater than consistent with efficient collective decision making. Sooner or later, therefore, as so often happens in large multinational institutions, real power will have to devolve to a smaller "inner" group formally or informally charged with resolving differences on critical issues. But who will be allowed to join this exclusive club? Would it be the members of the Executive Board, who might be expected to take a broad approach to the euro zone's needs and interests? Or would it be a select coterie of central-bank governors, whose views could turn out to be more parochial? For the moment, no one knows.

Second is the critical matter of exchange-rate policy. Under the Maastricht Treaty, the ECB is assigned day-to-day responsibility for the euro's external value. Authority over the more general orientation of policy, however, is uneasily shared with both the Council of Ministers, representing national governments, and the European Commission in Brussels. Plainly, power over exchange rates was meant to be shared in some form of consensual process. But, equally, these provisions could turn out to be a sure recipe for political deadlock and drift. Again, no one knows.

Finally, there is the issue of external representation. Who is to speak for the euro zone on broader macroeconomic issues such as policy coordination, crisis management, or reform of the international financial architecture? Here there is no answer at all, leaving a vacuum at the heart of EMU. No single body is designated to represent EMU at the International Monetary Fund or in other global forums. Instead, the Maastricht Treaty simply lays down a procedure for resolving the issue at a later date, presumably on a case-by-case basis. This is a cop-out that, at a minimum, compounds confusion about who is in charge. At worst, the vacuum condemns the euro zone to lasting second-class status, since it limits the group's ability to project power in international negotiations. As one source warns (McNamara and Meunier 2002: 850): "As long as no 'single voice' has the political authority to speak on behalf of the euro area, as the U.S. Secretary of the Treasury does for the American currency, the pre-eminence of the U.S. in international monetary matters, as in other realms, is likely to remain unchallenged."

III. GOVERNMENT PREFERENCES

But is Europe really likely to accept such an unappealing outcome? Whatever the logic of market competition, the Europeans can hardly be expected to leave market actors entirely to

their own devices – particularly if that means passively submitting to the continued dominance of the dollar. Currency rivalries, in practice, reflect the influence of government preferences as well as market forces. Once we introduce government preferences, however, the outlook becomes considerably more cloudy.

A critical distinction

One thing is certain. A strategy to maintain or enhance market position will be Europe's preferred choice. Rational policymakers are unlikely to turn their back on the considerable benefits that may be derived from broader circulation of their currency. But following a suggestion I have made elsewhere (Cohen 2003a), a critical distinction must be drawn between two different kinds of monetary conflict: *informal* and *formal*.

Given the stakes involved, there seems little doubt that the Europeans will do all they can to promote the attractiveness of the euro, with the objective of cultivating widespread use by *market* actors. Rivalry for market use – what I call *informal* conflict -- is natural between major currencies. It is less evident, however, whether Europe will be motivated to go a step further, to seek to influence the behavior of *state* actors – that is, to sponsor formation of an organized currency bloc, what I call *formal* conflict. Within the European neighborhood, a bloc can be expected to form more or less naturally. That is uncontroversial. The question is: Will Europeans seek to offer direct inducements to governments elsewhere, beyond the European neighborhood, to encourage greater use of the euro? About this prospect there is more uncertainty, not least because the balance of benefits and costs implied by that extra step is not at all clear.

What is clear is that whatever Europe does is sure to be closely watched by Washington. Any move to promote an organized euro bloc outside the European neighborhood would, by definition, transform the low politics of market competition into the high politics of diplomatic confrontation. The risk is that policy maneuvering could lead to increased political tensions, particularly if monetary initiatives were perceived to be encroaching on established regional relationships.

Precisely for that reason, however, it is more likely that Europe, ultimately, will act with restraint to avoid a direct confrontation with the United States that could jeopardize more vital political and security interests. While some Europeans might relish the prospect of a blunt challenge to the world's "last remaining superpower," others will not – including, in particular, most of the EU's newest members, whose history and geography provide strong motivation for maintaining close ties to Washington. A European consensus in favor of an open break with the United States is difficult to imagine. The safest bet, therefore, is that currency rivalry will be restricted mainly to the realm of market transactions. The one exception could be in the Middle East, where rivalry for the monetary favor of OPEC governments could conceivably generate a serious battle.

