The Euro vs. the Dollar in the Political Economy of Global Monetary Governance: Perceptions of the Financial Elites in China, the GCC and Brazil

Miguel Otero-Iglesias

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Oxford Brookes University
Global Politics, Economy and Society Doctoral Training Programme
Department of International Relations, Politics and Sociology (DIRPS)
School of Business (SB)

Supervisory Team

Director of Studies: Prof. Magnus Ryner (DIRPS)
Second Supervisor: Dr. Stephen Hurt (DIRPS)
Third Supervisor: Mr. Andy Kilmister (SB)

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Declaration

This thesis is entirely my own work and it has not been submitted for a degree at another university.

Parts of the thesis draw on passages from the following publications, which can be found in the Appendix, Part B:

'The Influence of the Euro in Reshaping Global Monetary Governance: Perceptions of Financial Elites in Brazil and China', *European Law Journal*, 18(1), 2012, 124-44.

'The (in)tangible Euro challenge to the Dollar: insights from the financial elites in Brazil and China, *Cambridge Review of International Affairs*, 2011, forthcoming. Available online through i*First,* 10 August 2011.

'EU-Brazil Transformismo in the Reconfiguration of the Global Financial Order', *Austrian Journal of Development Studies*, 25(1), 2009, 103-18.

Abstract

The central concern of this thesis is to explore whether the euro is challenging the dollar as the top international currency in the international monetary system (IMS) and, if so, whether this is enhancing European monetary power in global monetary governance. The research has been designed so as to develop an empirical adjudication within the 'euro vs. dollar' debate taking place in the fields of International Economics and International Political Economy. The study, which develops a constructivist analytical framework concerned with both the material and ideational footprint of the euro, provides evidential support in favour of the euro-sceptic literature. By analysing through extensive fieldwork the perceptions on the euro and the dollar of financial elites in China, the Gulf Cooperation Council (GCC) countries and Brazil, three key dollar-holding regions, this thesis demonstrates that the euro is far from competing with the dollar for the position of top international currency. The lack of a political authority to underpin its monetary space is the central reason for this underperformance.

Nonetheless, this thesis also proves that the financial elites in Brazil, China and the GCC are increasingly frustrated about the malperformance of the dollar as the main anchor of the IMS. The euro cannot compete with the greenback for top international currency status, but its consolidation as the second most used international currency has exposed the weaknesses of the dollar. In this regard, the euro *does* challenge the dollar, as advocated by the euro-optimist literature. Not as a rival, but rather as a mirror that shows the structural and ideological flaws in the current Flexible-Dollar-Standard (FDS). Hence, while the results of this research demonstrate that the euro is incapable of challenging the dollar in a strict material sense, they provide evidence to support the claim that its legacy does so from an ideational point of view by widening the preferences in the construction of the IMS, and the agenda of international monetary governance, away from dollar-unipolarity.

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List of Figures and Tables

List of Abbreviations

ABMI	Asian Bond Market Initiative
ACU	Asian Currency Unit
ADB	Asian Development Bank
ADIA	Abu Dhabi Investment Authority
AMRO	ASEAN+3 Macroeconomic Research Office
AMU	Asian Monetary Union
ASEAN	Association of South East Asian Nations
ASEAN+3	ASEAN plus China, Japan and South Korea
BCB	Brazilian Central Bank
BIS	Bank for International Settlements
BNDES	Brazilian Development Bank
BRICS	Brazil, Russia, India, China and South Africa
BSA	Bilateral Swap Agreement
CASS	Chinese Academy of Social Sciences
CCR	Agreement on Reciprocal Payments and Credits
CIC	China Investment Corporation
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralization Agreement
COFER	Currency Composition of Official Foreign Exchange Reserves
EC	European Commission
ECB	European Central Bank
ECU	European Currency Unit
EFSF	European Financial Stability Facility
EMH	Efficient Market Hypothesis
EMU	European Economic and Monetary Union
ERM	European Exchange Rate Mechanism
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
EZ	Eurozone
FDS	Flexible Dollar Standard
FED	Federal Reserve System of the United States of America
FINEP	Brazilian Innovation Agency
FOREX	Foreign Exchange Market
FSAP	Financial Services Action Plan
FT	Financial Times
FX	Foreign Exchange
GCB	Gulf Central Bank
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GMC	Gulf Monetary Council
GSP	Growth and Stability Pact
HKMA	Hong Kong Monetary Authority
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
IMS	International Monetary System
IPE	International Political Economy
IR	International Relations

MU	Monetary Union
OCA	Optimum Currency Area
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of the Petroleum Exporting Countries
PBoC	People’s Bank of China
PRI	Palais Royal Initiative
QE	Quantitative Easing
RMB	Renminbi
SAFE	State Administration of Foreign Exchange
SAMA	Saudi Arabian Monetary Authority
SDR	Special Drawing Rights
SML	Local Currency Payment System
TIPS	Treasury Inflation Protected Securities
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNASUR	Union of South American Nations
US	United States of America
USTD	United States Treasury Department
WTO	World Trade Organisation

1. Introduction

The global financial crisis initiated in the United States (US) in 2007, and its damaging recessionary aftermath, have raised questions about global monetary and financial leadership. The bloating structural twin (current account and budget) deficits of the US, which for many, especially in emerging markets, have been the main source of the crisis, are increasingly seen as a major threat to the stability of the world economy (Bergsten 2009a; Chin & Wang 2010; Al-Jasser 2011a). As a consequence, the centrality of the US dollar in the international monetary system is highly contested and policymakers and investors around the world are looking for possible alternatives (Zhou 2009a; Sanya Declaration 2011; Farchy 2011a). The obvious beneficiary of the troubles of the dollar should be the euro, the second most used international currency. Unfortunately, the global crisis has equally shown the structural flaws of the European currency, jeopardising its potential challenge to the 'greenback'. From a euro-sceptical point of view, dominant in the Anglo-American world, this crisis is just the start of the end of the single currency, an experiment in monetary sovereignty pooling that never had a chance to survive (Feldstein 1997, 2010; Brittan 2010). By contrast, for euro-optimists, and there are many in Europe and the rest of the world, this crisis is the golden opportunity that was required to integrate further European Economic and Monetary Union (EMU), and consequently to make the euro stronger and more resilient for the future (Darvas et al. 2011; *Xinhua* 2010b; Eichengreen 2011a; Münchau 2011). This debate is not new. Even before the single European currency arrived as 'virtual' money to the markets in 1999, and as 'real' coins and bills to the streets of Madrid, Paris, Rome and Berlin in 2002, there were proponents and detractors of EMU. Prominent economists such as Bergsten (1997), Portes and Rey (1998) and Mundell (1998) announced that the creation of the euro was the greatest challenge to US hegemony in international monetary affairs since the US dollar took over from British sterling as the most used international currency in the years following the First World War. Pointing to the size and exporting capacity of the Euro-zone (EZ) economy and the strong mandate for price stability attached to the European Central Bank (ECB) in the 1992 Maastricht Treaty, they predicted that the euro would quickly compete with the American currency for global currency status. These predictions were favoured by some policymakers in Europe, especially the French, who have since Charles de Gaulle's complaints in 1960s tried to mitigate, if not eliminate, the 'exorbitant privilege' that the centrality of the dollar offers to the US (Kirshner 1995; Eichengreen 2008; March 2009). In this regard, the euro has never been seen by a large majority of European policymakers only as an economic project to enhance and consolidate the common market and to protect it better from external shocks. It has also been conceived as a political project that would strengthen European integration and consequently make Europe more independent and powerful in shaping global economic and monetary governance (Dyson & Featherstone 1999; Verdun 2000; Chang 2003; Jabko 2006, 2010; Marsh 2009).

However, not everyone was so 'optimistic' about the prospects of the euro at its birth. Other distinguished economists such as Dornbush (1996), Cooper (2000) and Kenen (2002) identified at an early stage three main obstacles that would hamper the rise of the euro. The first limitation refers to the difficulties of managing asymmetric external shocks in a currency union which falls short of being an Optimum Currency Area (Mundell 1961, 1973a, 1973b; McKinnon 2000; De Grauwe 2009a). This is especially true when there is no centralised budget able to transfer large funds from better-off to worse-off regions within the Union. The recent sovereign debt crisis in the EZ periphery, and the difficulties encountered to terminate it, demonstrate this point in practice. The second shortcoming is linked to the first and points to the fragmentation of the European debt markets. For euro-sceptical authors it will be very difficult to see the euro challenge the predominance of the dollar until the Europeans integrate their debt markets and issue a common debt instrument equal to the Treasury bill of the US, the safest and most liquid financial instrument in the world. In this specific area, and this might be considered counterintuitive, the EZ sovereign debt crisis has increased the euro's chances to become a global currency. To fund the rescue packages for its periphery, the EZ has started to issue for the first time debt instruments backed by the EZ as a whole through the newly created European Financial Stability Facility (EFSF). In other words, the EZ has finally agreed to issue what are *de facto* Eurobonds in order to lower the financing costs of those countries that are in financial need. Finally, the third obstacle is path-dependency. New currencies can only overtake incumbent international currencies if the latter are perceived to underperform as the main anchor of the international system for a protracted period of time due to policy mistakes of the issuing country or a steady decline in its economic and political power. In this area the jury is still out.

Increasingly, the dominant belief is that US economic and political power is declining in relative, although not in absolute terms (Cohen 2010; Bénassy-Quéré & Pisani-Ferry 2011; Eichengreen 2011a; Roubini 2011; Ferguson 2011). But then, the same was argued before in the 1960s and 1980s and the US was able to reinstate its dominant position (Cox 2001; Magnus 2011). On the policy front what really dominates is profound uncertainty. The effects of the global financial crisis have been so deep and protracted that literally nobody knows whether the US authorities have managed it in the best possible way. Nonetheless, despite these doubts, what is certain is that the extremely loose monetary and fiscal policies adopted by Washington have triggered considerable criticism from Europe and the BRICS (Brazil, Russia, India, China and South Africa) countries (Evans-Pritchard 2009; Beattie et al. 2010).

Given the current unstable economic outlook and the uncertainty that has surrounded the faith of the dollar for some time, it is no wonder then that the disagreements of analysis and prediction on the possible euro challenge to the dollar have continued over the years up to present days, not only in the field of Economics (Chinn & Frankel 2008; Papaioannou & Portes 2008 vs. Posen 2009; De la Dehesa 2009) but also in the International Relations (IR) and International Political Economy (IPE) literatures. Scholars such as Calleo (1999), Kupchan (2002), Altvater and Mahnkopf (2007), McCormick (2007) and Eichengreen (2011a) have argued that the consolidation, and possible survival of the euro, represents better than anything else the gradual formation of a united European superpower, while authors such as Cafruny and Ryner (2007), Konings (2008a), Plaschke (2010) and Cohen (2010) have responded to these predictions by pointing to the structural weaknesses of the European project, still politically and economically divided and as a consequence still tracking behind the US in determinant fields such as credit creation (finance) and military protection (security), arguably, the two most important of the four pillars (which also include production and knowledge and ideas) of Susan Strange's (1994) groundbreaking 'structural power' framework.

The aim of this thesis is to contribute to this debate, and hence its central concern is to explore whether the euro is challenging the dollar as the main international currency and, if so, whether this is enhancing European monetary power in global monetary governance. In order to do so it addresses two important shortcomings in the existing literature. First, most research on this topic is eminently rationalist and/or materialist. The Economics literature is exceedingly based on rational-choice approaches which draw on narrow economic variables, while the IPE literature has a tendency to focus predominantly on the structural-material conditions in the International Monetary System (IMS). In both fields the analysis is generally overly theoretical and, when it comes to agential behaviour, highly speculative. Second, when studying the euro challenge to the dollar very few authors in the debate (Bowles & Wang [2008] for China; Johnson [2008] for Russia; and Momani [2008] for the oil exporting Gulf countries; Brazil is mostly absent) draw attention to the views and perceptions of policymakers and financial elites of key dollar-holding emerging countries such as China, which today holds more than $3 trillion (Yao 2011) in foreign reserves and is the main creditor to the US; important geostrategic countries such as the oil exporting states of the Gulf Cooperation Council (GCC), which are not only the suppliers of the main source of energy in the world economy but also large holders of foreign reserves; and economic and financial upcoming powerhouses with increasing regional and global geopolitical significance such as Brazil. These three regions (which form the three case studies of this thesis) are systemically important in the IMS. Consequently, the views and portfolio management strategies on the dollar and the euro of their political, economic and financial elites cannot be overlooked. The principal aim of this study is to fill these gaps. Thus, its original contribution to the literature lies in the fact that – unlike the few exceptions listed above, which draw mostly on secondary sources – it is an empirical and cognitive study of the perceptions and intentions of these elites through extensive, in-depth fieldwork in the aforementioned regions.

Theoretically and methodologically, the primary objective of this research is to move away from narrow quantitative economic analyses. While this study engages with this literature, it offers extensive empirical fieldwork focused primarily on financial elite interviews in order to grasp qualitatively how key agents in dollar-holding countries subjectively perceive the impact of the euro in the IMS. If for no other reason than that the euro has always been both an economic and a political project (Verdun 2000; Chang 2003; Jabko 2006, 2010; Marsh 2009), it would be awkward to analyse its international currency trajectory only using strict economic variables. Fortunately, the field of IPE has always analysed currencies in a wider scope than the traditional and orthodox functions of money as a unit of account, medium of exchange and store of value. While these quantitative and measureable areas are important to consider, they do not cover all the dimensions of money. Money has also political (Strange 1971; Cohen 2008a; Helleiner 2008, 2009) and social (Simmel 1978, Gilbert & Helleiner 1999, Kirshner 2003a, McNamara 2008), aspects that cannot be overlooked. As will be shown below, money is essentially credit, and as the same word indicates, money is based on *credo*, thus on social trust and faith. On the assumption that the holder of a coin and a banknote will receive back what is owed to her under the implicit guarantee of the political authority that controls a given monetary space (Ingham 2004; Hall 2008). When this central authority is absent as today in the EZ, then this promise is put into question. Thus, money is not a neutral instrument of exchange as neoclassical economics would interpret it; its material and abstract value, and its ideational symbolism are socially constructed and therefore (inter)subjectively formulated and reacted upon. Economic agents develop their own perceptions on the future of the dollar and the potential challenge of the euro not exclusively on objective and rational predictions and calculations. They are also influenced by the set of norms, beliefs and institutions that surround them. As Blyth (2002:42), drawing on John Maynard Keynes, argues, the economy "is as much a subjective construct as an objective reality". This is especially true when analysing money, which has inherently and ubiquitously as much to do with politics as with economics (Kirshner 2003b).

Considering this multidisciplinary interpretation of money, this thesis covers predominantly through qualitative methods the economic, political but also socio-cultural dimensions of the ascendance of the euro as an international currency vis-à-vis the dollar, and in doing so, it demonstrates how this wider understanding is more appropriate to comprehend the full impact of the arrival of the euro upon the international financial system. Following the footsteps of Susan Strange and Charles Kindleberger, authors such as Kirshner (1995, 2003b), Cohen (2006) and Helleiner (2008, 2009) have in recent years developed theoretical frameworks which understand currencies as an extension of national sovereignties and their use overseas as one of the most visible symbols of influence and power in foreign affairs. With this thesis, I have endeavoured to find out whether this is also true of the union of states issuing the euro. In this sense, I have tried to go beyond the structural and material impact of the euro and also discover its ideational footprint. More specifically, my principal aim has been to investigate how financial elites in China, the GCC and Brazil subjectively perceive European influence – enhanced through the internationalisation of the euro– in the reconfiguration of the IMS in the midst of the greatest financial crisis (2007 up to time of writing) since the Great Depression of the 1930s.[1]

The analytical framework developed for this research is based on the emerging constructivist literature in IPE interested in situations of Knightian uncertainty (Blyth 2002; Abdelal et al. 2010). This type of uncertainty, prevalent in unique moments of major economic distress when economic agents "are unsure as to what their interests actually are, let alone how to realize them" (Blyth 2002:9), is commensurate to the context that has emerged in the aftermath of the global financial crisis. Throughout the timeline of this research, the financial elites investigated have been confronted with a series of major uncertainties. What will the structural effects of the crisis be? Who will carry the burden of adjustment after this crisis? Is the apparent decline of the US transitory or long-lasting? Until when will the US be able to increase its deficits? Is the US trying to inflate away its debt through so called Quantitative Easing (QE), euphemism for printing money? Will there be a run on the dollar? When? What can be done when it happens? How do we confront rising inflation provoked by QE? Will the euro be around in 10 years time? Will EMU develop into political union or break up? How do we move from dollar unipolarity to a multipolar system? These are the questions that financial elites in emerging markets are asking themselves now without finding any concrete answers. This sense of haziness was palpable in a large number of interviews. Thus, this is a moment of Knightian uncertainty, and as such it has the potential to produce a systemic shift in the institutional framework of the IMS. In this regard, ideas take here a prevalent role. As

[1] Research for this PhD thesis started in September 2007, consequently its development has occurred alongside the volatilities and uncertainties of the current global financial crisis, by now coined 'Great Recession', which started in August 2007 with the collapse of the 'subprime' mortgage market in the US and which has the potential to change the structures of the international financial system. The different phases of the crisis have radically changed the outlook for the dollar and the euro. While in mid 2008 the crisis seemed constrained to the US, and the dollar was depreciating at a rapid pace, triggering doubts about its future as a reserve currency vis-à-vis the challenge of the euro. Two years later, in mid 2010, the crisis showed the structural deficiencies of EMU and policymakers in the EZ and the ECB had to come up with unprecedented unorthodox monetary policies and a multilateral financial rescue fund to save the survival of the euro. While this thesis has always attempted to go beyond these conjunctural movements in order to identify the structural and long term trends, it is important to stress here that the research has occurred in such turbulent times that it has been difficult to discern what is conjunctural from what is structural. The crisis is still unfolding at the moment of writing with growth and employment patterns still very weak both in the US and the EZ. It is safe to say that this crisis is a moment of Knightian uncertainty (Blyth 2002), as will be explained below.

suggested by Blyth, ideas are crucial in 5 stages: 1) in how the crisis is interpreted as to reduce uncertainty; 2) in building consensus around the sources of the crisis; 3) in developing arguments that contest the incumbent institutional framework; 4) in proposing and building a new architecture; and, finally, 5) in maintaining the new framework, although this fifth stage will not be covered here because, as will be argued below, we are still between stages 3 and 4.

This overall constructivist theoretical framework is built upon Helleiner's (2008; 2009) typology of international currencies, which he borrows from Strange (1971), and which is explained in Chapter 2. If one wants to analyse international currencies and their evolution and impact it is useful to identify first what kind of international currencies the dollar and the euro actually are within this typology. Thus, by exploring the interpretations of policymakers and financial elites in China, the GCC and Brazil on the future of the IMS this research sheds light on the question whether the dollar is falling from 'top' to 'negotiated' international currency, as Helleiner suggests, and in turn whether the euro has been able to take advantage of this situation. Once the different types of international currencies are identified, the second step is to find out what actual political benefits an international currency offers to the issuer state or union of states beyond the obvious economic gains of seigniorage. Thus, the second key concept explored here is that of international monetary power as developed by Cohen (2006). For him international monetary power emerges from the advantage of being able to delay and deflect adjustment costs emanating from balance sheet imbalances through the attainment of *autonomy* and *influence* in financial matters. While accepting this overall logic, since Cohen operates predominantly on the material sphere of power, in order to grasp fully not only the material but also, crucially, the ideational dimensions of European influence in monetary governance, I try to unpack the concept of monetary power further by building on what Lukes (1974, 2005) has dubbed the 'third face' of power. Cohen's outline of international monetary power is very useful in identifying the outcome side of macroeconomic and monetary diplomatic negotiations (essentially the two first faces of power: decision-making and agenda-setting). However, his approach is too behavioural to recognize the ideational effects of the euro discovered throughout this empirical research. By contrast, Blyth's (2002) focus on the power of ideas in times of systemic crises provides here a more useful theoretical backdrop.

Blyth's Knightian framework fits also well with Helleiner´s typological outline, especially when it comes to describe the position of the dollar in the IMS. Helleiner's view of the dollar as an increasingly 'negotiated' or 'political' currency points to one of the main features that have characterised the present turmoil: the uncertainties surrounding the future of the greenback. On the one hand, important emerging powers such as the BRICS (Brazil, Russia, India, China and South Africa) have for the first time openly questioned and criticised the centrality of the dollar in the system, effectively calling for a *renegotiation* of its status as the main anchor of the world economy (Parker et al. 2009; Zhou 2009a; Thomas 2009; Kim 2010). For them, the exorbitant privilege is a source of constant instability because it permanently generates unsustainable global imbalances. On the other side, for the US, the exorbitant privilege is an enormous advantage. Due to the central position of the dollar in the world economy, the US has not only delayed its adjustment costs for decades – essentially living well beyond its means – but now confronted with the current crisis, it has also tried to use its international monetary power to deflect as much as possible some of the adjustment costs upon the other powers in the world economy. This has been done passively, following a strategy of 'benign neglect' in relation to a depreciating dollar, which is the consequence of extraordinary loose monetary and fiscal policies – thus hurting economies with floating exchange rates like the EZ and Brazil, who see their export competitiveness erode[2], but also hurting pegged dollar holders like the GCC and China, who see their dollar denominated assets decline in value. And, actively, by demanding from the authorities in Beijing a substantial appreciation of their currency and from the Europeans, especially from the Germans, more fiscal stimuli to increase domestic demand and so rebalance their growth strategies and the growth patterns of the world economy at large.

One of the main causes of the current financial crisis has been the great imbalances generated between the US, which has consistently run increasing current account deficits in the past decade, and China and other Asian economies, which have enjoyed

[2] Here it needs to be said that Germany is the country that has coped best with an overvalued euro. Moreover, a strong euro debilitates its European competitors (e.g. France and Italy). Thus, it can be argued that a strong euro has been advantageous for the German manufacturing sector (see Chapter 7).

the equivalent surpluses derived from these imbalances.[3] This so called Bretton Woods II system (Dooley et al. 2003), based on US overconsumption and Asian export-led growth[4], with the accumulated foreign reserves in dollars recycled back into the highly deregulated and liquid American financial system, has shown its limits with the global financial crisis that began in 2007. The long awaited adjustment process appears to have arrived. The question now is whether the adjustment costs will be shared more or less equally or whether there will be losers and winners. In this matter, exchange rates and foreign reserve management play a major role and so do negotiations among the key players of the system to coordinate macroeconomic policies that can deliver a rebalancing of the world economy on a sustainable growth path. The G20 network, which has become with this crisis the main forum for global economic governance, could, a priori, be the site to achieve this macroeconomic coordination. Given this apparent new multilateral framework which brings together both developed and developing countries, and considering also that US dollar uni-polarity in global monetary affairs seems more questioned than ever among policymakers and financial elites in the EZ and emerging markets, the aspect of European monetary power that will be tackled in the latter part of this thesis is to identify how much influence the Europeans have gained through the consolidation of the euro as the second most used currency in shaping this negotiation process.

In essence, what will subsequently be explored is to what extent does the euro challenge, both materially and ideationally, the prominence of the dollar in the IMS and, subsequently, based on the empirical evidence collected, how are the achievements of this challenge reflected in the development of European monetary power in the governance of the IMS. This thesis seeks, then, to assess whether the euro is fit to rival the dollar as the main international currency and whether this might bring a change in leadership in the governance of the IMS. This question however can be broken down in terms of more specific questions. If the euro is rivalling the dollar, how is it doing so? Is it triggering a diversification trend among key dollar holders?

[3] Other causes of the crisis have been the deregulation of the financial markets worldwide, especially in the US, the increased deleveraging achieved by increased securitization techniques adopted in Wall Street, the miscalculation of risks by the three major rating agencies, and the desire by US authorities to offset increased income inequality by promoting cheap credit channels for housing and consumption to the bottom layers of the society (see Rajan 2010).

[4] This export-led growth model is also present in the northern countries of the EZ, especially in Germany, but also in the Netherlands, Austria and Finland.

Are financial elites of key emerging markets such as China, the GCC and Brazil unhappy about the performance of the dollar as the main anchor of the world economy? If so, do they have any viable strategies to change the status quo? Following those, how do they see the position of the Europeans in this regard? Has EMU, in the eyes of these elites, given the Europeans more leverage and presence, hence more autonomy and influence in the IMS? In essence, in their subjectively constructed understandings of the evolution of the European single currency, has the euro provided the Europeans with more international monetary power? It is important to stress here that while I take a constructivist approach in providing answers to these questions, I do not discard the material side of the material-ideational duality. Quite the contrary, by analysing how financial elites interpret the current IMS and its possible evolution, the material reality will be constantly invoked. In this regard, I understand here the material and the ideational, and in the same manner structure and agency, as ontologically intertwined and dialectically constituted. In essence, they are the two sides of the same coin (Giddens 1984).

1.1 Main Arguments

I have taken as my point of departure for this thesis the arguments put forward by both those that have predicted that the euro would soon challenge the dollar as the main international currency (Bergsten 1997, 2005; Portes & Rey 1998; Mundell 1998; Calleo 1999; Chinn & Frankel 2005, 2008; De Cecco 2009) and those that have stated the contrary (McKinnon 1998; Cooper 2000; Kenen 2002; Cohen 2003, 2009a, 2010; Cafruny & Ryner 2007; De la Dehesa 2009; Plaschke 2010). Thus, this research has been designed so as to contribute to arbitration between two hypotheses. The ultimate aim has been to produce an empirical adjudication, or one could say, *verdict*, between these opposing arguments. Accepting the euro-optimists' thinking that the euro area would shortly surpass the US in GDP, that it would also accelerate quickly the integration process of its financial markets and that the supposedly relentless decline in the value of the dollar would make global investors drop the American currency for the more solid euro, the first of these hypotheses is:

> *The euro is increasingly competing with the dollar for the role of international currency in China, the GCC and Brazil due to the increase in economic output of the Eurozone, the exchange rate strength of the euro and the integration process of the European financial markets.*

On the other hand, considering the shortcomings put forward by the euro-sceptics based on the fragmentation of the debt markets in Europe, the governance and political divisions within EMU and the military weaknesses of the Europeans, the opposing hypothesis is:

> *The euro is not able to compete with the dollar for the role of international currency in China, the GCC and Brazil because EMU lacks an integrated debt market and it is not able to project its monetary power globally due to its political divisions and its military weaknesses.*

Fieldwork for this research has shown that overall the verdict of the financial elites in China, the GCC and Brazil tilts in favour of the second hypothesis if we consider only the material dimension. Providing empirical evidence for this is one of the main contributions of this study. As Chapter 4 elucidates, while it is true that these elites are keen to diversify their portfolios into euros (and they have and will actively try to do so in the future, especially now that the EZ will issue more sovereign debt to overcome the crisis), this diversification is limited for several reasons. The main obstacle is the lack of liquidity in the European markets, primarily in the sovereign debt markets. European public debt bond markets are still fragmented in national issuances. This means that they are not as liquid as the US Treasury market and therefore they are less attractive to foreign investors. The lack of liquidity in European financial instruments stops major dollar holders such as China or some of the GCC states to aggressively diversify out of the greenback. Any audacious diversification act by any of these big players moves the markets instantaneously and triggers a herd effect. A big diversification out of dollars into euros by China, who holds over $3 trillion in foreign reserves, would send the euro dramatically upwards and thus create bigger trade tensions between China and the Europeans and complicate even further the global rebalancing process.

The lack of liquidity in European debt markets is one of the major shortcomings of the euro when rivalling the dollar. But it is not the only one. There are institutional and political, and also military aspects that impede its ascent. The current financial crisis has pushed them all to the forefront. The euro is not backed by one country like the dollar, but by 17 (with more supposed to come) sovereign states with their own macroeconomic policies. This means that cooperation and coordination is very slow and arduous. EMU has a supranational central bank but not a state, or at least, a fiscal union, to support it. This is seen as a permanent weakness vis-à-vis the US. While the Federal Reserve (FED) and the US Treasury could act in unison and quickly to mitigate the disruptions caused by the global financial crisis, the European supranational institutions have been perceived from the outside to go through rounds of negotiations and disputes between the different member states in order to assemble a common position. European political disunity has been especially evident in relation to dealing with the Greek debt problem and its contagion to other peripheral EMU countries in the first half of 2010. It took the Europeans months to come up with a comprehensive rescue package to solve the situation and finally it was only after consulting with the White House and after securing financial and technical support from the IMF that they came up with the final decision to establish the historic €500 billion-strong European Financial Stability Facility (EFSF). The inclusion of the IMF in this rescue fund is seen by the financial elites investigated as a sign of weakness, reinforcing the view that the Europeans are incapable yet to sort out their own house and that they are still dependent on guidelines coming from Washington.

For most elites in emerging powers the political fragmentation in Europe is disappointing. They would rather have a strong Europe that can act as a counter-balance to the US both in the financial but also in the strategic field. Policymakers in the GCC countries for example are unhappy about American unilateralism in military affairs. What they perceive as the erroneous handling of the Iraq war is a case in point. They would like to diversify both their foreign investments but also their military protection out of US uni-polarity. They have already started to do so by welcoming more French military presence in the Gulf. Generally speaking a more assertive Europe would be positively welcomed in Brasilia, Beijing, Riyadh and Abu Dhabi. In fact these financial and political elites predict and hope that this will happen in the future given that, in their view, national parochialism is not an option for the Europeans vis-à-vis the challenges of the 21st Century. Nonetheless, until this potential European unity arrives (if it does at all) the euro will not be able to compete on an equal basis with the dollar for the throne of main international currency. Up to then it will remain a 'neutral' international currency, following Helleiner's typology.

Does this mean that the primacy of the dollar as the main international currency is uncontested? As Chapter 5 will show, this is not the case, and the argument outlined here constitutes my second main contribution to the literature. Financial elites in Brazil, China and the GCC are unhappy about the performance of the dollar as the main anchor of the international financial system. The euro cannot compete with the greenback for top international currency status, but its consolidation as a very strong 'neutral' international currency with stronger demand and deeper investment absorption capacity than any other rival to the dollar in the last 50 years has exposed with more clarity the weaknesses of the dollar. In this regard, the euro *does* challenge the dollar. Not as a rival, but rather as a mirror that shows the defects in the flexible-dollar system (FDS). The complaints of the financial elites in emerging markets focus on two main aspects. The first relates to the volatility inherent to the floating exchange rate regime of the dollar-standard, and the second to the so called 'Triffin Dilemma' emanating from having a sovereign nation issuing the reserve currency of the world and consequently having to run bloating current account deficits (Triffin 1960). Since the closure of the 'gold window' by Richard Nixon in 1971, the IMS has constantly experienced financial crises and shown great instability due to persistent global imbalances. The financial crisis in South East Asia in 1997-98 and the global financial crisis (2007-up to now) are just the two most obvious examples. While in the first, policymakers and technocrats in the West could point to the lack of efficient market mechanisms due to policy intervention and widespread corruption in countries such as Thailand, Indonesia and South Korea as the main causes of the crisis, the more recent financial turmoil has shown that the deregulated financial-led growth model of Wall Street, based on the Efficient Market Hypothesis (EMH), was inherently flawed (Prechter & Parker 2007; De Grauwe et al. 2008; De Grauwe

2009b; Rajan 2010). Given this outcome, it is no wonder then that Chinese, Brazilian and Gulf officials have started to question the asymmetries in the FDS.

My empirical adjudication then shows that neither of the two starting hypotheses is totally right. The euro-sceptical literature is correct to an extent when it states that the euro will not topple the dollar. The euro-optimist literature, however, is far from wrong when it argues that the euro represents a major challenge to the dollar. The key question is to define what do we mean by *challenge*? If challenging means substituting, then my research sides with the euro-sceptical camp, but if challenging means questioning, contesting, even discrediting, then the euro-optimists have a point. In a sense, the main conclusion of this thesis is that scholarship on the euro vs. dollar debate needs to be more careful in considering the framing of the debate. By focusing only on whether the euro will substitute the dollar as the main international currency, it is implied that the notion of structural change does only occur in this winner and loser scenario. It is suggested that substantial change does only occur with tipping-points. I argue, however, that change is permanent. By focusing only on the top of the currencies pyramid, the literature is overlooking what happens at the bottom and in the middle. By representing over 25% of total foreign reserves, the euro has shown that dollar unipolarity can be contested. The scenario of having one dominant currency and then the rest is very different from having one prevailing currency, a second currency in the middle, and then the rest. While in the first scenario there is no real competition, in the second scenario the projection of the second currency spurs the other contenders to improve their own capacities. In other words, the dollar was overwhelmingly dominant until the coming of the euro. With the consolidation of the single currency, however, China, the GCC and Brazil have realised that they can also either create a regional currency or promote the use of their own national currencies. Here we see the link between the material and the ideational. The material ascendancy of the euro has triggered an ideational desire to internationalise different currencies. This in turn has triggered the material promotion of these currencies.

Ideas do also matter in analysing the recent global financial crisis. While financial elites in emerging markets hold the US responsible for the current crisis, US officials see it the other way round. The subjective interpretations are here different. Ben Bernanke (2005, 2007, 2011), chairman of the FED, has insisted that one of the main causes of the crisis has been the savings glut accumulated in Asia, especially China, during the Bretton Woods II system. By stockpiling their enormous reserves in US treasury bonds and mortgage backed securities, Asian countries facilitated cheap credit to US citizens, triggering an unsustainable path of over-leveraging. Nonetheless, even considering this account of the causes of the crisis – not accepted at all in Beijing – the status of the dollar as the main anchor of the system remains questioned. As the issuer of the main international currency, the US provides liquidity to the rest of the world. By doing so, however, it needs to run current account deficits. If this is done *in perpetuum*, the credibility of the US to repay back its debts is eroded and this makes the whole system inherently unstable. This Triffin Dilemma is what financial elites in Brazil, China and the GCC would like to overcome. However, they know that as long as a national currency (the euro included) is the reserve currency of the world the dilemma will persist for the issuing government will always try to tilt this 'exorbitant privilege' in favour of its national interests rather than the common global good.

The question that arises then is whether this can be avoided at all. Can we have a global supranational reserve currency that can function worldwide as unit of account, medium of exchange and store of value that is not a national currency? Before the arrival of the euro this was very difficult to imagine. However, the EMU project has somehow changed this pessimism (at least up to the more recent debt crisis). In this regard it has become an epoch-marking event in the evolution of the IMS. The consolidation of the euro as the second most used reserve currency has shown financial elites in China, the GCC and Brazil that monetary sovereignty sharing is possible on a regional scale, which means that, in theory (notwithstanding the recent difficulties in EMU) this could be true also for the global level. Chapter 6 amplifies the argument on this ideational influence of the euro. While the euro is a long way from competing with the dollar for top currency status in the international system because of its material and structural constraints, its ideational impact in the minds of the financial elites of emerging markets has been considerable. EMU is not only seen as a successful attempt to protect the EZ better from external shocks coming from the inherently unstable flexible dollar system (as was the case during the first part of the global financial crisis), it is also seen as a template for both regional and global monetary cooperation and monetary sovereignty sharing procedures. If it succeeds, the likelihood for more regional and global cooperation is increased. If it fails, it will show that monetary sovereignty is difficult to share beyond the state level. In this regard, the management of the current debt crisis in Europe is of great interest around the world, not least because the regional imbalances in the EZ between core and peripheral countries mirror to some extent the imbalances on a global level. This crisis has shown that confronted with major external shocks a monetary union is very difficult to sustain without a degree of fiscal integration. The harbinger is facing huge obstacles, as predicted by the euro-sceptics. If it is able to overcome them, the project will be consolidated and it will increase its appeal as a role model. If it does not, it will prove the resilience of the Westphalian state system in monetary affairs. In both cases EMU serves as a laboratory for the rest of the world.

Until this major test is undertaken, though, important emerging markets will not sit back and watch. This crisis has shown them that they are too vulnerable to the volatilities of the dollar standard, thus they are trying to come up with their own regional and national alternatives. Although regional monetary cooperation in Mercosur, South East Asia and the GCC is not as developed as in Europe, it is certainly worthwhile summarising what have been the major achievements so far. On the basis of having EMU as a template, several projects have been emerging. All of them have been created with the objective to gain monetary autonomy and consequently overcome dollar dependency in the IMS. In South America there is the Mutual Credit Agreement, a swap agreement among central banks to reduce the use of dollars in bilateral trade (Arraes 2009; Chin 2010). Furthermore, in the Mercosur context Argentina and Brazil have started to invoice their bilateral trade in their local currencies, and the plan is that Uruguay and Paraguay will follow suit. These developments are in stark contrast with the currency boards linked to the dollar used in the 1990s. In South East Asia, the Chiang Mai Initiative (CMI) between ASEAN countries and South Korea, Japan and China wants to develop into an Asian Monetary Fund (Zhang Ming 2009). If this project is successful, this region might even be more advanced than the Europeans in pulling together fiscal resources, even if its multilateral institutional framework is still underdeveloped. Finally, in the GCC there is a strong commitment by its major economy, Saudi Arabia, to create a monetary union similar to EMU. There have been certain setbacks, with Oman and UAE dropping out of the project, but the long term commitment persists and a regional monetary council, predecessor of a future regional central bank, has already been established. Chapter 6 will focus on these developments.

Confronted with major difficulties to accelerate their regional monetary frameworks due to political divisions and mistrust among the different sovereign member states, and considering also the difficulties faced by the European harbinger in dealing with the financial crisis without having the mechanisms for properly institutionalised macroeconomic coordination, some of the regional hegemons such as Brazil and China have not been wasting their time in promoting their own national currencies in international trade. Empowered by their huge foreign reserves – accumulated precisely to avoid the inherent instabilities and volatilities of the flexible dollar-standard regime – and strengthened by their economic performance during the crisis, these two nations have started to feel self-confident enough to invoice their bilateral trade in their own local currencies, thus sidelining the dollar. This trend is very much in its infant stages, but it shows the determination to avoid the American currency as the sole medium of exchange in international trade. This determination is especially strong in Beijing, and yet again the euro functions here as a blueprint for successful internationalisation of a currency in a relatively short amount of time. The euro has given the EZ more autonomy in monetary affairs. This is an achievement that emerging markets want to emulate.

This new self-confidence has also been visible on the global level. BRICS countries as a whole have openly called for the end of dollar supremacy in the international monetary system. The watershed in this regard was the publication just before the G20 2009 summit in London of an essay by Zhou Xiaochuan, the Governor of the People's Bank of China (PBoC), the Chinese Central Bank, arguing in favour of the IMF Special Drawing Rights (SDRs) as a possible dollar substitute for international reserve currency functions (Zhou 2009a). Chapter 7 focuses precisely on the position, and possible influence, of the EZ in relation to the SDR debate triggered by China and taken up by France during its G20 presidency in 2011. An adaptation of Lukes' three faces of power framework, seen as an extension of Cohen's monetary power concept, will be used to understand better this European influence. It will be argued that the Europeans have considerable influence in the third face based on preference-shaping. As mentioned before, EMU acts as a harbinger for global monetary sovereignty sharing and it can also be a laboratory to overcome trade imbalances. Therefore it is a source of ideational inspiration on those fronts.

However, is this influence in preference-shaping translated into influence in agenda-setting on a global level? Here the Europeans were certainly punching below their weight until the coming of the global financial crisis, sometimes because they did not have the institutional or structural means and know-how to do so (the UK and the City of London not being part of the EZ is a clear handicap) or sometimes because they did not want to take the responsibility. At first, for instance, the European response to Zhou's SDR proposal was lukewarm. Nonetheless, a year later the French have started to actively explore tighter cooperation with the Chinese on the reform of the IMS and together they have managed to persuade the other powers, including the US, to put this topic in the G20 agenda for 2011. In this regard, the French alone have shown that the Europeans have more influence in the second face of power than commonly believed. It also shows that if the French, the Germans and perhaps even the British would work closer together, and propose a set of reforms in unison, they would be able to project even more global monetary power. However, since this is not the case, European monetary power is so far only limited to the second and third faces of power where ideas for reform are proposed and discussed, but it does not reach onto the first face of power where proposals are decided and enforced. Following, Blyth's five ideational steps, the EZ is not able to use its experience in monetary sharing as a possible blueprint that can be used after the period of contestation to construct new institutions. This is hardly surprising, though. Right now, not even the Americans are able to impose their will in the G20 negotiations to reform the IMS. As the undeniable hegemon in financial matters they are a gatekeeper when it comes to agenda-setting (no topic enters the agenda without their consent) and they have veto power in decision-making (no reform is implemented without their approval), but they are not strong enough to convince other players to do what they want them to do. China is not de-pegging substantially its currency from the dollar and the Europeans have been reluctant to follow expansionary fiscal policies to overcome the crisis as demanded by the US. In this regard, it seems that we are gradually witnessing a "leaderless monetary system", as suggested by Cohen (2009b).

If not coordinated at a multilateral level through cooperation, the adjustment costs necessary to offset the global imbalances will need to be distributed unilaterally through more naked economic and political power. As in the Great Depression, competitive currency devaluations are spreading between the major powers in what has been labelled by the Brazilian minister of finance Guido Mantega as 'Currency Wars'. The consequences of these moves could lead to major tensions and conflicts. Some expert commentators on China with an international perspective have been announcing for some time that protectionism will be the name of the game in the next decade (Pettis 2009b, 2010). The evidence collected from the financial elites interviewed for this thesis gives some credence to this view. A fragmented system divided in regional trading blocs is a possible outcome. A monetary system of increased multicurrency competition is something desired by some (Eichengreen 2011a) and feared by others (Kindleberger 1986, 2000). Even if things continue as they are and the US dollar remains the main international currency in an open world trade system where the American citizen continues to be the consumer of last resort, it is difficult to imagine how the US will be able to increase further its already skyrocketing twin deficits without provoking at some point a collapse in dollar confidence. We are certainly entering unchartered waters. Never in history was the issuer of the international currency so much in debt. Some people in China and other parts of the world are already starting to see the end of the fiat money regime introduced after the collapse of Bretton Woods and envision a return to the gold standard. This gold-based future system, the possibility of a multicurrency competition framework or, just the opposite, the creation of a truly multilateral global currency framework are three possible future scenarios that will be explored in the last part of Chapter 7.

1.2 Contribution to the Literature

The main objective of this thesis is to contribute to the debate centred on whether the euro is challenging the dollar as the main international currency and consequently whether the EZ can compete with the US in governing the international monetary system. It provides significant new empirical evidence that supports those that think that the euro does not pose a material threat to the supremacy of the dollar. However, it does also show that the euro vs. dollar debate, as currently framed, is somehow misleading. If we want to capture the full impact of the euro in the IMS we have to look not just at its material, but also at its ideational footprint. In this sense, a chief contribution of this research is its in-depth grounded study of key financial elites, from both the public and private sector, involved in foreign reserves management and monetary policy in crucial foreign reserve holding countries such as China, the GCC region and Brazil. Prominent authors in the field of international currency competition such as Helleiner and Kirshner (2009) have pointed to the lack of detailed studies in the literature on international reserve management. I have tried to fill this gap. The material gathered is based on a triangulation between secondary sources (academic and journalistic), official documents (when possible) and 76 semi-structured financial elite interviews in London, Rio de Janeiro, São Paulo, Brasilia, Beijing, Dubai, Abu Dhabi, Riyadh and Jeddah. The interview material is here more than merely supportive to other sources of evidence. Given the lack of official documents due to the sensitivity of the topic (foreign reserve allocation is state secret in most countries and is not readily available in private banking documents) the information gathered through the interviews acquires a preponderant role. This is reinforced by my understanding that this is the first academic study that has had the privilege to access financial elites in traditionally hermetic places when it comes to monetary affairs such as China and Saudi Arabia.

Since the main aim of this study has been to provide the verdict of these elites on the two competing theories favouring and rejecting the euro challenge to the dollar thesis, the overall methodological framework that I have been using in the field can be described as 'theory testing' (George & Bennett 2004) within a constructivist research agenda (Odell 1979, 1982; Adler 1997). Based predominantly on the use of the specific method of in-depth semi-structured elite interviews (Dexter 2006), my final objective has been to understand how financial elites sitting in key emerging markets capitals understand, perceive, analyse and react in their foreign reserve management and monetary policy-making to the trajectory of the euro vis-à-vis the dollar. These voices have been overlooked in the literature. Most of the analyses on the euro vs. dollar debate have focused on US and EZ economic fundamentals and on rational and/or material political-economic interpretations that predetermine and prefigure the behaviour of these elites. Here the approach is empirical and agential, on the assumption that it is only through this methodological path that it is possible to capture how the *euro has changed the socially constructed IMS*. As Odell has argued when analysing the collapse of Bretton Woods, the previous systemic shift in the IMS, "behaviour depends not on reality but on how reality is perceived and interpreted…substantive ideas held by top policymakers and advisers [are] as decisive or necessary elements of explanation. The core claim of this cognitive approach is that changes in reigning ideas help produce changes in policy content" (1982:58). This thesis follows the same approach, with the exemption that it adds top banking executives as influential agents in the formulation of monetary policy.

Chapter 3 will elucidate more in depth the concepts, case studies and methodology used during the study and the differences and obstacles encountered during the three fieldwork trips. In the first part I will provide a detailed explanation of how I understand key concepts for this research such as money, ideas in Knightian uncertainty, power, and governance. After that I will explain the general rationale for choosing Brazil, China and the GCC (and within this region the UAE and Saudi Arabia) as the three case study regions. This will be done by summarising the literature on these regions and by showing how this study contributes to existing scholarship. Brazil has been chosen because it claims to be the 5th largest economy of the world (Leahy 2011), one of the biggest holders of US treasury bonds (USTD 2011), and also because it is seen as the most diplomatically active BRICS state in the realm of global economic governance. Arguably, it functions as the spokesperson of the BRICS on the global stage. Brazil is also interesting because traditionally it (and Latin America at large) has always been under the dollar sphere. Hence any move out of this sphere of influence would signify a blow to the three decades long unquestioned dollar-standard in this region and the world at large. Surprisingly, the literature in this field has greatly overlooked this important country.

The inclusion of China as a case study does not need much argumentation. As the existing consensus in the literature confirms, China is a key player when it comes to solve the global imbalances conundrum. It is with over $3 trillion in reserves the biggest holder, and by default, creditor of US debt. On top of this, its geopolitical influence is of increasing importance. Some commentators close to the American government such as the influential Zbigniew Brzezinski go even so far to scrap the zero from the G20 and consider that global economic governance is a matter of the G2, the US and China (Jian 2009). As will be shown below, the Chinese are not so keen to endorse this proposal (Qin 2009). They are much more comfortable in a multilateral setting with the other BRICS states around the table.

The GCC on its part is of great importance too. It is the biggest exporting region of oil, arguably the most strategic commodity for industrial, industrialising and post-industrial economies, and as a consequence it is also a region with large foreign reserves. There are a great number of authors (Gowan 1999; Momani 2008; Leverett 2008; El-Gamal & Jaffe 2010) who think that the status of the dollar as the main international currency depends heavily on oil being kept priced in dollars. Other prominent authors in the field of international currencies such as Cohen (2009b) have indicated that this could potentially be the first battle ground between the dollar and the euro, especially considering that the Middle East has closer geographical, historical and economic ties with the EU. These assumptions alone justify the GCC as a key case study. Consequently elite interviews have been conducted in the two biggest economies of the region: Saudi Arabia and the United Arab Emirates (UAE).

This study might also potentially be seen as breaking new ground in offering insights about the ideational influence of the euro as a blueprint for regional monetary cooperation, the formation of a multi-currency system and even the creation of a multilateral global currency. This unexpected outcome (not foreseen as a possibility before the fieldwork) might sound to some surprising given the difficulties that EMU is going through at the moment, with most commentators agreeing that the original EMU design was inherently flawed. But to ignore these findings would be a mistake. To the contrary, this is an issue that warrants more attention by researchers in the future. Regional monetary cooperation is slow and might not go anywhere in Latin America, South East Asia and the GCC. If there are plenty of euro-sceptics, there are even more in relation to a Latin American, an Asian or an Arabian Gulf single currency. But these processes are developing and need to be considered, and in most of them the euro has been functioning as a role model, inspiration, template or harbinger. Moreover, as I will elucidate, for a significant number of participants interviewed in Beijing, the Chinese proposal of substituting the dollar for IMF SDRs has precisely the euro as a workable reference of a supranational currency artificially created and then brought to the streets.