Informal conflict

Although Europe has an obvious incentive to promote the attractiveness of the euro, aspirations officially remain modest. According to authoritative statements by the European

Central Bank, the development of the euro as international money – to the extent it happens – will mainly be a market-driven process, simply one of many possible byproducts of EMU. Europe, says the ECB (2002: 11), “does not pursue the internationalisation of the euro as an independent policy goal... It neither fosters nor hinders this process.” These carefully considered words, however, may be dismissed as little more than diplomatic rhetoric, revealing nothing. Behind the scenes it is known that there is considerable sentiment in favor of a much more pro-active stance.

More revealing, therefore, is not what the ECB says but what it does. Especially suggestive is the bank’s controversial decision to issue euro notes in denominations as high as 100, 200, and 500 euros – sums far greater than most Europeans are likely to find useful for everyday transactions. Why issue such large notes? Informed sources suggest that the plan may have been decided in order to reassure the German public, fearful of losing their beloved Deutsche mark, that notes comparable to existing high-denomination DM bills would be readily available. But that is hardly the whole story. In reality, it is also likely that the decision had something to do with the familiar phenomenon of currency substitution: the already widespread circulation of large-denomination dollar notes, especially \$100 bills, in various parts of the world. In the words of one knowledgeable source (Rogoff 1998: 264): “Given the apparently overwhelming preference of foreign and underground users for large-denomination bills, the [ECB’s] decision to issue large notes constitutes an aggressive step toward grabbing a large share of developing country demand for safe foreign currencies.” Europeans who favor more widespread use of the euro have openly applauded the plan. Writes one (Hüfner 2000: 25): “The United States is able to obtain goods and services by simply giving foreigners pieces of green paper that cost pennies to print... There is no reason why the United States should monopolize these benefits.”

What more could Europe do, apart from issuing high-denomination notes? The answer lies in the three reasons for the euro’s sluggish ascent to date. More could be done to lower transactions costs for non-residents in European financial markets. International investments in euro bonds and stocks might be encouraged with selected tax incentives, including abolition of any withholding or reporting requirements. Similarly, broader use of the euro for vehicle purposes could be underwritten with targeted subsidies for European banks, lowering the cost of commercial credit for third-country trade. More could also be done to reverse the anti-growth bias built into EMU’s institutional structure and to clarify the governance structure of EMU. As indicated, much room exists for policy actions to make the euro more appealing to market actors.

How will Washington react to such competition? Publicly, the United States remains unconcerned. Policy statements regarding a prospective challenge from the euro have been studiously neutral, avoiding provocation. But such words too may be dismissed as diplomatic rhetoric, concealing as much as they reveal. As Richard Portes (1999: 34) observes: “It is difficult to believe that the American authorities are indifferent.” In fact, in Washington too there is considerable sentiment behind the scenes in favor of a more pro-active stance designed to respond in kind to any direct threat to the dollar. Introduction of the ECB’s large-denomination bills, for example, quickly generated counterproposals to issue a rival \$500 Federal Reserve note, designed to preserve America’s seigniorage earnings abroad. The probability is that aggressive policy measures from Europe will ultimately provoke countermeasures from Washington, with both sides doing what they can to maximize market use.

IV. FORMAL CONFLICT?

This does not mean, however, that Europe must necessarily go the next step, to seek to influence *state* behavior. As compared with the benefits of extensive market use, the additional gains from sponsoring a formal currency bloc could be considerable. But so too could be the costs, political as well as economic, discouraging new initiatives. Prediction, therefore, is chancy. The Europeans, as indicated, will no doubt make every effort to promote use of their new money at the market level wherever they can. It is also evident that they will not discourage greater reliance on the euro by nearby governments, particularly in East-Central Europe and the Balkans. But none of this will trigger geopolitical conflict with Washington unless the EU's aspirations begin to spread beyond its immediate neighborhood to regions more traditionally aligned with the United States. The safest bet is that the Europeans, ultimately, will act with restraint to avoid direct confrontation with the United States. Arguably, only in the Middle East is there a significant risk of serious tension.

That is not to say that there are no Europeans with more global ambitions for the euro. Quite the contrary. Portes and Rey (1998), for example, plainly favor what they call the "big euro" scenario, where the euro would join the dollar as a global currency. The dollar, they declare (1998: 308), "will have to share the number-one position." But this is a minority view. Most informed opinion in Europe accepts that there are limits to what might be regarded as the natural home for a formal euro zone.

An EMU bloc certainly would include most if not all of the countries of Europe itself, including of course all the ten new members that joined in 2004. Beyond EMU's present dozen members, six regional jurisdictions have already adopted the euro as their exclusive legal tender, including the tiny enclaves of Andorra, Monaco, San Marino, and the Vatican as well as Montenegro and Kosovo, two special cases in the Balkans (Winkler *et al.* 2004). In addition, several regional economies are pegged to the euro via currency boards, including Bosnia and Herzegovina, Bulgaria, Estonia, and Lithuania; and most other nearby currencies are more loosely linked. Some maintain basket pegs that give greatest weight to the euro; others have adopted systems of managed floating with the euro unofficially used as an anchor. Momentum toward full "euroization" will only grow as EU enlargement proceeds. As Pier Carlo Padoan suggests (2000: 101): "The case is easily stated. What matters is not 'if' but 'when.'" Every regional government aspiring to join the EU club expects to adopt the euro, too.

Whatever the rate of momentum, however, Washington is unlikely to take offense. The United States has never questioned the EU's privileged interests in what is universally acknowledged as its own backyard. Indeed, for geopolitical reasons Washington might even be inclined to prod the Europeans along. More positive support for the new members promises to bring greater stability to a potentially volatile region. As Randall Henning has observed (2000: 18): "The consolidation of the monetary union contributes to economic and political stability in Central and Eastern Europe.... If the monetary union were to fail, Central and Eastern Europe would probably be considerably less stable... As a consequence, U.S. manpower and resource commitments would have to be correspondingly greater. This geopolitical consideration is profoundly important for U.S. foreign policy."

Nor is Washington likely to take offense if the growing EMU bloc were extended to

encompass as well countries of the Mediterranean littoral and sub-Saharan Africa that have close economic and political linkages with the EU. These too are regarded as part of Europe's backyard. Some of their currencies are already pegged to the euro, including most prominently the CFA Franc in central and west Africa, for which Europe's new money has seamlessly taken over the anchor role previously played by the French franc; and for most the euro is already an important reserve currency. Here too Washington might even prod the Europeans along in the interest of regional stabilization.

The critical question is: Might Europe aspire to go further? There is no evidence that the EU would seriously consider challenging the dollar in Latin America or Asia, where Washington's interests are clearly seen as privileged. These areas, Europeans acknowledge, are America's turf. But what about the Middle East, with its concentration of wealthy oil exporters? If the dollar-euro rivalry is to lead to direct confrontation anywhere, it will be here.

V. THE MIDDLE EAST

Three factors explain why the Middle East could become a currency battleground. First is the sheer scale of monetary riches in the area controlled directly or indirectly by national governments. Exports of oil generate massive revenues for state authorities in Saudi Arabia, Kuwait, and other countries scattered around the Persian Gulf; and much of this wealth, in turn, is either stored away in central bank reserves or invested abroad in publicly held portfolios. What these governments decide to do with their money can have a major impact on the relative fortunes of international currencies.

Second is the instability of great-power alignments in the area. In the euro's immediate neighborhood, the United States may happily defer to the EU; conversely, across Latin America and Asia, Europe may still accept Washington's strategic dominance. But in geopolitical terms the Middle East is a contested region, as the still unfinished business of Iraq clearly testifies. For the moment, most governments in the region find it prudent to accept U.S. leadership and even U.S. troops. But with their ample economic and cultural ties to the area, Europe's governments remain committed to playing an important regional role. Resentment of Washington's displacement of Europe's historical pre-eminence in the area is rife among Europeans.

And third is the seeming contradiction between the region's commercial ties with the outside world and its financial relations. Foreign trade is dominated by Europe, which is by far the biggest market for the Middle East's oil exports as well as the largest source of its imports. Yet financial relations are dominated by the United States and the almighty greenback. America's dollar is not only the standard for invoicing and payments in world energy markets. It also accounts for the vast majority of central bank reserves and government-held investments in the region and is the anchor, de jure or de facto, for most local currencies. In the eyes of many the disjunction seems anomalous, even irrational. Repeatedly, the question is asked: Would it not make more sense to do business with the area's biggest trading partner, Europe, in Europe's own currency rather than the greenback? And if so, would it not then make sense to switch to the euro as a reserve currency and monetary anchor as well?