Another finding raised here is that in the view of most participants the Europeans are still playing a limited role in shaping monetary governance despite the consolidation of the euro as an international currency. This is because they are still divided along national lines. There is Germany, France and the UK, but there is no single European voice in monetary affairs. This weakness is disappointing for financial elites in Brazil, China and the GCC. Their main aim is to reduce US power and for that they would like to count with a more united Europe as their ally. One good example of this is the call for the end of dollar primacy in monetary affairs. The BRICS countries know that this can only happen if the Europeans as a unit are on board (demonstrating the latent power of the Europeans) and so far this does not seem to be the case. Only the French have shown interest in actively working with the Chinese and the other BRICS in the reform of the IMS, while the Germans and the British have taken a backseat.[5] Notwithstanding European caution, the BRICS countries' calls to restrict US power show two things: first, that US hegemony is still ubiquitous and secondly, that it is in relative decline, since one of the features of the theory of hegemony (both from a Kindlebergian [1986; 2000] and Gramscian [Cox 1983] perspective) is that the hegemon is able to provide a stable and comfortable system to maintain both its power and please the elites, especially financial elites, of subordinated countries. I will show through the evidence collected that this does not seem to be the case with a great number of financial elites in Brazil, China and the GCC.

This does not mean that US hegemony is about to vanish. The financial elites consulted still acknowledge that the US remains the most powerful nation on earth and this is likely to continue for some time. However, its strength is diminishing and this means that it will have to compromise and consider the views and interests of other emerging powers such as a more united Europe and the BRICS countries. In the eyes of the financial elites of Brazil, China and the GCC consulted here the dollar is

[5] The French President Nicolas Sarkozy has in several occasions declared that the international monetary system needs to be reformed, and that Chinese demands need to be considered in this regard (Hall 2010). He also said that the French presidency of the G20 which will take place in 2011 will focus on this issue. So far it is too early to conclude whether this is simple political posturing or a serious attempt to actively steer the global reform agenda. What is clear is that France has been able to include the topic onto the G20 agenda, despite US reluctance, thanks in part to Chinese support.

becoming a *negotiable* currency, not only from an implicit point of view with the US keeping its market open to Chinese goods and providing military protection to the Gulf states and great parts of Asia, it is even ripe to be negotiated explicitly, at the table, within the G20 framework. Here is where different intersubjective interpretations of the reality clash with each other. The BRICS countries think the rules of the dollar-standard should be renegotiated (especially aspects such as foreign reserve liquidity provision, capital controls and intervention in the foreign exchange market to stabilise exchange rates), the US does not. Officials in Washington still think that their nation is powerful enough to set the norms and rules of the system. US sovereignty in monetary affairs is non-negotiable for them. As a consequence of this, and European divisions, monetary global governance is today in a stalemate with unpredictable consequences.

1.3 Chapter Outline

The thesis is divided as follows. After this introduction, in the next chapter I will provide a multidisciplinary literature review on the topic summarising all the economic, political and social elements that will be touched upon when analysing the empirical results. The first part of the chapter is dedicated to present the two contending hypotheses on the euro challenge in the Economics literature. Once this is completed, it will become clear why strict economic variables and measurable data of international currency use are not enough to explain why the euro has not been able to challenge the dollar. This explanation is given by IPE analyses focusing on the political, institutional and military weaknesses of the EZ. However, even this literature does not capture the whole complexity of the topic. By using overly material analyses, most of this literature is not able to grasp the socio-ideational impact of the euro. The last part of the chapter shows how a constructivist IPE approach that considers, in addition to economic variables and structural-material factors, also social-agential elements, provides a more nuanced and detailed toolbox to identify all the different material and ideational forces that are at play.

While in the second chapter I present a mapping of the theoretical debates relevant for the overall argument of the thesis, in the third chapter I elaborate on the key concepts, the case study regions and the methodology used throughout this research. The first part of this chapter is dedicated to explaining in detail four key concepts necessary to understand the results emanating from the empirical investigation. These concepts, which are all overlapping but will be presented one by one for analytical purposes, are money (understood primarily as a medium of social interaction between creditors and debtors); power (in its three faces); the role of ideas in Knightian uncertainty (how ideas play a major role when it comes to analyse institutional change); and monetary governance (as a set of norms and principles established and abided by public and private economic actors formally and informally). After considering the conceptual framework of this research, the second part of the chapter proceeds to explain the rationale for the three case study regions. By presenting the overwhelming predominance of speculative and material studies on these regions, I will show why it is useful to study the subjective perceptions of financial elites in Brazil, China and the GCC countries in order to understand the full impact, material and ideational, of the euro in the transformation of the IMS. In the third part of the chapter I explain why I have chosen semi-structured elite interviews as the primary method of enquiry to test the given hypotheses. In the last section of this chapter I will finally summarise the differences and difficulties encountered to access financial elites in Brazil, China, UAE and Saudi Arabia so that future researchers in this field can build on my experience.

The fourth chapter is the first to concentrate on the research material collected and its focus is to show how the euro is not ready to materially challenge the dollar. As explained before, the main reasons being the lack of an integrated pan-European debt market and the political divisions still dominant in the EZ. Essentially in this chapter I argue that the euro is still an ‘orphan currency’ (Malfa 2002) without a state apparatus to back it up in difficult times like the current crisis and without a military that can serve as protection shield for vulnerable areas like the GCC. Despite these shortcomings, the overwhelming majority of financial elites interviewed do not think that the euro will break up. The common view is that the road towards further political integration will be bumpy and twisted but ultimately the Europeans will come up with solutions to make EMU more resilient. Long term confidence in the European project is not limited to the ideational sphere. China in particular has shown its support to the euro by buying public debt from EZ peripheral countries precisely when they were under huge speculative attacks from predominantly euro-sceptic Anglo-American hedge funds. With the empirical evidence at hand it can comfortably be argued that China has had major influence in the survival of the euro. It can also be said that both the material and ideational appeal of the euro is strong enough to make China want to have a second strong international reserve currency.

China's backing of the euro does not come for any specific sentimental attachment to Europe. It is rather to satisfy its desire to establish a multicurrency IMS with different alternatives to the dollar, and until the Chinese Renminbi becomes an international currency, the euro is the only alternative available in order to diversify out of the risks associated to the dollar. In the fifth chapter I focus precisely on how financial elites in Brazil and China, and to a lesser extent in the GCC, are unhappy about the performance of the dollar as the anchor of the system. The consolidation of the euro has helped to reinforce these perceptions. The two main reasons that explain this discontent are volatility and the Triffin Dilemma. In this chapter I will show how the global financial crisis and the unorthodox monetary policy of Quantitative Easing (QE) have greatly damaged the reputation of the US in monetary affairs. China and other emerging economies fear that the US might inflate its debt away by adopting extra loose monetary and fiscal policies. They are proposing to introduce multilateral and bilateral mechanisms that would restrain the 'exorbitant privilege' of adopting lax macroeconomic policies without disciplinary consequences. So far, though, the US is not willing to make any substantial concessions in this field. The financial elites of emerging markets think that the status of the dollar needs to be renegotiated. US officials disagree.

Given that there is so much discontent about the dollar-standard and that emerging markets cannot do much to change the status quo, the sixth chapter focuses on possible alternatives on a regional and national scale. Here the euro shows that it has had great ideational effects as a role model for regional monetary union. I will provide a summary of these trends in the three case study regions covered. However, regional monetary union is not easy (the European experience shows it) and as a consequence regional hegemons such as China and Brazil, and even Saudi Arabia (which is now leading a much more reduced and manageable GCC monetary union), are eager to internationalise their own national currencies. But even under this path the successful experience of the euro is studied in detail. The euro has managed to become the second international currency in less than a decade and this is a source of great admiration in the emerging markets. Thus, I will argue that the harbinger role of the single currency is maintained even if these countries opt for the internationalisation of their own currencies. These objectives are not mutually exclusive. China, for instance, is considering how Germany had first an international currency of its own and then, to avoid political tensions within its region, it was willing to merge its currency into a regional currency. This could also be a possibility for China given that its superpower status worries many of its neighbouring countries.

While the sixth chapter focuses on the regional level, in the seventh and last chapter I pay attention to monetary cooperation or disputes on a global level. My aim here is to explore how these financial elites see European monetary power in relation to US supremacy. On the basis of the material gained through the interviews and further triangulation with other primary and secondary sources, the key question tackled here is to identify, on the back of euro internationalisation, the influence of Europe in global monetary governance. To do so I use Lukes' division of three faces of power as the analytical tool, while I expand the third face of power with Blyth's focus on how ideas are crucial in the different phases that precede the transformation of systemic structures, especially in times of systemic crisis like the one that we are just witnessing. In this battle for ideas, I argue that the Europeans, through the euro, have gained considerable influence in the third face and second faces of power focused on preference-shaping and agenda-setting. Increasingly, emerging powers, including China and Brazil, are favouring a multi-polar and multilateral monetary system governed by a set of rules and check and balances similar to the ones to be found in EMU, and they are willing to support the Europeans in shaping the global agenda for reform. France and China, for instance, have strengthened their cooperation on the reform of the IMS to a significant degree. However, the reality so far is that the Europeans are not able to come up with concrete proposals for reform backed by the EZ as a whole nor are they powerful enough to stop the US to continue to exploit its exorbitant privilege. Thus, considering that they are the only ones that can hitherto challenge US power in this field, global monetary governance is in a deadlock. Increasingly, countries are resorting to unilateral foreign exchange interventions and capital controls to cope with the instabilities of the FDS. The last part of the last chapter considers three possible future scenarios emanating from this conjuncture: 1) the emergence of a multicurrency system based on different currencies competing for international use; 2) the collapse of fiat money and the return to a gold standard and 3) the overcoming of the current stalemate in global monetary governance with the creation of a multilateral global currency to avoid exchange rate instability and the Triffin Dilemma.

Chapter 2: The Euro vs. Dollar Debate in the Economics and IPE Literatures

The Economics and IPE literature covering 'the euro challenge to the dollar' topic since the late 1990s can be divided in those scholars that fall in the camp of the euro-optimists who argue broadly in favour of the following thesis:

> *The euro is increasingly competing with the dollar for the role of international currency due to the increase in economic output of the Eurozone, the exchange rate strength of the euro and the integration process of the European financial markets.*

And those who form the euro-sceptical camp who point to the obstacles that the European currency faces to de-throne the dollar by subscribing broadly to this other thesis:

> *The euro is not able to compete with the dollar for the role of international currency because EMU lacks an integrated debt market and it is politically too divided to assure internal cohesion and exert global monetary power.*

These two differing hypotheses, still maintained to present days, have been the starting point of this study. In the first part of this chapter I will consider in greater detail these contending hypotheses, focusing on macroeconomic variables. Presenting currently available economic data, I will show how after more than 10 years of existence, the European currency has underperformed in relation to the expectations of the euro-optimists. The economic data on international currency use publicly available support the sceptics. Roughly speaking, the dollar still dominates in 60 percent or more of global transactions and reserve holdings, while the euro falls below the 30 percent level in these areas (De la Dehesa 2009; ECB 2010a).

But such data alone does not explain the whole story, especially if they are incomplete (data for international trade invoice and central bank foreign reserves allocations, for instance, are only partially available). The numbers are representative enough to support the view that the euro is far from challenging the greenback in a material sense (and that is why I will present them) but it is also true that they do not explain in full why this is the case. In the second part of this chapter, therefore, I turn for that to the literature that combines both economic and political arguments. By studying with rigour political aspects, several IPE authors have greatly enhanced our understanding of the topic. They have been able to highlight the political weaknesses of the euro and the relative strengths of the US dollar, even if the greenback is weakening in absolute terms. They have shown that a currency can only become the top international currency if there is an active political commitment by the issuing authorities to make this currency the leading currency. This is presently not the case for the EZ. In addition, they have also focused on geostrategic and military aspects that are vital to comprehend the resilience of the dollar as the leading international currency. These are all issues that I incorporate and develop when presenting the empirical findings collected during my fieldwork.

In the last section of the chapter I argue however that these analyses, based mostly on material considerations, are not comprehensive enough to capture all the inroads opened up by the euro in its challenge to the dollar. By focusing only on the question of whether the euro will topple the dollar, most of the literature has overlooked the ideational impact of the single currency. Drawing on more constructivist understandings of money, in this third part of the chapter I will argue that the euro and the dollar do not only compete in the economic and political spheres, they rival each other also in public perceptions. To fully grasp the impact of the euro in the IMS one needs to consult in detail measurable economic data and analyse structural political considerations. But in addition, it is important to investigate the impact of the euro upon the subjective perceptions of the general public at large, and more importantly, upon key players in the global financial markets. The euro has triggered ideational effects that can only be discerned by focusing on agential behaviour and understanding. In this regard, the agents that I consider in a vantage point to interpret the evolution of the IMS are the private bank and public foreign reserve managers. Therefore, the last part of this chapter will give a first glance on how these financial elites subjectively *construct* the euro challenge to the dollar. This first insight will set the stage for what will be dealt with in subsequent chapters.

2.1 The Euro vs. Dollar Debate in Economics before the start of EMU

2.1.1 The 'Euro-Optimist' Hypothesis

One of the first economists predicting the ascendance of the euro as a strong international currency was Fred Bergsten. Already in 1997, five years before the euro hit the streets of Europe, he would write that:

> The creation of a single European currency will be the most important development in the international monetary system since the adoption of flexible exchange rates in the early 1970s. The dollar will have its first real competitor since it surpassed the pound sterling as the world's dominant currency during the interwar period (1997:83).

Focusing on the economic might of the EU – with output and trade figures stronger than those for the US – and also on the strong mandate that the ECB had received from the Maastricht Treaty to ensure a strong currency, Bergsten predicted that "there will probably be a portfolio diversification of $500 billion to $1 trillion into euros" and that "most of this shift will come out of the dollar" (1997:84). As a consequence of this diversification, in his calculations "the dollar and the euro are each likely to wind up with about 40 percent of world finance, with about 20 percent remaining for the yen, the Swiss franc, and minor currencies" (1997:84). For Bergsten this development would also have important political ramifications. He concluded that "a bipolar currency regime dominated by Europe and the US, with Japan as a junior partner, will replace the dollar-centered system that has prevailed for most of this century" (1997: 83).

One year later, in 1998, Robert Mundell, another prominent euro-optimist, would come up with bolder predictions. For him, the historical significance of the arrival of the euro was much greater than President Nixon's decision to close the 'gold window' in 1971 or even the Bretton Woods arrangements of 1944 which created a completely new monetary system. While those changes did not alter the power configuration in the international monetary system (IMS):

> This is not so with the introduction of the euro. The EMU countries will eventually comprise a transactions domain that is considerably larger than the dollar area. As an economic giant, Euroland will fully be the equal of the US, and the euro will become an international currency on the same scale as the dollar. From the deeper significance of monetary power relationships, the introduction of the euro will be the most important change in the international monetary system since the transition, achieved during World War I, from the pound to the dollar as the dominant international currency (1998:227-8).

As can be observed, both Bergsten's and Mundell's predictions are based on economic considerations (mainly trade and output numbers and also diversification tendencies among international investors) but the effects they envision are not limited to the economic realm, they stretch to the political field. As Mundell concludes, "members of the EMU will get not just a currency on a par with the dollar and the right to a share in international seigniorage[6] but will also have greater influence in running the international monetary system" (1998:237). Therefore, for both these authors, issuing an international currency and acquiring greater monetary power go hand in hand. One leads to the other. The more the euro is used in the world, the greater will be European influence in shaping the governance structures of the IMS. While I accept this relationship, I differ with Mundell and Bergsten in the causality effect. For these authors greater use of an international currency provides the issuer with more international monetary power. Causality is here understood as linear. However, as Richard Portes and Hélène Rey (1998) point out, in this matter the causality is relational not unidirectional. It is true that progressive internationalisation of a currency gives the issuer state or union of states greater say in global economic governance, but only up to a point. After that, active political action needs to be taken to further expand monetary power and consequently promote the internationalisation process. Once this is successfully achieved, the worldwide use of the currency will increase, and this in turn will further strengthen the issuer's monetary power. The relationship is symbiotic as Mundell and Bergsten suggest, but it is not that one side

[6] As acknowledged by the European Commission (2008:221), "international seigniorage is the implicit income received by a country's (in the case of EMU, union of countries) monetary authorities from the fact that non-residents hold large quantities of domestic cash, which bears no interest. This allows the county (or union of countries) that issues the currency to obtain real resources (net imports) in exchange for almost costless notes".

determines the other, both elements need to feed each other to maximise their performance.

Portes and Rey, who can also be classified as ‘euro-optimists’, do precisely consider this interactive relationship. Their analysis based on econometric modelling establishes accurately the integration process of European financial markets as the key, one can say, independent variable in determining whether the euro will topple the dollar. Inching towards the IPE terrain, from the very start of EMU they acknowledged that this variable would only be optimised by an active policy of financial market integration and international currency promotion by the European authorities. They justified this political activism on the grounds of the benefits that come with issuing an international currency. While they covered briefly how an international currency translates into political power and prestige (something I will discuss in greater detail below), their attention is more directed to the economic gains, which they consider less “nebulous”.

Portes and Rey’s argument has several merits. First of all they highlight the trade advantage of buying and selling products in one’s own currency, thus avoiding exchange rate risks for local companies and institutions. Secondly, they point to the ‘exorbitant privilege’ that a country acquires by being able to finance balance of payments deficits with liabilities denominated in the country’s own currency, which makes the country less reliant on foreign reserves. Thirdly, the use of its own currency protects the country better from external shocks (i.e. price volatilities). And finally, and most importantly, it reduces the country’s financing costs due to the centrality and demand-pull of its currency in the system. Furthermore, an international currency provides the issuing country also with international seigniorage, defined, “as the ability to obtain real resources (net imports) in exchange for almost costless notes” (1998:309). In the case of the greenback, foreign residents hold approximately 60% of total outstanding US dollar stocks. In Portes and Rey’s calculations, this means that annual revenues of international seigniorage for the US account to circa 0.1% of US GDP, which updated to 2010 GDP figures, would reach an actual sum of $14.6 billion.[7]

In addition, these authors have identified another source of seigniorage for the US, which is often neglected in the literature. This additional advantage emanates from the extraordinary liquidity of the US Treasury debt market. This liquidity drives yields down, which in their calculations brings a 'liquidity discount' that amounts to annual benefits of $5-10 billion (1998:309-10). Considering that US debt issuance increased substantially as a consequence of the 'Great Recession' and that yields on US Treasury bills, notes and bonds have remained at historic lows in the past years, this figure must be significantly larger for 2010.[8] Finally, Portes and Rey point to the efficiency gains obtained in financial intermediation activity from the deepening of foreign exchange and financial markets. If the euro increases its share as an international currency and more international trade is invoiced in the European currency and the European debt bond markets are better integrated and converge in regulation and commissions, transaction costs will be reduced and liquidity increased. This means that less labour is necessary to deal with these activities in European companies. The material gains derived from the reduction of these transactions costs are for Portes and Rey of the same magnitude as the seigniorage gains. Therefore, they "provide a new economic argument for policy-makers who wish to promote the international role of the euro" (1998:310).

By taking for granted the macroeconomic strengths of the EZ and by assuming that European financial markets will liberalise and integrate at a rapid pace and hence rival soon the centrality of Wall Street in monetary affairs – not least because of European political determination – but also because in their opinion the UK (and the City of London with its financial expertise, externalities and know-how) would join the EZ very soon, Portes and Rey concluded their analysis in a very similar vein to Bergsten and Mundell:

[7] US 2010 GDP figures of $14.6 trillion are taken from the IMF World Economic Outlook Database updated in October 2010. Using another set of calculations than those used by Portes and Rey, Cohen (2008a:258) comes up with a slightly higher figure for US international seigniorage revenue of $16-22 billion. Still he thinks that these calculations are conservative.

[8] At the time of writing (June 2011) the US has just hit its congressional debt ceiling set at $14.294 trillion. However, the yield on the 10 year Treasury note features still at below 3%.

> Given the euro's fundamentals – the EU's economic size, the liberalization and integration of its financial markets, and confidence in its international creditor status and stability-oriented monetary policy – we find that the most likely outcome is that the dollar will have to share the number one position (1998:308).

With the benefit of hindsight, one can confidently say today that most of the assumptions presented by Portes and Rey in their 1998 calculations have not materialised. While it is true that financial markets in Europe have been integrating further, thanks to policy decisions like the Financial Services Action Plan (FSAP) set in motion by the European Commission in 1999 (Galati & Wooldridge 2006), transaction costs are still higher in Europe than in the US (Grant 2010). London remains outside the EZ and, most importantly, the ECB has not shown any signs to actively promote the internationalisation of the euro. This evolution has been left to market forces, which means that the euro lacks the political leg necessary to increase its international usage.

2.1.2 The 'Euro-Pessimist' Hypothesis

These political weaknesses in the construction of EMU have been precisely the focus point of euro-sceptic scholars. Rüdiger Dornbush (1996), for instance, identified from an early stage some internal limitations that would hamper EMUs global aspirations. His analysis is of relevance today because he predicted with great accuracy some of the difficulties experienced by EZ periphery countries as a consequence of the effects of the Great Recession. Drawing on the fact that the EZ is not an Optimum Currency Area (Mundell 1961, 1973), and considering that the Maastricht Treaty limits any transfer of funds from one country to another, Dornbush foresaw that potential asymmetric external shocks or growth disequilibria within EMU would be extremely difficult to manage under a single monetary policy. Historically in Europe these asymmetries would be offset by moves in the exchange rate, but lacking this mechanism, and a common fiscal policy that allows transfers between EZ member states (something Dornbush does not conceive as feasible in the European context), the adjustment costs will have to come through the labour markets. Fully aware of the troubles ahead for EMU, his overall outlook was pessimistic:

> The most serious criticism of EMU is that by abandoning exchange rate adjustment it transfers to the labor market the task of adjusting for competitiveness and relative prices. […] In backward regions unemployment will rise, as will social problems and complaints about integration. If exchange rates are abandoned as an economic tool, something else must take their place. Maastricht promoters have carefully avoided spelling out just what that might be. Competitive labor markets is the answer, but that is a dirty word in social-welfare Europe (1996:120).

It is certainly striking how this description written 15 years ago resembles closely the situation experienced at the time of writing in countries such as Portugal, Greece, Ireland and Spain (derogatorily labelled as the PIGS countries by financial market traders), which are all suffering high unemployment, massive public spending cuts and major labour reforms.

While Dornbush focused on the internal problems of the euro, two other economists, McKinnon (1998) and Kenen (2002) analysed the euro challenge thesis from an international market perspective. Following a standard Economics textbook explanation of money, they stressed that in order to analyse the euro vs. dollar competition it was helpful to separate the functions of any international currency in three: unit of account, medium of exchange and store of value. For the first two functions, they argued that market actors prefer a single international currency. For the latter, though, competition between different international currencies is likely, and even desirable. The function of unit of account refers to the invoicing of contracts or pricing of commodities in one particular currency. The international pricing of oil in dollars is a good example. The medium of exchange function, on the other hand, relates to the vehicle currency used to exchange different currencies in the foreign exchange (FX) markets. It is difficult to exchange Mexican pesos for Russian rubles. Therefore, the most common strategy is to exchange the pesos for dollars and then the dollars for rubles. Here again there is always one particular currency that performs this function, which makes it the vehicle currency. Moreover, once this currency is consolidated "it becomes a natural monopoly" (McKinnon 1998:33), meaning that "it cannot readily be dislodged, even if another currency could do just as well. A synchronized switch would be needed, and it would be hard to achieve unless it would greatly enhance the efficiency of foreign-exchange trading" (Kenen 2002:348). This pattern is based on what is called network externalities. Chinn and Frankel (2008) make an analogy to 'lingua franca' languages. Traders use a particular currency because they know that others are likely to use it as well. This creates historic path-dependency and inertia that is very difficult to break. This is not only true for the private sector. Central banks peg normally (if they follow a currency peg) to this international currency to avoid price volatility from imports invoiced in that currency. They also use this currency to intervene in the markets because it is cheaper and more efficient to do so and as a consequence they are also likely to maintain a great part of their reserves in that same currency.

Things are different in the function of store of value, which is normally associated with keeping wealth in a particular currency because market agents trust its long term value. In this regard, in the current system based on fiat-money which is not backed by any metallic asset, as was the case in the Gold Standard, it is important that the central bank issuing the international currency has credibility among market agents in controlling inflation and not monetizing the countries' deficits. This is a precondition to acquire a store of value status among investors, as will be underlined in the empirical chapters of this thesis. Nonetheless, in this particular function several reserve currencies with different fluctuating exchange rate trends can easily compete. As explained by Kenen, "portfolio optimization involves the efficient management of risk and thus fosters diversification rather than dominance" (2002:348). This distinction between the three functions of an international currency is important in order to analyse, for example, the behaviour of the State Administration of Foreign Exchange (SAFE), the Chinese institution responsible to manage Chinese foreign exchange reserves. China has with \$3.2 trillion[9] foreign reserves (approximately 50% of its GDP) by far exceeded the necessary precautionary amount to maintain its peg to the dollar[10] and cope with possible external shocks, thus its diversification incentives are undoubtedly higher.

[9] This is the figure given by the People's Bank of China, the Chinese central bank, as per 30 June 2011.
[10] In June 2010, the People's Bank of China, the Chinese central bank, announced that it would loosen the tight peg to the dollar and go back to a basket peg, a policy undertaken before, from 2005 until 2008, when the financial crisis in Wall Street brought great instability to the markets and the direct peg to the dollar was reintroduced. Nonetheless, despite the announcement in the year between June 2010

Nonetheless, as Cooper (2000) foresaw a decade ago, foreign reserve managers do not only look for safe storage and high returns. They do also consider the liquidity of the assets that they buy, especially if they have to make use of them in unpredictable intervals. Money needs to be stored in a convenient medium, and this medium is today provided by the US Treasury debt market where:

> Amounts measured in billions of dollars can be bought and sold readily, 24 hours a day, anonymously, without influencing the price of the outstanding bills. In effect, for large holders the US T[reasury]-bill has become interest-bearing money. It can be converted into means of payment at virtually no cost (2000:188).

The EMU does not have a deep and liquid debt market equivalent to the US Treasury market. On the contrary, debt markets in Europe until the Great Recession were relatively small (the Growth and Stability Pact does only allow for annual fiscal deficits of 3% of GDP in normal circumstances) and nationally fragmented (there was no large pan-European debt issuance until the creation of the EFSF in May 2010). These limitations have always provided a ceiling on the projection of the euro as an international reserve currency.[11]

Finally, before concluding this section, it is important to highlight that the three functions of international currencies are strongly interconnected. A vehicle currency is likely to function also as a reserve currency, but it is also true that a reserve currency might gradually become a vehicle currency. This can be explained by an example. If the European debt markets were to integrate in one, they would acquire greater liquidity, this in turn would mean that China would be able to invest more of its reserves in euros and so achieve a greater diversification in its portfolio in pursuit of higher returns. By seeing the advantages of this, the Chinese authorities and

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and June 2011 the Renminbi (RMB) has moved only very gradually (around 5%) against the greenback.

[11] At the moment of writing, EZ debt issuance has increased dramatically due to the adoption of counter-cyclical fiscal policies to overcome the financial crisis 2007-2010. Almost every country in the EZ has surpassed the GSP fiscal deficit limit of 3% to GDP. The issuance of European debt is now not only limited to the national level. The European Financial Stability Facility (EFSF) set up to provide financial assistance to debt-laden countries in the EZ has started in January 2011 to issue Pan-European debt backed by all member states of the EZ. Nonetheless, this is not a pan-European debt market.

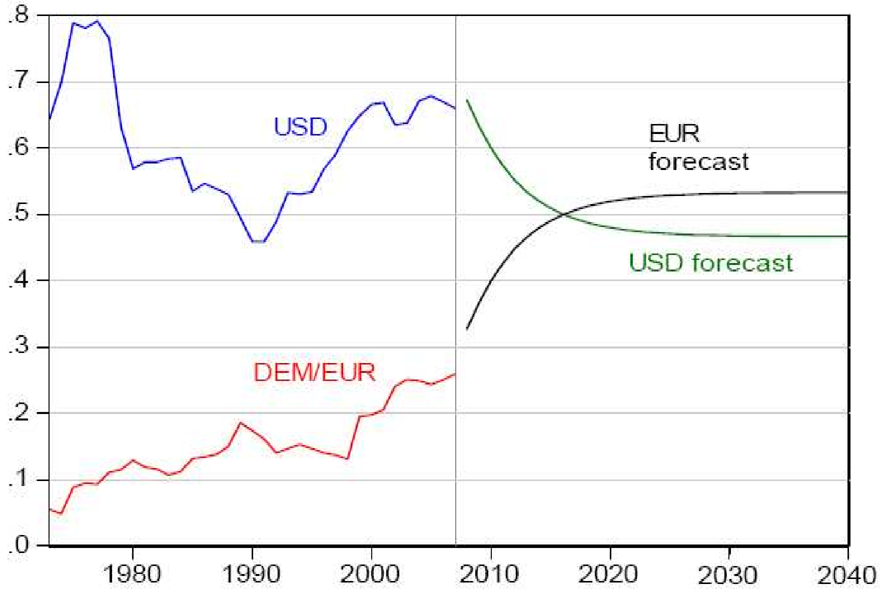
institutions would be encouraged to sell more of its products in euros to the EZ and this would mean that the euro would function more as a unit of account. The euros collected through this trade pattern would then presumably return to European financial markets for further investment and thus lower FX transaction costs for the euro, which then would mean that the euro would also increasingly be more attractive as a vehicle currency. Path-dependency, and especially hysteresis (a lag in response to changes already under way in the system), might hamper this process, but theoretically it is possible. This discussion is important when considering the possibility of the creation of a multipolar monetary system (see Chapters 6, p.238 and 7, p.263). Indeed, following this same logic diversification in reserve currencies might foster the use of more than one international currency as unit of account and thus question the network externality theory presented above (Eichengreen 2011b).

2.2 The Euro vs. Dollar Debate in Economics Today

2.2.1 The Euro-Optimist Hypothesis Reinvigorated

More than ten years after these two opposing arguments on the euro challenge to the dollar were first laid out, the debate in the Economics literature continues under the same opposing views. This has been the case up to the current sovereign debt crisis in the EZ and presumably, if the euro does not break up, it will continue in the future. Chinn and Frankel (2005, 2008) represent here the ‘euro-optimist’ camp. After predicting in 2005 that the euro would possibly surpass the dollar in 2022 as the leading reserve currency, their latest econometric calculations produced in 2008 pushed this tipping-point even closer to 2015 (See Figure 2.1).

Figure 2.1: Chinn and Frankel's predictions on the euro surpassing the dollar by 2015



Source: Chinn and Frankel (2008); Based on the IMF's Currency Composition of Official Foreign Reserve (COFER) data

Their predictions are based on the main factors that economists consider generally as determinant to gain international currency status: 1) economic size measured in output and trade; 2) deep, liquid and well-developed financial markets; 3) confidence in the value of the currency and 4) network externalities. In their view, while in the first two the EZ is catching up with the US (new members will make EZ GDP higher than US GDP and the City of London is becoming de facto the financial hub for euro-denominated financial instruments), the dollar is bound to underperform vis-à-vis the euro in the third factor. As they put it: "the US current account deficit is always a likely source of downward pressure on the dollar" (2008:58). Given this outlook and focusing on central bank foreign reserve management in their calculations because of its importance to fund US external debt, Chinn and Frankel answer the question of whether the dollar might lose its predominant position with:

> The answer is maybe 'yes'. The primary reason is that the euro now exists as a more serious potential rival than the mark and yen were. A secondary reason is that the United States by now has a 25-year history of chronic current account deficits and the dollar has a 35-year history of trend depreciation (2008:51).

In Chinn and Frankel's analysis thefore there will be a moment when dollar inertia will be broken and a new equilibrium will be found. This is the tipping-point that will catapult the euro to top international currency. This is a similar conclusion to the one reached by other euro-optimist economists such as Papaioannou and Portes (2008). As mentioned, for these authors the increased reserve role of the euro will affect the other two functions performed by an international currency: the vehicle currency role and the trade invoicing role. In other words, the former will stimulate the latter.

2.2.2 The Euro Challenge to the Dollar Measured in Quantitative Terms

Chinn and Frankel's econometric calculations, presented timely in 2008 when the dollar was depreciating at a rapid speed vis-à-vis the euro (see Figure 2.2) and when fears of a disorderly dollar collapse were widespread due to bloating US current account deficits (Roubini & Setser 2004; Roubini 2006; Krugman 2007),[12] triggered a rapid reaction by economists more sceptical with this outcome.

Figure 2.2: Euro-Dollar Exchange Rate; 1999-2011 Q2

Source: ECB (2011a)

[12] It is here important to note that before the Global Financial Crisis, the literature that pointed to the unsustainability of US debt patterns and the consequent global imbalances predicted that the crisis would arrive through a collapse in the confidence of the dollar and not through the subprime real state mortgage market (see Reinhart & Rogoff 2009:208-9).

It is here worthwhile presenting the response of De la Dehesa (2009) who provides a good summary of the international use of the euro to underscore his claim that the euro is still far away from posing a challenge to the greenback. Where possible, I update De la Dehesa's comprehensive data sample with the most up to date data at the time of writing. De la Dehesa assesses the euro challenge to the dollar on the basis of its relative weight in three different international markets: A) the international liability management market; 2) the international asset management market; and 3) the foreign exchange market.

a) International Liability Management

The issuing of euro-denominated securities around the world has increased substantially since the creation of the single currency. "According to the ECB, in a narrow sense – excluding domestic issuance of debt securities at constant exchange rates, i.e., adjusted by valuation effects – the share of euro-denominated debt securities of the total stock grew from 20% at the start of EMU in 1998 to a peak of 33.8% in mid 2005" (De la Dehesa 2009:7). This amount has slightly dropped in recent years, hovering just above the 30% mark. In 2009 the actual figure was 31.4% of total issuance (ECB 2010a). Dollar-denominated debt securities, by contrast, experienced a decline from 49% of total stock at the start of EMU in 1998 to a low of 41% in 2005, when the euro peaked. Since then, however, dollar-denominated issuance has increased and in 2009 (the latest figure to date) it stands at 46%. These data show a rapid growth for the euro in the first years with a plateau at around 30 percent. The dollar remains robust at around 45% while the biggest loser is the yen, still the third most used currency, but in a continuous downward trend. In 1998 it represented 18% of total issued debt; today its share is below 6% (ECB 2010a:17-8).

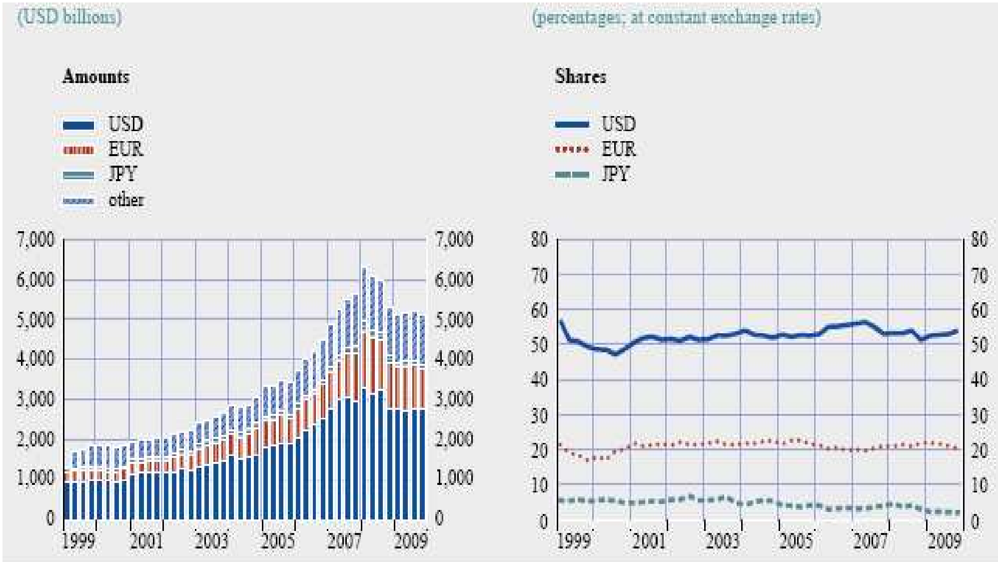
Figure 2.3: Stock of international debt securities (narrow measure): outstanding amounts and currency shares

Sources: BIS and ECB calculations.
Note: The shares at constant exchange rates are reported at Q4 2009 exchange rates.

Source: ECB (2010a)

De la Dehesa observes that most of euro-denominated issuance is in fixed income and not in equity markets. Equity markets in the EZ, despite efforts to integrate them, are still nationally divided and hence present a considerable 'home bias'. This makes them much smaller than their US equivalents. In De la Dehesa's (2009:8) calculations, at the end of 2008, the market capitalisation of the US equity market was US$9.4 trillion (35.2% of the world total and 67% of US GDP), while the EZ's was only US$5.8 trillion (21.7% of the world total and 46% of EZ GDP). Things are a bit different in fixed income debt, despite the aforementioned deficit of not having an integrated pan-European government debt market. Here the creation of a single currency has eliminated exchange rate risk improving overall demand. Bond and note issuers, both from the public and the private sector, have greatly benefited from this development. Financial institutions, predominantly in the UK and the US, for instance, have been particularly keen to borrow in euros. Overall, euro-denominated debt is prevailing in Central and Eastern Europe (80% of total issuance); the UK, Sweden and Denmark (58%) and North America (53%). In Africa the euro and the dollar are very close (the euro share is 41%), while in Asia (20%), Latin America (14%) and the Middle East (11%) dollar-denominated debt is still predominant (ECB 2010a:20). The same can also be said in relation to international loan markets. Here too the dollar is strongly favoured. As of 2009 only 20.3% of cross-border loans from banks to non-financial firms and households were denominated in euros. In the case of the dollar the share was close to 54%. This has remained so for the last decade, with the euro not making any significant advance.

Figure 2.4: International loan markets: all cross border loans by currency



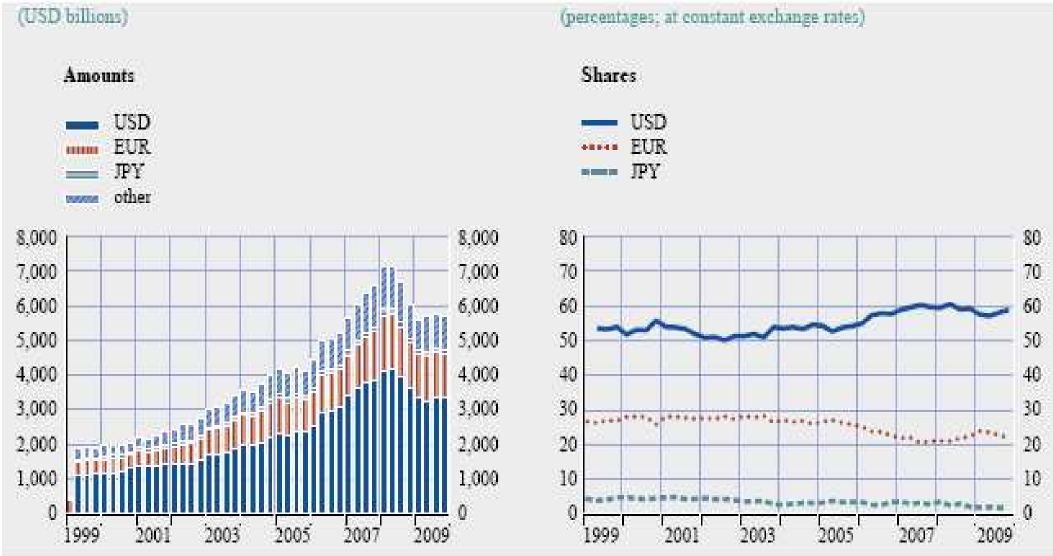
Sources: BIS and ECB calculations.
Note: The shares at constant exchange rates are reported at Q4 2009 exchange rates.

Source: ECB (2010a)

b) International Asset Management

In this section De la Dehesa (2009) provides very interesting 2006 data on currency composition of managed investment funds worldwide. Here the share of the euro only accounts for 0.7% of total assets owned by investment funds allocated in the US and Canada, and 27.8% for those in Western European non-EZ countries (the UK, Denmark, Sweden, Switzerland, Norway, Monaco and Lichtenstein). By contrast, the dollar's share reaches 97.1% in the former and 14.4% in the latter. The euro has achieved some gains since 1999 (the numbers were 0.2% and 26.8% respectively), but these are still minor. Average euro shares in investment portfolios in Central and Eastern Europe are around 50%. However, in other parts of the world the dollar is clearly dominant. In Japan portfolio share of the dollar is 44% vis-à-vis 20% for the euro, while in the rest of Asia, Latin America and Russia the dollar takes 80%, 95% and 92% respectively with only 4% for the euro. Nonetheless, De la Dehesa suggests that diversification into euros is rapidly increasing in these emerging markets. In cross-border deposit markets the euro is also well behind the dollar. In 2009 the share of euros was 22%, while that of dollars was touching the 60% mark (ECB 2010a:21-2). As an example, De la Dehesa (2009:10) indicates that in 2008 the euro's share of deposits held by OPEC countries was 18%, compared with the dollar's 77% share.

Figure 2.5: International deposit markets: all cross-border deposits by currency



Sources: BIS and ECB calculations.
Note: The shares at constant exchange rates are reported at Q4 2009 exchange rates.

Source: ECB (2010a)

c) <u>Foreign Exchange Markets</u>

In the foreign exchange markets, where the euro and the dollar compete for international vehicle currency in the function of medium of exchange, the share of the euro has not gained much ground either. The latest Triennial BIS Survey on foreign exchange turnover released in December 2010 shows how in 2001 the shares were 89.9% for the dollar and 37.9% for the euro, while now they are 84.9% and 39.1% out of 200%[13], respectively (BIS 2010, see Table 2.1).

[13] The 200% figure comes from the fact that in every transaction there are two currencies involved.

Table 2.1: Currency distribution of global foreign exchange market turnover

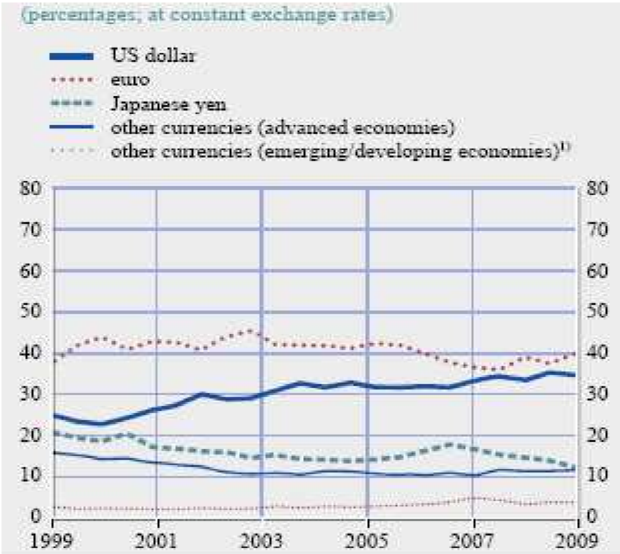
Currency	1998	2001	2004	2007	2010
US dollar	86.8	89.9	88.0	85.6	84.9
Euro	--	37.9	37.4	37.0	39.1
Japanese yen	21.7	23.5	20.8	17.2	19.0
Pound sterling	11.0	13.0	16.5	14.9	12.9
Australian dollar	3.0	4.3	6.0	6.6	7.6
Swiss franc	7.1	6.0	6.0	6.8	6.4
Canadian dollar	3.5	4.5	4.2	4.3	5.3

Mexican peso	0.5	0.8	1.1	1.3	1.3
Indian rupee	0.1	0.2	0.3	0.7	0.9
Russian rouble	0.3	0.3	0.6	0.7	0.9
Chinese renminbi	0.0	0.0	0.1	0.5	0.9

Source: BIS (2010)

Where the euro beats the dollar is in over-the-counter (OTC) interest rates derivatives. The share of the euro is 39%, while the dollar accounts for 34%.

Figure 2.6: Currency break-down of OTC interest rate derivatives



Sources: BIS and ECB calculations.
1) Difference between the total and the shares of AUD, CAD, CHF, DKK, EUR, GBP, HKD, JPY, NOK, NZD, SEK and USD. This may include some advanced economy currencies not reported separately. Although their shares are likely to be rather small, the figures reported should be seen as an upper bound.

Source: ECB (2010a)

However, the euro is actually losing presence in this market against the greenback. In 1999 the share of the euro was very similar, while that for the dollar was around 25%. In foreign exchange derivatives the dollar has by contrast maintained over the decade its 80% out of 200% share, while the euro has remained stuck at 40%. Not surprisingly the greenback is also overwhelmingly dominant in the issuance of more synthesised derivatives such as asset-backed securities (ABS) and credit default swaps (CDS). In these markets the US accounts for 67.9% of total issuance, followed far behind by the EZ with 10.6% and the UK with 9.6% of the share. The largest proportion of this issuance, 85%, is in the issuer's currency, making the dollar by far the leading currency in this field (De la Dehesa 2009:11).

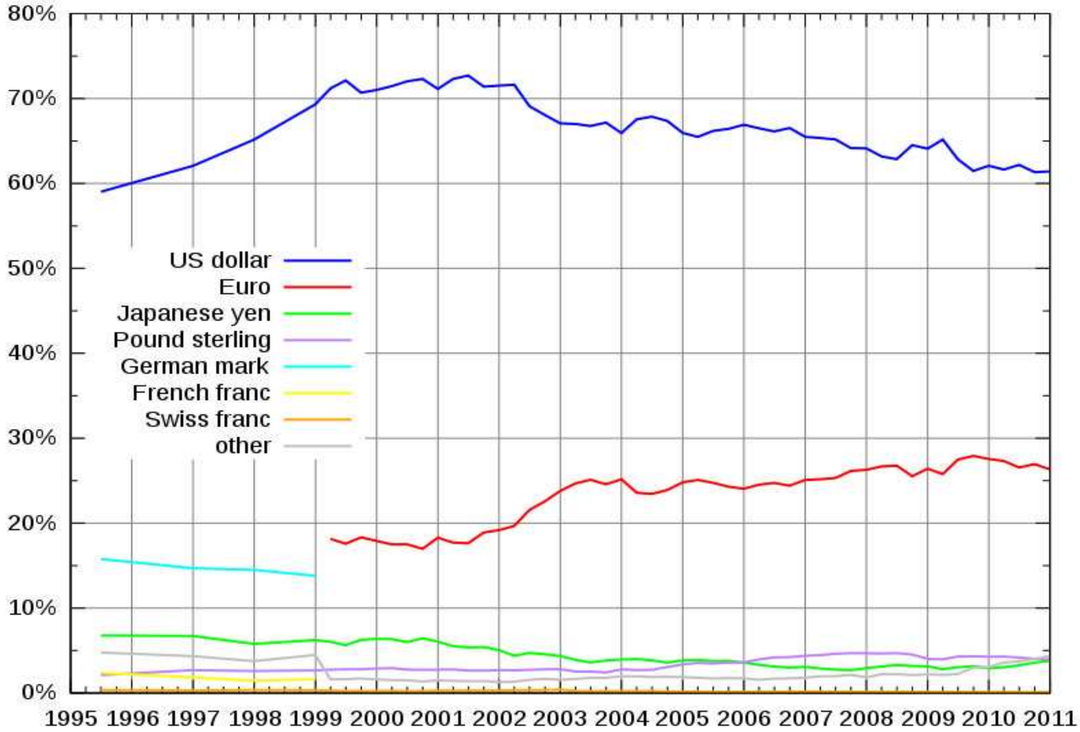
Nonetheless, where the European currency has achieved more inroads in its competition with the dollar is in the invoicing and settlement of international trade, a predictable evolution considering the trade might of the EZ. In its latest report the ECB writes that "since the launch of the single currency in 1999, the prominence of trade conducted in euro has increased steadily" (2010:25). On this same issue De la Dehesa (2009:11) states that the euro's average invoice share for global merchandise trade has increased from 18.2% in 2001 to 28.9% in 2007. EZ companies seem increasingly able "to impose their domestic currency both on their trading partners in the EU and on non-EU countries, pointing towards non-negligible producer currency pricing power" (ECB 2010a:26-7). Yet, the ECB report also acknowledges that this power diminishes as geographical distance from the EZ increases. ECB figures released in 2008 by the European Commission (2008) show that only 5.3% of EZ trade with Asian countries such as Indonesia, Japan and South Korea is invoiced in euros versus 80.1% in dollars (2008:120). Nevertheless, it is here important to highlight that these figures are mostly estimates. As was recognised by the ECB in its 2009 report:

> Ten years after the introduction of the euro, information about the currency denomination of invoicing or settlement of international trade flows continues to be scarce, considerable data collection efforts by the ESCB [European System of Central Banks] notwithstanding. In fact, data are obtainable for less than a third of global merchandise transactions in 2007 (ECB 2009:36).

This statement effectively indicates that there is not sufficient data available to measure accurately the euro challenge in the key realm of international trade invoice, perhaps one of the most important domains in assessing the performance of an international currency in the function of unit of account. The ECB provides only 39.2% of currency denomination trade data for EZ countries (having only estimates for France and no export data for Germany, the two biggest economies of the EZ). Furthermore, for non-EZ countries this share falls to 32.6% and for other regions of the world it drops to 5.4% (even though these account for 60% of global trade). This caveat is not acknowledged by many authors who rely on these same data to assess the performance of the euro (Cohen 2009a; De la Dehesa 2009).

What is widely acknowledged in the literature is the lack of reliable data on currency composition of foreign exchange reserves in central banks. The most used data set in this regard remains the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER), which, as it is recognised by the ECB (2010a), does only cover around 60% of global reserves. Important foreign reserve holders such as China do not disclose their foreign exchange composition. Here again the performance of the euro as an international currency in the function of store of value is not quantifiable. COFER data, as of March 2011, show that the euro has steadily increased its share from 18% to 26.3% of total known reserves since 1999, versus a steady decline in dollar reserves from 71% to 61.4% in the same period (IMF 2011b). This indicates almost a 10% swing (see Figure 2.7) but, as mentioned, these numbers should be interpreted with caution because they miss around 40% of total stock. Nonetheless, the figure below shows clearly that there is now a considerable gap between the second most used currency, the euro, and the rest. This provides an incentive for other regions and countries to try to close this gap.

Figure 2.7: Global distribution of global foreign exchange reserves



Source: COFER, IMF (2011b)

More interesting are the figures that the ECB (2010a:35) gives for other important nations, which do disclose to some degree their reserve composition. These estimations indicate that as of the end of 2009 the euro represented over 60% of UK, more than 40% of Canadian and close to 50% of US reserves. The ECB also gives 2008 figures for Russia, showing that the euro share was very close to 50%. This is in line with the 2009 report of the Russian Central Bank (RCB) which showed that the euro had surpassed the dollar as the main reserve currency. The European currency takes now 47.5% of the share of total reserves, while the dollar counts for 41.5% (Eichengreen 2011a:135).

It is useful to finish this section with the Russian central bank's diversification move out of dollars and into euros because it shows clearly what this quantitative overview can and cannot tell us about the euro challenge to the dollar. Where the amount of data is representative, the challenge is easily measurable. The figures show that, while the euro has increased its share in debt-issuance, investment management and foreign exchange (FX) activity to around 30% on average, the dollar is still clearly dominant in roughly two thirds of activity. Because of lack of reliable data, evidence is not as clear cut in the invoice of international trade and foreign reserve management of central banks. Thus, Chinn and Frankel's euro challenge hypothesis is not totally disproved. Moreover, even if Chinn and Frankel would be considered wrong based on factual evidence, as De la Dehesa assumes, the question that still remains is, why is that not the case? Why is the euro unable to de-throne the dollar? For De la Dehesa, the answer is simple. The market performance of the euro as an international currency has been remarkable. However, "unless the EU can construct a political governance system similar to that of a federal state it will be very difficult for the euro to overtake the dollar as the world's dominant currency" (2009:18). Therefore, the answer to the question lies not exclusively in Economics. It hinges on both economic and political factors combined, which is essentially the study field of IPE.

2.3 The Euro vs. Dollar Debate in International Political Economy

2.3.1 The Political Determinants of International Currencies

As was summarised in the previous section, the Economics literature agrees broadly on four main facilitating factors to achieve international currency status: A) large economic size; B) broad and deep financial markets; C) confidence in the currency's value; and D) network externalities (Lim 2006).[14] Taking an IPE approach that engages with this same framework, Helleiner (2008) reduces these economic factors to three: 1) confidence; 2) liquidity; and 3) transactional networks, while arguing that *politics* has both indirect and direct influence on these areas. Indirectly, politics can affect the main economic determinants through several channels. Confidence in a currency can be sustained by economic factors but also, and this is where the IPE literature brings a new dimension to the debate, by "the broader international security power of the issuing state" or by "a consistent conservative monetary policy that is credibly embedded within domestic politics and institutions" (Helleiner 2008:358). As will be shown in subsequent chapters, the former is epitomised by US military power,

[14] In his review of the literature, Lim (2006) adds a fifth facilitating factor: 'Political stability', which as he recognises is only highlighted by economists "taking a more historical perspective" (2006:7) on the feasibility of monetary unions without fiscal union. Presumably, this fifth factor is for many mainstream economists included in the third factor focused on "confidence in the currency's value". As was seen recently with the Greek sovereign debt crisis, when the institutional edifice of a monetary union starts to be in doubt, the currency normally tends to depreciate.

especially in regards to the GCC, while the latter by the anti-inflation stand of the ECB, which is widely believed to have inherited the monetary conservatism of the German Bundesbank. The importance of having a conservative monetary framework in order to secure the international appeal of a currency is especially highlighted by Andrew Walter (2006). For him, to be able to sustain the privilege of issuing the top international currency in the long run "a successful monetary leader needs, among other things, to be *more* conservative in its monetary policies and financial institutions than most other countries" (Walter 2006:53). Based on a historical analysis, Walter demonstrates how every time the US has overexploited its privilege and adopted extremely loose monetary policies (in the late 1960s, the 1970s and in the present phase), triggering a depreciation of the dollar and fears of inflation, the centrality of the greenback as the major international currency has started to be questioned. Hence, "although the euro is not yet a serious rival to the dollar, the continued exploitation by the United States of its dominant monetary position could eventually make it so" (2006:67-8).

Apart from having a conservative monetary framework, Walter (2006:56) recognises also that the other key variable to make a currency international is to have deep and broad financial markets, and here Europe is still behind the US. This is why the dollar is still dominant. Nonetheless, as Helleiner highlights, the important aspect to remember here is that politics also matters in the integration and sophistication of financial markets. With the launch in 1999 of the Financial Services Action Plan (FSAP), which began its implementation phase in 2004, the European Commission (EC), for instance, has shown great commitment in creating a more integrated pan-European financial market. Despite this fact, the level of financialisation achieved in Europe is still very distant from that of the US. In the latter case, and the global financial crisis has been a consequence of this, large parts of the society have their savings in the stock market making them more liquid and hence more attractive for foreign investors (Seabrooke 2001, 2006). While this is a trend that has also started in Europe, the levels of participation are much lower (Konings 2008a). However, this might not be a complete disadvantage. The global financial crisis has shown that unfettered financial markets and over-financialisation can be disruptive. As Walter indicates (2006:56), the monetary leader needs well developed financial markets, but these markets need to be properly regulated to avoid major instabilities in the system.

The US has not developed this type of *stable* regulatory framework, and as will be shown in chapter 5, this is why its credibility as the financial leader is currently in jeopardy.

Finally, transactional networking can also be enhanced indirectly by the political behaviour of governmental authorities. These public institutions can help to open up new markets through diplomatic negotiations; they can increase governmental aid to key regions; and they can spread their own clearing and payments systems to further encourage the use of their respective currencies. As Helleiner suggests, "in the current age, European political initiatives to make euro-based clearing and payments systems as attractive as their dollar counterparts will play a significant role in influencing the euro's ability to challenge the dollar's international position" (Helleiner 2008:359). The ECs and the ECB's recent efforts to establish derivative clearing houses based in the EZ go precisely in that direction (Grant 2009; Tait & Grant 2009). However, here as well, the EZ has been considerably cautious if not reluctant to enhance the role of the euro. To make the euro an international currency able to rival the dollar, European policymakers would need to design an active policy of euro promotion in international trade and finance as developed by the US authorities in the 1910s and 1920s (Eichengreen 2011a). In this regard, as will be explained in chapter 6 (p.233), the contemporary Chinese Government's plan to actively promote the internationalisation of the Renminbi (RMB) might pose a greater challenge to the dollar in the long run. In any case, what the historical experiences of the dollar and the euro show is that there needs to be active political promotion of a currency in order to make it the leading currency. This is an aspect that certain earlier euro-optimists such as Bergsten and Mundell underestimated.

While all the above measures can be classified as active although still indirect political promotion of a currency, politics has also direct influence on the use of an international currency. To clarify this point Helleiner recuperates Strange's seminal 1971 taxonomy of international currencies, which is deliberately both political and economic "consciously regarding the two as inextricably intermixed" (Strange, 1971:217). Strange identifies four types of international currencies: 1) Top Currency; 2) Master Currency; 3) Neutral Currency; and 4) Negotiated Currency. The direct influence of politics in the Master Currency is clear because Strange meant here a *de* *facto* territorial domination of one state by the issuer state of the master currency. Today master currencies have fallen into disuse (although dollarized countries such as Ecuador, El Salvador and Panama could be seen as contemporary relics of this practice). A Top Currency, in contrast, acquires this privileged status mainly because of economic factors. It may be defined as "the currency that has world economic leadership, the currency of the predominant state in the international economy" (Strange 1971:221). The dollar has certainly deserved this status in the decades up to the recent financial crisis. It is to be seen whether it can maintain it. The best example of Neutral Currency, or also called Passive Currency, is the Swiss franc, which is a stable currency with its own attractiveness but which has neither the means nor aspirations to become the top international currency. I argue that the euro is also currently no more than a strong 'neutral' international currency in most parts of the world, while it may be considered a "top" currency within its own regional sphere of influence. In this regard, it is important to note that Strange's currency types are not rigid, but rather fluid. "Any international currency can assume different roles *simultaneously* in different contexts" (Helleiner 2008:360).

The last type of international currency is the Negotiated or Political one. In this case, the issuer of the master/top currency loses political or economic might, as would be the case today with the US in the aftermath of the financial crisis, and hence some of the follower countries might start doubting about its anchor role in the system. The issuer, in turn, might need to offer certain financial (i.e. market access, debt issuance in foreign currency) or political (i.e. military protection) inducements in order to persuade them to continue to use its currency. As Helleiner points out (2009:71), these concessions might not be explicitly negotiated at a table. They might just be implicitly conveyed by the issuer and the followers. In today's context, however, this negotiated framework is both implicit and explicit. It is implicit because the US needs (increasingly reluctantly) to keep its market open to Chinese goods and to protect militarily the GCC countries to maintain the status of the dollar as the main international currency. And it is also explicit, because the governments of the BRICS countries, especially China, have openly stated that they want to see the end of dollar dominance in the IMS and that they are ready to start negotiations on this topic in multilateral fora (Parker et al. 2009; Zhou 2009; Kim 2010). Given this context, Helleiner's typology is most appropriate to understand the current positions of the euro and the dollar in the system. While the dollar is increasingly sliding from top to negotiated currency, supported upon politically motivated financial and military inducements, it is precisely the willingness of the US to maintain this support which makes the dollar, at least for the moment, keep its edge vis-à-vis the euro, which remains mainly an international passive/neutral currency due to its political under-achievements.

2.3.2 The Euro's Political Shortcomings

Once political determinants are included in the picture, the euro-optimist hypothesis loses strength. There are very few authors that see the euro as the next top global currency (De Cecco [2009] is the exception), while there are many more that think otherwise (Cafruny & Ryner 2007; Cohen 2010; Plaschke 2010). One IPE author who has pinpointed the political weaknesses of the European currency in its path to rival the greenback is Cohen (2010). A review of his work on this topic over the last decade provides an accurate summary of the euro's shortcomings, while it also reflects how the dollar has slowly weakened in its role as top international currency. Cohen's detailed study of the euro challenge to the dollar reaches two noteworthy conclusions. Firstly, the euro does not represent a threat to the dollar, yet. And, secondly, the dollar is increasingly malfunctioning as the main anchor of the IMS. In other words, what Cohen indicates is that the euro might be catching up with the dollar, but this is not so much a consequence of euro strengths, it has more to do with dollar weaknesses. This is a point also stressed by Eichengreen (2009, 2011a), who can be classified as one of the few American scholars who has consistently developed a euro-optimistic analysis, even throughout the EZ sovereign debt crisis.

Cohen divides the euro's political shortcomings in three: 1) the fragmentation of the European financial markets; 2) the anti-growth bias entrenched into the Maastricht Treaty; and 3) the governance difficulties associated with a decentralised monetary union. The first weakness has been explained earlier. It relates to how European policymakers have certainly achieved some progress in stimulating the integration process of European financial markets (Galati & Wooldridge 2006), the creation of the pan-European Euronext stock exchange being a good example, but this has only been achieved through indirect political intervention, following Helleiner's political determinants framework. Direct political commitment to merge sovereign debt markets in one pan-European issuance or to establish a pan-European public financial markets regulator and supervisor is missing – although the global financial crisis and the EZ sovereign debt crisis have provoked certain changes in this direction.[15] Nonetheless, hitherto these limitations in the governance of the EZ financial markets prevent the euro from competing with the dollar.

The second shortcoming exposed by Cohen refers both to the sole mandate of price stability given to the ECB, which is banned by law to perform the task of lender-of-last-resort to its member states,[16] but also to the controversial Growth and Stability Pact (GSP) embedded in the Maastricht Treaty. As De Grauwe (2006) criticises, by capping the fiscal deficits of member states to an annual 3% of GDP, the possibility to use expansive, Keynesian style, fiscal policies to spur growth in times of declining activity is undermined. This might be convenient for Germany (and the Netherlands, Finland and Austria), which relies heavily on export-led growth, but for EZ Mediterranean economies more dependent on domestic demand this monetarist straitjacket is difficult to bear, especially if they are confronted with a major financial crisis as seen in recent times. It is not surprising therefore to hear former EC President and Italian Primer Minister, Romano Prodi (2010), continuously referring to the GSP as "stupid" and calling for a more federal EZ.

This second weakness can structurally be linked to Cohen's first. Both point to the fact that the EZ is a monetary union without a "federal" fiscal structure that can support it. By rejecting the possibility to create a pan-European public debt market

[15] The global financial crisis has evidenced the need for greater pan-European coordination in financial market regulation and supervision. Emergency reaction to the crisis in 2008 was uncoordinated and nationally fragmented. Since then and on the basis of the Larosière Report (2009) it was agreed to establish a European Systemic Risk Board (ESRB), bringing together all EU member states financial markets' supervisors. Nonetheless, the ESRB, and its three agencies focused on banking, securities and insurance supervision and based in London, Paris and Frankfurt, respectively, have only a consulting character. Day to day financial regulation and supervision, and of course, fiscal responsibility, will still be decentralised nationally. On the issuance of common European debt, there have also been certain developments. Funding for the newly established European Financial Stability Facility is obtained through what are *de facto* Eurobonds (see Chapter 4).

[16] The so called 'no-bail-out' clause of the ECB entrenched in the Maastricht Treaty has been partially broken in practice during the ongoing sovereign debt financial crisis when the ECB decided from May 2010 onwards to buy government bonds in the secondary markets of member states in financing difficulties such as Greece, Ireland, Portugal and Spain.

able to channel funds to a centralised budget, charged with overcoming asymmetric shocks, the EZ discards the option of developing a macroeconomic strategy for growth in times of depressed demand.[17] As De Grauwe (2006) explains, monetarists in Brussels and Frankfurt would argue that it is precisely this rigid framework designed to avoid moral hazard among member states that will eventually promote labour market flexibility and make the EZ an optimum currency area able to increase its growth potential. But even under this assumption, there is only a degree of flexibility that can be enforced in the EZ before labour discontent, caused by diminishing welfare and protection, degenerates into social unrest, as Cafruny and Ryner (2007) convincingly point out.

Overall, the effects of this conservative monetary framework for the euro's international trajectory are mixed. On the one hand, as explained above through the analysis of Walter (2006), investors around the world might be attracted by the political commitment to price stability of the ECB and the GSP, especially if they see unsustainable profligacy in the US (De Cecco 2009). On the other hand, they might be disappointed by the lack of political zeal to foster higher growth in the EZ. My empirical research indicates that Cohen might give too much weight to the anti-growth bias argument. While financial elites in the three case study regions might mention the relatively lower growth rates of the EZ vis-à-vis the US in explaining why the euro is not able to compete with the dollar, they emphasise much more the lack of liquidity in the European markets as the main factor that explains this phenomenon. In this regard, this study supports more Walter's analysis than Cohen's. The conservative monetary and even fiscal framework of the EZ does not hinder, it actually enhances the international appeal of the euro. However, what is equally true is that this strength produces a weakness. As argued by Vermeiren (2011), drawing on the varieties of capitalism literature, the problem for the EZ is that this conservative framework has an in-built appreciation bias for the euro. This might be appealing for

[17] The current financial crisis has brought to the fore the limitations of the GSP when confronted with major external shocks. The lack of macroeconomic coordination has produced unsustainable internal imbalances in the EZ which have brought Greece, Ireland and Portugal to the brink of default due to its deficits. Lacking the mechanisms to deal with this situation, European policymakers had to come up in a matter of months with a European Financial Stability Facility (EFSF) of €500 billion (plus another €250bn provided by the IMF) to save the integrity of EMU. They have also decided to set up a Task Force in order to improve macroeconomic coordination within the EZ. However, some observers have already indicated that the new GSP framework might again be heavily focused on promoting stability and not on fostering growth (Münchau 2010b; Tilford 2010; Verhofstadt et al. 2011).

Germany, which is very competitive and used to a strong currency, but it has detrimental consequences for the rest of the EZ which suffers under a permanently over-valued euro, which is a consequence of the US policy of benign neglect towards a weakening dollar. As will be shown in the next chapters, this is a structural flaw that the EZ needs to resolve if it wants to increase its international monetary power.

In any case the two aforementioned weaknesses converge in Cohen's third political shortcoming of the euro, which can be summarised in a simple question: Who is in charge of Euroland? Again, as with the previous weaknesses, this flaw points to the fact that there is an asymmetry between monetary policies being decided at a supranational level, and fiscal and macroeconomic policies being designed and implemented at a national level. Moreover, there is no single voice for the euro, as has been repeatedly denounced by the EC (2008). Technically it is the president of the Eurogroup, but in practice there is a cacophony of uncoordinated authorities that speak for the euro. This cacophony is especially evident at the IMF. Thus, the EZ lacks a federal authority equivalent to the US Treasury. There is no pan-European Ministry of Finance that can act internally, within the EZ, as the coordinator of macroeconomic policy, and externally, in the EZ's relations with the US, Japan or China, in order to mitigate the effects of external shocks. The recent financial crisis has been a clear example of this. While the ECB has been able to react quickly to the shortage of credit that started in 2007 with massive liquidity injection, member states had to negotiate during months a combined fiscal approach on the matter (Pisani-Ferry & Sapir 2009). This has "left investors with an important question: How much trust should they put in the euro and European financial markets when fiscal cooperation has failed to keep pace with financial and monetary integration?" (Helleiner 2009:75). As the Italian politician La Malfa (2002) put it some time ago, without political unity matching monetary union, the euro will essentially remain an 'orphan currency'.

This shortcoming is evident in international foreign exchange coordination, a strategic realm in relation to unwinding existing global imbalances and the over-valuation of the euro. If the Europeans want to negotiate any deal on a global level, it remains unclear who will be sitting in front of the treasury secretary of the US and the ministers of finance of China and Japan. Article 219 of the Lisbon Treaty establishes that foreign exchange agreements between the EZ and third states need to be decided unanimously by the Council (in this case the EcoFin, the council of ministers of finance) on a recommendation of either the ECB or the EC and only after consulting both the ECB and the European Parliament, and always without prejudice of price stability. As Cohen puts it, this is a "recipe for political deadlock and drift" (2003:590). This structural weakness is not only apparent in exchange rate policy, it transcends to every issue linked to global monetary and internal financial affairs, and consequently also to the role of the euro as an international currency. The lack of political unity prevents the EZ from influencing, in a *politically direct* way, global monetary governance, and as a consequence, it hinders it from actively using the full potential of its international monetary power, as Mundell and Bergsten expected.

2.3.3 From Dollar Uni-Polarity to a One-And-a-Half System

Notwithstanding the shortcomings in the political structure of the EZ, in recent years Cohen has started to recognise that with the introduction of the single currency "some measure of power has indeed shifted across the Atlantic" (2008b:459). Where before there was dollar uni-polarity, today there is a 'one-and-a-half' monetary system (Cohen 2010). EMU has provided the Europeans with more protection to resist external shocks emanating from the US. Following Cohen's (2006) conceptualisation of international monetary power, more than *influence*, the euro has given the EZ increased *autonomy* in monetary affairs vis-à-vis the US. While before the euro the US was able to bully individually different European states and force them to follow its monetary guidelines (Henning 1998, 2006; Walter 2006), this is not as straightforward today. Recent tensions within the G20 forum between the US and the EZ in relation to implementing expansionary or restrictive fiscal policies to overcome the Great Recession constitute evidence in this direction (Beattie & Peel 2010; Rove 2010).

During the recent financial crisis, the euro has also avoided exchange rate disturbances and speculative foreign exchange attacks within the EZ, a common feature in previous crises (Wyplosz 2009).[18] Overall, Cohen acknowledges that in the last decade the EZ has gained greater monetary independence while the dollar and the US have seen its leadership role put in question, especially in the aftermath of the recent financial crisis which originated in the US. In line with many other analysts (Roubini & Setser 2004; Duncan 2005; Roubini 2006; Krugman 2007; Eichengreen 2007a; Obstfeld & Rogoff 2009; Bergsten 2009a), Cohen thinks that the chronic balance of payments deficits of the US are unsustainable in the long run and eventually they will undermine the world's faith in the dollar. Sceptical to the possibility of policymakers in Washington addressing this trend with unpopular austerity reforms, Cohen's predictions point to a transition between the current 'one-and-a-half' to a leaderless currency system with different currencies (probably the dollar, the euro and the Chinese RMB) in competition for international use:

> A weakening dollar is unlikely to be replaced by any other single currency. The outlook, rather, is for a more fragmented currency system, with three or four monies in direct competition in different parts of the world. Sustained cooperation among the major players is unlikely […] Much more probable is a prolonged leadership struggle, particularly in such contested regions as the Middle East and East Asia (2009b:163).

I will cover these contesting regions and Brazil in the empirical Chapters 4, 5 and 6.

2.3.4 The Euro's Geopolitical Limitations

Pointing to this leadership struggle and making a corollary between monetary power and consequent political and even military power, several authors in the wider field of International Relations (IR) saw in the creation of the euro the first step for the realisation of a European superpower (Calleo 1999; Kupchan 2002; Haseler 2004; Reid 2004; McCormick 2007). Bellicose analogies to describe the birth of the euro were not spared among these euro-optimists in IR theory. Reid wrote that "for the Europeans, the dreams of grandeur, the hope of creating 'the weapon with which to

[18] While it is true that foreign exchange turbulence has been avoided through the euro, market instability within EMU has now shifted to the spreads in government bond markets and other related derivative markets such as Credit Default Swaps (CDS). This weakness points to the fact that the EZ lacks a combined public debt market. I will return to this in subsequent Chapters.

fight back' against the might of the US dollar, are likely to come true" (2004:85). In a similar vein Haseler (2004:76) stated that "so integrated and centralised is the money of the EU that on monetary policy the Union speaks 'with one voice', and with a vengeance!" Calleo (1999:6), on his part, would state that the euro's "success will push the EU towards rounding out its commercial and financial power with more effective and autonomous collective diplomatic and military power". Finally, for Kupchan the creation of the euro is a stepping stone to establish a European federal state more independent from the US economically, and militarily, leading probably to frictions between the two blocs in the future. These IR analyses can be dismissed for overlooking some of the fundamental economic variables explained above, but fears about the euro provoking military tensions between the US and the EZ have not been limited to the field of IR. Economists such as Feldstein (1997) have presented similar worries since the start of EMU. Feldstein went even so far as to argue that the euro could be the seed for a future war among Europeans (as was the case in the American civil war) or even a war between the EU and the US, due to differing world views. Highlighting the political consequences of the creation of the euro, which for him would eventually lead to political union, Feldstein would warn about the potential military might that such a union could gather:

> The creation of a political union based on the EMU with explicit authority to develop a common foreign and defense policy would accelerate the development of an independent European military structure capable of projecting force outside Western Europe (1997:70).

Feldstein has not been the only economist who has warned about the negative political and military consequences of an increased competition between the dollar and the euro. International monies can be seen as the projection of statecraft overseas and this might trigger tensions and conflict (Kirshner 1995). The incumbent hegemon, in this case the US, might not be willing to share some of its privileges with the new challengers. Kindleberger (1986), for instance, the father of hegemonic stability theory, has persistently warned about leaderless transition periods. In his opinion, which contrasts with that of those that have criticised his determinism and advocated the possibility of a more cooperative international order after US hegemony (Keohane 2005), "for the world economy to be stabilised, there has to be a stabiliser – one stabiliser" (Kindleberger 1986:304). For Kindleberger, "a world in which one nation is in the decline and no other has risen to take its place in ensuring peace and stability is likely to encounter trouble" (Kindleberger 2000:17).

The US is today without doubt the main military stabiliser of the world. Its military might is uncontested. Material capabilities are leaning clearly in favour of the US. This is partly why the dollar remains the main international currency, an aspect which is underplayed in Walter's (2006) analysis. This study shows that the resilience of the dollar as the main international currency relies heavily on the implicit negotiated framework explained above in which the US offers military protection to different parts of the world and, in exchange, these regions (in this case East Asia, except China, and the GCC) keep trading in dollars. Does the EZ have the capabilities or willingness to change this? The answer is a categorical no. The EU can be seen as a normative power, a civilian power, a soft power and a market power, but it is certainly not a hard power, or at least not yet (Laïdi 2008). As Posen (2009) rightly explains, geostrategic dimensions are generally overlooked in the euro vs. dollar debate because monetary officials are keen to avoid them for diplomatic reasons and because economists see them as too 'nebulous' or 'conspiratorial'. Nonetheless, "national security capabilities and foreign policy projection more broadly of the government behind a potentially global currency do heavily influence the extent to which other countries take up that currency" (Posen 2009:86). In this regard, some moves by France in the GCC region with a new military base in Abu Dhabi and future potential moves by China in East Asia might change this situation in the long term, but in the short term the dominance of the dollar is assured.

2.4 The Euro vs. Dollar Debate in the Ideational Sphere

2.4.1 International Currencies as a Social Phenomenon

As should be clear by now, to understand international currencies in their full complexity it is necessary to consider both economic variables and political factors. As Kirshner (2003b:647) states, it would be a mistake to overlook the "inescapable politics of money". Thus, drawing on Ingham's (2004, 2006) work on the nature of money, the inherent political features of money will be thoroughly explored in the next chapter. However, as Kirshner also hints at, this is not comprehensive enough. Money is not only the product of economic and political material capabilities. Money is also socially constructed in everyday-life economic relations. There is an inherent cultural symbolism in currencies that transcends the materiality of economic and political factors. This is not to say that material capabilities take a secondary role. As will be shown below, material structures and capabilities determine to a great extent agential behaviour. But this does not mean that the ideational realm does not play a substantial role in international currencies. As Kindleberger once wrote, “a country’s exchange rate is more than a number. It is an emblem of its importance to the world, a sort of international status symbol” (1970:198; cited in Kirshner 2003a:15). Following this path, Zelizer (1999) has argued that money is not a culturally neutral or socially anonymous object, its value and reputation are profoundly shaped by cultural and social phenomena. Walter does also emphasise this point. For him, “money is, after all, a social convention whose value in exchange and as a store of value depends on it being in comparatively short supply relative to other goods, services, and assets, including other monies” (2006:62).

Thus, for a full study of the euro challenge to the dollar it is necessary to explore this social context and try to grasp how this challenge is socially and culturally perceived worldwide. Most of the analyses presented above are overly rationalist, materialist and structuralist in their approach, treating agency in an abstract sense. Consequently, they are not as well suited to fully apprehend the social impact and change triggered by the euro. Key economic agents such as sovereign and private wealth fund managers develop subjective perceptions within a specific social environment. They cannot be studied in isolation of the global social context. Thus, if we want to understand what they think about the euro and how they might change their behaviour normatively in reaction to it, it might be a good starting point to analyse how the euro has changed the social context in which they are embedded, and then see how they relate to it both ideationally and materially. There is certainly a vast constructivist literature in IPE which has analysed broadly the interconnection between ideas, norms and the creation and functioning of money (McNamara 1998; Gilbert & Helleiner 1999; Kirshner 2003; Jabko 2006; Helleiner 2006). However, hitherto studies that have tried to apply this approach to the euro vs. dollar debate are relatively rare

(McNamara 2008). The original contribution of this thesis is to fill this gap in the literature.

2.4.2 The Ideational Impact of the Euro in the Global Social Context

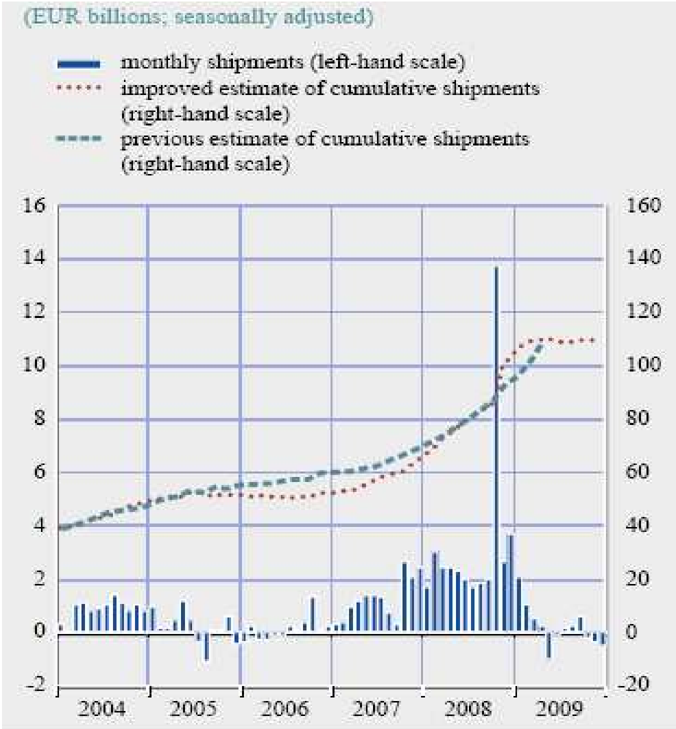
It is by now common wisdom that the euro is the first real global competitor to the dollar since WWII. It poses a much bigger challenge to the greenback than the Deutsche Mark and the Japanese Yen did in the 1970s and 1980s. This is not only acknowledged by respected economic historians who have studied the evolution of the IMS (Eichengreen 2008) and by financial elites in China, the GCC and Brazil, as will be illustrated below. It is also understood so, in a wider social context, by the general public. The increased global impact of the European currency is noticeable in the economic field: in the invoicing of trade transactions, in the foreign exchange and debt markets and in the coffers of central banks; but it is also observable in popular music, Hollywood movies, fashion milieus and every tourist destination around the world. Seen from the cultural prism, which transcends money matters, the euro has certainly penetrated most social layers on a global scale. A few recent examples suffice here to illustrate this point. In his video for the song *Blue Magic,* the popular US rapper Jay-Z is one of the first US rappers to use a suitcase full of 500 euro notes instead of the ubiquitous dollar wads and dollar-symbol neck chains traditionally wedded with American rappers. A few years ago, the Brazilian supermodel Gisele Bündchen surprised public opinion by asking to be paid in euros and not in dollars (*BBC* 2007). Confirming the global appeal of the euro, viewers all around the world can hear one of the villains in *Quantum of Solace*, the recent James Bond film, saying: "the US dollar isn't what it used to be, before handing a suitcase full of euros to a corrupt Latin American general" (Rojanaphruk 2008). The euro is not only identified and accepted as an international currency in every corner of the world, it has even reached the streets of the US. As *Reuters* informed a few years back, some shops in New York's East Village have started to accept euros. A historic event since "the acceptance of foreign money in Manhattan was unheard of until recently" (*Reuters* 2008). These might be considered impressionistic examples with no real economic and political meaning. Jay-Z, Bündchen, James Bond and shop owners in Manhattan will hardly decide the international currency of the moment. Nonetheless, they suggest a global cultural impact of the euro that needs to be included in a comprehensive state of the art review of the euro vs. dollar debate such as the one here undertaken. The quote from *Quantum of Solace*, for instance, appeared in a report by an ASEAN journalist writing about EMU as a role model for regional cooperation (Rojanaphruk 2008), a theme which will be covered in Chapter 6.

Much more significant than these examples is the fact that in value terms, with a total amount issued of over €800 billion, there are now more euros in circulation in the world than US dollars (ECB 2011b). Here again we see the interaction between the material and the ideational. The material fact that the euro has become a widely used international currency, stimulates its ideational appeal, this ideational appeal in turn fosters material change. The consequence of this process is that overseas demand for European bills has increased steadily since its inception (ECB 2010a). Several economists (Rogoff 1998; Posen 2005) have associated this trend to gangsters and money-launderers preferring for their illegal activities the higher denominated 200 and 500 euro bills than the 100 dollar bill, which is the highest note in the US, but this is only one part of the story. As a matter of fact, if one looks at ECB data about increased circulation of euro bills it turns out that over the years there was significantly more issuance of 100 than 500 euro bills, while issuance of 200 euro bills has remained almost flat (ECB 2011b). Whatever the ‘overground’ or ‘underground’ economic activity that is performed with these bills, what is without contestation is that this high amount of issuance represents a proportionally high source of seigniorage. Willem Buiter, currently chief economist of Citigroup, calculates that with so much issuance seigniorage returns to the ECB could average at least €50 billion per year (Fidler 2010). This is certainly not a negligible sum (roughly half of the Greek rescue package), which is very close if not higher than US seigniorage intakes, and which has already triggered complaints from policymakers in Washington.[19] This more micro-level analysis highlights another curiosity. While it is widely believed that the dollar was the ‘haven currency’, and therefore uncontested top international currency (Cohen 2009a), right after the collapse of the investment

[19] Larry Summers, former US Treasury Secretary and currently director of the National Economic Council advising the Obama Administration, makes explicit these complaints at a conference on the euro organised by the Peterson Institute for International Economics in 2008. He calls the issuance of €500 notes an “internationally uncivil act” and proceeds by saying: “If you calculate the seigniorage gain that results from the European act – it is essentially an interest-free loan forever of that amount of money – $50 to $100 billion can plausibly be attributed to it” (Summers 2009:196).

bank Lehman Brothers (the sudden surge of the dollar in the exchange rate provides evidence to support this), shipment data from the ECB show that there was also a huge demand for euro bills outside the EZ. On an average month the ECB hardly sends more than €2 billion in banknotes to overseas banks (see Figure 2.8), in the month after the collapse of Lehman Brothers the overseas shipment reached almost €14 billion (ECB 2010a), increasing proportionally the seigniorage gains for the EZ.

Figure 2.8: Net shipments of euro banknotes to destinations outside the euro area



Source: Eurosystem.
Notes: Net shipments = euro banknotes sent abroad minus euro banknotes received.

Source: ECB (2010a)

Here again we can see that the socially perceived value of the euro as a reserve currency and 'safe haven' among non-EZ residents in times of systemic market strain might be greater than mainstream economic indicators like the foreign exchange (FX) market might indicate. This is especially true in countries neighbouring the EU.

2.4.3 Euro-Optimism seen from the Perspective of Key Financial Actors

This wider global social context, which inevitably impacts on the 'social mood' of market investors, as the 'socionomics' literature has investigated (Prechter & Parker 2007)[20], is mirrored in the narratives and behaviour of key private and public financial market actors and institutions, for whom the euro is also increasingly playing a bigger international role, despite not being a material challenge to the dollar. It is important to include here the research developed by these key agents in the IMS because it indicates what is gradually emerging as the intersubjective global consensus in relation to the impact of the euro in the IMS. Economists at Goldman Sachs, for example, one of the most influential financial institutions worldwide, consider EMU "as a remarkable success so far, weathering widespread original scepticism, as well as a series of shocks – including 9/11 and the present market dislocations – while contributing to good and relatively stable growth throughout the Euro-zone" over the past decade (Goldman Sachs 2008:7). Contrary to mainstream perception and most IPE literature (especially the euro-sceptical one) which sees the EZ underperforming economically against the US, Goldman Sachs calculates that in the decade between 1998-2008 the EZ has had higher per capita and job creation growth than the US and this despite European workers working considerably fewer hours per year than their American counterparts. By contrast, the long term outlook on the dollar is generally bleak for Goldman Sachs. This makes its chief economist, Jim O'Neill, believe that "we are emerging into this very hazy and slightly worrying state of affairs where there isn't going to be any single country leading the world in the way the US has done and with it no single currency either" (Woods 2008). Interestingly, these remarks of one of the most influential actors in the markets coincide closely with the assessments of Cohen (2010) and Eichengreen (2011), perhaps the two leading scholars in IPE and Economics in the study of the IMS, and also with the bulk of the financial elites interviewed throughout this research. The general sense is that we are moving slowly

[20] Prechter and Parker (2007) state that unlike in the economic sphere, most activity in finance is not based on rational calculations, as the Efficient Market Hypothesis (EMH, see Fama [1970]) would predict, but rather on social moods and herding, this is especially the case in moments of market uncertainty like the current. The relevance of the socionomic literature to understand the evolution of international currencies and movements in the FOREX (FX) markets has been highlighted by one of the participants in this research. This person, who asked to remain anonymous, is in charge of the FX division of one of the biggest financial institutions in the world. More criticism to the EMH will follow in the next chapter.

from a unipolar to a multipolar monetary system, and that this transition is mired in widespread uncertainty (a topic covered in Chapter 3, p.96).

The head of the FX Division at HSBC, one of the leading foreign exchange trading desks in the world, David Bloom (2008), is also seeing a gradual shift out of dollar unipolarity. He compares the foreign exchange world to a cosmos and says that while before there was only one big currency sun: the dollar. Now there are two suns. One bigger, the dollar, and one smaller, the euro, but both with different satellite currencies linked to them.[21] Bloom summarises the short history of the euro in the metaphor of a baby that at the beginning needed to be nurtured and taken care of (referring to combined ECB and FED intervention in 2000 to stop euro depreciation) but that gradually has grown up and now is a young man, with its own evolving history, that can compete against the senior currency. On this note and contrary to Kindleberger and others who worry about potential conflict and instabilities, he believes that euro-dollar competition will be good. It will bring more diversification and therefore more options for global investors. For him, "the world prefers a euro that is a big, strong currency, which gives a choice out of the dollar" (Bloom 2008)[22]. This view is shared by the analysts at Deutsche Bank, another of the global heavyweights in the FX market. They calculate a further increase of the international role for the euro to between 30-40% of global share in the medium to long term. The view at Deutsche is that "a bipolar system is not per se unstable […] competition between the dollar and the euro regarding the international role is basically a good thing. Such a permanent beauty parade is expected to provide a big incentive for policymakers on both sides of the Atlantic to pursue sound economic and fiscal

[21] The 'euro sun' has around 40 'satellite currencies' that either follow a strict peg or have the euro in their currency basket (ECB 2010). The dollar has around 60 of these satellite currencies, some of them shared with the euro. While the dollar dominates in Asia and Latin America, the euro is increasingly gaining satellites in neighbouring regions such as Eastern Europe (Russian Federation), Africa (Morocco, CFA Franc Zone) and the Middle East (Iran, Kuwait). Despite this trend in favour of the euro, Cohen (2009a) points out that some of the pegs to the dollar are more important because of their GDP weight. This is the case for China (since 2010 de-pegged, following a basket), Hong Kong, Saudi Arabia and the UAE. However, outside the *de jure* pegs, the gravitational role of the euro, identified through correlation in exchange rate movements, has also increased in recent years. Galati and Wooldrige (2006) say that this gravitational pull of the euro has increased vis-à-vis the dollar for the British pound, the Australian, Canadian and New Zealand dollars and even for the South African rand and the Brazilian real and Chilean peso.

[22] Bloom has not changed his bullish long term outlook for the euro and his bearish views on the dollar despite the ongoing sovereign debt crisis in Europe. A recent interview published in *Handelsblatt* confirms this (Hackhausen & Panster 2010).

policies" (Deutsche Bank 2008:11). As will be shown this is an assessment shared by the financial elites in emerging markets.

Following this rationale, in recent years central banks around the world appear to have embraced actively the option of diversifying out of dollar unipolarity. This diversification does not occur in existing stocks. The dollar is there still dominant. It affects rather new foreign reserve entries. In the second quarter of 2009, for example, central banks reporting currency breakdown in their reserves "put 63 percent of the new cash into euros and yen", prompting Steven Englander, former FED researcher and now chief US FX strategist at Barclays, another important financial institution, to conclude that "global central banks are getting more serious about diversification, whereas in the past they used to just talk about it" (Ye & Worrachate 2009). The winner of this diversification trend seems to be mainly the euro. A survey conducted by Central Banking Publication and sponsored by Royal Bank of Scotland among central bank reserve managers between October 2009 and January 2010 shows that the European currency gained increased attractiveness in the aftermath of the financial crisis vis-à-vis the dollar (Pringle & Carver 2010). Not even the EZ debt crisis in mid 2010 seems to have changed this trend. At one of the peaks of the crisis, with the euro depreciating fast and with continuous talk in the markets that EMU could break up, foreign reserve managers at the central banks in Brazil, India, Russia, Japan and South Korea would assure that "their reserve currency portfolios were too big to change without affecting the markets, and there were no alternatives in the near term to the liquidity of the euro and the US dollar" (Kihara & Nicolaci da Costa 2010). Here again, as in the case of private banks, the *idea* of an emerging bipolar system (with a senior and a junior pole) seems to gain favour. The possibility of a future multicurrency system is also considered, although it is seen as a more long term scenario.

2.5 Summary

In this chapter I have provided a comprehensive literature review on the euro vs. dollar debate. It is a summary of what I see as the key material (both economic and political) and ideational variables that need to be considered to fully apprehend the euro challenge to the dollar in all its dimensions. In the first part I have presented the euro-optimist and the euro-sceptical hypotheses on the subject within the Economics literature and their underlying arguments, focused on economic size; financial market sophistication; confidence in the value of the currency and network externalities. Current data on the international use of the dollar and the euro show that the euro-optimists were too optimistic about the European currency. The dollar dominates roughly two thirds of global activity versus less than one third covered by the euro. However, these numbers alone do not explain why the euro has underperformed.

The IPE literature provides this explanation. It shows that a currency can only become *the* international currency if there is an active political commitment by the issuing authorities to make this currency the leading currency, an aspect that the Economics literature has not explored with sufficient rigour. This political commitment is not existent within the EZ. EMU is economically, politically and militarily too fragmented and uncoordinated to make the euro challenge the predominance of the dollar. Nonetheless, the euro has offered its member states more protection from dollar dominance, and this newly acquired autonomy has in turn exacerbated dollar weaknesses. Up to this point existing IPE literature offers a very accurate picture of the structural-material conditions of the IMS. Where it lacks nuance is in identifying the social-ideational impact of the euro. Using an ontological framework mainly focused on material change it is able to assert that the euro, while ascending, is not able to reach the dollar, while, the dollar, despite descending in absolute terms, is still dominant. However, this approach does not discern how these relative ascent and descent tendencies are perceived by key agencies in the international financial markets and how these perceptions are triggering subsequent material changes in a process of hysteresis. This can only be done through an approach which focuses on how the material impact of the euro in the IMS is ideationally interpreted at an agential level. The last part of the chapter focuses on these subjective perceptions of the material reality. It has established *prima facie* plausibility to the claim that the euro has become a truly global currency in the social and cultural sense, with great symbolic effects. Key agents in private banking and public foreign reserve management institutions are gradually seeing an evolution from a unipolar system dominated by the dollar to a bipolar system where a mildly descending senior pole (the dollar) and a mildly ascending junior pole (the euro) compete against each other.

In this regard, subjective perceptions play here a vital role. While from the point of view of the US, the dollar is still dominant, with everyone else far behind, as it has always been in the past five decades. From the point of view of the financial elites of emerging markets, there is now the dollar, *and the euro*, midway, far behind the dollar, but also far ahead of their currencies (see again Figure 2.7). This scenario provides a greater incentive to develop their own currencies as international currencies as when it was the dollar and then everyone else. The next chapter will show how I have conceptually and methodologically tried to grasp this complex material and ideational evolution in the construction of the IMS.

Chapter 3: Key Concepts, Case Studies and Research Methodology

After presenting the literature review on the euro vs. dollar question in the previous chapter, in this chapter I will present the conceptual and methodological basis of this thesis. The first part is devoted to explore four concepts crucial to the overall argument: money, monetary power, ideas in Knightian uncertainty and monetary governance. If money is understood as a measure and store of abstract value which is socially and politically constructed upon the underpinnings of a political authority, rather than as a neutral veil in the workings of the economy, then it becomes clearer why the EZ is an incomplete construction. Money is a social relation based on debt, and its resolution depends on the power struggle between the debtor and the creditor. This power struggle is normally mediated by the state, which functions as the borrower and lender of last resort. In the absence of this overarching political authority, as is the case now in the EZ, financial instability is very likely. In other words, monetary union is inherently unstable without a degree of political union. Ultimately, monetary sovereignty is gained through political power, and if necessary, violent means. This is valid for the regional as for the international sphere. It is impossible to understand the centrality of the dollar in the IMS without taking into consideration the military might of the US. In many regions the US is the guarantor of security. Thus, to generate international monetary power it is important to be a productive and financial powerhouse, but it is also crucial to be a military superpower. Finally, in order to set the rules of the game, it is also convenient to gather legitimacy. In this regard, ideas are important in the governance of the IMS. Ideas are not only important to maintain a particular system. They take a prominent role particularly in moments of systemic change. The endurance of the FDS, a system that has consistently shown its structural flaws, has been assured by its ideological underpinnings based on financial deregulation and flexible exchange rates. This system, which has been of great benefit for the financial sector and for countries with structural current account deficits, such as the US and the UK, has been shaken by the global financial crisis. Its legitimacy is now in doubt. The severity of the crisis has generated a context of so called Knightian uncertainty (Blyth 2002) in which economic agents are doubtful of how to safeguard their own interests. The material transformations are such that it is difficult to make sense of the reality. In these situations of systemic change, ideas help to interpret the reality, to contest it and to transform it. Nonetheless, this is not done in a material vacuum. Money, monetary power, and consequently, monetary governance, are based on material capabilities that cannot be overlooked. In this regard, the US is still the major player. Hence, any reform of the IMS depends on its consent. The problem is that the US is not willing to take the lead in this reform.