Together, these three factors add up to an obvious recipe for conflict, should Europe choose to turn up the heat. Certainly, the possibility of a switch to the euro is tempting from a European perspective. Almost immediately, given the large sums involved, the EU's new

currency would be vaulted to the “big euro” scenario favored by Portes and Rey (1998) and others, while restoring a measure of Europe’s historically privileged position in the Middle East. Arguably, the prospect might be tempting from the perspective of Middle Eastern governments, too, for sound financial reasons as well as to curb America’s presently overweening influence. It is well known that from time to time oil exporting states have actively explored alternatives to the dollar, only to be discouraged by the lack of a suitable substitute. Now, with the arrival of the euro, they see the possibility of a truly competitive rival for their affections. In the artfully composed words of a high official of the Organization of Petroleum Exporting Countries (OPEC): “It is worthwhile to note that in the long run the euro is not at such a disadvantage versus the dollar.... I believe that OPEC will not discount entirely the possibility of adopting euro pricing and payments in the future.”¹

Indeed, some straws are already in the wind. As early as October 2000, in a deliberate snub to the United States, Iraq’s now deposed dictator Saddam Hussein began demanding payment in euros for his country’s oil exports. He also converted his \$10 billion United Nations reserve fund into euros, making a considerable profit once Europe’s currency began to appreciate. And more recently Iran is known to have considered a similar strategy. Talk in OPEC of a switch to the euro has only intensified lately as the greenback has continued to weaken. Should Europe seek to take advantage of current market conditions, directly promoting use of its money by regional governments, it might find itself pushing against an open door.

Any effort along these lines, however, would surely provoke determined opposition from the United States, which clearly prefers to keep the region’s door as firmly shut to the euro as possible. For Washington today, there is no higher politics than the Great Game being played out in the Middle East. With so much at stake, the level of tolerance for a formal currency challenge from Europe would be correspondingly low, making geopolitical conflict a virtual certainty. Indeed, for some observers the conflict has already begun. America’s attack on Iraq, it is said, was motivated above all by the euro’s threat to the dollar. In the words of one widely circulated commentary (Clark 2003: 1): “It is an oil currency war. The Real Reason for [the war] is this administration’s goal of preventing further OPEC momentum towards the euro as an oil transaction currency standard.” Such a theory, wholly unsubstantiated by plausible evidence, obviously smacks of conspiratorial thinking.² But one does not have to be a sensationalist to recognize the seeds of truth that it contains. A battle of currencies in the Middle East could become serious.

Would Europe risk it? In the end, however strongly tempted, the Europeans are more likely to keep their aspirations in check, averting direct confrontation with Washington. Even after the Bush Administration’s decision to promote “regime change” in Iraq, there is no consensus among Europeans to risk the broader political and security relationship that they have long enjoyed with the United States. Beyond their currency’s natural home in Europe’s immediate neighborhood, therefore, they will most probably act with restraint. Maneuvering for advantage will undoubtedly persist, particularly in the Middle East. Monetary rivalry, however, is unlikely to be allowed to get out control.

V. CONCLUSION

Overall, therefore, the outlook for the dollar-euro rivalry appears relatively benign. In the

global marketplace, competition between the two contenders will continue to be intense, and the authorities on both sides of the Atlantic will do all they can to sustain the competitive appeal of their respective currencies. But at the level of inter-governmental relations, the low politics of market competition is unlikely to be transformed into the high politics of diplomatic confrontation, largely because Europe will not be eager to seriously provoke the United States. Miscalculations are always possible, of course, despite the best of intentions. The Europeans might well go too far in promoting use of the euro in the Middle East. The safest bet, however, is for mutual restraint, limiting geopolitical tensions.

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1. Yarjani 2002. Yarjani is head of OPEC's Petroleum Market Analysis Department.
 2. For a direct critique of the oil-currency war theory, see Caffentzis 2003.