The second part of the chapter will present the rationale for the three case studies: Brazil, China and the GCC region, and whilst doing so it will also serve as a brief review of the literature that has hitherto focused its attention on them in relation to the euro vs. dollar debate.[23] It will be shown why this thesis contributes to existing knowledge. Despite its increased importance in the world economy and its active diplomatic stance in favour of a monetary system out of dollar unipolarity, Brazil has been widely overlooked by the literature. Contrary, China and the GCC have received more attention because of their huge dollar reserves and their systemic importance. However, in all cases most of the analyses have ignored the views of the financial elites of these regions. An agential and empirical investigation of their subjective perceptions against preconceived theoretical assumptions is lacking, which is precisely the aim of this thesis. The last part of the chapter will be focused on summarising the overall methodology and the concrete methods that have been used, first to collect the evidence in each of the case study regions, and then to analyse it.

3.1. Conceptualising Money, Monetary Power, Ideas and Monetary Governance

3.1.1 The Sociological Nature of Money

Based on the research conducted throughout this study, I understand money, not merely as a narrowly defined medium of exchange, unit of account and store of value, as usually indicated in textbooks of Economics, but rather, more comprehensibly, as an abstract measure of value as developed by Ingham in *The Nature of Money* (2004). Drawing on Schumpeter, Ingham argues that historically there have been two

[23] The short literature reviews for every case study presented in this chapter are important because the empirical results exhibited in subsequent chapters are divided by themes and not by case study regions.

contending theoretical schools on money. The first, called commodity or 'metallist' theory, which starts with Aristotle, continues with Adam Smith (1986 [1776]), and is still prevalent in contemporary orthodox economic theory, sees money essentially as the universal commodity, the one that is relatively stable in value and easily exchangeable for all other commodities (this is why money has historically taken the form of gold or silver). 'Moneyness' is here reduced to 'exchangeability'. In this view, the three functions of money as unit of account, means of payment and store of value follow from, or can be included in the function of, medium of exchange. Thus, money, for this school, emanates *spontaneously* in the market place to facilitate barter.[24]

In stark contrast, the second theory, which can be described as the heterodox 'nominalist' school and has among other followers Simmel (1978 [1907), the early Keynes (1930) and Schumpeter (1994 [1954]), sees money foremost as an abstract measure of value, as unit of account (money of account) to settle credit and debt within a sovereign monetary space. In this conception, money, as an *abstract* measure of value, which is intersubjectively and politically constructed as an institutional fact upon the underpinning of a particular *authority*, is logically *previous* to any functions and forms that money can take as medium of transportation and storage of value in the market.[25] Its nature is therefore *dual*. This distinction is crucial because in the first interpretation, money is seen as a 'neutral veil' over the workings of the 'real' economy, while, in the second, money is socially and politically constructed and

[24] For this school, money as a unit of account emerged spontaneously in the market place through multilateral trade as the 'universal equivalent', that is the commodity against which all others can be valued and exchanged. However, proponents of this 'metallist' school, which includes today's mainstream neoclassical economics and its monetarist branch, but also Neo-Marxist such as Lapavitsas, have not been able to provide historical evidence to corroborate this outcome. See for this Ingham's (2006) response to Lapavitzas. Historical evidence suggests rather that the measure of abstract value through money of account has been determined since the Mesopotamian and Egyptian empires (c. 3000 to 500 BC) by a concrete political authority. See Ingham (2004), chapter 5.

[25] The word *previous* refers to the fact that money is first and foremost abstract and then physical. It is first a measure of abstract value before it can become a means of transportation and storage of value in the workings of the market. As Ingham (2006:260) stresses, it is important to differentiate between the existence of bilateral exchanges or barter and the creation of a genuine market. "Strictly speaking, a market is a system of multilateral exchanges in which bids and offers, *priced in a money of account*, can in principle produce a single price for a uniform good. Bilateral exchanges, or barter, do not produce a single price in this way – although neoclassical economic theory has tried, but failed to demonstrate this outcome". If bilateral exchanges or barter cannot produce a genuine *numeraire* (money of account) against which all other commodities can be valued and in which long-term contracts can be issued, logically the money of account needs to be first established by an authority in order to initiate market activity. This means that "money of account is logically anterior to the market".

therefore it is subject to social relations of power between the state, its creditors (the government bond holders) and its debtors (the taxpayers). In this second interpretation "the generic quality of 'moneyness' (measure and media of abstract value, as explained above) is to be found in a money of account *imposed* by an authority such as a state" (Ingham 2006:271, emphasis added). Money, seen in this light, is a form of sovereignty and thus it cannot be understood without reference to a political authority and its monopoly on the legitimate use of violence (here the material dimension is certainly crucial). Consequently, it can also not be explained without referring to social conflict. As Weber contended, control of the value and production of money is a weapon in "the battle of man with man" (Weber 1978:93, cited in Ingham 2004:79). This differentiation is particularly relevant to understand the current debt crisis in the EZ, since in the current construction of EMU there is an inherent power asymmetry favourable to international bond holders (the creditors or *rentiers*, mainly the financial sector) and detrimental to national borrowers (households and companies, the bulk of the taxpayers), who lack a genuine pan European political authority able to rebalance this asymmetry. I will come back to this point below.

For now it is important to understand that, following both the claim (Innes 1913, 1914) and state (Knapp 1973 [1924]) theories of money of the nominalist school, Ingham asserts that in modern capitalist societies, money is essentially credit/debt, which is based on the promise and inherent trust (again here the ideational is part of the story) that the borrower will pay back what it owes to the creditor. This debt will be measured by a yardstick (a *numeraire*) which is normally dictated by the state, which is, on the one hand, the main issuer of the 'money stuff' (legal tender) accepted for the payment of taxes, and on the other, the main determinant of its value since generally it is the biggest debtor and creditor within any given monetary space and the main agent that can intervene in the foreign exchange markets. This is not to say that the state is the only creator of money as a medium of exchange. It is just the only issuer. Private financial institutions play a crucial role in modern capitalism in the 'endogenous' creation (through the monetary multiplier) of all kinds of transferable credit products that function as money in the role of medium of exchange and store of value, but all of them still use the abstract money of account established by the political authority underpinning this monetary space. In today's IMS, for instance, this political authority is still the US, although its legitimacy is fading. Ultimately, it is down to this authority to guarantee in any circumstance (as in the event of a major crisis) the convertibility of existing dollar stocks in goods and services.[26] It is here worthwhile quoting Ingham to underline this point:

> Money is a promise, and the production of a promise involves trust […] this trust is not co-traders' *personal* trust […] On the contrary, money's significance lies in the fact that it resolves this problem precisely in large anonymous markets where interpersonal trust *cannot* be generated. Money is *assignable* trust. In the face of real-world radical uncertainty, self-fulfilling long-term trust is rooted in a social and political legitimacy whereby potentially personally untrustworthy strangers are able to participate in complex multilateral relationships. Historically, this has been the work of states (2004:74).

Hence, Ingham's sociological nature of money is of importance for this study for several reasons. First, by demonstrating that money is socially constructed, it reinforces the argument put forward in Chapter 2 (p.72) that money has social and cultural effects that go beyond the economic, and hence material, realm. Money therefore has symbolic connotations that need to be taken into account. Chapter 6 will focus on these symbolic and ideational effects in relation to the internationalisation of the euro. Second, money is essentially credit and hence the issuer of the international money, the international *numeraire*, has ample access to cheap international credit. This is an advantage (gained not least by having an international monopoly of military might) that offers enormous structural power to the US, an issue that will be covered in the next section. Third, by establishing that monetary societies are held together by social networks of credit/debt based on intracommunity trust, Ingham points indirectly to how money can enhance the sense of togetherness. As Helleiner explains:

> The use of a common money may foster a sense of community because money acts, in ways similar to language, as an elemental medium of social communication. When people share a common currency, their sense of

[26] To illustrate this point with an example, Ingham mentions how in 2003 when the Iraqi Saddam regime collapsed after the US invasion there were two different looters of banks. Those that cursed and torn Saddam's legal tender bills to the streets and those that carefully picked them up and stored them. The former had a clearer understanding of how money gets its value than the latter (2004:206).

> common identity may also be fostered by the fact that they experience phenomena together (2006:83).

The 2010-2011 debt crisis in the EZ, which triggered serious doubts about the future of the euro, is the first such experience in the short history of EMU. People located all over the currency area, in different nation-states, including the historical more euro-sceptical Germany, started to feel that 'their' currency was under siege from speculative attacks coming from the Anglo-American financial centres and that it needed to be defended (Mahler et al. 2010; *Der Spiegel* 2010a; Padoa-Schioppa 2010). Episodes like this might help to generate a sense of togetherness in the EZ. The crisis and its response will be a theme that will be covered in different parts of this thesis. Here it suffices to say that the share of a common currency has the *potential* to stimulate political unity. Of course, the reverse is also true. Money is based on sovereignty and political legitimacy. Without it, it is bound to fall apart.[27]

However, this aspect leads to the fourth and most important argument for this thesis that arises from Ingham's work. Until this pan-European political unity is created, which is still very much in doubt, the monetary space of EMU will be inherently unstable, and therefore unable to challenge the supremacy of the dollar (as will be shown in the next chapter), because it lacks this centralised and politically legitimised sovereign authority necessary to underpin any monetary space. Following the orthodox view that money is a neutral veil reduced solely to economic transactions, the drafters of the Maastricht Treaty endeavoured to depoliticise the euro, hence, to "de-commission the weapon", in Weber's terminology (Inhgam 2004:196). They believed the stability of the currency and the fight against inflation, the pursuit of 'sound money', could be achieved by limiting public indebtedness to certain ceilings, as the GSP stipulates, and by impeding the ECB's potential bail out of any of its member states. By doing so, however, they limited the member states' historic

[27] A review of the headlines of broadsheet newspapers within the EZ between January 2010 and June 2010 can give the reader a sense of how the crisis was perceived in the countries using the euro. Headlines saying that the euro was under attack from speculative Anglo-Saxon traders were common place and were even incorporated in the discourse of several European policymakers. The *Wall Street Journal* responded to this social mood in the EZ in its 16 February 2010 editorial entitled: "European Conspiracy Theory". It needs to be said that this crisis has also provoked euro-sceptic feelings among the general public, especially in Germany. Overall, however, the general perception is that the Europeans will make "whatever it takes to save the euro" since, for them, "if the euro fails, so will the idea of European Union". A pledge repeated in numerous occasions by several EZ leaders, including Angela Merkel, the German Chancellor (*Der Spiegel* 2010).

sovereign capacity to monetise debt, while at the same time they forced them to finance their budget deficits through the international bond markets, making them vulnerable to the discretion of international creditors, provoking a shift in the balance of power between the two. When during the most recent 2010-2011 debt crisis, EZ policymakers criticised Anglo-Saxon speculators for trying to bring EMU to its knees by widening the spreads between the yields of core and periphery government bonds (see Chapters 4, p.147 and 5, p.187), they should have rather blamed themselves for capping the monetary and fiscal tools required to confront such speculative attacks. It is here again useful to reproduce Ingham's words:

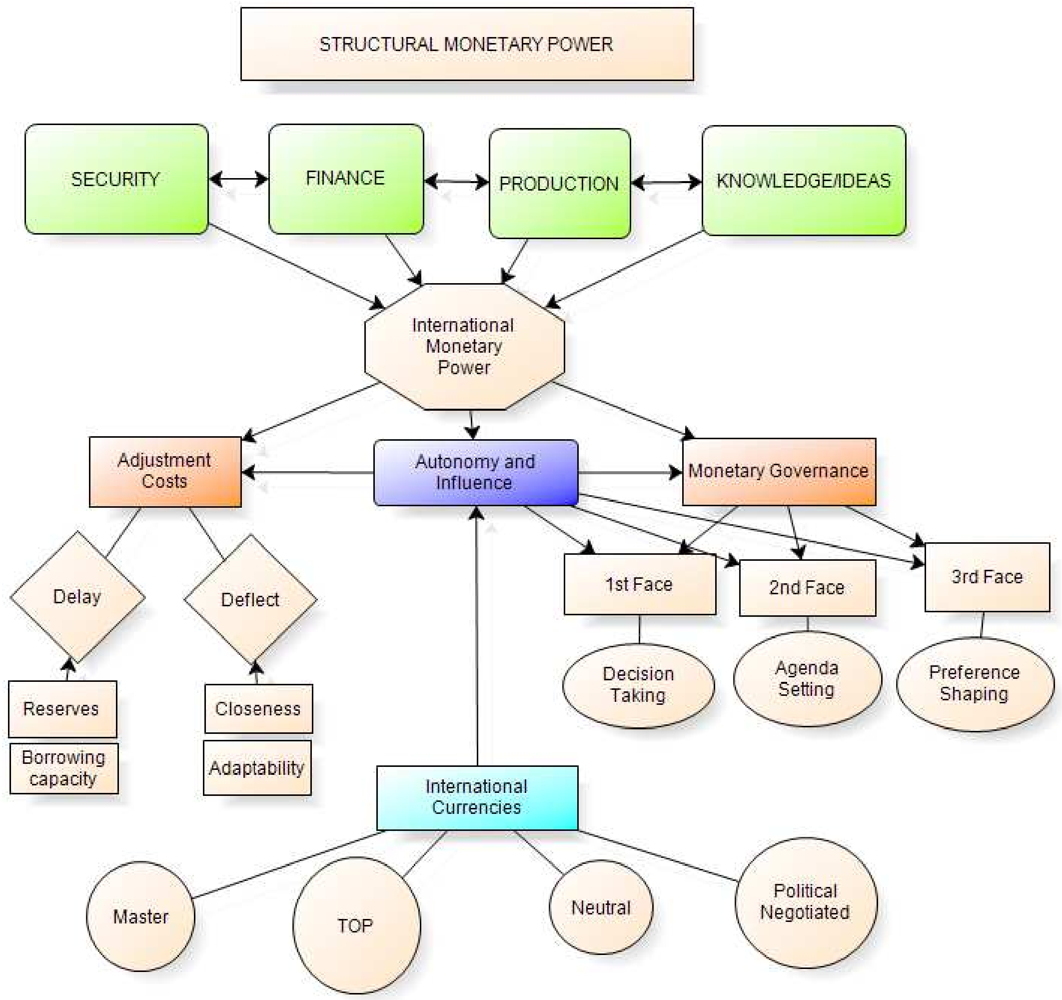
> The concept of neutral money as a symbolic medium of exchange for the market diverts attention from the fact that money consists in the social network of credit and debt of the capitalist economy. Money is constituted by the integrity of the payments system, which, if disrupted by large-scale defaults, may lead to a chain reaction and a monetary crisis. Controlling such events by acting as lender of last resort is, arguably, the most important and indispensable role of a central bank – more so than price stability (2004:195).

Ultimately these self-imposed institutional limitations were partly addressed by EZ policymakers when confronted with the possibility of a default by Greece, Ireland and Portugal, essentially, when the social struggle about the resolution of debt contracts between international bond holders, national states and national taxpayers arrived to its climax. On 9 May 2010 they had no other choice than take the decision to let the ECB overcome its orthodox rigidity of *price stability* and start buying in the secondary markets government debt of member states in financial difficulties in order to maintain the *financial stability* of EMU as a whole. From this moment on, the ECB has started to take indirectly the function of lender of last resort not only for the private banking system (the bond holders) but also for the national states (the taxpayers). This was not the only *political* decision taken that day. A proto fiscal union was also agreed by establishing a €440 billion strong European Financial Stability Facility (EFSF) which is now providing financial assistance to the EZ member states in financial need (EFSF 2011). With these historic decisions European policymakers confirmed that it is difficult to sustain a monetary union without a sovereign political union to support it. And, as will be demonstrated in Chapter 7 (p.270), this is valid for the regional as for the global sphere.

3.1.2 The Three faces in Structural Monetary Power

Now that I have explained how I understand money, the next step is to conceptualise how monetary power is developed. As the diagram shows (see Figure 3.1), at the general level I follow Strange's (1987, 1994) approach of combining four distinct but interlinked pillars in the generation of structural monetary power. These are the fields of security (military might), production (of goods and services), finance (creation of credit) and knowledge (including leadership in ideas).

Figure 3.1: Diagram on Structural Monetary Power[28]



[28] The next boxes of the diagram and their relationship will be explained in subsequent pages.

Without considerable influence in some or all of these different structures it is impossible for any country or union of countries to issue an international currency (for types of international currencies, see Chapter 2, p.64) and exert monetary power. It is important here to note that Strange's understanding of monetary power includes both material capabilities and ideational influences.

> Structural power is the power to choose and to shape the structures of the global political economy within which other states, their political institutions, their economic enterprises, and (not least) their professional people have to operate. This means more than the power to set the agenda of discussion or to design the international 'regime' of rules and customs (1987:565).

While Strange refers here to structural power in general, I argue that her overall conception is also applicable to the narrower concept of monetary power, as developed by Cohen (2006). Whereas Cohen limits his analysis to the behavioural tradition of focusing only on the first two faces of power (decision-making and agenda-setting)[29], as Strange suggests in her definition, it is also important to cover the more ideational (although still material) third face of preference-shaping, as developed by Lukes (1974, 2005). This will be done in the next section. In this section the aim is to present all the elements that operate in the formation of monetary power.

Like other authors who have covered the concept of international monetary power before (Kirshner 1995; Henning 1998), Cohen's analysis concentrates eminently on the power of avoiding adjustment costs in rebalancing the current account balance. For him, "the greater the relative capacity to avoid adjustment costs, the greater is a state's monetary power" (Cohen 2006:35). This power is achieved via two interrelated steps: *autonomy* and *influence* (see Figure 3.1). Influence implies that state *A* actively forces *B* to change its behaviour, and so carry more adjustment costs, while autonomy signifies that *B* has become more independent from *A*'s pressure. But, how are autonomy and influence developed in the adjustment process? Cohen (2006) says that there are two mechanisms. One is the 'power to delay' and the other is the 'power to deflect' the costs (see Figure 3.1). Since for deficit countries,

[29] See Bachrach & Baratz (1962).

adjustment always means a real permanent economic loss, normally deficit countries try to delay the adjustment. This is what the US has done in the last 30 years by running permanent current account deficits. This power to delay has been acquired by having easy access to international liquidity, essentially, by obtaining sufficient credit to cover the deficits.[30] The US has been able to achieve this through two channels. The first is the dollar. As I have explained in the previous section, money is credit. Therefore, the state that issues the international currency creates by default the international credit that it needs. However, this is not done automatically. For this to happen, this same state needs to develop a sophisticated financial structure that is able to absorb all this credit. This structural financial power of the US, which has received much attention in the literature (Helleiner 1994, 2006; Gowan 1999; Seabrooke 2001, 2006; Konings 2008b) and which is commonly believed to have flourished in the 1960s through the off-shore Eurodollar market in London, is actually older than that. Its foundational origins can be traced back to the early 20th century and the first financial innovations in 'securitization' of American banks (Konings 2008a).

Since the collapse of Bretton Woods, Wall Street, concretely the US Treasury debt market, is the epicentre of this structure, and the US financial sector has acted, through the process of 'financialisation', as the intermediary channel through which sufficient international liquidity has been generated to effectively cover the ever increasing, and for many unsustainable,[31]current account deficits of the US. This framework, which relies on the progressive openness of financial markets worldwide through international institutions such as the IMF, which is dominated by the US,[32] is what Gowan (1999) called the "Dollar-Wall Street Regime" and Seabrooke (2001) described as the "interactive embeddedness" between Washington, meaning the US government and the general public, and Wall Street, meaning the private financial sector. The expansion of credit instruments (loans, mortgages, credit cards etc.) to all layers of society, including the so called NINJAs (people with No Income, No Job

[30] Note that the other way to delay adjustment is to accumulate foreign reserves (See Figure 3.1 and 5.4). This is what China is currently doing. Since it does not allow its currency to appreciate as more capital comes into the country, it delays the rebalancing of its economy.
[31] At its peak during the period 2005-2006, the US current account deficit hovered around 6.5% to GDP. This is a level considered unsustainable in the long run for many analysts and policymakers. See Bergsten (2009a) for the former and González-Páramo (2007) for the latter. See also Chapter 2.
[32] In his review of how the US has promoted the lifting of capital controls all around the world, Cohen quotes a high US Treasury official who recognises that the IMF is "a convenient conduit for US influence" (Cohen 2008:198). For US influence in the IMF, see also (Woods 2003).

and Assets) and the proliferation of pension funds active in the stock market are clear evidence of this process. This immense credit creation is effectively one of the reasons why the euro is incapable of matching the structural financial power of the dollar.

The power of the US to delay adjustment through this structural power for decades is unquestionable. It is to be seen whether this delay can be stretched endlessly. For many, the current crisis has shown the limits, and huge social costs of these imbalances, and thus the adjustment process seems now unavoidable (Rajan 2010). But even in this scenario, the US has the power to deflect as much as possible the burden of the adjustment upon its trading partners. This can be achieved through different monetary power *influence* channels. The US can *actively* coerce its partners to undertake expansionary fiscal policies or to appreciate their currencies, or it can *passively* pursue a policy of 'benign neglect' in relation to a falling dollar to boost exports. As Henning (1998, 2006) has well documented, the US has applied this so called 'dollar weapon' upon the European states since the collapse of Bretton Woods. These deflection mechanisms have also included threats to withdraw its military protection from Europe during the Cold War, proving that the military structure, as developed by Strange, is also a determinant factor in leveraging monetary power (see Figure 3.1). In this regard, the US has exercised great influence upon its European trading partners. At the same time, though, it has fostered their efforts to cooperate closely on monetary matters in order to be more protected, hence more autonomous, from this influence. The creation of the euro is partly a consequence of this overwhelming influence (Henning 1998, 2006; Chang 2003; Jabko 2010)

For Cohen, however, EMU has only given the EZ member states more autonomy, but not more influence. It is important to stress that autonomy always precedes influence. To achieve the latter, it is necessary to acquire the former. Autonomy automatically generates passive influence because the power of others is restricted, but to *activate* this influence there needs to be a deliberate attempt to do so in what is generally understood in the literature as 'monetary statecraft' (Andrews 2006). Through the euro, the EZ has partially enhanced its autonomy. By issuing an international currency, liquidity access and consequently the power of delaying adjustments have been increased. Cheaper credit, thanks to lower public debt yields, has permitted deficit countries in the EZ to delay their structural adjustments for over a decade (Sinn 2011). It could be argued that this was detrimental in light of the brutal adjustment processes that are currently happening in the EZ periphery countries as a consequence of the Great Recession. But this does not eliminate the fact that, similar to the US, these countries were able to run current account deficits larger than would have been possible without the euro.[33] During this crisis, EMU has also protected EZ member states from exchange rate disruptions, a conspicuous European feature in previous crises (Wyplosz 2009). It has also allowed the ECB to inject unrestricted liquidity in euros to the EZ financial system, which had most of its balance sheets in euros, and not in dollars, like the financial systems in Asia and Latin America. An internationally accepted euro, with more liquid financial markets, has also been useful to buffer exchange rate movements against the dollar. Both when the euro strengthened in 2008, due to the start of the subprime crisis in the US, and when it weakened in 2010 during the Greek debt crisis, the movements were relatively gradual. They would have been steeper with a less liquid currency. Finally, EMU has also given the EZ member states more protection against US influence in macroeconomic diplomatic negotiations. Before the consolidation of EMU the small and medium sized economies of the EU were very vulnerable to US macroeconomic bullying because they had to deal with the big power individually (Henning 1998; Chang 2003). This has changed with the euro. Once the Europeans agree on one position (which is rarely the case), it is more difficult for the Americans to convince them to change their behaviour. A good example of this is the recent spat at the G20 between the US and the Europeans in relation to continuing with expansionary policies, as advocated by the Obama Administration, or starting with consolidation programmes, as defended by the Europeans as a bloc, including the British (Beattie & Peel 2010).

Nonetheless, the EZ is still taking a great deal of the adjustment costs coming from the US. Given that by now almost all major trading partners intervene in the markets to devalue their currencies (see Chapter 5, p.188), most of the dollar depreciation necessary to rebalance the US current account is absorbed by the euro, hurting EZ exporters. Moreover, exchange rate moves are always more harmful for the EZ than

[33] In 2007, the year before the crisis unfolded completely, the current account deficit for Greece was 14.1% of GDP, that for Spain 10%, for Portugal 9.5% and for Ireland 5.4%. In volume terms Spain, Italy, France and Greece (in this order) had in 2009 the biggest current account deficits of the world behind the US (IMF 2009).

for the US, for the US economy is far less open to the outside, and more flexible in its labour markets (Cohen 2006), two features that enhance its deflection power (see again Figure 3.1).[34] Some EZ policymakers, especially the French, have persistently shown their unhappiness with this situation and called for more international cooperation in exchange rate coordination, but so far they have not been able to change the status quo, not least because of the fragmented governance structure in EMU (see Chapters 4, p.144, and 7, p.256). This leads Cohen to conclude that "the Europeans clearly are now better placed to resist external pressures. Their collective autonomy has been enhanced. But Europe is still a long way from exercising the kind of leverage that monetary union might have been expected to give it. Influence has not been effectively actualized" (2008b:460).

Nevertheless, while Cohen's analysis is accurate in identifying the policy outcomes, it does not cover all the different layers of European power. To do so, I argue that his conceptual mapping needs to be expanded on the material (security and production) and ideational (ideas and beliefs) sides. If we want to have the bigger picture of monetary power, Strange's structural framework provides a more holistic understanding of how monetary power is to be gained. Apart from the developments in the financial realm (which have been covered in Chapter 2, p.52), in the production sector the EZ is on a par with the US. In the 2010 Forbes list of Top100 companies, the EZ has the same number of companies (27) as the US, showing that the global production capacity of both economies is very similar (Forbes 2010). In today's world, finance might be more important than production, but it would be a mistake to discard the latter. European small and medium sized enterprises (SMEs) are more internationalised than their American counterparts (EC 2010), a factor that helps the internationalisation of the euro. Where the difference lies, apart from the aforementioned US power in finance, is in the security side of Strange's framework. That the EZ has no military might behind it to match the US military is certainly an important factor in explaining why the EZ has not developed further its monetary influence. As was explained in the previous chapter, this military capability allows the

[34] ECB (2010) data show that imports and exports represent only 24.9% of US GDP, while this share reaches 38.5% for the EZ. It is also widely acknowledged that the US economy is more flexible than the EZ, especially when it comes to labour markets and bankruptcy procedures.

US to maintain the supremacy of the dollar based predominantly on political bargains (for the empirical discussion see Chapter 4, p.153).

Having referred here to the military power of the US, it would be disingenuous to claim that Cohen does not take military power into account when discussing monetary matters. He might not refer to it explicitly when he explains the macro-foundations of monetary power, but he has certainly included military issues when discussing the dollar vs. euro rivalry (2010). Thus, his wider approach on monetary power includes both relational power based on military capabilities, but also certain notions of Strange's structural power, especially in finance. However, Cohen's assessment of the EZ's influence in monetary affairs, as he himself recognises (2006:34), is only focused on what can be described as the two first faces of power, centred on the more material and observable processes of decision-making and agenda-setting. Where Cohen falls short is in covering what is known as the third face of power emerging, predominantly, from the realm of ideas. This third face of power was first highlighted by Lukes (1974) by arguing that

> *A* may exercise power over *B* by getting him to do what he does not want to do, but he also exercises power over him by *influencing, shaping or determining* his very wants (1974:23, emphasis added).[35]

This influence is realised through material capabilities, and certain institutions and norms, but also through discourses and ideas. As Langley (2009:130) notes, Strange was most likely influenced by Lukes when she developed her concept of structural power. This is the reason why she included the realm of knowledge and ideas in her conceptualisation. She might have also been inspired by the work of Robert Cox (1983, 1987), who, drawing on Gramsci's conceptualisation of hegemony,[36] based on

[35] It is to note here that in his 1974 conception of power, Lukes referred to this third dimension by only considering aspects related to domination. In 2005, however, he recognises that "it was a mistake to define power by saying that "A exercises power over B when A affects B in a manner contrary to B's interests" (Lukes 2005:12). Lukes proceeds saying that "power is a capacity not the exercise of that capacity […] you can be powerful by satisfying and advancing other's interests" (Lukes 2005:12). It is this type of power that I apply here.

[36] Note here the difference between the Kindlebergerian or Realist understanding of Hegemonic Stability Theory, more focused on economic and military, and therefore material, means to perpetuate a liberal order (see Gilpin 1987), and Cox' understanding of Hegemony which makes greater effort to combine both material and ideational aspects of power (see Cox 1987). Nonetheless, as Strange herself

coercion and consent, did also give importance to both material and ideational structures in the formation of power.[37] Nonetheless, while Strange highlights the importance of knowledge structures to legitimise a dominant belief system and ideology (as would be the case with neoclassical economics and the Efficient Market Hypothesis, as discussed below), her focus tends to emphasise material aspects of knowledge such as the arrival of new technologies, new systems of collecting, storing, and retrieving information and new systems of communication. And how these have "served to increase the concentration of power in the financial structure" (Strange 1994:134), the centre of this concentration being Wall Street. Unfortunately, she does not explain how a particular set of ideas and beliefs have sustained and perpetuated this structure and how ideas might possibly change it, especially in moments of financial crisis such as the present. For that, a more constructivist approach focused on the influence of ideas is warranted. As Blyth suggests, "ideas allow agents to reduce uncertainty, propose a particular solution to a moment of crisis, and empower agents to resolve that crisis by constructing new institutions in line with these new ideas" (2002:11). It is to this type of monetary influence that we have to turn our attention.

3.1.3 The Relevance of Ideas in the Construction of the IMS

The following question has puzzled students of the IMS for a long time: how can it be that a system as crisis-prone as the flexible-dollar-standard (FDS) has lasted for so long, now almost four decades? If one compares the Bretton Woods period after the Second World War with the current regime, initiated in 1971-1973 after US President Nixon closed the gold window, it becomes evident that the former was more stable, equitable and more growth enhancing than the latter (Blyth 2003; Duncan 2005; Reinhart & Rogoff 2008, 2009; Stiglitz & Greenwald 2010). The rules of the game were very different then to the current ones. The Bretton Woods system designed by

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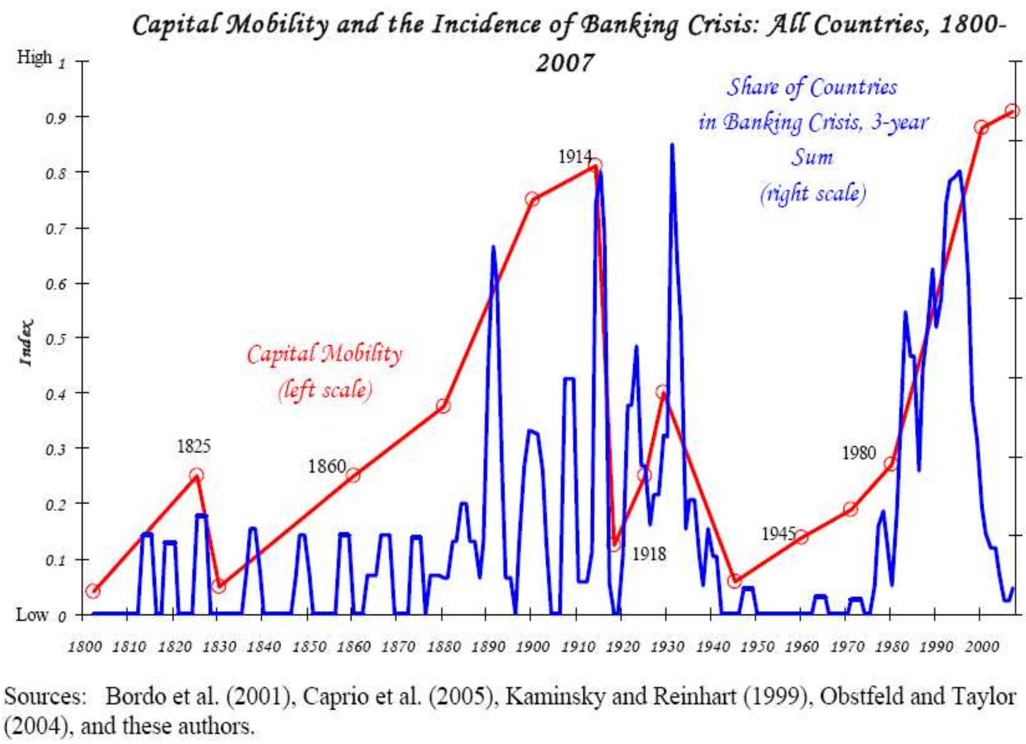
(1994:26) highlighted, Cox has a tendency to give more importance to the production field, and downplaying the financial realm (See also Ingham's [2006:61-3] critique of Marxist and Neo-Marxist analysis for their tendency to underestimate the power of finance capital). In this case, I agree with Strange when she notes that all four structures (security, production, finance and knowledge and ideas) are equally important.

[37] The combination of material and ideational power has also been acknowledged by liberal scholars such as Joseph Nye Jr. (1990, 2004), who coined the widely used concept of 'soft power'.

John Maynard Keynes, the chief British negotiator, and his American counterpart, Harry Dexter White, promoted the liberalisation of current accounts (to stimulate trade), but to avoid financial instability, it also introduced tight financial regulation, capital controls and fixed exchange rates, with the central currency in the system, the dollar, pegged to gold at $35 per ounce. This system which produced a Golden Age of financial stability and growth was substituted with the current regime based first on the free convertibility of the dollar, and subsequently on a steady increase in financial liberalisation, the opening up of capital accounts and the free floating of the most important currencies. The results of this switch for the stability of the system have been dramatic. In the past three decades there have been more than 120 financial crises around the world (Stiglitz & Greenwald 2010:21). Figure 3.2, taken from Reinhart's and Rogoff's (2008) detailed study of 800 years of financial crises, shows graphically the stark difference between the relatively flat line in the Bretton Woods period after the Second World War and the spikes before and after this era of tight capital controls.

Figure 3.2: The relationship between capital mobility and financial crises



Source: Reinhart and Rogoff (2008)

The question that immediately arises is how can we explain the maintenance of such a disruptive regime? Especially, since this is a regime that has produced a tremendous increase in income distribution inequalities around the world (Blyth 2003; ILO 2008). If the material evidence is speaking against this regime, what explains its endurance? Mark Blyth (2003) has studied this puzzle and for him the answer lies in the ideational realm. Of course, there are material factors behind the promotion of this system. Interest groups representing the international financial sector all around the world have been the main beneficiaries of this unequal and highly volatile system and therefore they are the ones lobbying for its maintenance. However, for such an unequal and disruptive regime to survive it needs to be legitimised. It is in this instance where the ideational level comes into play. As Blyth asserts,

> Such sustained inequality must be legitimised, and it is this issue that draws attention to the ideas underpinning the current regime. Examining the ideas of finance is necessary since the ability to consistently portray the current regime as both "the only way" and indeed the "best way possible" to organize the world's payments system is an important political weapon for those who benefit most from the regime's distribution (2003:242-3).

In this regard, the intellectual underpinning of the FDS has been the Efficient Market Hypothesis (EMH) as developed by Fama (1970). Following the EMH logic, the markets work at their best when they are left alone. In essence, what is needed is to avoid any intervention by the public hand in their operation, hence the policy recommendation since the 1970s has been to abolish financial regulation, capital controls and fixed exchange rates. This has been the prevalent *ideology* in mainstream neoclassical economics and among financial market actors up to the global financial crisis which started in 2007.[38] Before this systemic shock, which hit the centre of the financial system, Wall Street, constant financial crises occurring in the periphery were belittled. The EMH became such a powerful theory that it was elevated as singular truth, and consequently, it became empirically irrefutable. "After all, an efficient market, by definition cannot produce a crisis" (Blyth 2003:245). Thus, the financial crises in Mexico (1995), South East Asia, Russia and Brazil (1997-98), and

[38] Note that in Figure 1, the global financial crisis is not represented. The representative spike would certainly match, if not top, the height of the spike representing the 1929 Crash crisis.

Argentina (2001-2002) were not crises *of* efficient financial markets. Rather, they were the product of lack of transparency, widespread corruption and macroeconomic mismanagement. The solution advocated by the US in cooperation with the IMF was to liberalise even further these markets, not to tighten regulation. Paradoxically, this ideological dogma was dropped in 2008 when the crisis hit the core of the system with the collapse of the investment bank Lehman Brothers. In this case, the financial turmoil was interpreted as a *real* crisis which called for a reform of the system. Re-regulation became the new rulebook in Washington. As a consequence in 2010 the US Congress passed the 'Dodd-Frank Wall Street Reform and Consumer Protection Act' (known as the Dodd-Frank Act), arguably the greatest regulatory overhaul of the American financial sector since the 1930s.

This crisis is therefore not just another cyclical crisis in the evolution of the IMS, it is a systemic one. It is without doubt the greatest financial crisis since the Great Depression triggered by the 1929 Crash, and since its effects are still lingering at the time of writing (4 years on since the subprime crisis), it might potentially have comparable repercussions. In such periods of widespread uncertainty, the pillars of the system are shaken, and one of the pillars of the current system is the centrality of the dollar. This crisis has exposed the flaws in the FDS. As will be elucidated in subsequent chapters, it has demonstrated that the US structural deficits are a permanent source of instability. With this in mind, widespread calls for reform have come from as far apart as Beijing, Brasilia, Moscow, Riyadh, Paris and Berlin. The emerging consensus in these capitals is that dollar unipolarity in the IMS is not compatible with an increasingly multipolar economic and political world order. The centrality of the dollar was warranted when the US counted for almost 50% of global GDP, as in the years of the Bretton Woods system, and when it was the unquestioned hegemon in the system, but today the US share of world GDP is only around 25% and its status as the hegemonic stabiliser is seriously in doubt (Benassy-Quéré & Pisani-Ferry 2011). This anomaly needs to be changed. The problem is how to change it without provoking another major crisis. Confronted with this same question, most of the interviewees in this research would hesitate to give a firm answer. They *hope* that it can be achieved in a cooperative manner, but they have serious doubts about it. I argue that this high level of insecurity makes this transitional period an age of Knightian uncertainty, as developed by Frank H. Knight in 1921 (cited in Blyth

2002).[39] This type of uncertainty is qualitatively different from the one emanating from situations of high risk. As explained by Blyth, in risk situations

> Uncertainty as complexity presupposes that agents know their interests but cannot calculate how to achieve them without first reducing the set of possible strategies. Knightian uncertainty, however, does not reduce uncertainty to risk. Because the situation is "in a high degree unique", agents can have no conception as to what possible outcomes are likely, and hence what their interests in such a situation in fact are (2002:31-2).

Naturally, if one accepts this logic – and increasingly top policymakers in financial matters such as the president of the ECB Jean-Claude Trichet (2011a) are doing it[40] – then the EMH starts to lose its legitimacy (Prechter & Parker 2007; De Grauwe et al. 2008; De Grauwe 2009b; Rajan 2010). The EMH is based on the rational-choice-theory that agents act permanently as utility-maximising individuals. But if these individuals find it hard to recognise their own interests, how can they act rationally to maximise them? The whole concept of rationality is here put into question. What does it mean to act rationally in today's IMS? The example of China is a case in point. Is it rational for China to hoard $3 trillion (the equivalent of 50% of its GDP) in foreign reserves? For US policymakers it is not. By contrast, would it not be rational for China to sell its ever depreciating dollars before the greenback loses even more in value? (See next section). US policymakers and pundits say no because China would lose in the value of its existing dollar reserves. The rational advice from US policymakers to China is to appreciate its currency. But is that rational? China would

[39] Apart from my own empirical research, there are other factors that lead me to believe that we are in a moment of Knightian uncertainty in the financial and monetary system. When the price of gold hits every month new records, when the leading economies of the system (the US and the EZ) are threatened by debt defaults, when there is a global public debate about the reform of the IMS and another about whether to apply Keynesian or Hayekian policies to overcome the crisis, and when there is constant complain about the lack of political leadership in the system, then I think it is safe to argue that we are in a moment of unique uncertainty. All these different aspects will be tackled in the following chapters.

[40] In a June 2011 speech Jean-Claude Trichet defines the global financial crisis as a crisis of Knightian uncertainty. He concedes that "the promised benefits of financial risk management turned out to be illusory. Risk did not disappear, indeed in many cases it was magnified. And the process of deregulation led to a huge increase in private indebtedness and an accumulation of financial imbalances". In the same speech, Trichet does also recognise the limitations of modelling methods as applied by contemporary neoclassical economics. In his words: "A key feature of the uncertainty generated by financial crises is that it places decision-makers in uncharted territory. Events happen that were deemed to be almost impossible before the crisis, and were therefore difficult to forecast on the basis of statistical methods" (Trichet 2011a).

also suffer huge exchange rate losses on the value of its dollar reserves under this scenario. And this vicious circle can go on indefinitely. Is it rational when Chinese policymakers air their discontent about the FDS? For many analysts in the West, it is not because every time they do so the dollar drops and so does the value China's dollar reserves. For Chinese policymakers, however, it is rational because they want to change the system and this can only be done by articulating their discontent. The crux of the matter is that rationality depends on your identity, culture and institutional embeddedness (Watson 2005). For the majority of Western policymakers a system based on free capital movements and floating exchange rates is rational, for the majority of their Chinese counterparts it is not (Interview X-3 2009, Ding 2009b; Chin and Wang 2010; Zhou 2009a, 2011).

Here is where the role of ideas takes a preponderant role. To change the current, disruptive status quo, policymakers in Beijing, Riyadh and Brasilia need first to make sense of how the current crisis came about, then they need to figure out how to best cope with the current situation of uncertainty and then they need to generate a narrative that can lead to the transformation of the rules of the game (a matter discussed below). Normally, in these transitional periods what policymakers tend to do is to look at similar experiences. They try to find possible blueprints to amend the situation. It is in this context where the material-ideational impact of EMU emerges. If there is a region in the world that has tried to weather the instabilities of the FDS since its inception, this is the EZ. Since the collapse of Bretton Woods and the introduction of flexible exchange rates, the Europeans have battled to regain stability and autonomy in monetary affairs, first with the fixing of exchange rates among themselves with the European Exchange Rate Mechanism (ERM), and more recently with the introduction of the euro (Marsh 2009; Jabko 2010). In this regard, they have shown that monetary sovereignty sharing among independent nation states is possible. This is ideationally significant because, as Kirshner (2003:12) points out, "with regard to money, the power of ideas does more than just shape the possible. It defines the feasible". And this, of course, is valid also for monetary governance.

3.1.4 The Influence of Ideas in Global Monetary Governance

If we move then from the field of monetary power, as explained before, to that of monetary governance, essentially where this power determines the 'rules of the game', Cohen has identified two major trends in the evolution of monetary relations over the last fifty years. Both form the contextual background of this thesis.

> The first is a redistribution of power *among states*, principally involving a relative decline in the overwhelming pre-eminence once enjoyed by the United States. The second is a redistribution of power *from states to markets*, involving a relative increase in the role of non-state actors in deciding such fundamental matters as currency values or access to credit (Cohen, 2008a:5, italics in original).

If we start with the second trend, focused on the redistribution of power from states to markets, this development started with the collapse of Bretton Woods in the first half of the 1970s. Since then the rules of the game have been focused on reducing as much as possible any rules, under the EMH knowledge structure. Deregulation has been the name of the game until the global financial crisis. This has prompted many commentators to say that the FDS is essentially a 'Non-System' (Benassy-Quéré & Pisani-Ferry 2011). It is based on a certain set of norms, beliefs and ideas, but not on concrete rules as the Bretton Woods system was. Nonetheless, if there is not a formal but rather an informal governance structure dominated by private financial actors, the key question to ask is: *Qui bono*? Who wins from this informal governance structure which gives the financial sector such a powerful role? Drawing on Watson (2002), Blyth (2003) explains that the main winners of this non-system of persistent financial deregulation have been the US and the UK because these are the two countries with the largest structural deficits in the world, and therefore they are hugely dependent on large inflows of capital into their financial centres in order to finance these deficits. "This is why the current regime persists: it provides states with chronic structural imbalances and large financial interests a way of avoiding painful domestic trade-offs by rent seeking from the rest of the world" (Blyth 2003:256). In other words, the US and UK have been delaying their adjustment costs through the promotion of this system.

The global financial crisis, however, has shaken the overall structure of the IMS and its intellectual underpinnings. We are again in a moment of Knightian uncertainty, similar to the 1930s, in which incumbent institutions, such as the FDS, are being questioned, and new types of arrangements are being proposed. As Helleiner (2010a:627) indicates, the "crisis has clearly generated a legitimacy crisis for the neo-liberal globalized financial regime that emerged in the 1980s and 1990s" led by the US.[41] As will be shown in Chapter 5, US leadership in the IMS is increasingly questioned. The global financial crisis has shown the financial elites in emerging markets the flaws in the FDS and has encouraged them to look for alternatives. Throughout this process, mired in Knightian uncertainty in which policymakers do not know how to best escape from the 'dollar trap' (Krugman 2009), ideas are playing an important role. In this regard, it is useful to consider here Blyth's analysis on the influence of economic ideas in the different steps that contribute to systemic institutional change. For Blyth (2002:35) ideas matter in 5 concrete moments: 1) they allow agents to reduce uncertainty by interpreting the nature of the crisis; 2) they serve as collective action and coalition-building resources; 3) they are used as weapons that allow to attack and delegitimize existing institutions; 4) they are seen as institutional blueprints to construct new institutions; and 5) they underpin the new institutional framework.

If we translate Blyth's framework to current discussions around the reform of the IMS we can see how four of his five steps are currently in place. In relation to the first step, it needs to be highlighted how policymakers in Washington and China have been battling to assert their own interpretations of the causes of the crisis. In both capitals it is agreed that global imbalances have been the major trigger of the crisis, however, the explanations are very different. In the US the finger of blame is pointed towards China because it keeps its currency unfairly undervalued to generate export-led growth. In China, by contrast, the blame is directed to the reckless overleveraging

[41] While I subscribe to Helleiner's view in this regard, I am aware that this is not widely shared in the literature, especially in the critical IPE literature. Konings (2010), for instance, argues that neo-liberalism is a secular trend in the US, which survived the New Deal years, and which is unlikely to be stopped by the current crisis.

that took place in the US over the past decades. These two opposing views are epitomised by Ben Bernanke, Chair of the FED, and Zhou Xiaochuan, Governor of the PBoC. While for Bernanke the crisis is predominantly the consequence

> of a *global saving glut*, driven by the transformation of many emerging-market economies – notably, rapidly growing East Asian economies [especially China] and oil-producing countries – from net borrowers to large net lenders on international capital markets (Bernanke 2007, emphasis in original, brackets mine).

For Zhou Xiaochuan sitting in Beijing

> The outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system…The frequency and increasing intensity of financial crises following the collapse of the Bretton Woods system suggests the costs of such a system to the world may have exceeded its benefits (Zhou 2009a).

Here we see how different ideas about the reality have an impact on how the reality needs to be changed. For Bernanke the solution lies in convincing China to rebalance its economy from export to demand-led growth, which naturally implies an appreciation of the Renminbi (RMB). For Zhou, instead, the priority is to change the current, flawed IMS. In this regard, following on to Blyth's second step, Zhou has been able to establish a coalition of countries and international institutions and expert groups that have seconded his appeal for reform (see Chapter 5, p.179). Shortly after his analysis went public, the rest of the BRICS, several UN bodies and even France supported his call for reform. Matching Blyth's third phase, ideas have also increasingly become weapons to delegitimize the current IMS led by the US. The extremely loose monetary policy of quantitative easing (QE) adopted by the FED has been labeled by the Brazilian Minister of Finance Guido Mantega as the start of Currency Wars similar to the competitive devaluations of the 1930s. Harsh criticisms have also come from Chinese and European officials; all concerned about the US trying to exploit its dominant position in the system by deflecting its adjustment costs (Beattie et al. 2010).

Under this scenario of increased contestation, following Blyth's fourth phase, financial elites in China, the GCC and Brazil are starting to look at possible blueprints to be more protected from dollar shocks. In this sense, as will be shown in Chapter 6, EMU is seen as a potential template. Notwithstanding current difficulties related to the sovereign debt issues in its periphery, for a considerable number of participants in this research, EMU has provided the EZ member states more autonomy in monetary affairs. The *idea* of the success of the euro has had considerable impact on three levels, thus reframing the euro vs. dollar debate. 1) It has demonstrated that regional monetary union by sovereign member states is possible 2) It has shown that a multi-currency IMS might be more stable than an IMS overwhelmingly dominated by the dollar, and 3) It has opened the door to monetary sovereignty sharing at the global level. If monetary cooperation among independent sovereign states is possible at the regional level, then there might be a possibility for cooperation at the global level. In this regard, EMU functions as a laboratory for the rest of the world. If it fails, which is still a serious possibility, its experience will show that monetary sovereignty pooling is extremely difficult. However, if it succeeds, more such experiments will follow. As a consequence of these developments, as will be shown in Chapter 7 (pp.245-256), Europe has acquired considerable influence at the level of preference-shaping and agenda-setting. EMU is a blueprint to the reform of the IMS on a multilateral basis. However, the EZ is not able yet to take advantage of this situation. By being politically disunited, it is incapable to take a leadership role in the first face, where decisions about the reform of the IMS need to be taken.

Thus, against this backdrop, the monetary governance framework emerging has the following characteristics. As Cohen (2010) has suggested, we are moving from dollar uni-polarity to a 'leaderless' global system, in which "America's dominance of the monetary system has declined, especially in relation to Europe and East Asia" (Cohen 2008b:5). The Great Recession has only reinforced this trend. The US is still the dominant country in the system. No single reform can be implemented without its approval. The problem is that policymakers in Washington are unwilling to take a leadership role in the reform process. Giving up willingly the 'exorbitant privilege' is extremely difficult and no US policymaker wants to take this bold step. As a consequence of this stalemate, different parts of the world are trying to acquire more autonomy to be better protected against shocks coming from the FDS. A system with multiple subsystems of governance is emerging (Hall 2008). The creation of the euro is just the first reaction to the flaws of the FDS. Other examples are likely to follow in the form of increased regional monetary cooperation, and/or gradual internationalisation of other currencies. This might lead to a multicurrency system, as predicted 30 years ago by the historian Kenneth Dam (1982:19, cited in Hall 2008:115). However, as Helleiner (2010a) explains, the shift from one system to another is long and protracted. Conducting an analysis that is historically informed, he divides this shift into four phases: a legitimacy crisis of the previous system, an interregnum, a constitutive phase and an implementation phase. He argues that we are now entering an interregnum, in which different reform policy agendas, based on different ideas on the future of the IMS, compete against each other at the G20 level. The renewed legitimatisation of capital controls and FX intervention is just a first shift in the overall structure (see Chapter 5, p.188). Following Blyth's analysis, right now we are between phases 3 (contestation) and 4 (possible blueprints and creation of new institutions). Phase 5 (the consolidation of new institutions) is still mired in Knightian uncertainty.

3.2 The Three Case Studies: Brazil, China and the GCC Region

3.2.1 Brazil

Since Jim O'Neil (2001), chief economist of Goldman Sachs, included it in the BRIC acronym, Brazil has steadily gained more significance in the world economy. Brazil is today the largest world exporter of coffee, sugar, chicken, beef and orange juice (*Economist* 2009a). In addition, in 2007, Petrobras, the majority state-owned oil company, discovered vast off-shore oil reserves that could soon make Brazil a leading oil exporting country. Unlike Russia, however, Brazil is not only reliant on exporting commodities. Embraer is the third largest aircraft maker in the world after Airbus and Boeing, demonstrating that Brazil has a strong high-tech industrial base. Furthermore, unlike China, Brazil does not only depend on exports to grow. Its domestic demand is equally strong, which has helped it to weather the Great Recession relatively well. It was "among the last in and the first out" (*Economist* 2009b:13) of the current downturn with an annual GDP growth rate for 2010 of 7.5% (IMF 2011a). All this strength is reflected in its economic and financial position. Brazil has recently become the 8th largest economy of the world (IMF 2011a).[42] It is the 5th largest holder of US Treasuries (see Table 3.1) and it is with $351 billion the 6th largest holder of foreign reserves (BCB 2011a).

Table 3.1: Major foreign holders of Treasury securities (in billions of dollars)

Country	**Mar 2011**	**Feb 2011**	**Jan 2011**	**Dec 2010**	**Nov 2010**	**Oct 2010**	**Sep 2010**	**Aug 2010**	**Jul 2010**	**Jun 2010**
China	1144.9	1154.1	1154.7	1160.1	1164.1	1175.3	1151.9	1136.8	1115.1	1112.1
Japan	907.9	890.3	885.9	882.3	875.9	873.6	860.8	832.5	817.3	799.9
UK	325.2	295.5	277.9	271.6	242.5	209.0	190.5	181.0	107.2	94.5
Oil Exporters	222.3	218.8	215.5	211.9	204.3	207.8	215.4	211.7	209.3	210.2
Brazil	193.5	194.3	197.6	186.1	189.8	183.0	181.0	170.5	167.7	163.8
Taiwan	156.1	155.9	157.2	155.1	154.4	154.5	153.3	153.4	153.8	151.9
Caribbean Cts.	154.8	169.4	166.5	168.1	158.8	146.3	157.7	172.6	164.1	178.9
Russia	127.8	130.5	139.3	151.0	167.3	176.3	173.3	173.7	175.7	168.2
Hong Kong	122.1	124.6	128.1	134.2	134.9	135.2	131.9	133.9	131.2	137.0
Switzerland	111.6	110.4	107.6	107.0	107.0	107.7	110.0	113.0	111.8	106.5

Source: US Treasury Department (USTD 2011)

With economic clout has also arrived diplomatic assertiveness. Brazil has gradually taken a leading role among the BRICS and the emerging countries as a whole in its zeal to establish a more multilateral world economic order. It is, with India, the leader of developing countries in the World Trade Organisation (WTO). It is a model of gradual economic development under democracy, and a unique example of how to grow, redistribute, increase social cohesion and reduce poverty at the same time (Brainard & Martinez-Diaz 2009). Brazil has been influential in starting the G20 forum and it has been very vocal in calling for a substantive reform of the IMS with the objective to enhance the decision-making power of emerging markets in its governance institutions and with the ultimate aim to put an end, through negotiations, to US and dollar dominance in monetary affairs (*O Globo* 2009; Wheatley 2009).

Given this economic and political ascendency, Brazil qualifies as a good case study to assess the impact of the euro in the international financial system. By analysing how

[42] In March 2011, the Brazilian authorities declared that their country had passed the UK and France and that it was the 5th largest economy in the world (see Leahy 2011). This claim is still contested.

key Brazilian financial elites interpret the trajectory of the European currency in the last decade, one is able to discern to what extent the euro is able to compete with the dollar for international currency status, what kind of material and ideational impact the European currency has triggered among policy makers and private investors, and what sort of action has this impact motivated. The case of Brazil is particularly interesting because traditionally Latin America has always been seen as the 'backyard' of the US and hence a dollar dominated region. Several countries are even officially dollarized such as Panamá, Ecuador and El Salvador.[43] Thus, any move in this region out of dollar dominance and in favour of euro diversification would represent a tectonic shift in the IMS. Nonetheless, despite the arrival of the euro and the possibility for change, the tradition of allocating Latin America under dollar influence is maintained by prominent scholars in the field such as Cohen (2009b). In considering possible battlegrounds between the euro and the dollar he establishes that "there seems little reason to worry [about the euro challenge] in the Western Hemisphere, where a dollar bloc has effectively existed for some time; there, the greenback remains largely unchallenged" (Cohen 2009b:160, brackets added). This general view contrasts with that of Pier Carlo Padoan (2000), who already 10 years ago did not see Mercosur, where Brazil is the leading economy, as an uncontested dollar region. Quite the contrary, for him it is a neutral area where the dollar and the euro are likely to compete. As he explains:

> Competition is even more likely in the Mercosur case, which is particularly interesting because the region does not really belong to a dollar or a euro currency region, yet may have to choose between the two once the euro takes on a more global role. So the Mercosur case may be seen as a paradigmatic example of the implications of a bipolar monetary system (2000:103).

Within the wider Mercosur region, Brazil is certainly the most interesting country to study the implications of a greater global presence of the euro. Not least, because since the beginning of the new century Brazil has gradually moved away from the US and closer to the EU. As Klom argues, "although Brazilian foreign policy was geared

[43] Dollarization of Latin American countries was a trend favoured by some policy-making circles in Washington at the turn of the millennium, possibly as a counter-move to the creation of the euro (see [Helleiner 2003]), but in recent years these policies have lost considerable momentum. At the moment of writing no country in Latin America is considering this path.

towards the US for most of the twentieth century, and only occasionally towards Europe, the Mercosur project has in effect pushed Brazil in the opposite direction" (Klom 2003:356). This has been proven by Brazil's reluctance to sign the Free Trade Agreement of the Americas (FTAA) advocated by the US, while it has been slighltly more active in pursuing a free trade agreement between Mercosur and the EU (Schmalz 2008).[44] The reason for this was explained by President Lula when he stated that the EU is "the only Mercosur trade interlocutor that, putting on the table offers in all relevant areas, signals a positive disposition towards negotiations" (Poletti 2007:278). Against this diplomatic backdrop, it is no surprise then to see how in the last decade trade and investment volumes between the US and Brazil have decreased, while those between Brazil and the EU have grown. In 2010 the EU represented 21.7% of Brazilian imports against 15.1% of those of the US. This difference is even larger when it comes to Brazilian exports, with the EU receiving 21.2% of total volume and the US only importing 9.8% of Brazilian goods and services (MDIC 2010). In recent years, the EU has also been the largest Foreign Direct Investment (FDI) partner of Brazil in both directions (BCB 2005, 2008).[45]

Considering these numbers, and the importance of Brazil, not only within Mercosur but also Latin America and the world at large, the question that arises (and which will be answered in the following chapter) is whether this greater economic exchange between the EU and Brazil is mirrored by a greater use of the euro by Brazilian economic agents. Surprisingly, the literature has overlooked this area of the world in assessing the euro challenge to the dollar. This remains an understudied region within the euro vs. dollar debate which *per se* justifies its inclusion as a case study in this thesis. Moreover, with just a few exceptions (Chin 2010), the IPE literature has also hardly focused on the role of Brazil in monetary cooperation and governance at a regional and global level. This thesis will attempt to fill this gap, while it will also confirm that the euro is not able to challenge the dollar in this part of the world.

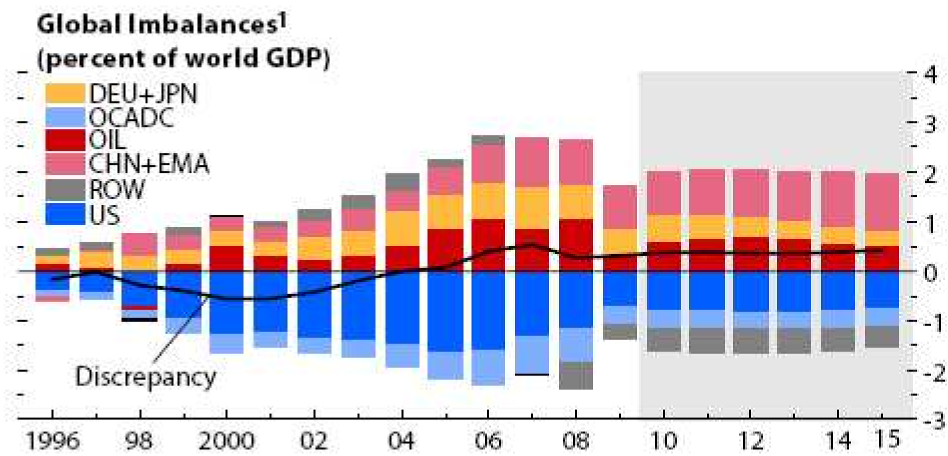
[44] At the time of writing, negotiations between Mercosur and the EU to sign a free trade agreement are still taking place. While Brazil is keen to sign a free trade agreement, it will only do so if the EU reduces its import tariffs on agriculture goods, something that the EU seems reluctant to concede. The negotiations seem to be in a gridlock due to these differences.

[45] Here it needs to be noted that China is increasingly gaining Brazilian export and import share to the detriment of both the US and the EU (see Wolf 2011a).

3.2.2 China

While Brazil does not attract much attention in the euro vs. dollar debate, this is certainly not the case for China. It is widely acknowledged in the literature that the 'Middle Kingdom' is and will play a vital role in the maintenance of the dollar as the main international currency. This is why China takes a predominant role in this thesis and why in this subsection I will take more space to present the different contending views on this case study. China is today the biggest creditor to the US. It holds over $1 trillion in US Treasuries (2011, see Table 1) and $3.2 trillion in foreign reserves (Yao 2011), with roughly 65% of those denominated in dollars (*Reuters* 2010a). This huge accumulation of reserves is a reflection of the current account imbalances between the US and China (see Figure 3.3). Given that these imbalances are perceived to be a major destabilising factor for the world economy and one of the main causes of the Great Recession (Wolf 2009; Rajan 2010), it is only logical that China's progressive accumulation of dollars has generated great debate.

Figure 3.3: The global imbalances between the key players in the system



CHN+EMA: China and Emerging Asia; OCADC: Spain, Portugal, the UK, Turkey and Central and Eastern Europe; OIL: Oil exporters; ROW rest of the World; US: United States. Source: IMF (2010a).

In order to summarise briefly the different views in the literature, it is appropriate here to use Helleiner and Kirshner's (2009) differentiation of 'marked-based', 'instrumental' and 'geopolitical' approaches on China and the future of the dollar. The marked-based perspective is the one favoured by 'euro-sceptic' economists (see Chapter 2, pp.46-50) who point to the attractiveness, depth and breadth, of the US market in explaining why China is tied to the dollar.[46] In the same vein, the instrumentalist approach does also explain China's support of the dollar based on economic factors, but instead of focusing on the features of the US market, it looks at the problem from the perspective of the Chinese government. This approach has two main variants. The first, which is widely known as the Bretton Woods II theory, is the one put forward by Dooley et al. (2003) who argue that East Asian economies – China being the most important of them – behave today *de facto* similar to Japan and Western Europe in the Bretton Woods system. They peg or soft-peg their currencies to the dollar in order to develop a 'mercantilist' export-led growth strategy. Thus, the world economy works in a circular fashion whereby these countries sell their products mostly to the US, which acts as the pull of demand. As a consequence, they accumulate huge foreign reserves in dollars, and afterwards they reinvest these same greenbacks in Treasury securities or other dollar denominated assets.

The second branch of this instrumentalist approach is headed by McKinnon (2007, 2009) who agrees with the Bretton Woods II assumption that the centrality of the dollar in the system depends heavily on China's peg to the greenback and its accumulation of foreign reserves in dollars. But he rejects the 'mercantilist' explanation, instead favouring a justification based on the monetary anchor role of the dollar by virtue of its function as the main currency for world economic settlements. In his view, the peg to the dollar is not as much a strategy to export more, but rather a policy to maintain macroeconomic and price stability in China, especially considering that Chinese financial markets are still underdeveloped. Following this logic, the accumulation of dollars can thus be seen as a self-insurance strategy against macroeconomic disruptions, and especially, as Governor Zhou (2011:167) argues, against financial "predatory speculation".[47] As will be shown in Chapter 5, the evidence collected throughout this research gives more weight to this hypothesis.

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[46] The chapters of James and Schwartz in Helleiner and Kirshner (2009) take predominantly this approach.

[47] The lack of well developed financial markets is one of the reasons why China has maintained tight control of its capital account and accumulated foreign reserves as a self-insurance strategy against financial turbulence. This was one of the lessons of the East Asian financial crisis in 1997-1998. The self-insurance strategy is underplayed by both Dooley et al. and even McKinnon. Others, such as Wyplosz (2007), are giving it greater weight in explaining China's and other East Asian economies' reserve accumulation. This is certainly the view of Zhou (2011), the governor of the PBoC. I will return to this issue in Chapter 5.

What unites these perspectives on China is that they do not consider the euro to be an alternative to the greenback for policymakers in Beijing. Not least because with so many dollars in its reserves, any move out of the American currency by China would trigger a sudden depreciation of the dollar, which would automatically reduce the value of outstanding reserves. This brings Krugman (2009) to conclude that China is in a 'dollar trap'. It cannot diversify out of the dollar without reducing the value of its reserves and it can hardly un-peg from the greenback for its reliance on export-led growth does not give it the leverage to appreciate its own currency since that would undermine its competitive edge, trigger unemployment and provoke social unrest. Hence, China will continue to favour the Bretton Woods II framework. My research shows that, while correct, this assessment is too static. While Chinese policymakers agree that they are in a dollar trap, they are actively trying to escape out of it.

The question is, is the Bretton Woods II framework sustainable? Is it rational? For Eichengreen (2004, 2007a) and others that follow his arguments (Roubini & Setser 2004; Setser 2008a) it is not. The US will not be able to finance indefinitely its current account deficits at low cost thanks to the continuous willingness by East Asian central banks to recycle their dollar reserves in low-yielding US treasuries.[48] At some point, and here is where the notion of change comes into play, governments such as the Chinese will de-peg from the dollar. Representing the euro-optimist strand of the literature, Eichengreen stresses that one of the differences between the original Bretton Woods system and the current Bretton Woods II informal arrangement is that before there was no alternative to the greenback. US creditors had to accept a decline in the value of the dollar. Now, however, "the large, liquid market in euro-denominated government securities provides an attractive alternative to holding US treasury bonds for the central banks of emerging markets" (Eichengreen 2007a:26). The Bretton Woods II arrangement relies on an informal cartel of East Asian central

[48] Setser (2008a) provides some figures on what is actually the cost for China of accumulating huge amounts of its reserves in low yielding US treasury securities. In his calculations "the annual cost of adding \$600bn (15% of China's GDP) of unneeded reserves to China's stockpile is roughly 5% of China's GDP." Setser also quotes Charles Dumas from Lombard Street Research who "estimates that China makes 1-2% on its (largely) dollar reserves. It then loses up to 10% on the exchange rate and suffers a Chinese inflation rate of 6% for a total real return in RMB of about minus 15%. That is a loss of \$270bn a year, or a stunning 7-8% of GDP." Here it needs to be said that part of this loss could be seen as an insurance premium for potential financial distress. See previous footnote.

banks that support the dollar through their export-led strategies, but this cartel is fragile[49] since as Eichengreen explains:

> The countries of Asia are unlikely to be able to subordinate their individual interest to the collective interest. It may be in their collective interest to hold dollars to keep their currencies down and the dollar up, but it is in their individual interest to get out before the bottom falls out of the US currency (2005:12).

Economically speaking a gradual diversification out of the dollar and into the euro would make sense for China. Contradicting the Bretton Woods II literature, the EU is now the greatest export market for China. The latest figures show how the EU absorbs 20.5% of Chinese exports against 17.7% going to the US. The EU is also a larger import source for China, representing 11.4% of the total, while only 7% correspond to the US (MoCoC 2010). These data prove that the final decision is not only economic, but also political. With the amount of reserves that China has, any abrupt move out of the dollar would signify a major blow to the US. It would certainly break loose what Larry Summer's (2004) called the "balance of financial terror" between the two countries, and collaterally, it would also hurt the EZ through an over-valued euro. As will be explained below, and this contradicts Eichengreen's notion that the euro has sufficient liquidity to be an alternative to the dollar, one of the main problems for Chinese policymakers is precisely that the European currency is incapable to absorb a substantial portfolio diversification move by China. This is one of the main sources of frustration for Beijing.

The literature with a geopolitical approach on China and the future of the dollar focuses precisely on these tensions in the system. In this regard, Kirshner (2008, 2009) warns that the unwinding of the current huge imbalances between the US and China will not be as smooth as in 1971 when the Bretton Woods system broke up or

[49] Eichengreen (2007a) makes an analogy between today's informal cartel of East Asian central banks to support the dollar and the formal cartel of the 'Gold Pool' in the 1960s, which tried to maintain the price of a gold ounce at $35. Back then the cartel broke because France started free-riding in order to avoid a future depreciation of the greenback. Eichengreen states that today's cartel is even more fragile than the Gold Pool because in the 1960s Western Europe and Japan were in permanent contact with the US through the OECD and the G-10. Today East Asian economies among them, and in relation to the US, have weaker institutional links that can hold the cartel together in moments of distress.

in 1985 when the Plaza Accord was finalised. Then, Western Europe and Japan were willing to accept a weaker dollar, and consequently a greater share of the adjustment costs, because they were both US allies dependent on Washington for their security. This is not the case with China, which is seen more as a rival in Washington than as an ally. This brings Kirshner and others (Bowles & Wang 2008) to predict future monetary tensions between the US, the main debtor, and China, the main creditor, in the system. Thus, the dollar has become a negotiated currency in Helleiner's (2008, 2009) international currency typology as explained in the previous chapter and further developed through empirical evidence in Chapter 5.[50]

All these approaches provide in turn different hypotheses on where China stands in relation to the future of the dollar, the possible challenge of the euro and the sustainability or not of the global imbalances. My aim in the next chapters will be to test them against my empirical findings. In recent years, a few authors have tried to present the 'Chinese rationale' on the future of the dollar (Bowles & Wang 2008; Murphy & Wen 2009). However, they have mostly focused on secondary sources. They have not studied the direct views of policymakers and banking executives, and certainly not their concrete subjective perceptions on the euro challenge to the dollar. The following chapters will attempt to fill this gap.

3.2.3 The Gulf Cooperation Council Region

The geopolitical approach on the future of the dollar gains its significance when studying the views and behaviour of the financial elites of the six states forming the Gulf Cooperation Council (Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Bahrain and Oman). This region is not only relevant for its vast accumulation of foreign reserves. As the largest export region of oil (still the most used source of energy worldwide), it has also great geostrategic significance. As for its reserves, the region lacks in transparency in this regard, but it is widely assumed that in total, counting both public and private wealth, the GCC holds between \$1.5 and \$2 trillion in foreign assets (Momani 2008; Setser & Ziemba 2009), which makes it almost as

[50] For an in-depth analysis on how creditor emerging markets have increased their influence in shaping, not only US monetary, but also US foreign affairs policy, see Setser (2008b).

important as China in foreign reserve management. Two institutions, from the two biggest economies within the GCC, account for the lion's share. The central bank of Saudi Arabia, called the Saudi Arabian Monetary Agency (SAMA), which manages approximately $500 billion (Setser & Ziemba 2009), and the United Arab Emirates' (UAE) biggest sovereign wealth fund (SWF), the Abu Dhabi Investment Authority (ADIA), which has an estimated portfolio close to $800 billion (Truman 2007; Interview Y-9 2010). Most of these foreign reserves are denominated in dollars (between 60% to 80%)[51] due to the fact that oil has been priced in dollars since in 1975 the US persuaded Saudi Arabia to convince its OPEC partners to switch oil invoicing from the IMF SDRs to the greenback (Spiro 1999). Since that moment, as Momani puts it, "having the dollar used as the 'main invoice currency' for oil makes trade of this vital resource the new post-Bretton Woods' Fort Knox guarantee of the dollar" (Momani 2008:293). Given that oil is the most traded commodity in the world, both by value and volume (Momani 2008), the invoice of oil in dollars and the subsequent recycling of these dollars by GCC states in dollar denominated assets in the US is quintessential (and for this reason an important case study region) for the maintenance of the greenback as the leading international currency. As will be demonstrated in the following chapter, the US is perfectly aware of this and in order to keep the status quo unchanged it provides a security umbrella (military might is here crucial) to the GCC, in what can be considered as a tacit agreement in which the dollar functions as a negotiated international currency. This makes Momani conclude that "geopolitics, rather than economics, will dictate Gulf dollar loyalty" (2008:310). My research, presented below, corroborates this hypothesis.

Similarly to the cases of Brazil and China, from a trade perspective it would make sense for the GCC to diversify further into the euro and move away from its strict dollar peg to a basket peg where the euro plays a greater role, something that only Kuwait has marginally implemented. In 2009, the EU was by far the GCC's major source of imports, representing almost one third of the total (Eurostat 2010).[52] This

[51] Momani (2008) gives the figure of 60%; Setser and Ziemba (2009) estimate the dollar share is around 80%; my own research points to an average figure of close to 70%.

[52] The EU is the source of 27.6% of GCC imports, while the share of US is only 10.1%. In GCC exports, the US has a slightly bigger share (6.8%) than the EU (6.7%). Significant is here that the four largest recipient countries of GCC exports are all in Asia. These are Japan (17.7%), South Korea (13.7%), India (8.2%) and China (7.6%). Overall, the EU is the GCC's largest trade partner, followed by Japan and South Korea. The US ranks only 6th (Eurostat 2010).

means that, by virtue of the peg to the dollar, every time the FED adopts loose monetary policies (which might not be appropriate for the economic cycle in the GCC) and the dollar falls against the euro, the likelihood of inflation in the GCC increases. This was last seen in the 2007 and 2008 period when the euro was consistently trading at above $1.40, with an all time high of $1.5990 on 15 July 2008. During this period inflation rates in the economies of the GCC were in double figures and consequently the alternative to de-peg from the dollar gained considerable momentum. UAE and Qatar were especially attracted to follow Kuwait's path and peg to a trade-related basket while the Saudi authorities were keen to maintain the status quo for geopolitical reasons (Kerr 2008; Drummond 2008; El-Gamal & Jaffe 2010; see Chapter 5, pp.174-6).

A geopolitical approach is precisely what Cohen (2009a, 2009b) adopts when studying this region. For him, the Middle East in general, and the GCC in particular, might become the first battleground between the dollar and the euro. The case for stronger euro presence is certainly strong. For the Europeans it might be tempting to gain more influence in a wealthy region, historically always closer to Europe than to the US, and for GCC policymakers the option of diversifying away from the dollar into the euro would not only be economically attractive, it would also reduce their geostrategic dependence on the US. This makes Cohen write that if the Europeans were to promote actively a greater use of the euro by the governments of this region, they might find themselves pushing against an open door. But subsequently he also warns that any move in this direction would be met by stark opposition by the US.

> For Washington, there is no higher politics than the Great Game being played out today in the energy-rich Middle East. America needs both the region's oil and continued support for the greenback […] With so much at stake, the level of US tolerance for a formal currency challenge from Europe would be correspondingly low, making geopolitical conflict a virtual certainty (2009b:161).

Cohen also acknowledges that for many commentators this conflict has already started with the war in Iraq, which for many was a war between the US and Europe in light of the fact that on 6 November 2000 – deliberately one day before the US presidential election between Al Gore and George Bush Jr. – Saddam Hussein started selling its oil, through the UN 'Oil for Food' programme, in the European currency. Cohen is keen to point out that there is no evidence that can link these two events together, but at the same time he also recognises that "one need not be a sensationalist to recognize the seeds of truth" that this reasoning contains (2009b:161).[53] Iraq has not been the only country in the Middle East that, due to its rivalry to the US, has shifted the sale of its oil from the American to the European currency. Iran has done so for several years (El-Gamal & Jaffe 2010:123-4) and recently it has acknowledged that most of its foreign reserves are in euros (Derhally & Nasseri 2009). The Iranian President Ahmadinejad, with support from Venezuela, another country hostile to the US, has even gone so far as to propose the pricing of oil in currencies other than the greenback (especially the euro) within the OPEC organisation, but here again Saudi officials have shown their strong opposition to any move that could destabilise the dollar, and consequently, the stability of the region (El-Gamal & Jaffe 2010:123).

Despite clear opposition by Saudi officials against any move out of the dollar in the short-term, their calculations might possibly change when considering a medium to long-term horizon. In a controversial report, Robert Fisk (2009) suggests that there have been secret talks between GCC (including Saudi) officials and officials from China, Russia, Japan and France to discuss the possibility of pricing oil in a basket of currencies in a time span of 10 years. This information was quickly dismissed as mere speculation by Russian and GCC officials, but interestingly the Chinese did not come out to deny it. The markets have certainly given it some credit. As the influential *Financial Times* blog *Alphaville* reports, "*The Independent* is a reasonably credible news source and we suspect that the leaks made to the newspaper are to be taken quite seriously. Certainly the markets are taking it as such, and we should also" (Kaminska 2009). My research provides support to Fisk's hypothesis. The talks are taking place; another matter is whether the project will materialise. The important thing to note here is that the literature covering the future of the dollar and the possible challenge of the euro in the GCC region (Momani 2008; Leverett 2008; El-

[53] It is certainly interesting how the theory stating that the US invaded Iraq to preserve the dominance of the dollar in the region, which at the beginning circulated only as a conspiracy theory through the Internet (being Clark's [2003] article the most cited one – but there are hundreds of the same sort in all possible languages), finally found its way into mainstream IPE. Clark's work is now edited in a book, see Clark (2005).

Gamal & Jaffe 2010) has so far looked at all these moves through secondary sources. In the following chapters I will draw on these analyses, but as in the case of Brazil and China, I will also present the empirical findings of my fieldwork, focused eminently on the perceptions and analyses of the financial elites of the biggest economies of this region: Saudi Arabia and UAE.

3.3. Research Methodology

3.3.1 Following a Constructivist Research Methodology

Since the main aim of this thesis is to grasp how key financial actors in Brazil, China and the GCC partly *construct* through their perceptions and their actions relating to the euro challenge to the dollar, the research methodology used here is built on what can be broadly defined as constructivist interpretive epistemology. In this regard, I endorse Adler's view that "based on a pragmatist philosophy of science, constructivism turns interpretation into an intrinsic part of a scientific enterprise that seeks to explain the social construction of reality" (1997:328). As should be clear by now, I consider both the material and the ideational elements of the problem. In this sense I concord with the literature that has tried to solidify constructivism by including elements of realism in its analysis. As Meyer and Strickmann (2011:68) suggest,

> Placing realists' insights on material (and not only power) capabilities in a modernist constructivist framework allows […] new avenues of investigation on how material and ideational factors are co-constituted. Such a framework facilitates a more nuanced examination of how material structures reinforce or undermine existing norms and beliefs, how old and new ideas shape preferences and how these translate into interests that are actively pursued.

John Odell was one of the first scholars to apply such a pragmatic and cross-theoretical approach in studying changes in the IMS. While also considering theories centred on material capabilities, he stresses that "in analysis of policy change beliefs should be elevated to an equal theoretical level" (1979:80). Ultimately

> Behaviour depends not on reality but on how reality is perceived and interpreted […] Substantive ideas held by top policy makers and advisers [are] decisive or necessary elements of explanation. The core claim of this cognitive approach is that changes in reigning ideas help produce changes in policy content (Odell 1982:58).

Following this same cognitive logic, and considering the two contesting hypotheses (the euro-optimist and the euro-sceptical) presented in the previous chapter, the methodological framework that I have used when collecting evidence in the three case study regions falls broadly under what George and Bennet (2004) describe as 'theory testing' through case study research. Concretely, the main method that I have used to understand how key policymakers and financial elites in the three case study regions cognitively perceive the reality of the IMS was semi-structured elite interviews with subsequent interpretative coding (Dexter 2006; Aberbach & Rockman 2002). The aim has been to identify empirically, through qualitative and interpretive methods, which of the two contending theoretical approaches in the euro vs. dollar debate provides more accurate answers to the question of whether the euro is challenging the dollar as the main international currency. The collection of evidence to evaluate these hypotheses, however, has driven me beyond the narrow scope of testing established theories into the realm of new 'theory development' (George & Bennet 2004). As will be explained in detail in chapter 6, the empirical findings collected point to certain ideational effects of the euro that hitherto have been widely overlooked by the literature. The gradual, if not complete, consolidation of EMU as a transnational monetary-sovereignty-sharing framework that enhances regional economic and political integration and the consequent consolidation of the euro as the second most used currency in the world, have had a major impact on how the financial elites of the three case study regions subjectively relate to the possibility of establishing greater monetary cooperation in their own regions, the internationalisation of their own sovereign currencies and the reconfiguration of the IMS. In this regard, my research calls for the reframing of the euro vs. dollar debate by considering not only material but also ideational aspects.

3.3.2 Semi-Structured Financial Elite Interviews

The core of the material that will be presented in the next chapters comes from 76 semi-structured financial elite interviews (Dexter 2006) undertaken during the summer of 2008 in Brazil, the spring of 2009 in China and the winter/spring of 2010 in Saudi Arabia and UAE, the two leading economies of the GCC.[54] It needs to be noted here that the research in Brazil has been less comprehensive than in China and the GCC. I believe that the perceptions of the financial elites of the latter two play a bigger systemic role in the IMS and therefore more attention has been dedicated to them. Nonetheless, the views of the Brazilian elites serve to support the overall argument. The full list of interviewees is available in the appendix. Further material was obtained in and outside the fieldwork during informal conversations, seminars and conferences, and through detailed local and international media analysis which provided essential background information. In addition, before undertaking the three fieldwork trips, a number of exploratory interviews were conducted in spring 2008 with currency traders (especially those focused on the case study regions) from the FX division of HSBC Bank in London, one of the leading FX desks in the world. Since the literature has hitherto failed to cover how financial elites in China, Brazil and the GCC assess the euro challenge to the dollar and its impact in the reconfiguration of the IMS, most of the evidential triangulation is based on journalistic accounts, some official documents (when available) and intra-corroboration between different interviewees. The secondary literature has been used to contextualise and corroborate the findings and analyse them on a more theoretical and abstract level. It is here important to stress that the aim of this research was not to discover the final and uncontested perceptions of Chinese, GCC and Brazilian financial elites as a whole about the future of the dollar and the possible challenge of the euro. The number of interviews and the qualitative nature of this study do not provide the necessary base to reach such a conclusive assessment. The objective is rather exploratory and the interviews indicative. The task here is to show how a certain number of key financial elites of these three case study regions perceive and

[54] The three fieldwork trips cover quite neatly the evolution of the current financial crises in its different phases. In 2008, when I was in Brazil, the EZ was generally perceived to be resilient to the crisis. In 2009, when I was in China, some of the debt problems in the periphery of the EZ were already on the horizon. In 2010, when I was in the GCC, the Greek debt crisis and the possible break up of EMU was the main topic of discussion. The interviews include thus both contexts of euro strength and euro weakness.

answer the research questions stated above. General themes will be put forward in the next chapters to summarise the research results, but the reader needs to be aware that these findings, and the more abstract analysis that will be offered upon them, are limited to the reduced research universe outlined.

Financial elites have been defined for the purposes of this study as 1) senior officials in the ministries of finance, central banks and their associated foreign reserve management agencies, sovereign wealth funds and public development banks; 2) senior executives in the biggest private or public-owned commercial banks; and 3) senior members of think tanks, universities, research institutes and specialised press whose main area of expertise is finance and money. The first group is of great importance because these are the policymakers that ultimately decide the management of the foreign reserves and the monetary policy of their respective countries. The second group is relevant because these executives are very influential in determining where the private sector of their countries will place their international investments. Even if they are not influential in some of these decisions, they will always have a vantage point as to where and in what currency these investments are allocated. These executives are also sometimes advisers to the government of their countries. The third group, despite its secondary nature, is also important because members of think tanks, universities and media form the wider 'epistemic community' (Adler 1997) of these countries that can shape general social perceptions, attitudes and investment decisions and any monetary policy that can emanate from this communal cognitive evolution. In some instances, some representatives of this latter group are also advisers to the government; therefore they can be considered primary sources.

3.3.3 Access to the Financial Elites

Given the sensitivity of the topic, most of the government and banking officials interviewed asked for anonymity, thus their names and positions will not be disclosed in the main text or in the interviewee list in the appendix. Nonetheless, in order to prove the reach and depth of this study, the list discloses all the institutions that have at least provided one participant to this research. The offering of full academic confidentiality has been a decisive factor in accessing policymakers and banking executives. This has been especially the case in China and Saudi Arabia, where public and private financial elites are not used to being openly interviewed by researchers. The tools and strategies used to access the elites have been different in the three case study regions. In Brazil the fieldwork was easier and thus I would describe it as of open access. By being fluent in Portuguese, I was able to reach the elites through e-mail and/or phone, and in a relatively short amount of time, set a meeting day for the interview. In China, by contrast, I would never have reached policymakers and senior banking officials without the help of the Institute of World Economics and Politics (IWEP) at the Chinese Academy of Social Sciences (CASS) in Beijing, where I was a visiting scholar for three months. In China access is heavily reliant on gatekeepers with the necessary networking influence to open the doors of targeted interviewees. Without such gatekeepers it is extremely difficult to access financial elites. Finally, in the GCC the main strategy was networking in order to produce a snowball effect. In both Saudi Arabia and UAE, once I started interviewing some elites they directed me to other elites. However, it needs to be said that in Saudi Arabia fieldwork research is more difficult than in the UAE. First of all, similarly to China, for Saudi Arabia it is necessary to obtain a formal invitation from a research institute (in my case the Business College of Alfaisal University in Riyadh where I was also a visiting scholar for two months) to enter the country as a researcher. Secondly, once in the country any researcher is advised to be patient as well as tenacious in obtaining consent from the local financial elites for the interviews. The time span between the first contact and the interview (if it takes place at all) is usually longer in Saudi Arabia than in UAE, where most of the financial elites are expatriates, usually keener to be interviewed.

3.3.4 Acquiring the Interview Material

Once the elites agreed to be interviewed, the conversations were usually insightful and friendly. None of the interviews lasted less than 30 minutes. In most cases the duration was around one hour or more. Some interviews lasted even a few hours (one interview with a Chinese banker set the record with five hours!) which means that in general the interviews were sufficiently in-depth to grasp the subjective perceptions on the dollar, the euro and the future of the IMS. A large number of interviews were tape-recorded after asking for consent. This happened especially in Brazil, to a lesser extent in UAE and to a more reduced level in Saudi Arabia. In China recording was strongly discouraged by my gatekeepers, who explained that it was not commonly accepted and could put off my interviewees, especially those participating under academic confidentiality. In all the cases when recording was not allowed, I took notes during the interview and after that I went straight to the computer to upload the content of the conversation in as much detail as possible while the information was still fresh in my head. The coding process through the NVivo software would then occur at a later stage.

In Brazil the interviews were conducted in Portuguese, while in China, Saudi Arabia and the UAE in English, except one interview with a Chinese banker who needed the assistance of an interpreter. It is to be said here that my lack of command of Chinese and Arabic has constrained my universe of participants largely to those with fluency in English and therefore more exposed to Western media, knowledge and in many cases Western education. It is unclear whether this bias has distorted the results of my research in any particular direction. Only a similar study conducted by fluent Chinese and Arabic speakers would be able to shed some light on this issue. Another bias in the answers could be my European identity. It can be argued that the interviewees could have been inclined to speak more positively about the euro considering that they sat in front of a European researcher. However, in light of the critiques that most of these elites directed to EMU when comparing it to the US, I believe that, if existent, this bias was rather minor. Finally, there is also a temporal bias in my data collection. Most of the interviews were conducted before the EZ sovereign crisis reached its peak. To reduce this bias, I have tried to triangulate further my results with more updated evidence and I have remained in touch, especially with my Chinese gatekeepers, in order to identify whether there had been a radical change in attitude towards the EZ.

3.4. Summary

By establishing the conceptual and methodological foundations of this thesis, the main aim of this chapter has been to connect the previous chapter, which provides a comprehensive review of the literature, with the empirical chapters to be presented below. The first part has been dedicated to define key concepts in the overall unfolding of the argument of this thesis. These concepts are: money, monetary power, ideas in times of Knightian uncertainty and international monetary governance. This conceptual framework is important to understand the interconnection between the material and ideational elements in the governance of the IMS. It is impossible to explain the resilience of a monetary framework as crises prone as the FDS without understanding its political, military and ideological underpinnings. This system has mostly benefited countries with structural current account deficits, primarily the US, the hegemon in the system, and the financial industry linked to Wall Street. The global financial crisis, however, has shaken the foundations of this system. The current context of Knightian uncertainty has the potential to trigger systemic change in the configuration of the IMS. The governance of the IMS is again ready to be reshuffled. Does this mean that the euro will topple the dollar at the top? As will be demonstrated subsequently, the answer is a clear no. If we understand money from a nominalist angle based on credit and state theories of money, as Ingham does, and monetary power from a structural perspective, as Strange advocates, then it becomes clear why the euro project is still seen with uncertainty by international investors. As long as there is no politically legitimised authority with the capacity to guarantee the long term success of EMU these doubts will remain. This does not mean that EMU has not provided EZ member states with more monetary power. The ideational influence of EMU as a blueprint should therefore not be underestimated. Against the backdrop of a loose global monetary governance structure, characterised by a dysfunctional FDS without a clearly defined leader, the idea of establishing a system where a certain degree of monetary sovereignty is shared both at a regional and at a global level is gaining appeal.

How all this structural configuration impacts in the minds of financial elites in systemically important emerging markets such as Brazil, China and the GCC and how they might react to this material reality, is what a constructivist approach like the one developed by this thesis tries to reveal. Brazil is important here because it is one of the largest holders of foreign reserve, it is the economic powerhouse of Latin America and it is one of the most active BRICS countries in the reconfiguration of the IMS. China, on its part, is systemically important because it is the biggest creditor of the

US and it is gradually rising as its biggest economic and political rival. Finally, the GCC region is of great significance for the future of the IMS because it is the main supplier of oil and consequently the second largest holder of foreign reserves. The invoice of oil in dollars remains one of the most important pillars of US hegemony in monetary affairs.

The last part of this chapter presents the rationale for using qualitative methods such as in-depth, semi-structured financial elite interviews, and evidential triangulation through multiple secondary sources, to understand how the IMS is perceived and analysed in the main capitals of the aforementioned case study regions, some of them not easily accessible for academics in financial matters such as Beijing and Riyadh. The ultimate aim of this thesis is to find out how financial elites, from large foreign reserve holding regions, interpret the position of the dollar in the system, the potential euro challenge, and consequently the future configuration of the IMS. While taking into consideration structural factors, the focus is here on concrete agents and how these agents understand reality. As Blyth (2002:34) suggests, “what is critically important in understanding agents’ behaviours are the ideas held by agents, not their structurally derived interests”. This is so because their interests derive from how they interpret the structures that surround them, hence from the ideas that they generate by engaging with these same material structures. So far the literature has tried to predict the behaviour of key financial agents in Brazil, China and the GCC based on structurally conceived assumptions. In subsequent chapters I will focus on their behaviour based on their cognitively generated ideas.

Chapter 4: Constructing the Material Limits of the Euro Challenge to the Dollar

After introducing in Chapter 2 the literature review, and in Chapter 3 the main conceptual and methodological underpinnings of this thesis, this is the first chapter dedicated to present the empirical research results obtained by examining the case studies of China, the GCC and Brazil. Its aim is to show what have been hitherto the main inroads of the euro vis-à-vis the dollar. It presents the material limits of the euro challenge to the dollar in the three case study regions. It is important to stress that the emphasis here is on the tangible elements because the more intangible impact of the euro will be covered in Chapter 6. This separation is done for analytical purposes, acknowledging the fact that ontologically the material and ideational are co-constituted. The chapter is divided in four parts. The first focuses on the achievements of the euro in becoming an effective diversification alternative, while the other three concentrate on its main structural limitations in challenging the greenback. As the first section demonstrates, the European currency has become an attractive diversification tool in investment portfolios and international trade invoice, especially in periods of dollar depreciation. On the basis of this success, European importers and exporters are increasingly able to impose their currency pricing power in trade transactions. However, the euro is still far away from challenging the dollar. From a market point of view (see Chapter 2, pp.46-61), the incumbency advantage of the American currency is still very strong. Factors such as inertia in international trade and investment; the sophistication and depth of US financial markets; and the perceived dynamism and pro-growth business environment of the US economy, are all helping the greenback to maintain its privileged position. Politically, the EZ also has the disadvantage that it is a monetary union without a fiscal union (see Chapter 3, pp.83-9 for a conceptual discussion). This is an asymmetry that needs to be overcome not only to see the euro challenging the dollar, but, more crucially, to secure its survival as a currency. Until this shortcoming is solved there will always be doubts about the long term viability of EMU. However, faced with the question of whether the EZ will integrate further or break up, most participants in this research would predict the former. These ideational subjective perceptions have been corroborated by some of the actions of their countries. In the midst of the EZ periphery sovereign debt crisis, the international investor who has shown most confidence in the future of the euro has been the Chinese state, which has purchased debt bonds from EZ countries with financial difficulties. This crucial support by a big player such as China has in turn convinced other investors to maintain their faith in the single currency. But even if the euro comes out of this crisis stronger, there is still a final weakness that will remain. Unlike the dollar, the euro has no military might behind it to promote and secure its use. For a number of interviewees, the issuer of the international currency has usually been the military superpower of the time. This is a point stressed by Strange (see Chapter 3, p.89). Despite some minor evolutions in this regard, the EZ has shown its unwillingness to challenge the US in the military realm. Until this is the case, the euro is very likely to remain a neutral international currency in Helleiner's typology (see Chapter 2, p.64). The limits of the euro are separated here in market, political and military factors. This is done for analytical reasons. However, it is important to note that these shortcomings are intertwined. Depending upon the particular case study region, sector or agent, one might weigh more than the others but all of them play a part in hindering the euro challenging the dollar.

4.1 The Inroads of the Euro as a Diversification Tool

4.1.1 The Euro as an Alternative Store of Value

From the early days of EMU, the emergence of the euro as a potential challenger to the dollar was greeted favourably by investors around the world. This is especially true for the Chinese government. In 1999, year of the launch of the single currency, the Foreign Minister of China, Tang Jiaxuan, stated: "We believe that the birth of the euro will help advance the process of European integration and establish a more balanced international financial and monetary system" (Tang 1999). Chinese policymakers were never completely satisfied with dollar unipolarity in monetary affairs and thus they welcomed the euro as a counter-balancing project with the potential to help them diversify their national savings in different currencies. For them, the euro would bring more choice and therefore more stability to the system. This belief was widely shared in East Asia, as Xu Mingqi notes:

> Generally speaking, East Asians were not as sceptical as Americans when the EU embarked on […] the euro. East Asians welcomed the euro basically for

> two reasons: the first was that it would be more convenient and efficient for them to do business and travel around the EU countries with a single, unified currency; and the second was the hope that the euro, backed by the EU's economic size and strength would eventually become an alternative choice of international currency vis-à-vis the US Dollar (Xu 2007:273).

This interpretation has been reinforced in subsequent years. In 2002, when the euro was physically launched, Xiang Huaicheng, the Chinese Minister of Finance, called for more diversification into the euro by saying: "It's better to put all our eggs in varied baskets rather than a single one. I might suggest to my colleagues in other government departments to buy more euros. Obviously the euro is getting stronger these days…no one will doubt the success of the euro" (MoCoC 2002). In 2005, the Chinese Prime Minister, Wen Jiabao, continued saying that a successful euro would bring a more stable system and thus China would "support the role of the euro in maintaining international financial stability" (Wen 2005). During the same period the governor of the People's Bank of China (PBoC), Zhou Xiaochuan, declared: "We have long attached importance to the holding of a certain amount of euro assets" (*Xinhua* 2005), indicating that Chinese FX reserves should be invested in different currencies other than the dollar to avoid exchange rate risks. As was explained in Chapter 2 (p.48), diversification is an important factor in foreign reserve management.

The importance of the euro as a diversification instrument against dollar depreciations has been confirmed by the interviews conducted throughout this research. A large majority of participants in China, but also in Brazil, UAE and Saudi Arabia highlight the fact that the euro has given them another choice in the allocation of their foreign investments, thus deepening the necessary portfolio diversification. As one official from a central bank other than the Chinese points out,

> The arrival of the euro at the end of the 1990s was greeted positively by both central banks and private investors because back then the dominance of the dollar was almost absolute. The German mark had certainly not the strength that the single currency has today and the yen has always been seen as a currency highly intervened by the Japanese government. The euro, instead, has become a free floating and convertible currency that acts efficiently as another international currency (Interview S-1).

Following this same train of thought, a participant in one of the biggest commercial banks in Brazil explains that today his clients have the perception that on its own the dollar is not good enough in the function of international store of value. In recent years there has been a diversification trend in several currencies other than the dollar, and logically because of the size of the EZ, the euro is seen as the best alternative to the greenback (Interview W-8 2008). An asset manager from a large private investment institution in Saudi Arabia agrees with this diversification strategy. Admitting that previously almost all of his managed wealth went to the US and was denominated in dollars, he recognises that it is bad to put all the investments in one country and one currency. He points to the fact that 'there is diversification in all types of financial instruments, so why not have diversification also in currencies'[55] (Interview Z-3 2010).

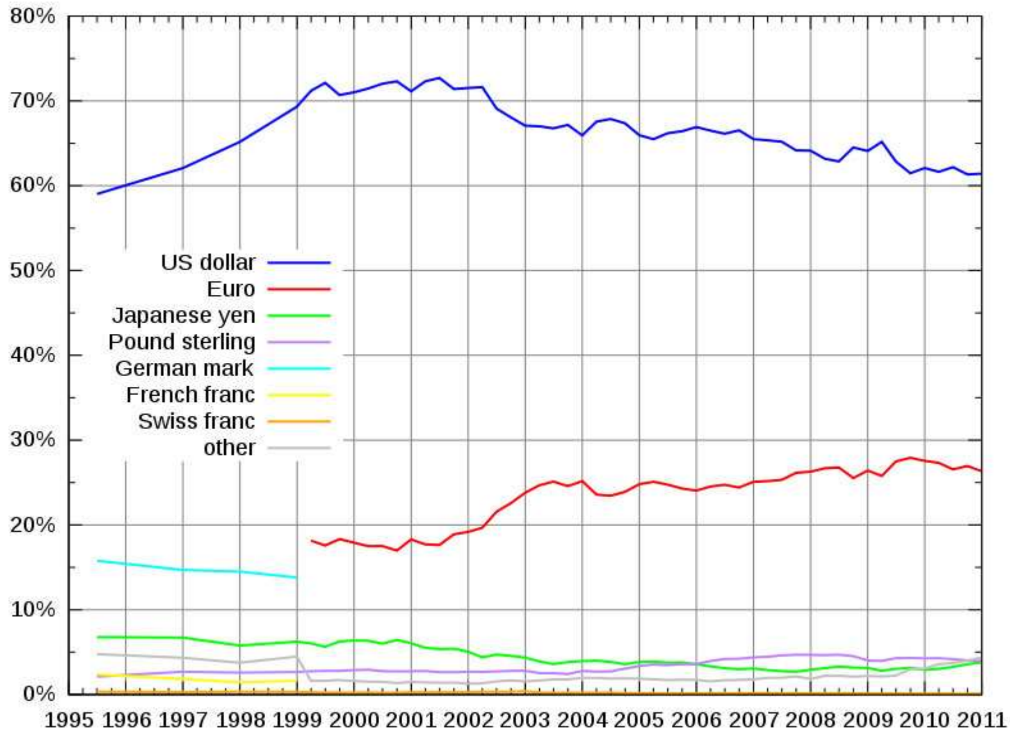
The euro scores well against the dollar especially among conservative investors given that the ECB has price stability as its sole mandate, unlike the FED which has both employment and price stability as its main objectives (Interviews Shi 2009; X-6 2009; X-12 2009; Y-9 2010). "The fact that the ECB is so determined to fight inflation is very attractive for those investors that want to put part of their wealth in a certain currency with the hope that this currency will increase in value", says Francisco Eduardo (2008), Professor of Economics at the Federal University of Rio de Janeiro and senior adviser to the Brazilian development bank BNDES. The Head of the FX division of one of the largest financial institutions in the GCC seconds this assessment. In his opinion, 'the euro is a very stable currency because it is managed by the ECB, the most independent central bank in the world which has acquired enormous credibility and reputation among market participants in recent years' (Interview Y-9 2010).[56] This credibility has been underpinned by a gradual increase since 1999 of the share of the euro from 18% to 27% in the foreign reserves of central

[55] Note that from now on in the quotes that come from interviews that have not been recorded, I use single inverted comas '…' to signify that I am paraphrasing the source. When the quotes have been recorded, I use the double inverted comas "…".

[56] The increased credibility of the ECB among market actors is also recognised by David Bloom, Head of the FX division of HSBC London, one of the leading FX desks in the world. In his opinion in the years leading to the financial crisis the credibility of the FED was highest, followed by the Bank of England (BOE), with the ECB in third position. However, during the crisis, the ECB overtook with its performance the BOE and even matched the FED in the hierarchy of world central banks as seen from the point of view of the markets (Bloom 2008).

banks around the world (see Figure 4.1 and Chapter 2, p.59). The appetite for euros is especially pronounced in emerging markets, including China, which is the biggest holder of reserves with over $3 trillion. This has been acknowledged by the deputy governor of the PBoC, Wu Xiaoling, by saying that "with the economic development of the European Union and the stability of the euro, the increasing proportion of euros in reserves of central banks is an inevitable trend" (*Xinhua* 2007a).

Figure 4.1: Global distribution of global foreign exchange reserves



Source: COFER, IMF (2011b)

China's currency distribution of foreign reserves is a state secret, nonetheless in an article published in the *China Securities Journal*, an official publication, unnamed managers from SAFE state that China's reserves are roughly similar to the global average. 65% are in US dollars, 26% in euros, 5% in British pounds and 3% in Japanese yen (*Reuters* 2010a). Estimations gathered through my interviews in China are in line with these figures (Interview X-12 2009; Interview X-19 2009).

The evidence that I have collected in the three case study regions suggests that the diversification benchmark for the euro in foreign investment portfolios hovers around 25-30% in the GCC and China but it is still considerably lower for Brazil, where the euro underperforms significantly in relation to its global average. Two recent investment reports, one from the biggest sovereign wealth fund in the world, the Abu Dhabi Investment Authority (ADIA), with an estimated portfolio of close to $800 billion (Truman 2007; Interview Y-9 2010), and the other from the Brazilian Central Bank (BCB 2010), which by the end of 2009 managed $240 billion, serve to illustrate this divergence. The report from ADIA establishes a regional investment benchmark for North America of 42.5%, for Europe of 30%, 15% for developed Asia and 17.5% for emerging markets (ADIA 2009). Further evidential triangulations through interviews in UAE corroborate ADIA's 30% benchmark for euro-denominated assets (Interview Y-9 2010). By contrast, the 2009 report from the BCB, which in recent years has lifted its secrecy on the currency distribution of its reserves, indicates that its portfolio is divided in: 81.9% US dollars, 7% euros, 3.7% British pounds, 3.5% Canadian dollars, 1.9% Australian dollars and 2% in other currencies such as the Japanese yen (BCB 2010). As can be seen, in both reports the euro is the second currency by some margin, but in the case of the BCB its diversification strategy is considerably lower. The explanation for this difference resides in the volume of reserves. When the reserves are higher than the minimum necessary to secure the financial stability of the country, diversification becomes more pronounced. This is the case for China and the GCC, which have foreign reserves in the trillions of dollars. In Brazil, by contrast, the foreign reserves have only recently topped the countries' private and public international liabilities, which are overwhelmingly denominated in dollars.[57] Therefore, the diversification trend has only started very recently, as recognised by the report. As Brazil continues to increase its foreign reserves through the projected export of large amounts of newly found oil, its sovereign wealth fund will have new benchmarks in foreign exchange allocation "favouring the euro", as acknowledged by Maria Celina Arraes (2009:161), an official at the BCB.

[57] The percentage of Euro-denominated Brazilian external debt reached just 6.1% in 2007 (Arraes 2009).

4.1.2 The Euro as an Alternative Currency in Trade Settlement

The consolidation and strength of the euro as a reliable international currency has not only had effects in the function of store of value. The European currency is also increasingly used as currency of trade settlement. As observed in Chapter 2 (p.58), there are no reliable data on international currency invoice, but anecdotal evidence suggests that in the past decade this trend was especially pronounced when the dollar went through phases of strong depreciation. In the second half of 2004, for instance, when the greenback experienced a steady slide and the European currency reached at the time the historic record of $1.36 (see Figure 4.2), exporters in Brazil started to invoice their products in euros. With the Brazilian Real strengthening much faster against the dollar than the euro, the settlement of contracts in the European currency was officially encouraged by the Brazilian state and by industrial agencies in different sectors. One of the most internationalised Brazilian banks, Banco do Brasil, which has strong links with the federal government, advised its customers to invoice their contracts in euros and started to offer hedging products in the European currency for those exporters that were still using the dollar in their contracts (ANBA 2005; RBCIN 2005).

Figure 4.2: Euro-Dollar Exchange Rate; 1999-2011 Q2

Source: ECB (2011a)

A similar trend was to be seen in China during another period of dollar weakness. In the first half of 2008 when the European currency reached an all time high of $1.5990 (see Figure 4.2) many Chinese manufacturers started to price their products in euros. Back then the Chinese RMB was appreciating strongly against the greenback and less against the euro, so the European currency became more attractive to avoid a further squeeze in the already small margins of Chinese manufacturers. A series of reports in the Chinese press of the time illustrate this diversification. Xue Kun, for example, a manager of a small food and machinery exporter from Beijing, was quoted saying: "We are probably facing the toughest time [referring to dollar weakness and yuan strength]… so we suggest shifting to the euro for our transactions because it is more stable" (*China Daily* 2008, brackets added). Similarly, Lu Jia, a sales manager from a leather manufacturer declared: "Starting clearing of euro transactions rather than the US dollar is not easy for my company [referring to path-dependency in the use of dollars in international trade], but it is still worth a try given a faster yuan rise this year" (*Xinhua* 2008, brackets added).

While trade settlement in euros is increasing during periods of dollar weakness, the same is true in reverse when the dollar gains in strength. Indeed, in the first half of 2010, when the euro depreciated considerably against the greenback due to the Greek debt crisis, reaching a bottom of $1.19 (see Figure 2), similar reports in the Chinese press would hint to a return to the dollar as the preferred invoice currency (Liu 2010; *Xinhua* 2010a). This indicates that the euro has certainly increased its appeal as a useful diversification currency for international settlements for Chinese manufacturers and it is likely to augment its share if the dollar goes through more phases of sudden depreciation, but until now local Chinese reports suggest that as much as 80% of Chinese exports are still denominated in dollars (*Xinhua* 2010a).

However, the remaining 20% is very likely to be mostly contracts in euros, especially considering that the EU absorbs roughly 20% of Chinese exports (see Chapter 3, p. 113). Through the consolidation of the euro as an international currency the Europeans seem to be able to do most of their trade in euros, above all when it comes to their exports (see data in Chapter 2, p.58). Again, anecdotal evidence collected during the fieldwork suggests that European exporters are increasingly able to impose their currency in their sales. This is especially true for European high-end luxury producers and high-quality machinery manufacturers. The greater the prestige and the market share of a brand, the bigger is the European exporter's currency pricing power. In this sense, a German multinational corporation such as Daimler is more likely to sell its Mercedes in euros than a medium-sized Spanish company which sells water fountains. The currency pricing power of the Europeans is especially visible in the GCC. Several statements by the Governor of the Central Bank of UAE, Sultan Bin Nasser Al Suwaidi, on currency invoice of GCC trade prove this. It is worthwhile reproducing at length his currency breakdown because it gives a unique insight, from a country that has in Dubai a trading hub, on how international trade is currently invoiced.

> The UAE imported goods worth 36% of all its imports from Asian emerging economies and 10% from USA and Canada and 4% from GCC countries; this is straight 50% of all imports, all denominated in US dollars. If we add Australia and New Zealand, Africa, other Arab countries and other countries; at least 70% of these countries' trade with the UAE were done using US dollars or a currency pegged to the US dollar. Japan exports (UAE imports) are 69.5% denominated in US dollar, as per Bank of Japan letter to myself. Also imports from the UK should be at least 50% denominated in US dollar. This leaves the Euro Area which represents only 20% of UAE imports, which could be purely denominated in a non-US dollar currency. On the other hand, about 70% of our exports are priced in US dollars, i.e. our oil and gas exports (Al Suwaidi 2006b).

Al Suwaidi's statement points to a number of trends. First of all, it reaffirms the dollar as the most used currency in international trade by an ample margin. Second, it shows that the EZ is the only region of the world, apart from the US, that is able to invoice most of its trade in its own currency. This relates to the autonomy concept explained in Chapter 3 (p.90). It is important to note that Al Suwaidi explicitly qualifies the percentage of invoice in dollars for Japan and the UK, but it does not so for the EZ. There is an implicit acknowledgement that imports from the EZ are predominantly denominated in euros. Interviews with participants in the biggest banks of the GCC corroborate this (Interview Y-16 2010; Gükkent 2010). Hedging activity against euro fluctuations is widespread in the region. In another speech Al Suwaidi ratifies this by saying: "As an outsider to the euro, the GCC countries must have economic reasons to hold euros, one of these reasons is to pay for the import bill" (Al Suwaidi 2006a). The third aspect noteworthy from the previous statement is that *only* 70% of UAE exports: i.e. oil and gas exports are priced in dollars. Given that these two commodities are internationally priced in dollars, one would imagine that a larger percentage of UAE exports would be denominated in dollars. What makes up for the remaining 30%? For Mohammad Ahmed Zubair, senior economist at the Islamic Development Bank (IDB), based in Jeddah, Saudi Arabia, the explanation lies in that the Europeans and other oil importers, but especially the Europeans, are buying bilaterally, outside of the international markets circuit, oil and gas from Saudi Arabia and other GCC countries in their own currencies. "The unit of account remains the dollar but the medium of exchange, thus the currency of settlement, is very likely to be mostly the euro considering the economic power of the EZ" (Zubair 2010). This explanation was later corroborated by a former senior government official of Saudi Arabia. He was unmistakably positive about the fact that European oil companies pay in euros when they buy oil directly from Saudi Arabia. For this same participant, the payment in euros is not only beneficial to the Europeans. Saudi Arabia itself is very keen to receive payments in different currencies, such as the euro or the Japanese yen, to diversify its portfolio (Interview Z-5 2010). This in turn would explain the 30% gap found in Al Suwaidi's statement.

4.2 The Market Shortcomings of the Euro

4.2.1 The Incumbency Advantage of the Dollar

The euro has certainly made significant inroads in reducing dollar unipolarity in international monetary affairs, but despite these achievements the evidence suggests that the European currency is still far from contesting the number one position of the greenback. One of the reasons, as explained in Chapter 2 (p.47), has to do with inertia. Once market participants are used to one particular international currency, it is difficult for them to change to a new one, unless, as seen above with the switch in trade invoice between dollars and euros, the incumbent currency underperforms considerably and the challenger provides a better alternative. But even then, as seen by the comments of the Chinese manufacturers, the switch might be difficult due to network externalities. The reality is that market agents in Brazil, China and the GCC have used the dollar as their international currency for several decades. As a Saudi participant, expert in financial matters puts it, ‘it is very difficult that a young currency like the euro, with just 11 years of history, can compete with a currency that has been around for more than a century’ (Interview Z-13 2010). The GCC is perhaps from the three regions the one where path-dependency is most obvious to the observer. Most of the interviewees in UAE, for instance, were expats in advisory positions calling for greater diversification out of the dollar based on economic considerations (see Chapter 5, p.172-6), while complaining about the local elites' reluctance to de-peg from the greenback. For others such as the chief economist of the National Bank of Abu Dhabi, Giyas Gökkent, an expat himself, the reliance on the peg is understandable. “It is an old policy of more than 30 years, it is a simple policy, and it has served this region well” (Gökkent 2010). Gökkent recognises that in 2008 there was a lot of talk about de-pegging because of high inflation, but that has now cooled-off and the policy has remained untouched (partly also because of political reasons as will be explained below). A financial journalist from a Dubai based newspaper does not see a greater move out of the dollar in the short to medium term either. She says that “something very big needs to happen to change that. The ruling elites, most of them from an older generation, do not have sophisticated financial expertise. That is why they have expats advising them about international investments and monetary policy. But even if the expats advise them to de-peg, as they sometimes do, they will not do it. They are very conservative with their money. They need to see first the wolf at the door step before they diversify aggressively out of the greenback” (Interview Y-6 2010).

Path-dependency also hampers the euro in Brazil and China. As in the case of the GCC, most Brazilian and Chinese foreign investment has gone to Wall Street and the US for decades. Thus it is difficult for the euro to change this overnight and divert suddenly most of the investment to the EZ, especially considering that the financial markets in Europe are still less sophisticated than in the US, and that to a large extent people still think that future growth projections are better for the US than the EZ. Here we can see how the ideational plays a fundamental role. Francisco Eduardo, from BNDES, says that the slow penetration of the euro in Brazil is explained by the fact that Brazilian business people are used to thinking in dollars because most transactions within Latin America and with other parts of the world such as Asia are conducted in dollars. In addition, "the Brazilian banking system has always operated out of the US for its international transactions. Brazilian banks have their accounts in Wall Street. They use the financial services provided by Wall Street. This is difficult to change" (Eduardo 2008). Senior managers at the biggest Brazilian commercial banks, while acknowledging that more customers are looking to diversify into the euro, say that this trend is marginal due to the incumbency advantage of the dollar, which is still culturally engrained (Interviews W-8 2008; W-9 2008; W-10 2008; W-11 2008). They point out that the dollar is still the reference currency in Brazilian international accounting and statistics, in the business media, in the stock exchange, in the futures market and in how treasury departments in companies assess and avoid risks. There is also the assumption that because of its flexibility the US economy will come out of the current crisis quicker and stronger than the EZ.[58] On top of that, as of late the Brazilian Real has become a reliable currency. "Brazilian investors are more confident in their currency, so even if the dollar weakens, there is not so much urgency as before in finding an alternative. The alternative is the Brazilian Real" (Interview W-9 2008), as will be discussed in Chapter 6 (p. 240).

Dollar path-dependency can also be found in China. Throughout most of the 20th century, especially in the first half, with long periods of hyperinflation, the dollar has been the international currency to store value in Chinese popular culture, from ordinary people to financial elites (Xie 2009). This is to some extent still the case today, principally when it comes to overseas wealth allocation and foreign investments. The dollar has certainly lost credibility in recent years among the Chinese, as will be shown in the next chapter, but the US economy in general and Wall Street in particular are still the target of most Chinese investment. The reason

[58] As of the time of writing (June 2011), both the US and the EZ are coming out of the 2007-2009 Great Recession with anaemic growth. Nonetheless, unemployment has hit considerably harder the US than the EZ. As Bernanke conceded in a recent speech at the ECB, "the US unemployment rate has stagnated for about eighteen months near 10 percent of the labour force, up from about 5 percent before the crisis, the increase of 5 percentage points in the US unemployment rate is roughly double that seen in the euro area" (Bernanke 2010:4). The IMF (2011a) growth projections for 2011 and 2012 are better for the US than for the EZ. IMF growth estimates for the US in 2011 are 2.8% and those for the EZ 1.6%. In the EZ Germany has shown very strong numbers throughout 2010 and 2011, but the EZ periphery has barely shown any growth, indicating a divergence between core and periphery in the EZ. Nonetheless, it has to be said that GDP per capita growth has been very similar in the EZ and the US over the last decade and growth divergences are also present between the different states in the US. See Trichet (2011b).

for that is explained graphically by a senior asset manager of one of China's biggest commercial banks, and by extension, one of the largest banks in the world by market capitalisation. This participant explains that the euro is not able to challenge the dollar because

> Wall Street is the deepest and broadest financial centre of the world. Only the future will tell whether the evolution of the financial markets will be stronger in the EU than in the US, but so far history speaks in favour of Wall Street. The US is the leader. It is the master. Europe, on the other hand, is just a pupil. As such, it has a lot of room for improvement, which means that the European financial markets have great potential to integrate further. Another question, though, is whether they will challenge the master. Hitherto they do not (Interview X-16 2009).

Apart from the structural financial power alluded to by this participant (and explained in Chapter 3, p.91), the US has another advantage vis-à-vis the EZ. 'It is one country, with one language, one business culture and one set of regulations', says Chen Xin (2009), senior researcher at the European Studies Institute of the Chinese Academy of Social Sciences (CASS), a governmental think-tank. Europe, by contrast, is fragmented in different markets with different languages, business cultures and legal frameworks. This is one of the reasons why traditionally Chinese businessmen felt more comfortable about doing business in the US. They did not understand Europe. It was just too complicated. But for Chen this is beginning to change. Chinese entrepreneurs have recently started to target more prominently Europe for their investments, and with that aim they have developed their language skills and know-how about Europe's heterogeneous business environments. Since 2009, with the eruption of the financial crisis in the EU, and with EZ countries, especially France and Germany, more inclined to drop their traditional reluctance to Chinese investments, the Chinese government has actively encouraged its business community to divert its investments to Europe (Chen 2009; *Economist* 2011b). With this objective it has started to send so called 'governmental purchasing teams' to different European countries to do the political work necessary to facilitate business.[59] On a more discreet

[59] The latest Chinese EZ 'purchasing delegations' were headed by Chinese premier minister Wen Jiabao and Chinese president Hu Jintao and targeted specifically debt-laden southern EZ countries such

strategy, the Chinese sovereign wealth fund China Investment Corporation (CIC), which manages around $300 billion, has also recently explored several investment opportunities in the EZ, including in the German car-maker giant Daimler, which has already sold a 9.1% stake of its business to International Petroleum Investment Company (IPIC), another sovereign wealth fund, this time from Abu Dhabi (*Reuters* 2009a). For Chen, this recent investment drive into Europe is facilitated by the EZ having a single currency. 'With the arrival of the euro, making business in both directions with the EZ has become much easier because there is no exchange rate volatility between the different European currencies as there was before' (Chen 2009). This is especially true for trade. Thus, "the EU is now China's leading partner in trade and exports, as well as the biggest source of imports and technology transfers, while China represents the EU's second-largest trading partner and fastest-growing, and most dynamic export market" (*China Daily* 2010a). The single currency is not the only factor that explains this trend, but for Chen and for many other participants, it is certainly an important one.

4.2.2 Insufficient Liquidity in the Euro Debt Markets

While the single currency facilitates trade between Europe and the rest of the world, and while it increases the attractiveness of the EZ as a recipient of foreign investment, especially if EZ countries keep lowering their restrictions to inflows of foreign capital, there is still a major obstacle that hinders the euro's ability to compete with the dollar. The European currency still lacks a single public debt market as deep and broad as the US treasury market, hitherto the most attractive market to allocate vast stocks of foreign reserves. A number of key participants in all three case study regions declared that they would like to diversify further into the euro, but unfortunately there is not enough liquidity (an essential factor to become the top international currency, as seen in Chapter 2, p.45-9) in the European government debt markets to absorb all this new investment (Interviews W-10 2008; X-3 2009; X-12 2009; S-11 2010). From the interview sample of this research it can be argued then that Cohen's anti-growth bias (see Chapter 2, p.65) is not the major obstacle for the euro's challenge to the dollar.

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as Greece, Portugal, Italy and Spain, but also France which signed $20bn worth of contracts with China. See *China Daily* (2010b), *Economist* (2011a, 2011b), Li (2011).

Rather, it is the lack of depth and breadth in the European markets. Chinese officials, from different government agencies, stated that they would welcome a fully integrated pan-European debt market, because it would give them more options for diversification. By contrast, for the moment at least, the European sovereign debt markets are too small and fragmented (Interviews X-3 2009; X-12 2009; X-19 2009). One Chinese official lamented that, with trillions of dollars in reserves, China could not even move a small amount of its portfolio into the European markets because that 'would send European government debt yields to the floor and bond prices to the roof, while the consequent appreciation of the euro would seriously damage the European export industry and trigger diplomatic tensions' (Interview X-12 2009). Jamil Anderlini, the *Financial Times* correspondent in China, confirms that the Chinese government has been trying to diversify into the euro for several years now, especially when it comes to new incoming foreign reserve stocks, but "the euro is just too small for the amount of reserves that they accumulate every month" (Anderlini 2009). Ding Yifan, director of the Development and Research Centre, a think-tank sponsored by the Chinese State Council, comes to the same conclusion. For him, the euro is still weak in relation to the dollar because of liquidity problems. There is no European bond to match US treasury bonds. In his opinion, 'the Europeans should create a Eurobond. If they do so Chinese investors would be very happy to invest in this kind of instrument' (Ding 2009b).

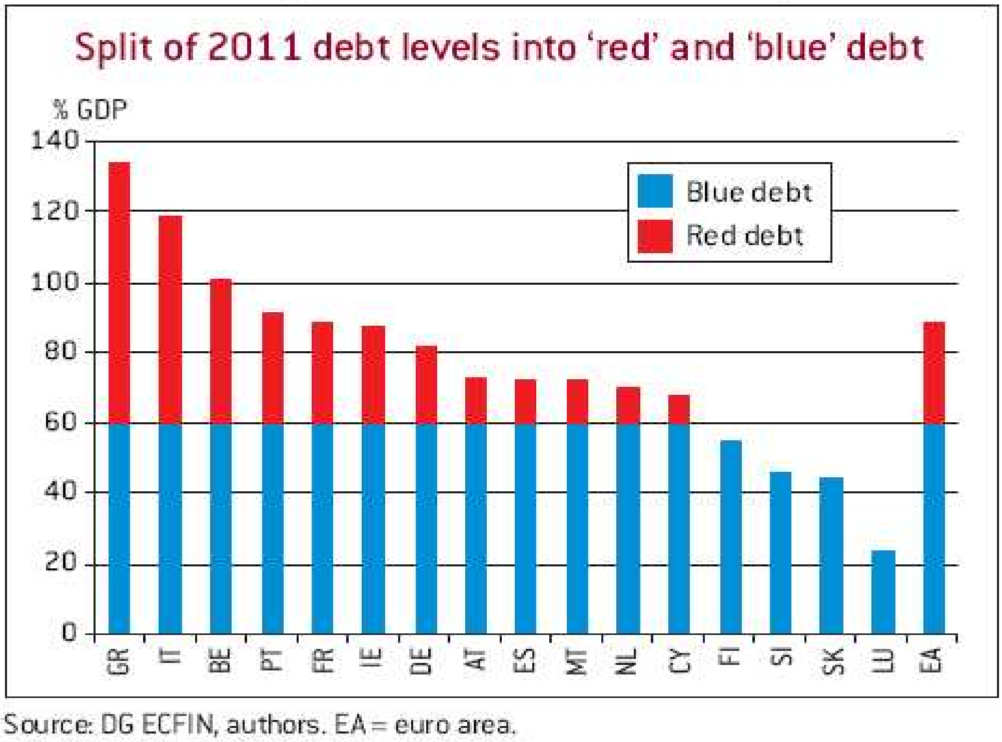
A participant from a commercial bank in Brazil points to the same problem. While his bank is keen to invest in European sovereign debt markets and has done so for decades, for this senior banker "it is always disturbing to deal in Europe with different transaction costs, regulations and risk premiums" (Interview W-10 2008). A similar response also comes from the GCC, both from the private and the public sector. The chief economist from one of the largest commercial banks in the region recognises that there is high demand for a pan-European bond. He explains that many of his local customers come to him asking to invest in pan-European debt only to discover that such an instrument does not exist. This is puzzling for them. 'They do not understand how the EZ can have a single currency, but when it comes to invest in it, they find that they have to deal with different fiscal policies, different markets and different regulations' (Interview Y-16 2010). Interviews conducted with officials from the central banks in the GCC have confirmed further the lack of liquidity in euro-denominated assets. In one particular case, one senior official disclosed that a few years back his bank had attempted to make a major move into the European currency, only to find out that it had moved the market so much that it had provoked a herding effect, discouraging the same official to continue the diversification operation (Interview S-11 2010). UAE central bank governor Sultan Al-Suwaidi's approach on the issue is here symptomatic of the shallowness of the euro markets. He speaks for other big investors worldwide when he says: "Can the Euro Area absorb large amounts of investment funds from GCC countries in a short period of time? […] The answer is … obviously, no" (Al-Suwaidi 2006b).[60]

The lack of liquidity in euros would change if the EZ member states would decide to issue a common debt instrument. The idea is not new for policymakers in Brussels. The first to call for the creation of a joint European debt bond was former President of the European Commission (EC) Jaques Delors who in his 1993 economic agenda (which preceded the Lisbon Agenda) saw in the Eurobond a good instrument to finance the EU budget and other pan-European projects designed to stimulate growth (*EurActive* 2010). The next EC president to propose the idea was Romano Prodi, who in 2000 commissioned a group of financial experts, led by Alberto Giovannini (2000), to write a special report aimed to explain in detail the technicalities of issuing common European bonds to attract foreign capital. The project, however, was rejected by the European Council, mainly due to German opposition (*EurActive* 2010). There is a clear majority of EZ member states that have favoured along the years the creation of a Eurobond, including France, Italy and Spain and Belgium. But the German government pays the lowest yields for its debt and therefore it is the least interested in jeopardising this privilege through a combined debt instrument. After this negative vote the idea remained forgotten in the drawers of the EC for almost a decade, but with the intensification of the debt crisis in the EZ periphery and the necessity to establish mechanisms to secure the financial stability of EMU, the idea was put again on the table by the President of the EU Council Herman Van Rompuy to the members of the special 'Task Force' created to establish a more integrated

[60] Coincidently, without giving any precise reference Momani (2008:307) states that "the UAE's Central Bank Governor announced in March 2006 that it would diversify 10 per cent of its foreign exchange holdings from dollars to euros". While this was in March, the above quote is from November 2006. It seems that in between these two announcements, there was a clear realisation within the UAE central bank that there was not enough liquidity in euro-denominated assets to switch large amounts of sums from dollars to euros.

economic governance structure in the EZ (Hönighaus 2010). The concrete proposal put forward is the 'Blue Bond' idea (see Figure 4.3) generated by Delpla and Weizsäcker (2010).

Figure 4.3: The 'Blue Bond' Eurobond proposal



Source: Delpla & Weizsäcker (2010)

According to this proposal, the combined issuing of European debt would only cover the less risky 60% of every country's debt-to-GDP ratio (the so called senior blue bonds), while the rest (the more risky, junior red bonds) would be issued by every country separately (see Figure 4.3). With this suggestion, which crucially maintains market discipline for profligate member states as desired by Berlin (Issing 2009), advocates of the Eurobond, among them the EU President Herman Van Rompuy and Jean-Claude Juncker (Juncker & Tremonti 2010), the current President of the Eurogroup,[61] hope that they can persuade Germany to embrace it. It is to be seen

[61] The current president of the European Commission, José Manuel Barroso, does also favour the issuing of Eurobonds. In his 'State of the Union' address delivered on 7 September 2010 he declared: "We should also explore new sources of financing for major European infrastructure projects…For instance, I will propose the establishment of EU project bonds, together with the European Investment Bank (EIB)" (*EurActive* 2010). The EIB has been issuing the equivalent of Eurobonds for some years

whether they will be successful. As of the time of writing the negotiations about the future structure of EMU and the necessity to issue Eurobonds are still ongoing.[62]

Notwithstanding the outcome of these negotiations, for many the €440 billion strong European Financial Stability Facility (EFSF) agreed in May 2010 to calm the European sovereign debt markets is already issuing a proto-Eurobond. During the negotiation process to set up the EFSF several EU diplomats would point in this direction. One EU official said: "The Rubicon has been crossed", referring to the fact that with the establishment of the EFSF the Germans had for the first time agreed to issue a combined pan-European borrowing instrument. Another EU diplomat would be even more straightforward in defining the EFSF: It is "a Eurobond in all but name". A third, who was involved in the negotiations, said: "In this case the bond issue from the entity [the EFSF] with the guarantee of 15 eurozone countries could be seen as Eurobonds" (Traynor 2010, all quotes in this paragraph). Even Juncker would fall short of denying this interpretation. He asked himself: "Can the vehicle we are going to put in place on Monday take us to the issuing of Eurobonds? If I said 'yes', then everything would be done to avoid the creation of this instrument", in a clear reference to German sensitivity to this particular topic but also clearly implying that the real answer to the question is: "yes" (Sinn 2011). Yet again we see here how *the idea* of a Eurobond could potentially become *reality* in the not too distant future.[63]

This development is significant because the temporary EFSF will become in 2013 the permanent European Stability Mechanism (ESM), which will have a €500 billion fund to cope with any future financial crisis in the EZ. Both the funding of the EFSF and the ESM will essentially mean that in the next years the EZ will issue large amounts of pan-European debt instruments. Ironically then, the current sovereign debt crisis might actually enhance the role of the euro as an international currency. As shown above, there is certainly high demand in Brazil, China and the GCC for European debt

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now (in 2009 the sum reached €79 billion) but the amounts are relatively small compared to the €4 trillion that Delpla estimates that the 'Blue Bond' proposal could generate (*EurActive* 2010).

[62] See the latest EuroUnionbond proposal by Prodi and Quadrio Curzio (2011).

[63] As of the time of writing, policymakers from EZ peripheral countries and large parts of the financial sector have increased their pressure on the German Chancellor, Angela Merkel, to agree to issue Eurobonds in order to put an end to the euro debt crisis. So far she has resisted this mounting pressure on the grounds that, for that to happen, the EZ needs to integrate further politically. See Milne (2011). It is worthwhile here noting that both opposition parties in Germany, the Social-Democrats (SPD) and the Greens have openly stated that they are in favour of issuing Eurobonds.

instruments with enough liquidity to compete with US treasury bonds. Mark Austen, managing director of the Association for Financial Markets in Europe (AFME), which represents 197 financial institutions, and has commissioned research on the subject (EPDA 2008; EPDA 2009), agrees with this diagnosis. For him, the creation of Eurobonds "would be more like Treasuries, which would be a big plus in terms of greater liquidity, attraction for overseas investors and lower funding costs" (Oakley 2010). He suggests that the lowering of yields would even apply for Germany due to the high demand for these bonds worldwide. This leaves only the elimination of the market discipline mechanism as a possible German stumbling block to the proposal (Sinn 2011). But for a Western economic adviser to the Government of UAE this should not be an obstacle either. He stresses that in the US there is issuance of federal debt, state debt and local debt, and the market disciplines every state according to its performance. California, for instance, now pays higher yields because it has mismanaged its budgets. The same would happen in Europe despite the creation of a Eurobond. For him a Eurobond would be a win-win situation. "It would give countries such as the UAE the opportunity to diversify further away from the dollar, while it would supply the EU with a needed source of funding for pan-European growth projects in two areas in particular: R+D and infrastructure" (Interview Y-7 2010).

At the time of writing the first 'Eurobond' debt instruments issued by the EFSF to finance the rescue packages of Greece, Ireland and Portugal have been met with great demand from international investors, especially from East Asia and the Middle East (Oakley 2011). This constitutes evidence in favour of my argument that, despite the current sovereign debt crisis in the periphery, there is great demand for combined EZ debt instruments in the emerging markets.

4.3 The Lack of a Political Union to Underpin the Euro

4.3.1 The Fragility of Having Monetary Union without Fiscal Union

The lack of a combined pan-European debt bond market is connected to a wider weakness of the EZ when compared to the US, that it is a monetary union without a fiscal union to support it. For a large majority of participants in all three case study regions, as long as EMU does not develop further fiscal coordination and even political union there will always be doubts about the future of the single currency, and consequently the euro will never be able to challenge the primacy of the greenback in monetary affairs. This assessment (which relates to Ingham's state theory of money, see Chapter 3, p.83) comes both from officials at the central banks and other government agencies, but also from executives at the commercial banks and other private or semi-private investors. The difficulty of managing a monetary union without fiscal coordination became only too evident during the financial crisis. When European financial institutions, several of them with transnational operations, were faced with insolvency problems, there was no pan-European fiscal authority to support them. The management of the crisis was first reduced to the national level with a lack of coordination among EZ member states (Pisani-Ferry & Sapir 2009). For an official at one of the central banks this highlights the difference between the dollar and the euro. 'The US is a federal state, with one united fiscal policy. The EZ, on other hand, despite having a European Central Bank with a united monetary policy, is formed by different sovereign member states, each with different fiscal policies, which, in occasions, can fall apart' (Interview S-1). Shen Minggao, chief economist of the Chinese business magazine *Caijing*, summarises well some of these concerns by indicating that the economic size of the EZ is comparable to that of the US, but the euro has still a long way to go to challenge the dollar. "This crisis has effectively shown the main weakness of the EZ. It is an economic area well integrated but it is still politically divided. The EZ has a central bank but not a central government. This creates a lot of uncertainties in the minds of people" (Shen 2009).

Even when EU member states try to make the effort to unite and confront challenges in a coordinated fashion, as was later the case once the financial crisis became more acute, for Jorge Chami, Economics Professor at the Federal University of Rio de Janeiro, "this process is normally slow, because it has to be built on protracted rounds of negotiations and consensus-building processes, embedded in a very bureaucratic framework. This is a feature that international investors dislike. They like quick and coordinated action" (Chami 2008). Yu Yongding, a prominent Chinese economist and former member of the Monetary Policy Committee of the PBoC, is also disappointed with how the Europeans confronted the crisis. He says that 'there has been a lack of political unity. There has not been a collective effort to overcome the crisis. Everything has been driven by national interests. There is a monetary union, but there is no unity in fiscal policies' (Yu 2009). Yu's words delivered in 2009 would be confirmed a year later when in spring 2010 the EZ had to confront the sovereign debt crisis in Greece. Despite the Greek financial situation spiralling out of control, with contagion effects spilling over to other EZ periphery states, and with the markets fearing an imminent collapse of EMU, EZ policymakers needed three months (from February until May 2010) of tortuous negotiations to agree the rescue package for Greece and the setting up of the EFSF. The entire process was mired in national parochialism with the German Chancellor Angela Merkel receiving much of the blame for sticking too closely to the 'no bail-out' clause of the Maastricht Treaty. Embarrassingly, in these crucial moments in the history of the euro, it was US policymakers who had to tell their European counterparts to take matters into their own hands. The wake up call came on 22 April 2010 in Washington DC in a G7 meeting of finance ministers. As disclosed by Alistair Darling, the UK chancellor at the time, the message from American policymakers was "why can't you take action? You know you've got to do something". For Darling, "you can't overstate the fact that America, with increasing incredulity and anxiety, was watching Europe's inability to act" (Barber 2010).

This same incredulity was apparent among GCC financial elites as these events were unfolding. German reluctance to help Greece was a surprise for many, but even a bigger shock was to hear that Germany was in favour of bringing in the IMF to solve the crisis. For a senior executive at a commercial bank in Saudi Arabia the idea of calling the IMF to solve the problems in the Union is a very negative outcome. For him this is a surprise since one would imagine that the Europeans would be able to sort out their own problems. 'If they cannot do so, then they are weak. The IMF is here to help developing countries not developed ones' (Interview Z-4 2010). As Münchau (2010a) explains, the IMF was called in because, unlike the EU, it has the experience, personnel and the instruments to provide emergency aid in an effective manner. Ultimately, this seems to have been the main reason why the IMF has been asked to participate both in the €110 billion Greek rescue package and the overall €750 billion worthy rescue fund (€440 from the EFSF, €60 from EC and €250 provided by the IMF), despite ECB opposition to the idea (Atkins et al. 2010).

However, Münchau also points to the same conclusion as the one presented above by the Saudi participant: "Advocates of an IMF-led bail-out conveniently ignore the disastrous signal that this would send to the financial markets about where the eurozone is heading in the future. It would demonstrate that the eurozone was incapable of sorting out its own problems" (Münchau 2010a).

For a number of participants interviewed during this time in the GCC region the involvement of the IMF undermines the credibility of the euro on a number of levels (Interviews Z-4 2010; Z-5 2010; Sfakianakis 2010; Tariq 2010; Zubair 2010). First, it shows that EMU is not as integrated as they thought it was. If EMU does not have internally the technical know-how and expertise and the supranational institutional framework necessary to deal with such a crisis, then the project is much less developed than they would have thought. Second, the presence of the IMF shows how Europe is still very dependent on the US, since the IMF is widely seen as an institution controlled by Washington. And, thirdly, and this is more related to US financial structural power (as explained in Chapter 3, p.91), this crisis has shown that the EZ is still vulnerable to Anglo-American financial speculation, largely seen as responsible for the sudden collapse in value of the euro during the crisis.[64] This line of thinking is shared by John Sfakianakis, chief economist of Banque Saudi Fransi and advisor to the Saudi Arabian Monetary Authority (the Saudi central bank) and the Ministry of Finance. For him, the Greek crisis has shown the structural limitations of the EZ vis-à-vis Anglo-Saxon speculation. If the euro wants to survive, the EZ will have to create a European Monetary Fund (EMF).[65] 'What is clear is that the IMF cannot co-decide EZ fiscal and monetary policy. This cannot be the solution in the long run. The EZ needs to strengthen its fiscal cooperation. It needs to move towards

[64] As mentioned in the previous chapter, the idea that Anglo-Saxon speculators were to blame for the collapse of the euro was widespread also in the EZ at the peak of the crisis. Newspapers in France, Spain, Greece and other countries would publish reports and editorials following this line of argument. They would also criticise newspapers like *The Economist*, the *Financial Times* and the *Wall Street Journal* for scaremongering against the euro. EZ policymakers would also blame Anglo-Saxon speculators for the misfortunes of the single currency. Spain and Greece went even so far as to ask their secret services to investigate possible market and media plots against the single currency (Pérez 2010). For a response to these accusations, see the editorial of the *WSJ* on 16 February 2010: 'European Conspiracy Theory' and *The Economist*'s Charlemagne blog entry of 6 February 2010: 'There is no conspiracy to kill the euro'. The Anglo-Saxon conspiracy theory gained increased momentum in the EZ after the *WSJ* published an article informing that a number of big hedge fund managers plotted during a dinner in Manhattan to bet against the euro (Pulliam et al. 2010).

[65] It is to note here that for a number of commentators the EFSF and the future EMS are a European Monetary Fund in all but name. See De Grauwe (2011). Essentially it follows, the European Monetary Fund idea developed by Gros and Mayer (2010).

a fiscal union. This is the only way the euro will be able to survive' (Sfakianakis 2010). A senior official at one of the GCC central banks agrees. For him 'the debt crisis in the EMU periphery is a real test for the Europeans. They have to establish the crisis management structures for the future. If the Europeans integrate further in relation to fiscal union, then the euro will slowly compete with the dollar in the medium to long term. If they do not, then a catastrophic scenario of a break-up cannot be ruled out' (Interview S-11 2010).

In this regard, it needs to be said that, as a consequence of the sovereign debt crisis, the EZ has enhanced and deepened its economic governance structures. Macroeconomic policy and supervision is now more coordinated through the 'European semester' and the European Systemic Risk Board (ESRB), and as mentioned, there is now a permanent European Stability Mechanism (ESM) to deal with future financial crises, which can be considered a de facto EMF. However, as De Grauwe (2011) points out, the ESM still gives too much leverage to the financial markets vis-à-vis debt-laden EZ periphery countries (see Chapter 3, p.87). The conditionalities and restrictions are too harsh to promote growth in these countries. Given these constraints, until the EZ decides to come up with a structure resembling a federal budget which allows for leaner fiscal transfers its fragility will persist.

4.3.2 The Ubiquitous Phantom of a Euro Break-Up

While lingering in the background since the creation of the euro, the likelihood of a possible break-up of the EZ has resurfaced with force during the current financial crisis, especially since it became obvious in early 2010 that Greece was unable to meet its debt obligations. Since then reports and open editorials hinting at the possibility of a break-up of EMU have been common place in the international financial media coming out of New York and London (Allen 2010; Harui 2010; Heaney 2010; Klaus 2010; Rachman 2010). For longstanding euro-sceptics, coincidently a large number of them based in the US and the UK, the fiscal troubles of the EZ periphery – which are still acute as of the time of writing – only prove that they were right about the structural shortcomings of the EZ project. As explained in Chapter 2 (p.46), for many of them the Achilles heel of EMU is that, in addition to not being an Optimum Currency Area (OCA), it is a currency union without the necessary federal fiscal budget to transfer funds from less hit to more financially troubled regions (Krugman 2010). For a number of commentators in the US and the UK the debt crisis in the EZ has reinforced their view that the euro has always been a bad idea with a finite duration (Brittan 2010).[66] Outspoken critics of the single currency across the Atlantic such as Martin Feldstein have gone even as far as to encourage Greece to unilaterally leave the single currency and take a temporary "holiday" from the EZ (Feldstein 2010).[67]

This rather pessimistic outlook on the euro contrasts with the beliefs put forward by the financial elites interviewed. The insights of the interviewees in China and the GCC are here particularly interesting because they were collected while the euro debt crisis was unfolding, unlike the interviews in Brazil which were conducted before the collapse of Lehman Brothers when the fate of the euro was not an issue. For an overwhelming majority of participants both in China and the GCC the likelihood of an EZ break-up is extremely remote. They would acknowledge that by not having a full-fledged fiscal union there will always be doubts about the project, and this in turn hinders the euro challenging the dollar, but a dismembering of the EZ is very unlikely in their opinion.[68] Some would even criticise Anglo-Saxon media, commentators and scholars for giving too much credit to this possibility. Tarik Yousef, dean of the Dubai School of Government and adviser to the Government of Dubai, says that "there have always been naysayers on the euro. These pessimists are very likely to remain pessimistic. But the euro is here to stay. Those that scaremonger are mostly Anglo-Saxons who are not in the EZ. Some of them [referring mainly to the British] need even to present a gloomy picture of the euro to justify why they are not in it" (Yousef 2010). Zhou Hong, director of the Institute of European Studies at CASS, strikes a similar cord. She denounces the scaremongering of American commentators as a US

[66] The pessimistic views on the euro by US economists in academia and the FED are thoroughly investigated by a European Commission paper by Jonung & Drea (2009) entitled: "The Euro: It can't happen. It's a bad idea. It won't last: US economists on the EMU, 1989-2002". A marked exception is Eichengreen (2007b; 2009; 2011a), who, as mentioned in chapter 3, represents the euro-optimist branch among US mainstream economists.

[67] For a European reaction to Feldstein's proposal, see Baldwin and Wyplosz (2010): "How to destroy the Eurozone: Feldstein's euro-holiday idea".

[68] As mentioned, while it can be argued that these interviews were taken before the crisis in the EZ periphery reached its peak, I have tried to follow the debates in China very closely since then and the general view remains bullish on the survival of the euro. This is confirmed by a recent study on the future of the EZ conducted by the Japanese investment bank Nomura (2011).

strategy to split the Europeans in order to weaken them. For her, ‘the same strategy is also used for China. The US would like to see China split in seven parts, but this is unlikely to happen’ (Zhou H. 2010). In the current context of Knightian uncertainty about the future of the EZ (see Chapter 3, p.96), the differences in perceptions and interpretations between American analysts and the Chinese financial elites are quite stark. This is evident when considering the views of Michael Pettis, Professor of International Finance at Peking University and one of the most influential American experts on China. For him the euro will have the same destiny as other currency unions such as the Latin monetary union built around the French franc in the 19th century. “The historic record shows that currency unions are created when there is a cycle of liquidity expansion, as seen in the past decade, but when this ends and there is a contraction of liquidity, as is shown by the current crisis, monetary unions tend to collapse” (Pettis 2009a). Having this in mind, Pettis is quite pessimistic about EMU. In his opinion, Italy and Spain will soon be unwilling to bear the pain of adjustment and consequently they will embrace the possibility to debase their debts by leaving the euro and introducing their own currencies.

By contrast, most financial elites in China would disagree with Pettis’ predictions. They think that leaving the euro would be too costly economically and politically for any country in the EZ. Besides, they are convinced (here is where ideas take a central role) that the Europeans will deepen their integration process because this is the only way that they can maintain their influence in the world. For a lot of these elites it comes down to a survival instinct (Interviews X-6 2009; X-12 2009; X-19 2009; X-28 2009). The Europeans will realise that they can only survive if they integrate further, if they split up, they will perish. The influential Yu Yongding summarises well the general impression of the Chinese financial elites on the future of the single currency. In his view there are two possible options: the EZ integrates further and creates common economic governance or it goes backwards and the union disintegrates. Acknowledging the gloomy perspectives put forward by euro-sceptics such as Pettis, he stresses that there is nothing inevitable in life. ‘History shows us that monetary unions are very fragile in times of crises. This is true. But history is only good to explain history, not to explain the future’ (Yu 2009). This optimistic take on the euro coincides with the research results on Chinese perceptions of the EU by Zhu Liqun, a Chinese IR scholar. She also finds that the “Chinese are optimists and like to believe that ‘the road is tortuous, but the future is bright’” when it comes to describing European integration, which they see as “irreversible” (Zhu 2008:150-1). Ultimately, Chinese confidence in the euro is derived from what China scholar Shambaugh (2008:128) calls ‘cognitive dissonance’, which is “the natural proclivity to selectively look for confirmation of one’s pre-existing beliefs and to reject evidence that contradicts these beliefs”. Chinese financial elites (and this is also applicable to some extent to Brazilian financial elites) dismiss the idea of a euro break-up because they believe in the construction of a multi-polar world order out of US hegemony (Belluzzo 2008; Rebelo 2008; Xue 2009; Yu 2009). In this ideal scenario they want to see a strong, united and independent EU pole with enough strength to act as a counterbalance to the US. The euro is the vivid representation of this, and therefore the possibility of its demise is rejected.

However, Chinese policymakers’ optimism on the future of the euro is not limited to the realm of perceptions. Their ideational interpretations are reflected in their material actions. This is where the ideational and the material converge. Some of the recent brightness of the euro is partly due to Chinese confidence in the long term consolidation of the single currency (the relation between confidence and money is explained in Chapter 3, p.83). One of the most critical moments in the 12 years of euro history came on the 26 May 2010 in the midst of the Greek debt crisis when a report by the *Financial Times* disclosed that China’s SAFE was “reviewing its holdings of eurozone debt in the wake of the crisis” (Oakley & Anderlini 2010). At that moment, the EFSF rescue package had finally been agreed but the euro was continuing in freefall approaching the $1.20 mark (See Figure 4.2). Once the *FT* report was published, the reaction of the markets was imminent and the single currency plunged another 1.5%, nearing a four-year low against the greenback. Confidence in the euro was vanishing. However, in what can only be interpreted as a coordinated rescue action, the Chinese government stepped in and stabilised the value of the euro in a decisive moment. Only hours after the *FT* report was published, in an unusual statement for its uniqueness in responding to media rumours (Li et al. 2010), SAFE labelled the report as “groundless” and stressed that as a “responsible long-term investor and, under the principle of maintaining diversified investments, Europe has been and will continue to be one of the major markets for investing China’s exchange reserves” (Anderlini & Oakley 2010). To eliminate any shadow of doubt, the same day the president of CIC would also come out publicly in defence of the single currency by saying that "CIC will keep its investment level in Europe, no more, no less. Short term fluctuations won't bring serious effect on us" (Anderlini & Oakley 2010). Chinese official euro-support did not stop there. Just a few days later, the president of another big Chinese investment fund, the National Social Security Fund, Dai Xianglong, would also back the single currency against speculative attacks by saying that the EZ's sovereign debt crisis was only temporary and that the more long term worry was "future turbulence in the dollar as a result of widening deficits in the US" (Dennis 2010). The Chinese strategy to help the euro did finally work. The single currency reached a bottom of $1.1942 on the 8 June 2010 and it bounced back to over $1.30 less than a month later. Since then China has openly shown its support to the single currency, verbally and by buying bonds from the countries in the EZ periphery. In July 2010 it made a $1bn offer to buy Spanish debt (Oakley & Sakoui 2010), in August 2010 Yu Yongding, speaking informally on behalf of the PBoC, declared that his nation had bought "quite a lot" of European bonds (Zachariahs & Harui 2010), and in October 2010 China invested first in Greek (*Handelsblatt* 2010) and then in Portuguese debt (Wise 2010).

These purchases of European bonds in a time when a number of EZ periphery countries are struggling to finance their debts point to several trends. First, they show how Chinese optimism on the future outlook of the euro can easily be transformed from subjective perceptions to actual investments with real long term material impact. As a case in point, George Soros, a big investor in the FX market, who during the crisis was betting against the euro, declared that the Chinese government actually "saved the euro" (White 2010).[69] Second, as explained above, China is very keen to diversify as much as it can out of the dollar. The issuance of more euro-denominated debt is therefore seen as a good opportunity. And, thirdly, by supporting the euro and the EZ in a moment of crisis, the Chinese government is seeking to augment its

[69] In an interview to *Reuters* George Soros declared that "once it was discovered that China was a buyer, the euro jumped from its value of $1.20 to $1.30". After this move, Soros' perceptions on the future of the euro changed. Before, the possibility of a break up of the euro was in his mind (Allen 2010) but after "China had a role to play in its survival", his opinion changed to a more optimist outlook on the integrity of the EZ (White 2010; *Reuters* 2010c). Soros was reported to have been in the dinner of Hedge Fund managers who decided in February 2010 to bet against the euro (Pulliam et al. 2010). It seems that Soros has changed his faith on the euro after being "burned" by China's euro-support strategy. His comments hint in that direction.

political influence in Europe and gain the Europeans as allies in monetary governance disputes. This was proven by a subsequent meeting between the Chinese Prime Minister Wen Jiabao and the euro-troika officials. Unlike on other occasions when the main theme was the appreciation of the RMB, as demanded for some time by the US and the EZ, this time ECB president Trichet and his colleagues had to perform a balancing act between their demands and their explicit gratitude for China's "confidence in sovereign treasuries in Europe" (Grajewski & Taylor 2010).

Interestingly, China's support for the euro was also acknowledged by senior executives at several commercial banks in Saudi Arabia (Interviews Z-4 2010; Z-15 2010). While making clear that the euro will not be able to compete with the dollar until the Europeans create a united treasury, they would discard the option of a break-up. Their confidence in the future of the euro is partly based on the idea that Germany and France have invested a lot in the EMU project to let it fail, but also on the feeling that China will stand behind EMU. In the midst of the debt crisis, one senior banker would declare that in his opinion 'the Americans would see with good eyes the break-up of the euro, so would the British, but the Chinese are diversifying into the euro. They will support it. They will use this opportunity to diversify further. They have done so for a while and they will continue to do so' (Interview Z-4 2010). A few months later his words would be proven right.

4.4 Europe's Unwillingness to Become a Military Superpower

4.4.1 US Military Dominance in East Asia and South America

While the shortage of political integration in Europe explains why the euro is not capable of threatening the primacy of the dollar yet, another key factor is the lack of European military ambitions (Cafruny & Ryner 2007). History shows that the issuer of the international currency is normally the military power of the time. As Ingham (2004, 2006) points out, the long term endurance of a monetary space cannot be understood without making reference to the political authority which underpins it, if it need be, through violent means. This is also valid today for the US. As shown in Chapter 2 (p.70) and elaborated further in Chapter 3 (p.89), there is a longstanding tradition in IPE, going back to Strange, to link the issuance of the international currency with military might. This linkage has also come to the forefront during my fieldwork research in Brazil, China and the GCC. Here it is helpful to separate Brazil and China from the GCC. While the first two see themselves as regional leaders increasingly able to challenge US military power in their regional spheres of influence, the GCC countries do not hide their dependence on US military protection in confronting the threat of Iran. This in turn means that military aspects have greater influence in the use of the dollar in the GCC than in China and Brazil. Nonetheless, several interviewees both in China and Brazil would mention geopolitical and military reasons when explaining why the euro is unlikely to challenge the dollar in the near future. For Franklin Serrano, Professor of IPE at the Federal University of Rio de Janeiro and a scholar with close links to the ruling Workers' Party, the dominance of the dollar is very deep because of the military power of the US. There is no challenge in this regard coming from the euro. He says that what strikes Brazilians is that:

> Yes, there is this euro project, but there is no equivalent project to create a common state, with a common defence policy. Even individual member states such as Germany and France, for instance, seem to have subcontracted military defence to the US. If one thinks of a challenge, then the euro would have to be part of a bigger project around the notion of …power, but this is not the case (Serrano 2010).

For Serrano this shortcoming is crucial because for him the switch from an international currency to another is always the consequence of political events. It comes usually after wars. It is not derived smoothly through market behaviour. In this regard, from the perspective of his office in Rio de Janeiro, he sees US military might only too close geographically through the advance of the Plan Colombia. For him, South America is still militarily controlled by the US and this military power is reflected in the use of the dollar in his region. This does not mean that Brazil, as an upcoming regional hegemonic contender, is happy about increased US military presence around its borders. As a matter of fact, the reactivation of the 4^{th} fleet of the US Navy in 2008, with the aim to cover the coasts of Central and South America (USN 2008), and the decision by the Colombian government to allow US military forces to use its bases have received stark criticism from the Brazilian government

(O'Shaughnessy 2009). But Serrano's point is that this US military presence shows how Europe is still very distant in matching US geopolitical influence in Latin America, and the world at large (Fiori et al. 2008).

A similar geopolitical configuration can be observed in East Asia. China has clear aspirations to become the regional political and military hegemon, but the US is still the dominant military force in the region. This security provision makes it difficult for countries such as Japan and South Korea, which have US military bases in their territories, to move away from the greenback. As explained in Chapter 2 (p.64) through Helleiner's currency typology, it can be argued that there is a tacit agreement between the US, on one side, and Japan and South Korea and the South East Asian region at large, on the other, to use the dollar as the foreign currency in international transactions in exchange for US military protection. The dollar functions thus as a 'negotiated' international currency. This is spelled out by Jamil Anderlini, the correspondent of the *Financial Times* in Beijing:

> [East] Asia is still a conquered region run by the US, and therefore it is a dollar monetary area, because the dollar is the currency of the conqueror. You have only to look at the troops that they have in Japan, Korea and their military ties with Taiwan and in Central Asia. […] The reality is that there are longstanding political tensions between China, Japan and Korea and the US is here to maintain stability (Anderlini 2009).

US military dominance in the region is unlikely to be challenged in the near term. And if there is a challenge, it is certainly not going to come from the EU which is still subordinated to the US when it comes to geostrategic and military issues in South East Asia. As Nicola Casarini (2009) demonstrates, during the mid 2000s there was an attempt by some EU member states, chiefly Chirac's France and Schröder's Germany, to strengthen the commercial and political ties with China in the aerospace and defence sectors. There was even a commitment to lift the arms embargo against China. However, these first moves intended to establish a 'techno-political linkage' between the EU and China were "perceived by the United States and its Asian allies as having a potential disturbing effect on East Asia's strategic balance and the United States' security interests in the area" (Casarini 2009:3). Consequently, after strong opposition from the US against the lifting of the arms embargo and the European political strategy at large, the EU finally decided to "gradually realign its foreign and security policy in China and East Asia on the position of the United States" (Casarini 2009:1). In the future, the threat to US military dominance in East Asia might come from China itself. China has become recently more assertive in claiming South East Asia as its natural sphere of influence. This might bring it onto a collision course with the US (Fisher 2008). But, again as in the case of Brazil and Latin America at large, what is beyond doubt is that the EZ has no visible intention to substitute the US as the provider of military protection to the region. Hence, from a geopolitical point of view, the euro is equally unlikely to replace the greenback in South East Asia.

4.4.2 The Dollar and the US Security Umbrella in the GCC

While in the cases of Brazil and China the geopolitical approach seems to be more relevant to understand why smaller neighbouring countries are inclined to keep using the greenback – and in consequence why China and Brazil, through regional network externalities, are also forced to use it despite their increasing reluctance to do so (as will be explained in the next chapters) – the situation is very different in the GCC. Unlike China and Brazil, and similarly to Japan and Korea (threatened by China), and Colombia (threatened by Venezuela), the GCC relies on US military protection, especially against the perceived threat of an ambitious Iran, the aspiring regional hegemon, which has clear intentions to build nuclear capabilities. This brings Momani to write:

> The US security umbrella remains a decisive factor for why GCC states and, in particular Saudi Arabia, which is most threatened internally and externally and which leads the GCC, would not give up on the dollar and why GCC public authorities would keep pegging their currency to the dollar (2008:310).

My fieldwork research in Saudi Arabia and the UAE confirms this statement. Thus, it shows that by analysing ideational interpretations of reality it is certainly possible to capture the material elements of the research problem. Government officials both in Saudi Arabia and the UAE would deny any influence of geopolitics in their monetary policy. They would explain the pricing of oil in dollars and the related peg to the greenback on economic grounds, an official line that has been put forward in several occasions by the governor of the Saudi central bank Muhammad Al-Jasser (Karam 2010). Other participants outside of government, however, would see a strong link between the use of the dollar in the GCC and US military protection (Interviews Y-1 2010; Y-7 2010; Y-8 2010; Z-5 2010; Z-9 2010; Z-13 2010; Z-15 2010). "The political-economy arguments are very strong for sticking to the US dollar", says a Western adviser to the Government of UAE. "There are 120 American war ships out there in the Gulf. And they are there for one reason only, to protect the flow of oil from the GCC and Iraq to Europe and the US" (Interview Y-7 2010). A number of participants would refer to the second Iraq War when considering the option of pricing GCC oil in a currency other than the greenback (see Chapter 3, p.116). Asked whether his country would be willing to sell officially its oil in euros, a local senior researcher at a think-tank in Abu Dhabi would respond: 'This is what Saddam Hussein did, didn't he? Well, we all know how that ended' (Interview Y-1 2010). This shows that in the GCC the belief that the US invaded Iraq in order to "dissuade further OPEC momentum toward the euro" is widespread (Essayyad & Algahtani 2005:78). Another participant, who until recently was advising the Government of Dubai, would disclose that in the early years of the euro UAE and other GCC states were willing to diversify up to 15% of their reserves (a considerable amount given GCC total reserves) into the euro (See this chapter, pp. 140-41), but they were stopped by US pressure. He recalls how during that time they had a lot of visits from US officials persuading them not to make the move. For him, "the pricing of oil in greenbacks and the GCC peg to the dollar are crucial factors in maintaining the dollar as the world international currency, and therefore the US will oppose any move to change this" (Interview Y-8 2010). A senior scholar in Saudi Arabia would agree with this assessment (Interview Z-13 2010), while another would say that this issue was extremely sensitive and taboo among Saudi government officials. He remembered how one official at the Saudi central bank was fired because he was actively promoting the option of de-pegging from the dollar (Interview Z-9 2010). Asked about the politics behind the use of the dollar, a former senior Saudi official would not deny the political element. He would explain that the use of the dollar in the GCC was based on both economic and military factors because both go hand in hand. His train of thought went like this: "The US is the biggest economy in the world; the US dollar is the international currency; oil pricing is set in the markets, and since the markets are functioning in dollars, Saudi Arabia receives dollars.[70] On top of that the US is also the greatest military might, it protects this region. Therefore, it is only normal that the GCC has a peg to the dollar" (Interview Z-5 2010).

However, for a number of participants the current status quo might not last forever. And here again is when *change* plays a major role. The US, once it weakens economically, might not be willing to carry alone the burden of providing security to the region and the region might find other providers of security. Christian Koch, director of International Relations at the Gulf Research Centre, a think-tank with offices in UAE and Saudi Arabia, says that the second Iraq War was a watershed for the political elites in the GCC. "They were very disappointed about how the US conducted the invasion because they advised them not to dismantle the army and the Baath Party, but the US officials would not listen. They would just do things unilaterally, in their own way. This made the GCC elites realise that they were overly dependent on the US in security affairs" (Koch 2010). A very similar analysis comes from Leverett (2008). For him, "since the September 11, 2011 terrorist attacks – and, more intensively, since the US invasion of Iraq in 2003 – the Saudi leadership has been re-evaluating the kingdom's long-standing strategic partnership with the US". As a consequence of these disagreements, in 2004 the Saudi Petroleum Corporation stated that "the days when the Kingdom was willing to blindly accommodate US interests are gone. This has had an impact on all aspects of Saudi foreign policy: regional relations, Iraq, strategic views, and of course, oil policy" (Essayyad & Algahtani 2005:76). After the Iraq watershed policymakers in the GCC have tried to hedge their defence alliances with the objective of bringing more players to the table. This explains why some GCC countries have joined in recent years the Istanbul Cooperation Initiative of NATO[71], which is seen as an organisation run

[70] Momani (2008) does also stress the point that the pricing of oil in one currency or another is today mostly decided by the markets. As mentioned in the section covering invoice of oil, it is very likely that bilateral contracts between European oil companies and GCC countries are made in euros, but that does not eliminate the fact that most of the oil is sold through the international markets, which price oil in US dollars. As Momani also suggested, for a number of participants in this research a tipping point that could change this inertia could be created if oil exporters such as Norway and the UK, which are closer to the EZ, would sell their oil in euros. But until that does not happen, the dollar will remain the oil currency.

[71] NATO's Istanbul Cooperation Initiative was launched in June 2004 with the "aims to contribute to long-term global and regional security by offering countries of the broader Middle East region practical

predominantly by the US but in cooperation with other partners; why they have welcomed the engagement of the European G3 (Britain, France and Germany) in the negotiations with Iran on its nuclear programme, and why the UAE has asked France to establish a military base on its soil (Koch 2010).

The opening of the French base in Abu Dhabi, in a strategic location overseeing the shipping corridor of GCC oil, is significant because it shows for the first time European willingness to carry some of the security burdens of the region.[72] As French President Sarkozy stated the day of the opening: “Through this base – the first in the Middle East – France is ready to shoulder its responsibilities to ensure stability in this strategic region” (*BBC* 2010). Does this mean that at some point the GCC will start selling its oil in euros?[73] For the above quoted adviser to the UAE Government, the answer is yes. At some point the US will weaken further, ask the Europeans to share the burden of protection and the GCC will start selling oil both in dollars and euros (a trend that appears to have already started informally, see this chapter, pp. 134-35). Nonetheless, the view is different from Saudi Arabia. The same former Saudi official quoted above is sceptical about the Europeans protecting his region. They will play a role, but not a significant one. He believes a more likely outcome will be the Chinese stepping into the void left by the US gradual withdrawal. In 2010 China has become the biggest importer of Saudi oil (Meyer 2010), so at some point they will be looking at protecting the shipping of oil from the GCC to China. Asked whether the US would allow Chinese interference in security matters, this former official would point to the fact that “the US is in financial trouble, it is getting economically weaker so maybe at some point they might even ask the Chinese to share some of the burden of the security umbrella. Economics and politics go hand in hand” (Interview Z-5 2010). As Leverett (2008) points out, Sino-Saudi relations have strengthened in the past years. It

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bilateral security cooperation with NATO” (NATO 2011). Bahrain, Kuwait and Qatar joined the initiative early 2005, while the UAE did the same in June 2005. Interestingly, Saudi Arabia, the biggest nation in the GCC, has not joined yet, despite being involved in the high level consultations that preceded the launch of the initiative. As in the case of de-pegging from the dollar (see chapter 3), the smaller GCC countries seem to be keener to diversify away in monetary and security matters from the US, while Saudi Arabia is reluctant to do so for fear of jeopardising its close relationship with the US.

[72] The French military base “Peace Camp” was opened by French President Nicolas Sarkozy in May 2009. As reported by the *BBC* (2010), “the new base will host up to 500 French troops and include a navy base, air base, and training camp”. This was the first time in many years that France opened a military base outside its territories.

[73] Essayyad and Algahtani (2005:77) quote officials from the Energy Directorate of the European Commission saying that they “could see the euro replacing the dollar as the main currency for oil pricing”. If these statements are true, it seems that this possibility is seriously considered in Brussels.

is not inconceivable that this relationship will develop in a strategic partnership. If it does in any meaningful way, then the centrality of the dollar in the GCC might fade away. Fisk's (2009) report on secret talks among GCC, European, Chinese and Russian officials to price oil in different currencies is widely perceived as accurate. The question is whether these talks will lead to concrete action, in essence, whether the ideational can be transformed into the material.

4.5 Summary

The principal aim of this chapter has been to show the tangible limits of the euro challenge to the dollar based on the theoretical and conceptual discussion that has been developed in the previous chapters. It shows why the euro-sceptic branch of the literature is correct in assuming that the euro is not able to substitute the dollar as the top international currency. The first section shows the achievements of the euro in becoming the second most used international currency in the roles of store of value and currency of settlement. Central banks and market agents have embraced the European currency as a valuable diversification tool against dollar depreciations. However, as the other three sections show, hitherto euro attractiveness is not sufficient to challenge the supremacy of the greenback. Market factors such as US dollar inertia and the lack of financial integration and liquidity in the euro markets; political shortcomings related to having a monetary union without fiscal and political union; and low European military ambitions, make the euro still a distant second to the dollar. However, what these three sections also show is that the limits to the rise of the euro are not fixed. They are in constant flux and therefore they are changeable. The euro might break up. This possibility cannot be excluded, especially considering that the possibility of creating a fiscal union still faces fierce political resistance in the different member states, not least in Germany. But if the euro survives, it is likely to increase its share as an international currency. Increased demand for EFSF proto-Eurobonds points in that direction. Further fiscal and political integration in the EZ is an outcome that should not be ruled out. The new economic governance structure emanating from the crisis is already more integrated than the one leading to the crisis. As several British participants (Interviews Y-9; Y-16 2010), now working for UAE financial institutions, point out: who would have told them in 1992 when they celebrated the collapse of the European Exchange Rate Mechanism (ERM) that ten years later the euro would be legal tender on the streets of Europe. Despite the phantom of a break-up continuously hovering over the euro, the widespread belief among financial elites in China, the GCC and Brazil is that the Europeans tend to solve crises through more integration rather than fragmentation. In moments such as this of Knightian uncertainty these beliefs carry considerable weight.

What this chapter also indicates is that subjective perceptions of top policymakers matter. What they believe determines how they act. If the Chinese Government would have had serious doubts about the future of the euro, it would not have invested large amounts of the hard earned national savings of its people in the single currency. As explained, this was not done for altruistic reasons. China has used the opportunity of the EZ sovereign debt crisis to advance its own interests: to diversify away from the dollar, to protect the value of its existing euros and to augment its political influence in Europe. Whatever the reasons, the outcome has been that the euro has become even more important in the international monetary system than it was. To borrow a phrase widely used during this financial crisis, the euro has made such inroads that it is 'too big too fail' both for the Europeans and for outsiders. The case of China is here paramount considering that roughly 26% of its $3 trillion FX reserves are in euros (almost $800 billion! More than the IMF and the ESM rescue funds combined). The same can also be said for the GCC, which also has huge reserves in euros. Brazil by contrast, has fewer investments in euros, but nonetheless it is also in its financial elites' interests to have an alternative to the dollar. The evidence collected suggests that investors in the three case study regions favour the survival of the euro not for any particular sentimental preference for the European currency, and certainly not to see it topple the dollar. Rather, they want the euro to do well because as the next chapter will show they are unhappy about the dollar's performance as the main international currency and they want to have other choices, and hitherto the euro is the only real alternative in sight.

Chapter 5: The Malfunctioning of the Flexible-Dollar-Standard

As I have shown in the previous chapter, the euro has a series of structural limitations that impede its challenge to the supremacy of the dollar in the IMS. Nonetheless, the European currency has become just in a decade comfortably the second most used international currency worldwide. Given its weaknesses, how can we explain the rise of the euro? How is it possible that a currency with such visible shortcomings has attracted so much international demand? The answer lies in that the current system dominated by the dollar, and referred to here as the flexible-dollar-standard (FDS), is also structurally flawed (see Chapter 3, p.96). As acknowledged by Cohen (2010), perhaps the scholar that has written most on this subject, the euro vs. dollar debate is not fuelled by the strengths of the euro, but rather by the weaknesses of the dollar and its underlying structure. The findings of my research corroborate this assessment. As will be shown below, discontent about the FDS is widespread among the financial elites in the three case study regions. Hence, the dollar is increasingly seen as a negotiated currency. In order to demonstrate this, the chapter is divided in four parts. The first section introduces in broad terms the main flaw of the system, which is that the US has the exorbitant privilege to run bloated current account deficits without any constraints on its macroeconomic policies. This has become more visible than ever in its response to the ongoing financial crisis. Instead of applying the hard medicine of the structural adjustment plans of the IMF that it has always advocated, the US has embarked on an unprecedented programme of fiscal and monetary expansion. This inconsistency between rhetoric and action has undermined the reputation of the US as the leading nation and the intellectual underpinnings upon which this leadership was based. The financial crisis initiated in Wall Street has shown once again how crisis-prone the FDS is. By adopting loose monetary and fiscal policies without any restriction since the collapse of Bretton Woods, the US has flooded the world with liquidity, thus functioning both as the 'benign' demand pull of the world economy, but also as the 'malign' trigger of unsustainable asset price bubbles and systemic banking crises (see Chapter 3, p.96). Once the main defect of the system has been presented, the second part of the chapter tries to go deeper into this structural flaw. The first sub-section shows how, due to this loose monetary policy, the dollar has been malfunctioning in its anchor role, while the second elaborates on what is generally perceived as the main cause of the problems in the international monetary architecture: the Triffin Dilemma. Once the diagnosis is completed, the third section of the chapter shows how the current system gives the US the possibility first to delay and then to deflect adjustment costs. This section focuses on the actual instruments that have been used in recent times to generate this monetary power, and the disapproving response that they have provoked among financial elites in emerging markets and Europe. It will be shown how the aggressive moves by the US have put the system under considerable stress. Finally, the last part of the chapter concentrates on Chinese proposals to *negotiate* the status of the dollar in the system and how these have hitherto been rejected by the US.

5.1 The Instability of a System Based on Undisciplined US Debt

5.1.1 The 'Exorbitant Privilege' Discontent Revisited

In what can be described as a déjà vu of the late 1960s, when the French President, Charles de Gaulle, and his Finance Minister, Valérie Giscard d'Estaing, complained about the 'exorbitant privilege' of the US (Kirshner 1995; Eichengreen 2008; 2011a), similarly today financial elites in Brazil, China and the GCC are proactively denouncing the fact that, by virtue of being the issuer of the leading international currency, the US has the enormous advantage of being able to run bloated current account deficits without facing any disciplinary constraints. This privilege has become only too evident in the aftermath of the debt-driven financial crisis which hit Wall Street in September 2008 with the collapse of the investment bank Lehman Brothers. Instead of taking the harsh disciplinary medicine of the structural adjustment programmes prescribed for several decades under the Washington Consensus by the IMF and the WB to countries facing balance of payments distress, the US has been able to implement a completely different programme. Rather than being forced to privatise state-owned enterprises, the US government has bailed out its financial and automotive industries, and in place of implementing the usual fiscal austerity and monetary tightening, it has chosen a strategy of fiscal expansion (with a \$790 billion government stimulus package)[74] and monetary loosening (with various

[74] The Obama stimulus package, officially labelled as the American Recovery and Reinvestment Act, was signed by President Barack Obama in February 2009. With a total sum of \$787 billion, it was one

waves of Quantitative Easing by the FED).[75] The contrast with the Asian financial crisis could not be starker. Then, the IMF, led by the US, enforced the shut down of insolvent banks, cuts in government spending, further deregulation of financial markets and the lifting of interest rates, a strategy that backfired completely, pushing the region even deeper into recession (Bello 1999). This provoked two long term consequences: an absolute distrust in Asia (and indirectly in Latin America) in the policies of the IMF and the market-led Washington Consensus at large, and the accumulation of foreign reserves as a self-insurance policy for future balance of payments' crises (Zhou 2011).[76]

The enforcement by the US of market-led reforms, based on the intellectual underpinning of the Efficient Market Hypothesis (see Chapter 3, p.98), upon other countries to overcome financial crises, while now using completely different policies to tackle its own financial troubles, has been criticised as a double-standard approach by a number of high profile participants in the three case study regions (W-1 2008; Rebelo 2008; X-6; X-28; Qin 2009; Yu 2009; Y-9 2010; Z-2; Z-5 2010). In this regard, with this crisis, the US has certainly lost some of its credibility and reputation as the leading country in international monetary affairs (Helleiner 2010a; Stiglitz & Greenwald 2010). The belief in the virtues of financial deregulation, one of the ideational corner stones of the FDS, is now seriously undermined, not only because of the material severity of the global financial crisis, but perhaps more importantly, because of the hypocritical attitude of the US. As a central bank participant points out, "US authorities have done during this crisis what they have always told the emerging markets not to do. They have always told us that we should not intervene in the activity of the market, that we should not bail-out the private sector. But now they did

of the largest economic stimuli in the history of the US. Tax breaks accounted for about a third of the money, another third was used to help states, the unemployed and for access to healthcare and the rest went to labour, health and education and infrastructure, energy and water.

[75] Quantitative Easing (QE) is the unorthodox monetary policy used by central banks in periods of sluggish growth when their official interest rates are close to zero and they still want to stimulate economic activity. To do so they create new money to buy different assets, usually government bonds to make them less attractive to risk-averse investors. The effectiveness of this strategy is still unknown, showing that we are in a moment of Knightian uncertainty. The supporters argue that it is a useful tool to avoid deflation, the detractors fear that it might spark inflation once the recovery is underway.

[76] The accumulation of reserves as a self-insurance policy against so called market imperfections, including "uncertainty about the availability of international liquidity in a financial crisis; large and volatile capital flows; absence of automatic adjustment of global imbalances; and absence of good substitutes to the US dollar" has been now acknowledged by the IMF (2010b). This shows that the Efficient Market Hypothesis (EMH) is now seriously questioned.

it themselves" (Interview S-1). In a similar vein, a senior Saudi scholar in Finance based in Riyadh but with a PhD in Economics from an American university, has no hesitation in saying that "the Americans talk the talk, but do not walk the walk. Their talk about market efficiency is very nice, but when they have to act as efficient-market-believers they do not do it, which is not good for them and not good for the whole world" (Interview Z-13 2010). Instead of reducing the level of debt after the crisis, the US has actually increased its overall external debt position by bailing out its baking sector and stimulating its economy. This is an issue of great concern for a number of participants. For them, the financial-led and debt-driven growth pattern pursued by the US over 30 years, up to the crisis, and to overcome it, is unsustainable. At some point the US will have to raise taxes and start living within its means. It will not be able to exploit its 'exorbitant privilege' forever. "The future growth pattern of the US needs to change. It cannot be based again on consumption and debt. This is unsustainable. The foreign creditors will not play along indefinitely. At some point they will lose confidence in the dollar and this can bring a major crisis", says Luiz Belluzzo (2008), chief editor of the Brazilian business magazine *Carta Capital* and former economic advisor to President Lula. At the time of writing, the US debt trajectory is a topic of great debate in Washington. On 16 May 2011, the US Government reached its debt ceiling of $14.294 trillion (over 90% of GDP). Republican and Democrat congressmen and women spent the following months debating on how to reduce this debt burden in the long run so as to come to an agreement to lift the debt ceiling again. After protracted negotiations mired in ideological stubbornness they came to a temporary agreement just a few days before the 2 August 2011 date in which the US Government would enter into technical default. This political stalemate prompted the greatest sovereign bond fund in the world PIMCO to sell all its US debt before the deadline (McCrum 2011). Notwithstanding this temporary agreement, as of the time of writing, the US political establishment has not come up with a credible plan on how to reduce the nation's bloated debt. As a consequence, for the first time in history, the credit rating agency Standard and Poor's has downgraded the creditworthiness of the US.[77] This

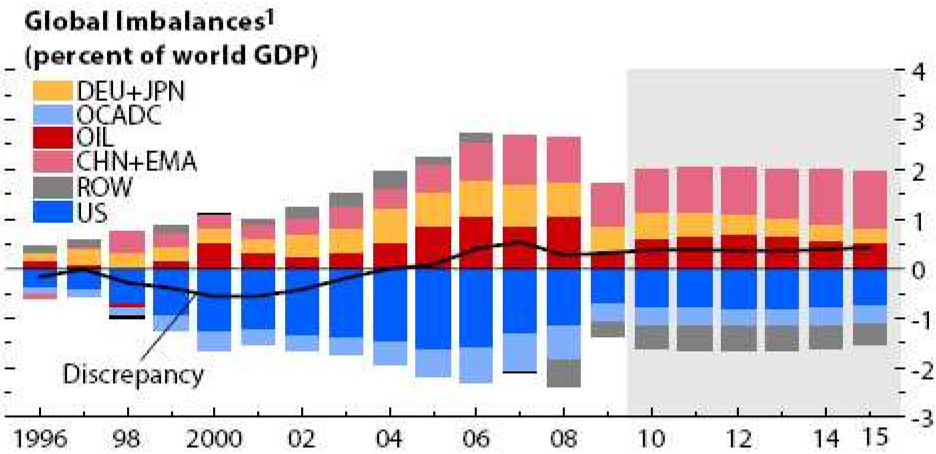
[77] As highlighted by the Chinese state-owned news agency *Xinhua* in an editorial published in response to the downgrading of Standard and Poor's, the Chinese credit rating agency Dagong Global downgraded the creditworthiness of the US already in 2010. In this same editorial it is said that "the credit rating cut is an overdue bill that America has to pay for its own debt addition and the short-

extraordinary situation is best described as Knightian uncertainty in the financial markets. The surge in the price of gold to historic records is a clear indicator of this (See Chapter 7, p.267). In the wake of the greatest financial crisis since the 1929 Crash, financial elites in emerging markets struggle to identify their best interests. If the US defaults, there will be a major crisis, if it stops stimulating the economy, there might also be a crisis, and if it builds up more debt to come out of the current crisis, there might be another bigger crisis down the road. How can global investors solve this conundrum?

As shown in Chapter 3 (p.99), in moments of Knightian uncertainty such as this, the first step taken by economic agents is to try to understand the causes of the crisis. They try to make sense of the reality. In this regard, the Chinese financial elites reject categorically the explanation advocated by FED chairman Bernanke (2005, 2010, 2011) and other Western commentators (Bergsten 2010; Wolf 2010a) that the financial crisis initiated in 2007 is partly consequence of the savings glut accumulated in Asia, especially in China, during the Bretton Woods II period in which the US functioned as the demand pull of the world economy (see Figure 5.1). Following this explanation, the dollar savings generated through mercantilist dollar-peg and export-led growth strategies in Asia were channelled back to the US and created a credit bubble that stimulated over-consumption and over-leveraging by financial institutions and private households. Thus, some of the blame for the global imbalances needs to fall on China because it maintains its currency undervalued against the greenback.

sighted political wrangling in Washington" (*Xinhua* 2011). It needs to be mentioned that the IMF (2011c) has also stated that the US lacks a credible strategy to reduce its mounting public debt.

Figure 5.1: The global imbalances between the key players in the system



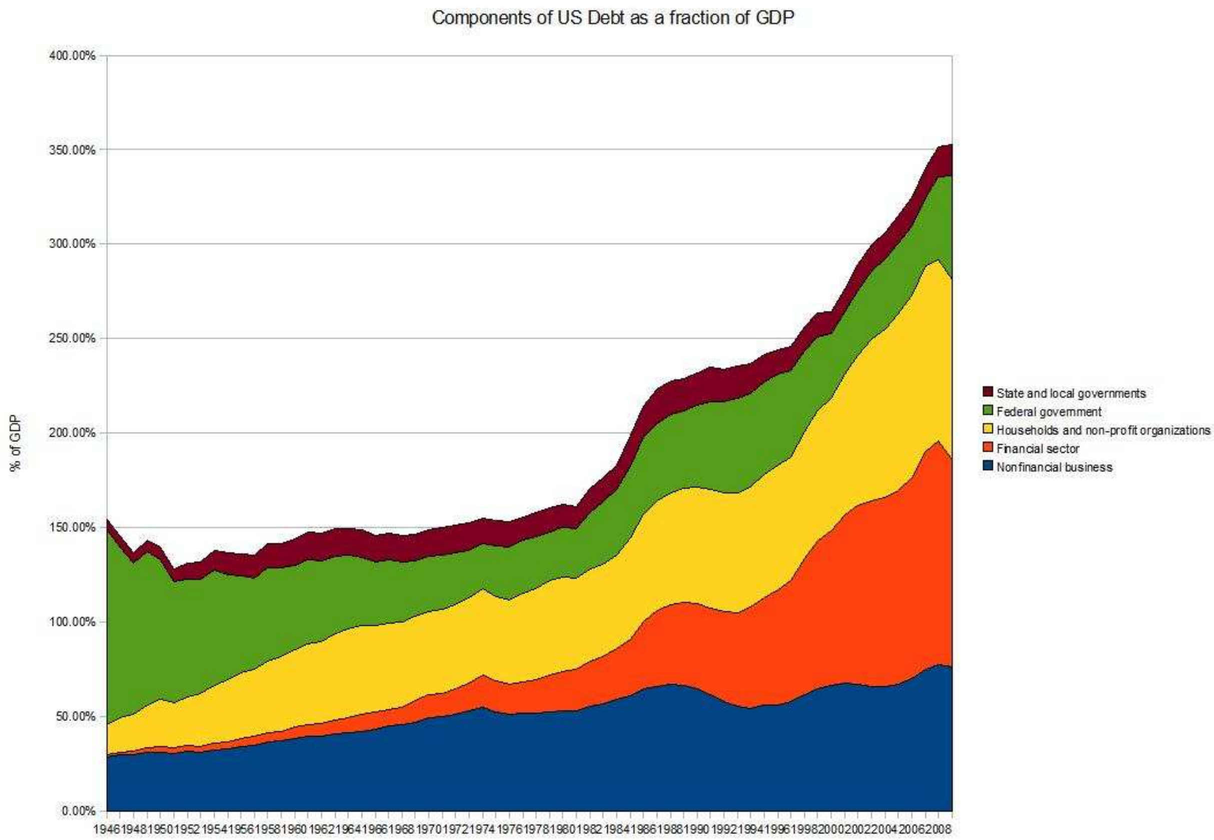
CHN+EMA: China and Emerging Asia; OCADC: Spain, Portugal, the UK, Turkey and Central and Eastern Europe; OIL: Oil exporters; ROW rest of the World; US: United States. Source: IMF (2010a)

For the Chinese financial elites, however, the problem does not lie on Chinese thrift, but rather on American profligacy fuelled by the centrality of the dollar in the IMS. As Chin and Wang (2010) explain in their review on Chinese debates about the future of the IMS, for Chinese leading policy strategists on international monetary affairs:

> The financial crisis has laid bare the defects of the existing international currency system, and they suggest that the world should look to diversify beyond the US dollar system […] The root of the current global problems is in the break from the previous Bretton Woods system, which has provided relatively stable exchange rates until the early 1970s. The current international currency system is said to have allowed the US to run consistent current account deficits, which in turn have led to its rising levels of external debt (2010:2-3).

One of these leading Chinese analysts, Cao Honghui, director of the Financial Markets Division at the Institute of Finance and Banking at CASS, agrees that the root causes of the crisis need to be found in the leveraging model of the US, a model that is completely unsustainable (see Figure 5.2).

Figure 5.2: Components of US total (public and private) debt as a fraction of GDP (1945-2009)



Source: Federal Reserve (2010)

The problem that he encounters, though, is that this crisis has also shown that the euro, the only other competitor currency around, is no alternative to the greenback. Not only for the structural reasons explained in the previous chapter, also because 'the Europeans, especially countries in the periphery such as Ireland and Spain, have bought into the same leveraging model seen in the US of cheap credit and real estate bubbles' (Cao 2009). In this regard, precisely when it was more needed, the euro has not functioned as the disciplinary alternative that many financial elites in the three case study regions hoped for. During almost a decade the consolidation of the euro as the second most used international currency was greeted positively by investors around the world because they saw it as a competitor currency that would constrain US profligacy. However, when the crisis finally struck, the structural deficiencies and lack of political unity in the EZ made the euro look even weaker than the dollar, which ultimately was seen as the less-ugly in the 'beauty contest' of the two currencies, and thus was able to maintain its international safe-haven status and, along the way, perpetuate the associated 'exorbitant privileges' for the US.

5.1.2 The Crisis-Proneness of the Dollar-Standard

The lack of suitable alternatives to the dollar does not mean, however, that financial elites in the three case study regions accept the status quo. For them, the dollar standard regime is institutionally flawed and consequently it is prone to continuous crises. One of the main complaints is that the current IMS lacks the checks and balances necessary to restrict the supply of dollars by the US authorities (Interview W-1 2008; Cao 2009; Zhang Ming 2009; Yousef 2010; Interview Z-5 2010). As a consequence "excess liquidity in the international monetary system has thus led to a situation where boom-bust cycles in asset prices have become the systemic norm" (Chin & Wang 2010:3). This view is shared by Ding Yifan, director of the Development and Research Center, a think-tank under the Chinese State Council. He argues that:

> Imbalanced international payment in the United States usually leads to an unstable dollar exchange rate, which has imparted financial instability to other countries. It is known that the outbreak of international financial crises since the 1980s have been closely related to a fluctuating dollar (Ding 2009a).

While statements like this are common amongst many participants in this research (showing that the intellectual underpinnings of the FDS are highly contested), it is here worthwhile referring to the work of Richard Duncan (2005), a financial analyst with more than 18 years' experience in Asia, to explain how the loose monetary policy of the FED and the increased issuing of debt by the US Treasury since the collapse of Bretton Woods have stimulated cycles of boom and bust around the world (see also Chapter 3, p.96). As he explains it,

> The enormous trade imbalances that have occurred during the post-Bretton Woods international monetary regime have flooded the world with liquidity, the surge in liquidity has caused asset price bubbles in shares and property markets, and the implosion of those bubbles has caused systemic banking failures (Duncan 2005:120-1).

With hindsight, his words, written at the start of the new Millennium, can only be described as premonitory to what was to come. In a convincing review of the causes of the financial crises in Latin America (including Brazil) in the 1970s and 1980s, in Japan in the late 1980s, Scandinavia in the early 1990s, and the Asian crises in the late 1990s, he demonstrates the linkages between capital inflows, accelerating credit expansion and the development of asset price bubbles, followed by systemic banking crises. This leads him to conclude that:

> During the Bretton Woods era, when international reserve assets grew only slowly, systemic banking failures were not a concern. After Bretton Woods collapsed, they became pandemic. The near exponential expansion of the world's monetary base is indisputably the reason why. […] So long as the world continues to be flooded with dollar liquidity spun off from the American trade deficits, new rounds of asset price bubbles must be anticipated (Duncan 2005:134-5).

The flood of liquidity generated by the US current account deficits is not only a cause for concern in Asia – where imported inflation has been a major problem for years – the same assessment comes also from the GCC. El-Gamal and Jaffe (2010) present a very similar argument to Duncan's, with the addition of including in their analysis the regionally specific variables of oil prices and geopolitical tensions. For them, there is a clear correlation between the loose monetary policy of the FED and the consequent hike in oil prices to offset the depreciation of the dollar. The recycling of ever increasing amounts of petrodollars is particularly destabilising for a number reasons. First, the inflow of large amounts of dollars cannot be absorbed by the GCC countries, which neither have the populations nor the economic diversification necessary to channel the new coming funds into productive activity. This leads inevitably to asset price bubbles and inflation. The blow and burst of the real estate bubble in the second part of the 2000s in Dubai is only the latest example. Second, due to these absorption limitations, most of the funds are normally recycled back to the US. However, as seen in the past years, and similarly to the funds recycled from Asia, this has facilitated the creation of cheap credit for US consumers, and the formation of unsustainable real estate and derivatives-driven credit bubbles, the latest of which has brought Wall Street and, with it, the whole world economy to the brink of collapse. Third, since the investment opportunities for the GCC states are limited, and there is a tacit security agreement between them and the US, another channel of petrodollar recycling is to use the inflow of dollars to acquire US military equipment.[78] However, this is also destabilising because it fosters a self-perpetuating arms race in the region with unpredictable geopolitical consequences.

Given this state of affairs, it is no wonder then to see GCC policymakers starting to question the benefits of the FDS, especially now that the euro has acquired a prominent international role. As El-Gamal and Jaffe summarise:

> The role of the dollar has been particularly problematic in the most recent phase of the cycle, as oil-exporting countries in the Middle East experience significant inflationary pressure because of the dollar's decline against the euro and the denomination of most of those countries' imports in the latter. Thus, the debt-based expansionary policies of the US […] are increasingly becoming a source of discontent. […] This discontent reached its peak in 2003, when the perceived geopolitical gains of supporting the dollar at their own economic cost were proven nonexistent as the US invaded Iraq against Saudi and other regional protests (2010:139).

El-Gamal and Jaffe cover here two aspects that are of relevance for this research. One is that the consolidation of the euro in the invoice of GCC imports is increasing the inflationary pressures in the region (a theme covered in different parts of this thesis), and the other is the confirmation that the Iraq war has been interpreted by the policymakers of the region as a watershed in the negotiated status of the dollar (see Chapter 4, p.156). For years, GCC countries were willing to accept, in exchange for military protection, the burden of high inflation and revenue loss as a consequence of their peg to a depreciating dollar. However, the Iraq war and its destabilising aftermath taught them that maybe it was time to look for alternatives, the euro being the most obvious potential candidate. A study on the viability of switching oil pricing

[78] In order to counteract the threat of Iran, in October 2010 the US announced its biggest arms sale to Saudi Arabia in history with an approximate value of $60bn (Dombey 2010). As some of the participants in Saudi Arabia would acknowledge, this sort of deals are part of an implicit agreement between the two countries, whereby the US offers military protection to Saudi Arabia and in exchange the Kingdom buys its weapons from Washington so as to help create jobs in the US.

to the euro by Essayyad and Algahtani (2005), two scholars from King Fahd University of Petroleum and Minerals in Saudi Arabia, epitomises this mood. In their policy recommendations the authors do not favour a full-blown switch to the euro yet because of the geopolitical and network-externalities-power of the dollar (see Chapter 4). Rather, they recommend using hedging tools against dollar depreciation or a peg to a currency basket composed by both the dollar and the euro, or by the IMF SDR basket. Thus, their conclusions are in line with the argument of this thesis that the euro is not ready to challenge the dollar yet. However, their work does also show the increasing discontent that the dollar-peg is generating among GCC financial elites (Karam 2010). This is spelt out by Abdelaziz Aluwaisheg, director general for international economic relations at the GCC General Secretariat in Riyadh. For him the peg to the dollar has been very detrimental for the GCC states. By following in the past decade the lax monetary policy of the FED, instead of monetary tightening, which would be more appropriate for the GCC context of double digit inflation, “we were losing everywhere, we were losing on inflation, we were losing on our depreciating [dollar denominated] assets and we were losing on our [oil] revenues”, says Aluwaisheg (2010, brackets mine).

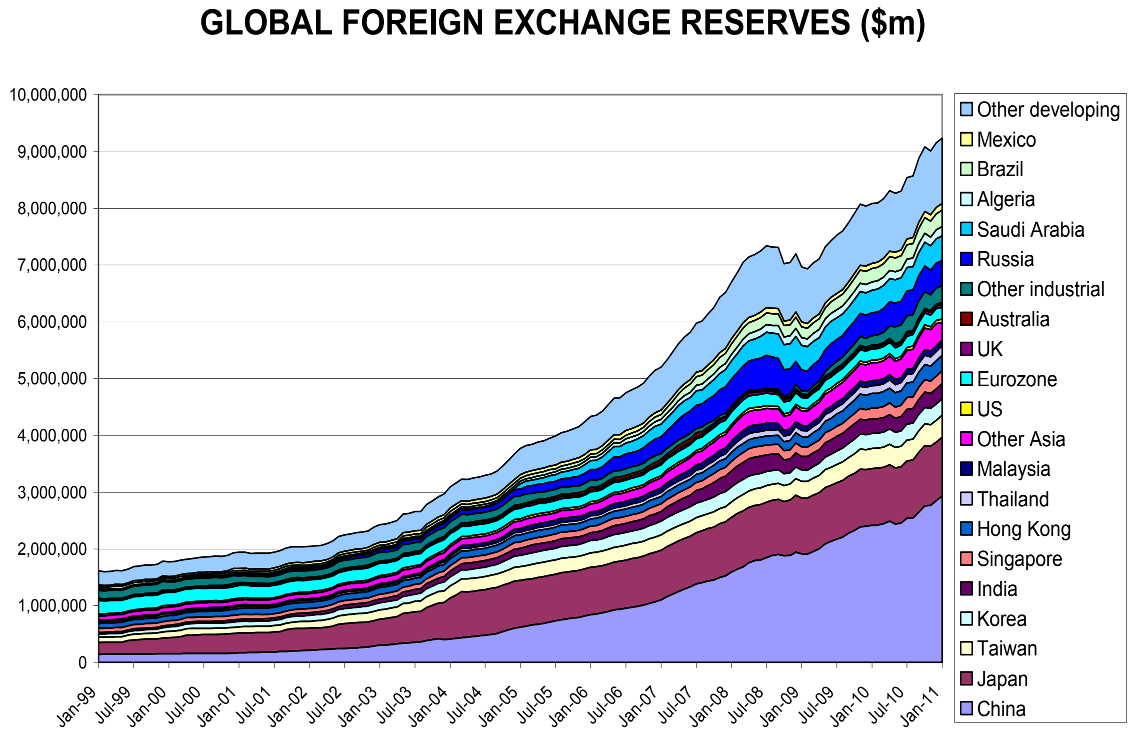
5.2 The Difficulties of Living with an Unstable and Eroding Dollar Anchor

5.2.1 The Enduring Questioning of the Dollar-Peg

In the past decades, and especially since the turn of the millennium, Brazil, China and the GCC have developed different strategies when confronting the flood of ever increasing global money supply emanating, as explained, to a great extent from the US current account deficits (See Figure 5.3).[79]

[79] As Duncan (2005:226) shows graphically, the global money supply, measured in international reserve assets, increased only 55% from 1949 until 1969 (20 years), when the Bretton Woods system started to collapse. From 1969 to 1971 (just three years), the supply jumped 57%, from 1969 until 1989 (20 years) the reserves rose a staggering 700%, from 1989 until 2000 they increased another 150%, while between 2000 and 2010 (10 years) the increase was over 350%, setting the highest record ever (the 2000-2010 figures are own calculations, based on Duncan’s and the latest IMF COFER 2011 data).

Figure 5.3: Increase in total supply of foreign exchange reserves (Jan 1999-Jan 2011)



Source: IMF (COFER), Wolf (2011b)

As the Europeans experienced in the 1970s and 1980s (McNamara 1998), in a context of greater global financial integration and continuous supply of liquidity emanating mostly from the US, all three regions had to confront Mundell's 'Holy Trinity' theory (formally known as the Mundell-Fleming model), which says that policymakers can only choose two out of three options: free capital flows, a fixed exchange rate and monetary policy autonomy. The choice, however, has been very different. Brazil, which suffered from hyperinflation and public indebtedness in the 1980s and early 1990s, chose in the mid 1990s, with the adoption of the *Plano Real* (conceived on the neoliberal policies of the Washington Consensus), to open gradually the capital account to foreign investment and fight inflation with a semi-fixed exchange rate to the dollar. This meant that its monetary policy autonomy was restricted and that it had to keep interest rates very high, reaching 43% in 1997, both to tame inflation and to attract foreign capital to finance the current account deficits which were the product of a Brazilian Real pegged at a relatively high value to the dollar (Schmalz 2008). Monetary policy autonomy was only regained in 1999 when Brazil introduced a floating exchange rate and an inflation targeting monetary policy framework after suffering yet another financial crisis. Since then, Brazil has been able to keep inflation levels under control and bring down the interest rates to near 10%. Over the years, then, the Brazilian authorities have opted for an open capital account, a relatively flexible exchange rate (with sporadic interventions) and an autonomous (though limited to inflation targeting) monetary policy to reach macroeconomic stability (Leitão 2011). Nonetheless, as will be shown below, even this type of restricted approach has not been enough to deal with the inflows coming from an extraordinarily loose monetary policy by the FED. With a flexible exchange rate, good macroeconomic fundamentals, high economic growth and the label of "investment grade" for the country, the Real has strengthened considerably in recent years against the dollar, forcing the Brazilian authorities to reverse partly their neoliberal policies and introduce taxes on new inward foreign investment. Thus, confronted again with Mundell's holy trinity, they have started to reintroduce capital controls in 2009 to win exchange rate stability (Talley & Cowley 2011). The gradual embrace of the EMH has been reversed.

Reaction to the loose monetary policy from the FED has been very different in the GCC. In this case the peg to the dollar has been maintained for several decades. This has provided stable exchange rates, but the trade offs have been a total dependence in monetary policy to the FED and the suffering of spikes of inflation every time the dollar depreciates and oil prices escalate (El-Gamal & Jaffe 2010). The latest of these phases occurred in 2007-2008 when the dollar approached the $1.60 mark against the euro and the price of a barrel of oil topped $147. At this point, inflation levels were so high (especially considering that the GCC imports 30% of its goods and services from the EZ) that policymakers in different GCC states began to question the anchor role of the dollar. These pressures accelerated after May 2007 when Kuwait decided to de-peg from the dollar to stem inflation and re-peg to a basket of currencies, including the euro. In 2008 both Qatar and the UAE (Drummond 2008; Kerr 2008) flirted with the same idea, and suddenly the issue of selling oil in a currency other than an ever depreciating dollar was again on the agenda of OPEC. As El-Gamal and Jaffe (2010:124) highlight, due to widespread inflation "the pressure on OPEC to switch to euro pricing [of oil] was continuously increasing into mid-2008. This led to a confrontation between Saudi Arabia and other OPEC countries", especially

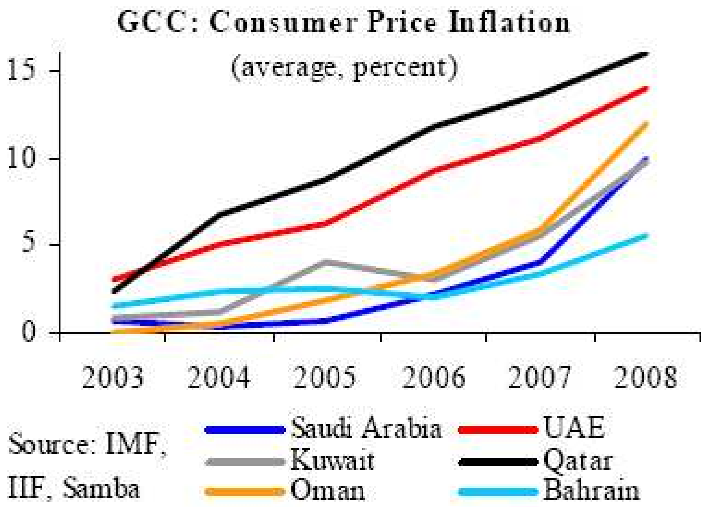
Venezuela and Iran.[80] The debate on whether to de-peg from the dollar was brought to the fore by OPEC's Secretary General Abdullah El-Badri's remarks in favour of pricing oil in the European currency to combat the dollar's decline. Given the weakness of the greenback, "maybe we can price the oil in the euro. It can be done, but it will take time", said El-Badri (Williams 2008). As always the response from Saudi Arabia was uncompromising. The then Vice Governor and currently Governor of SAMA, Muhammad Al-Jasser, "said that calls to price oil in euros were politically motivated and added that Saudi Arabia would continue to price its oil in dollars and maintain the dollar peg for the Saudi riyal" (El-Gamal & Jaffe 2010:124).

My fieldwork research, however, questions this statement. What seems to be politically driven, due to geopolitical considerations, as discussed in Chapter 4 (p.156), is the dollar-peg, and what arguably would be economically sounder would be to improve the tools to fight inflation. This is certainly the view of most participants in Saudi Arabia and the UAE who do not sit in governmental positions (Interviews Y-3 2010; Y-7 2010; Z-2 2010; Z-15 2010). Participants in the central bank would deny that the dollar-peg is politically driven. They would also deny that there has been a problem with inflation in 2008. They even go so far as to argue that the dollar-peg is a shield because every time the dollar depreciates, oil prices surge, which partly off-sets the loss in revenue from a weak dollar. John Sfakianakis (2010), from Banque Saudi Fransi, however, disagrees. He remembers how inflation in 2008 reached 11% (see Figure 5.4) and how it was certainly a serious problem for the country. A similar response comes from Abdelaziz Aluwaisheg, from the GCC Secretariat. Aluwaisheg does not want to enter into political debates in relation to the dollar-peg, which are out of his competence – he underlines – but when it comes to economics he challenges the effectiveness of the peg for his region, especially now that the dollar is very unstable. For him the solution is to move towards a floating regime in order to win monetary policy independence, and if possible to do so by establishing a GCC currency union (a theme covered in the next chapter). He does also believe that Al-Jasser, even if he cannot state it openly, agrees on this point. He had listened to SAMA's Governor at the Economic Forum 2010 in Jeddah and while

[80] According to El-Gamal and Jaffe (2010:123-4), in response to US-led economic sanctions, Iran has been selling oil in euros for several years. "In fact, China's state-owned Zhuhai Zherong Corp., one of Iran's largest crude buyers, has been paying for oil in euros since late 2007".

he had reaffirmed the Saudi peg to the dollar in the short run, he had also repeated several times that "we are in an uncomfortable situation" with the dollar-peg and that we should start considering alternative options in the future (Aluwaisheg 2010).

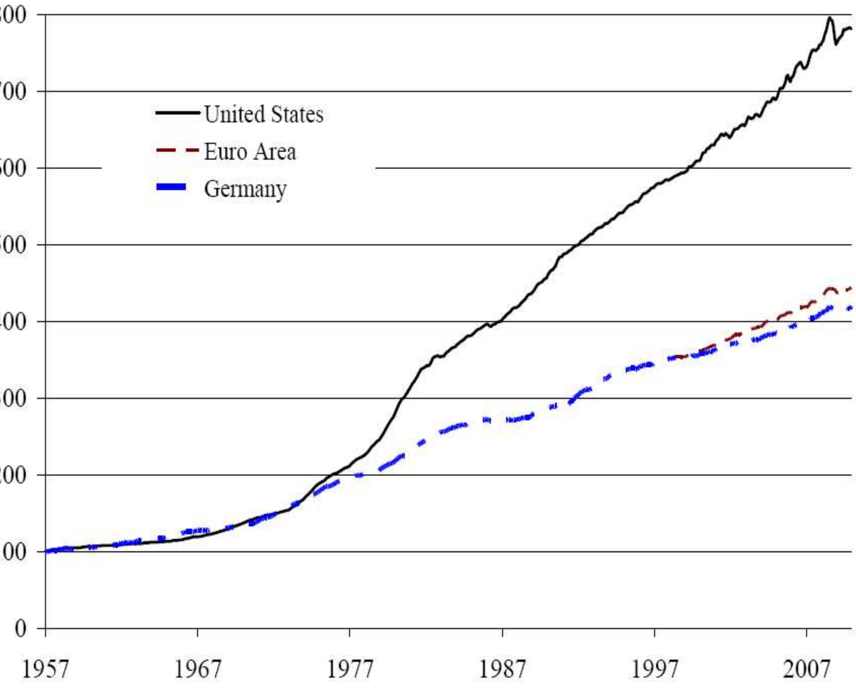
Figure 5.4: Consumer price inflation in the GCC (2003-2011)



Source: IMF, IIF, SAMBA (2009)

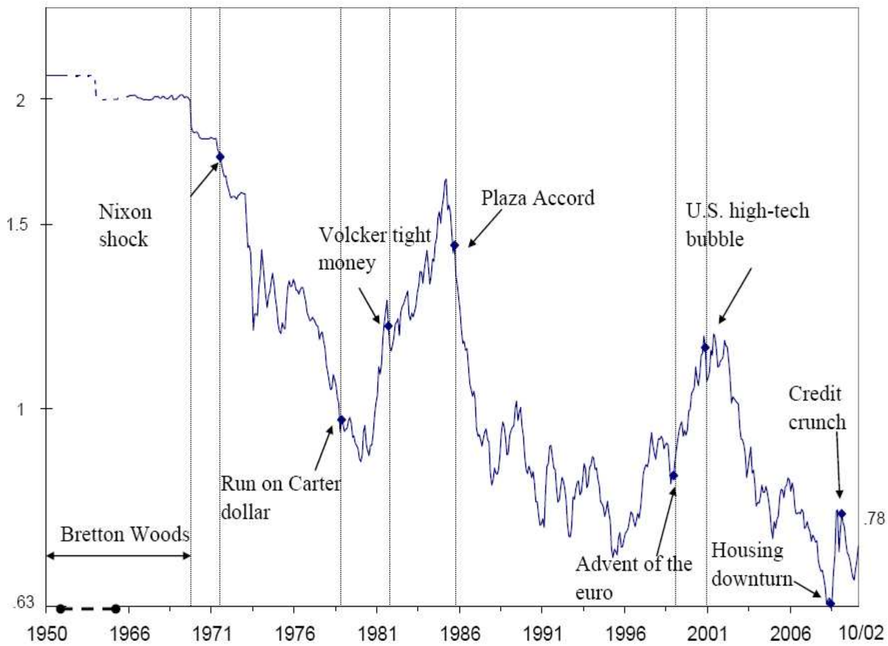
Thus, the anchor role of the dollar is increasingly questioned. Not only in the GCC, also in China. This is recognised by Ronald McKinnon, a regular visitor to the Middle Kingdom. He concedes that, with the loose monetary policy adopted in the past decade by the FED, "the dollar has become increasingly erratic as an anchor for price levels and financial stability in the American and world economies" (McKinnon 2010:7). By contrast, the euro has performed much better as an anchor since its inception. To prove this, he makes reference to the inflation and exchange rate levels of both currencies. In both cases the euro performs stronger (see Figures 5.5 and 5.6).

Figure 5.5: Consumer price indexes for the US, Germany and the EZ (100= 1957)



Source: IFS and globalfinancialdata.com

Figure 5.6: Mark-Euro/dollar exchange rate (1950-2009)



Notes: Exchange rates before 1999 are calculated with DM rates.
Source: www.globalfinancialdata.com and Federal Reserve Economic Data

Source for both figures: McKinnon (2010)

The consolidation of the euro as a stable neutral international currency points here to a recurrent theme. The euro, as shown in the previous chapter, is not able to displace the dollar as the main international currency, but nonetheless its relatively strong performance has highlighted some of the weaknesses of the dollar over the years. This has been acknowledged by a number of participants in all three case study regions, especially in China, where the ECB's inflation fighting culture is particularly appealing. For a large majority of Chinese financial elites interviewed the loose monetary policy of the FED has made the dollar a very unstable monetary anchor (Interviews X-6 2009; X-28 2009; Cao 2009; Qing 2009; Yu 2009). China has always been sceptical about the benefits of the FDS in a world of free capital movements. This is the reason why Chinese authorities have chosen in Mundell's holy trinity framework to keep their capital account relatively closed in order to maintain a dollar peg and certain autonomy in their monetary policy. The peg to the dollar has been especially valuable for them because in principle it would bring macroeconomic stability, a competitive exchange rate for their exports and, collaterally, it would also help them accumulate foreign reserves as a self-insurance policy, precisely against the volatilities inherent in the FDS.

But yet again this crisis has shown that this response is not satisfactory. In recent times the anchor is not bringing stability, rather the opposite. The loose monetary policy by the FED stimulates the entry of speculative capitals into China, despite capital controls,[81] which in turn accelerates inflation and asset price bubbles (Yiping 2010). Chinese unhappiness about the dollar anchor is best summarised by the chief economist of one of China's largest commercial banks. For this participant, who has spent many years working in the US and is familiarised with the literature covering international currencies, 'Charles Kindleberger (1986, 2000) is right when he states that the world economy functions at its best with just one, stable international currency. That is the ideal system. But, what happens when the anchor currency becomes too unstable and you are pegged to it? When it shakes constantly and it is too volatile and you jump with it?' For this participant, the answer is clear. 'There is the necessity to find alternatives to the current dollar-based system. These alternatives

[81] As reported by the *Financial Times*, despite capital controls in China, "money from abroad pours into the country. The central bank calculates that for every dollar the US central bank prints, 40 cents winds up in China" (Sender 2010).

might not be as efficient as the ideal system, but they might be better than the current, unstable dollar-standard framework' (Interview X-6 2009).

5.2.2 The Main Cause of the Instability: The Triffin Dilemma

Amid the ongoing financial crisis, the search for alternatives to the dysfunctional dollar-dominated monetary system has motivated policymakers from emerging countries, especially from the BRICS states, to publicly call for the end of the dollar-standard and the start of negotiations (thus the dollar becoming *explicitly* a negotiated currency) in order to find more satisfactory solutions. These demands started in earnest in March 2009, before the G20 summit in London, when Xhou Xiaochuan (2009), the Governor of the People's Bank of China (PBoC), proposed in a widely published article to replace the FDS with a supra-national reserve currency similar to the IMF SDRs. As Chin and Wang (2010:1) note, this article was a "game-changing moment […] because it marks the first time the Chinese leadership has publicly issued a high-profile statement of concern about the international currency system". The significance of the article was not reduced to the Chinese contexts. From its publication onwards policymakers in other key emerging markets, global multilateral institutions and European leaders would publicly endorse Zhou's concerns. In this regard, Zhou has activated the second and third steps in Blyth's understanding of how ideas play an important role in systemic institutional change (See Chapter 3, p.102). It has fostered coalition-building among those that are unhappy with the FDS and it has given them the courage to use ideas as weapons to delegitimize it.

In June 2009, in their first joint summit in the Russian city of Yekaterinburg, Brazil, Russia, India and China, the BRICs,[82] jointly called for a more diversified international monetary system (*BBC* 2009). One month later, in the July 2009 G8+G5 summit held in the Italian city of L'Aquila the Chinese secretary of state Dai Bingguo stated in front of US President Obama and other world leaders that China wants "a better system for reserve currency issuance and regulation, so that we can maintain

[82] The BRIC term is yet another example of how the ideational can become reality. What in 2001 was just a loose idea promoted by Jim O'Neill (2001), from Goldman Sachs, is now a reality, with regular meetings of the head of states of these countries. In the 2011 meeting, which took place in the Chinese city of Sanya, South Africa joined officially the group of the BRICs making it the BRICS.

relative stability of major reserve currencies' exchange rates and promote a diversified and *rational*[83] international reserve currency system" (Parker et al. 2009, emphasis added). These demands were backed by the other BRICS leaders, and also by French President Sarkozy who declared: "We cannot stick with one single currency…we've still got the Bretton Woods system of 1945…60 years afterwards we've got to ask: shouldn't a politically multipolar world correspond to an economically multi-currency world?" (Thomas 2009). During this same period several reports from the United Nations (UN 2009; UNCTAD 2009) would also propose multilateral alternatives to the increasingly dysfunctional FDS. The general feeling worldwide was summarised by Li Ruogo, chairman of the Export-Import Bank of China (a fully state-run Chinese bank) and former central bank vice governor, when he declared: "The financial crisis caused the global economy to suffer heavy losses and it also let us clearly see how *unreasonable* the current international monetary system is" (Rabinovitch 2009, emphasis added). Yet, again we see how ideas are used as weapons to delegitimize the FDS by presenting it as irrational.

For financial elites in emerging markets what makes the dollar-standard system so unstable and prone to crises is the fact that it is a system based upon a national currency as the main reserve currency. This means that the issuing authorities of this currency, in this case the FED, are more focused on adjusting their monetary policies to domestic considerations, rather than to global demands. As Zhou explains:

> The outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system. Issuing countries of reserve currencies are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries' demand for reserve currencies […] They may either fail to adequately meet the demand of a growing global economy for liquidity as they try to ease inflation pressures at home, or create excess liquidity in the global markets by overly stimulating domestic demand. The Triffin Dilemma, i.e., the issuing countries of reserve currencies cannot maintain the value of the reserve currencies while providing liquidity to the world, still exists (Zhou 2009a).

[83] As mentioned in Chapter 3, what is perfectly rational for US policymakers, might be seen as irrational for their Chinese counterparts, and vice-versa.

The governor of the Chinese central bank points here to two main themes covered in more general terms above, but which need to be unpacked here in more detail. Although he says that in general the FED might have too tight or too loose monetary policy in relation to the demands of the rest of the world, by referring explicitly to the current financial crisis, it becomes evident that Zhou's main source of concern is the lax monetary policy adopted by the FED. Nonetheless, even if one would accept that the world needs the amount of liquidity provided by the FED, which no doubt has made the US economy the 'benign' demand pull in the system, this provision of liquidity points to a second flaw in the system, which is that by providing this liquidity the US automatically needs to run current account deficits and this in turn pushes the value of the dollar down, which ultimately jeopardizes the store of value role of what should be the reserve currency of the system.

Here it is important to highlight that, while it is undeniable that the lax monetary policy of the FED has flooded the world with liquidity for decades, which has brought great financial instability to the overall system, it is also true that some of this liquidity was crucial to maintain the consumerism levels in the US, and hence make the US market the locomotive of global demand. This has been particularly beneficial for countries such as China and other emerging markets, which in the past decades have followed an export-led growth model to modernize their economies. This source of demand coming from the US and underpinning the so called Bretton Woods II system is acknowledged by Luis Manuel Rebelo, president of FINEP, the Brazilian Agency for Innovation. Nonetheless, in his view this demand is unsustainable in the long run because it is based on ever increasing levels of debt.

> The hegemonic position of the dollar as the main international currency has allowed the FED to develop monetary policies that have stimulated the national economy and consequently generated levels of deficits that would be impossible in non-hegemonic conditions. This is a fact. But the problem is that this generates the well known dilemma which says that as these deficits widen, they do also erode the credibility of the dollar as the main international currency (Rebelo 2008).

Thus, for Rebelo, and a number of other participants (Interviews W-10 2008; X-6 2009; X-19 2009; Qin 2009; Zhang L. 2009; Z-5 2010; Tariq 2010), these contradictions in the structure of the system, which are at the core of today's global imbalances between the US and the major exporting nations (especially China), have gradually undermined the centrality of the dollar in the IMS. In this regard, he believes that "the successful launch and consolidation of the euro already reveals the flaws and weaknesses existent in the dollar dominated system" (Rebelo 2008). His view, which coincides with that of Henning (1998, 2006), is that the Europeans realised in the 1970s and 1980s that they needed to be better protected from the instabilities generated by the flaws in the FDS, and this is why they decided to create the euro. Now, a similar process is happening in emerging markets, including Brazil, and this is why these countries are looking at creating alternative regional structures, drawing precisely on the lessons from the European experience (See Chapter 6).

5.3 The US Power of Delaying and Deflecting Adjustment Costs

5.3.1 The Unravelling of Bretton Woods II and the Need for a Weaker Dollar

Following the explanations above, it should be obvious by now that the centrality of the dollar in the creation of global credit has provided the US with enormous monetary power in delaying its macroeconomic adjustment (see Chapter 3, p.90 for the theoretical discussion). The maintenance for years of the Bretton Woods II system is the structural expression of this. Based on this monetary power, the US was able to run skyrocketing current account deficits without any disciplinary constraints, and by doing so it was able to be the main source of global demand for most of the rest of the world. Unfortunately, this system has a major drawback. As Duncan (2005: vii) elucidates, "the principal flaw in the post-Bretton Woods international monetary system is its inability to prevent large-scale trade imbalances" such as the ones that led to the greatest financial crisis since the Great Depression (Wolf 2009; Rajan 2010). Thus, this crisis has shown the limits of Bretton Woods II. But is this the end of this systemic configuration, or is it just a temporary halt to allow the US consumer to deleverage to a certain degree, and then start all over again?

Following the subjective perceptions about the future of the system from a number of key financial elites, it is very unlikely that the world will go back to the 2006 framework. As a senior banker from a Brazilian bank stated,

> It is time for the world to stop and think about a new international financial architecture. The US went from bubble to bubble; first it was the dot.com bubble, then the real estate bubble, which was blown further by a series of innovations in the financial system; the financial sector then became, as we have seen, 'too big to fail'; but what next? Honestly, I don't see the US coming with another bubble that can lift the world economy, especially because the world is now a different place. The BRIC countries will gain importance in the future. Demand will have to come from them (Interview W-1 2008).

Another banker, this time from China, is also very sceptical about going back to the old regime. He does not see the US recovering from this crisis soon. In his perception of the reality,

> This is not a normal business cycle crisis. This is something much more profound. The US and China need to change their growth models and this will not be done easily. The US has suffered altogether $11 trillion losses from this crisis. It needs to deleverage considerably in the future, but this will not take one or two years, as some might think. This will take 5 or 10 years. The system is totally flawed. I mean, what they have done in the US is insane. The level of leveraging was crazy. All this financial engineering, all this shadow banking system: US growth was based mainly on financial innovation. These times are gone (Interview X-6 2009).

A Chinese senior government official comes to a similar conclusion. This participant recognises that the dollar-standard regime of the past 30 years has been very beneficial for China. It has helped China to grow spectacularly thanks to export-led growth. 'Some in the government would even like to go back to those days', says this official, 'but the current crisis is just a consequence of the great imbalances created with the Bretton Woods II system. It is just a natural economic correction to a system that has reached its limits' (Interview X-3 2009). Evidence collected throughout this research suggests then that the Bretton Woods II thesis (see Chapter 3, p.111) is losing strength in Brazil and China. For a large number of key interviewees from these two countries, future demand will need to come from emerging markets and not from the over-leveraged US (Interviews W-1 2008; Belluzo 2008; De Paiva Abreu 2008; X-3 2009; X-6 2009; X-28 2009).

While I could perceive a state of unease, and sometimes excitement, among financial elites in China and Brazil about how the world will look like after the possible end of the US-centric Bretton Woods II system, the reaction among participants in the GCC region is rather muted. The differences in approach are understandable. While the financial elites in Brazil and China see themselves increasingly as major players in the world economy and therefore are confident to contest dollar-unipolarity and envision a multi-polar IMS, policymakers in the GCC are less ambitious. They prefer to sit on the sidelines and see how the big players resolve the global imbalances (Al-Jasser 2011a). The state of urgency is also less for them because they know that either way, if the Bretton Woods II system continues, or if emerging markets will be the new sources of global demand, the need for oil will be assured and this means that their economies will keep growing. However, the biggest worry for them is increased tensions between the major players. In general, they prefer to see a moderate and, if possible, coordinated transition through which the dollar can depreciate without creating financial havoc (Interviews Y-9 2010; Y-16 2010; Z-4 2010; Z-6 2010; Gükkent 2010). For Mohammed Tariq, who has worked in the financial markets in the West and now is the economic advisor to the President of the Islamic Development Bank in Jeddah,

> What is clear is that the dollar needs to go down until some sort of equilibrium is again re-established in the global imbalances. The depreciation in the value of the greenback is inevitable and dollar holders should accept it. The important thing, though, is that this decline should be gradual and protracted so that you do not trigger panic in the markets. This is crucial (Tariq 2010).

The need for a weaker dollar to regain competitiveness and reduce its current account deficits has been long acknowledged by the US government. This is when the power to delay adjustment is transformed in the power to deflect part of this necessary adjustment process upon others. This strategy started in the early 2000s and it has not ceased until now. As McKinnon points out, “the FED, and the US government more generally, were willing to tolerate the falling dollar from 2002 to 2008 (when Lehman Brothers collapsed and there was a bounce back of the greenback) because they believed that a lower dollar would reduce the burgeoning US trade deficit” (McKinnon 2010, brackets mine). During this time, most of the deflection of the adjustment costs of the US fell upon countries and regions with flexible exchange rates such as Brazil and the EZ, especially the latter (Truman 2004). The rise of the euro during these 6 years is certainly spectacular (see Figure 5.7).

Figure 5.7: Euro-Dollar exchange rate; 1999-2011 Q2

Source: ECB (2011a)

The European currency jumped a staggering 85% from its bottom of \$0.8642, registered on the 30 January 2002, to its all time peak of 1.5990 on the 15 July 2008 (ECB 2011a). In comparison, during this same period the Brazilian Real went from R\$2.44 to R\$1.59 to the dollar (FED 2011), which is a much less pronounced appreciation of near 35%,[84] but still enough to make a number of financial elites interviewed in Brazil in 2008 complain about the strength of their currency, whilst showing their admiration on how the EZ was able to absorb the strong appreciation of its currency (Interviews W-8 2008; W-10 2008). The rise of the euro during this timespan underlines a number of key features of the single currency. First, it shows the strong diversification move by foreign investors out of the dollar and into the euro during those years. This global demand for the euro consolidated the European currency as a very strong neutral international currency, but at the same time it also made it a victim of its own success (De Paiva Abreu 2008). With higher international demand for euro-denominated assets, EZ sovereign debt yields converged to German yields, creating almost a *de facto* Eurobond scenario of homogenous interest rates (See Figure 5.8).[85] This meant that EZ peripheral countries were able to emulate the US and live beyond their means thanks to cheap credit. Thus, it is undeniable that they gained monetary power of delaying adjustment by being inside the EZ (see Chapter 3, p.92). However, a strong euro and historically low interest rates made them less competitive internationally (and vis-à-vis their more thrifty EZ partners), so increasing their deficits to unsustainable levels.

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[84] During this period the peak of the Brazilian real against the greenback occurred on the 1 August 2008 at R$1.5580 to the greenback. This level was crossed the 27 April 2011 with the Brazilian currency reaching R$1.5570. This constant appreciation has forced the Brazilian Minister of Finance Guido Mantega to declare that we are living in Currency Wars, see section 5.3.2 in this Chapter.

[85] Note that before the crisis, EZ member states were able to obtain cheaper credit than the UK. The reasons behind this yield convergence in the EZ are twofold. First, international investors were very keen to diversify as much as possible out of US Treasuries, and European debt securities were the best alternative. Second, as explained in Chapter 4, international investors were treating the EZ as a *de facto* political union. They were assuming that the level of political integration and co-guarantee for the issued debt was so high that Greek government bonds were regarded almost as safe as German bunds. As it turned out, this was a gross miscalculation, showing again that markets are not as rational and efficient as widely portrayed. .

Figure 5.8: European sovereign bond spreads (basis points, 10 year bond spread to German Bunds)

Source: Federal Reserve Bank from Atlanta (2010)

Ultimately, the US mechanism of deflection via loose monetary policy and a weak dollar showed first the strengths and then the weaknesses of EMU. Protected by the shelter of a monetary union, unlike in the past the Europeans were now more resilient to the dollar weapon of depreciation (dollar holders around the world, who lost 85% of their purchasing power vis-à-vis European products can only prove this). However, by not having a coordinated and active exchange rate policy and lacking a fiscal union to overcome asymmetric shocks, the Europeans have also shown that they are still vulnerable to the inherent flaws of the FDS. The current crisis has highlighted the key features of EMU. On the one hand, there is an appreciation bias in the euro vis-à-vis the dollar because the ECB is internationally perceived as the most hawkish and independent central bank. In this regard, the lack of a powerful pan-European state is an advantage. However, on the other hand, the lack of a political authority with a federal budget and the power to function as the lender of last resort (see Chapter 3, p.87) makes the EZ inherently fragile and exposed to the speculative turbulences of the financial markets.

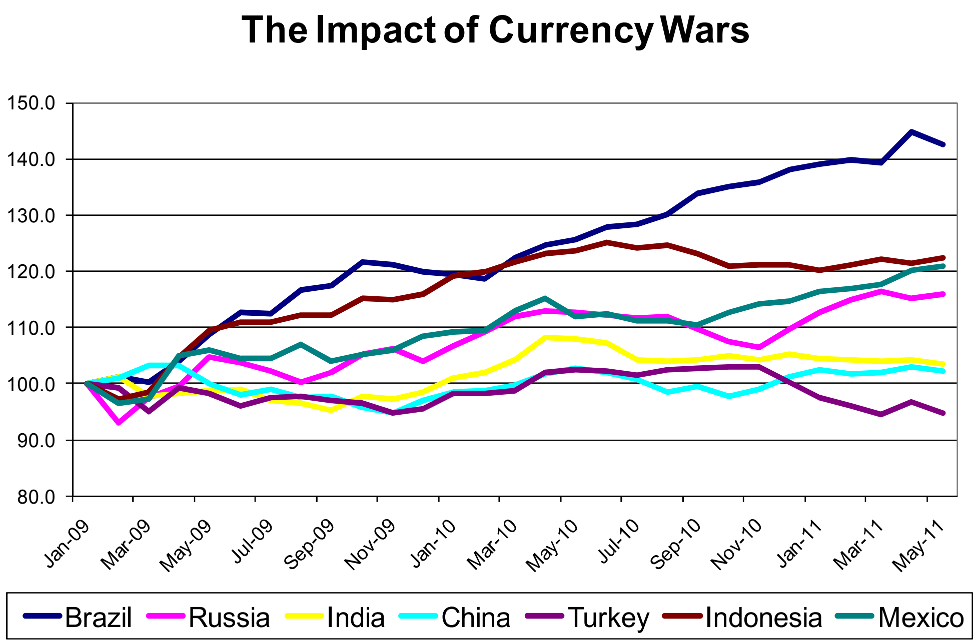
5.3.2 The FED's Quantitative Easing and the Threat of Currency Wars

Ironically then, the region that in principle was better protected from dollar shocks has been one of the most affected. The reason for this, however, is explained by the fact that the EZ has been the only big player that has played all the way, even amidst the current financial crisis, by the 'rules of the game' of the FDS (See Chapter 3, p.102). It has resisted the temptation to intervene in the FX markets to devalue its currency or to put restrictions on the capital account to avoid its appreciation. The same cannot be said about other key players in the system. As explained, China, most of the rest of Asia and the GCC are heavily pegged to the dollar, and since the financial crisis erupted, Switzerland, Japan and Brazil have all intervened in the markets to mitigate the appreciation of their currencies vis-à-vis the unorthodox loose monetary policy of the FED known as Quantitative Easing (QE). These reactions are clear evidence of how the tensions and contradictions in the FDS are pilling up. Knowing that a return of Bretton Woods II would be too destabilising, the US has decided to undertake the long-delayed adjustment and address its current account deficits. To achieve that the Obama Administration has made as one of its primary goals to double US exports in the coming years. However, to achieve that the US export industry needs to become more competitive. Therefore, adjustment is due. This can be done internally by deflation, as surplus nations such as China and Germany would like it, or internationally through the monetary power deflection mechanisms of generating a weaker dollar or forcing others to appreciate their currencies.

Since the appreciation of the euro has literally exhausted the absorption capacity of EZ member states, the US has redoubled its efforts to convince China to let its currency appreciate. China, however, is not willing to give in to US pressure. When confronted with this possibility, Chinese policymakers and financial elites refer quickly to how Japan bowed to US pressure for yen appreciation in the 1985 Plaza Accord and how this was the cause of Japan's economic decline (Bowles & Wang 2008; Interview X-3 2009; Eichengreen 2011a). For Chinese policymakers a strong appreciation of the yuan in a relatively short period of time is inconceivable because it would seriously damage the export sector and cause social unrest. As stated by Chinese Prime Minister Wen Jiabao: “If the yuan is not stable, it will bring disaster to China and the world. If we increase the yuan by 20% or 40% … many of our factories will shut down and society will be in turmoil” (Paletta & Miller 2010).

Given that the pressure on China has been fruitless so far, the FED has decided to launch what some have described as a ‘financial war’ against the rest of the world (Hudson 2010; Zhang Monan 2010). At the end of the summer of 2010 it announced that it would start a second round of Quantitative Easing (QE2), injecting another $600bn into the markets. This has been widely understood by analysts around the world, among them no other than former FED chairman Greenspan (2010), as a clear attempt to weaken the dollar further. This prompted a furious reaction in emerging markets and even in Europe. The Minister of Finance of Brazil Guido Mantega declared that “an international currency war” of beggar-thy-neighbour devaluations had begun (Wheatley & Garnham 2010). His reaction is understandable. With the sovereign debt crisis in the EZ lingering on, Brazil has taken most of the adjustment costs deflected by the US (see Figure 5.9).

Figure 5.9: FX fluctuations of major emerging markets currencies against the dollar



Source: JP Morgan, Wolf (2011b)

Fearing massive inflows coming from the loose monetary policy of the FED, during this time not only Brazil intervened in the FX market to hamper the rise of the real. The central banks of South Korea, India, Malaysia, the Philippines and Singapore were all suspected to be active in the markets fighting the slide in the dollar (Garnham 2010). Japan, one of the main allies of the US, announced publicly that it was doing so, undermining further the reputation of the FDS (Whipp & Beattie 2010). In a strengthening of measures, Brazil, Thailand and South Korea announced controls and taxes on capital inflows. For the first time in decades FX intervention and capital controls, two heresies of the FDS, have become again respectable, providing clear proof that the system is certainly under enormous stress (Hudson 2010). Even the IMF has made a u-turn and has validated the usefulness of capital controls (Ostry et al. 2010). The questioning of US leadership in global monetary governance is a theme that will be covered in more depth in Chapter 7 (p.260). Here it suffices to highlight how before the November 2010 G20 summit in Seoul, while the US was still blaming China for global imbalances, officials from Brazil, China and, significantly, also from Germany and the EZ as a whole would openly criticise QE2.[86] In this regard, following again Blyth's framework, they would use ideas as weapons to delegitimize the policies of the FED.

The Governor of the Central Bank of Brazil, Henrique Meirelles, for instance, would defend China by saying: "The biggest imbalance today is the American monetary expansion, which is being used to fight lower growth and unemployment still high in the US – this is the biggest injection of liquidity in the international economy" (Barden & Dantas 2010). Mantega, the Brazilian Finance Minister, would be even blunter in his criticism. "Everybody wants the US to recover, but it does no good at all to just throw dollars from a helicopter" (Beattie et al. 2010). Similarly, the German Economy Minister Rainer Brüderle would declare that "an excessive, permanent increase in money is, in my view, an indirect manipulation of the (foreign exchange) rate" (*Reuters* 2010b, brackets in original). His colleague, the Minister of Finance, Wolfgang Schäuble, was even more straightforward in his language: "With all due

[86] This was the first time in recent years that EZ officials would openly criticise the US deflection mechanism. Before the G20 Summit in Seoul Juncker, head of the Eurogroup, declared: "I think that the Europeans who are sitting around the G20 table will obviously have to put questions to our American friends regarding recent monetary decisions…There is great criticism of the Chinese policy, but in a different way they (the US) are pursuing exactly the same policy" (Strupczewski 2010).

respect, US policy is clueless… (The problem) is not a shortage of liquidity. It's not that the Americans haven't pumped enough liquidity into the market" (Rohan & Breidthardt 2010). Finally, Chinese criticism of the FED and the dollar-standard system came from Xia Bin, an adviser to the PBoC. In his words: "As long as the world exercises no restraint in issuing global currencies such as the dollar – and this is not easy – then the occurrence of another crisis is inevitable, as quite a few wise Westerners lament" (Beattie et al. 2010).

The enormous concern in China about the FED's strategy of printing money through QE was very visible during my fieldwork, and this was even before QE2 had started. A large number of Chinese financial elites interviewed would share their worries about a possible inflationary outcome and how this would negatively affect the value of China's national savings held in dollars (Interviews X-6 2009; X-27 2009; Cao 2009).[87] The general feeling would be very similar to the one expressed by Cheng Siwei, former vice-chairman of the Standing Committee of the Chinese Politburo: "If they keep printing money to buy bonds it will lead to inflation, and after a year or two the dollar will fall hard. Most of our foreign reserves are in US bonds and this is very difficult to change, so we will diversify incrementally reserves into euros, yen, and other currencies" (Evans-Pritchard 2009).[88]

The Chinese participants with more faith on the abilities of the FED to mop up excess liquidity once the crisis is over would worry about the political pressures in the US in favour of delaying the exit strategy, while the most critical with the FED and the US at large would declare that in their opinion the US will attempt to inflate its debt away

[87] Chinese policymakers have repeatedly expressed their concerns to their US counterparts about the inflationary outcome of Quantitative Easing. In a September 2009 cable dispatched by the US Embassy in Beijing and leaked by Wikileaks, one can read how Chinese Vice Minister Liu He of the Central Leading Group on Financial and Economic Affairs (CLGFEA) told in a bilateral meeting US Under Secretary for Economic, Energy and Agricultural Affairs, Hormats, that "he was a 'little worried" about the path of the US economy, fearing it might be reverting to the past model: the Fed was 'printing lots of money'". In the same cable it is also said that Zhang Yuyan, director of the Institute of World Economics and Politics (IWEP) at CASS, who also attended the meeting, "was concerned about the possible future inflation in the US that could erode the value of China's USD-denominated investments". See MacAskill's (2010) extensive coverage.

[88] Since the irruption of the financial crisis, China has not only tried to diversify away from the dollar into other currencies. It has also actively used its dollar reserves to buy gold, becoming the 5th largest gold holder in the world (Zhang R. 2009) and it has also used its reserves to help its state-owned companies to buy assets all over the globe in what is known as the Going Global strategy (Wang 2009; Zhou 2009b; Anderlini 2011a). Nonetheless, these assets are much less liquid as money or paper money (bonds) and therefore they are not a real diversification alternative.

by debasing the dollar. Xu Yisheng, an opinion columnist for *China Business News*, falls in the latter category. He describes QE as a 'malignant bloating' of liquidity that will bring huge inflation, and possibly the collapse of the dollar (Xu Y. 2009). The chief economist of one of the biggest commercial banks in the country, who has worked for many years in the US, is more circumspect in his analysis. He does not believe that the US will inflate away its debt purposely, and unlike some of his countrymen he is also a strong believer in the know-how and tools of the FED to mop up excess liquidity. However, his concern is with the timing of the exit. It is worthwhile to paraphrase here his insights:

> If you tighten monetary policy too rapidly you might end up like the Japanese. Political pressure coming from Congress will try to avoid this. They will try to have consolidated growth and let inflation rise for a while, but then monetary tightening might be too late. You have to understand that the FED has a systemic bias for inflation. This comes from Greenspan (Duck Greenspan), who did not want to stop the liquidity formation process, and it is now followed by Bernanke (Heli Bernanke), who wants to throw liquidity from a helicopter if necessary (Interview X-6 2009).

As these statements illustrate, worry about future dollar depreciation is widespread in China, be it in policymaking circles, in the banking community or among the general public. Thus, confidence in the dollar as the top international currency is fading. Timothy Geithner could certainly feel this in his first official visit to China as US Treasury Secretary. When he tried to convince his audience at Peking University that the US supports a strong dollar and that dollar-denominated "Chinese assets are very safe", the students' response was a loud and spontaneous laughter of disbelief (Conway 2009).

5.4 China's Failed Attempts to Renegotiate the Status of the Dollar

5.4.1 Chinese Proposals to Overcome the Dollar Conundrum

At this point of the discussion it should be clear that China has serious doubts about the status of the dollar as the world's top currency. Nonetheless, it should also be obvious that China has limited options when it comes to diversify aggressively out of the greenback. As demonstrated in Chapter 4 (p.139), the euro does not have enough liquidity to be able to absorb such a shift. Hence, China is in a dollar conundrum. It would be happy to diversify out of a reserve currency that it considers unstable and risky, but with over $3 trillion in reserves and roughly 65% of them denominated in dollars it cannot do so, not least because a sudden collapse of the dollar would signify a considerable loss in China's remaining dollar-denominated assets and trigger a global financial crisis of unimaginable consequences. As explained in Chapter 3 (p.113), China's pulling out of the dollar would be the financial equivalent of the nuclear option in international warfare. If applied, it would be the last option. In order to avoid this, China has put forward a number of proposals to the international community and to the US in particular to solve its currency conundrum. By doing so, it has signalled to the rest of the world that it considers the dollar a negotiable international currency. Here we enter in what can be considered the fourth phase of Blyth´s framework. It is here when ideas are used to propose a new institutional set up.

The last part of this chapter focuses on these proposals and US reaction to them leaving Brazil and the GCC partly aside because here China takes a prominent role. As shown above, Brazil sees also the necessity to move out of dollar-unipolarity, but it has far fewer dollar reserves than China and hence less to lose, so its activism is less pronounced. The GCC, on the other hand, takes an approach of wait and see. GCC policymakers are very cautious about not speaking out publicly against the dollar and the US in general. Nonetheless, as a former senior Saudi official recognised, it is "very positive that the Chinese have decided to raise the issue of reforming the IMS. Someone had to do it", he says. "We are as much frustrated as they are about the dollar, but we do not complain because we are very polite, even more polite than the Chinese and Japanese" (Interview Z-5 2010).

The first Chinese proposal to overcome the dollar conundrum was spelt out by Zhou, the Governor of the PBoC, in his famous article on the reform of the IMS. The central idea of the article is that the international community should "promote a greater role of the (IMF) SDR as a reserve currency. To achieve this, the IMF can set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired" (Zhou 2009a). This proposal was quickly embraced by Fred Bergsten, for whom the IMF substitution account in SDRs "would be a winning proposition for all concerned. The dollar holders would obtain instant diversification [SDRs are made out of 41.9% dollars, 37.4% euros and 11.3% pound sterling and 9.4% Japanese yen].[89] The US would avoid the risk of a free fall of the dollar. Europe would prevent a sharp rise in the euro. [Thus], the global system would eliminate a potential source of great instability" (Bergsten 2009b, brackets added). However, despite its attractiveness, and its support by other Asian countries, Brazil and Russia, the proposal was rejected by US President Obama, by FED chairman Bernanke and by Treasury Secretary Geithner[90] (*AFP* 2009; *Reuters* 2009b). As will be shown in Chapter 7 (p.253), the idea of reforming the IMS was only included in the G20 agenda once France actively pushed for it, demonstrating that the Europeans have more *influence* than the Chinese vis-à-vis the US when it comes to agenda-setting (the second face of power, see Chapter 3, p.95) in global monetary governance.

Nevertheless, Chinese proposals to negotiate with the US how to solve its dollar conundrum have not been limited to the multilateral level. China has now for some time asked Washington for guarantees on the future value of its dollar-denominated assets. The most direct demand came from Chinese Prime Minister Wen Jiabao in spring 2009 when he requested from the US "to maintain its good credit, to honour its

[89] This is the new currency composition of the SDR since the IMF's latest revision of the currency weights on 30 December 2010.

[90] Geithner actually sent the dollar on a temporary slide when he first said that he was "quite open" to the idea, only to recognise his error and amend his previous comments by saying that "the dollar remains the world's dominant reserve currency… and that's likely to continue for a long period of time" (Phillips 2009). This simple gaffe made the dollar lose 1% against the euro in just a few minutes, showing how sensitive this topic is for the markets.

promises and to guarantee the safety of China's assets" (Dyer & Beattie 2009). The view in Beijing is that since China is the largest creditor to the US it has the right to have a say on US monetary and fiscal policies. This perception by Chinese policymakers is graphically explained in economic terms by Xu Wang, a journalist specialised in international finance from the state-owned English-written newspaper *China Daily*. In his opinion, the Chinese leadership understands the dollar-centred IMS as a company that has been run by a family (i.e. the US). 'This family has been able to decide for decades how things should be run because it owned the company. Now, however, China wants to change the structure of the company and make it a shareholder company, where different shareholders agree on what are the best policies' (Wang Xu 2009a). That China can use its vast amounts of dollars to gain leverage upon US policy is a theme that has gained strength in China since 2007, when He Fan and Xia Bin, two prominent Chinese economists close to Government circles, aired for the first time the possibility that China could use its reserves as a "bargaining chip" with the US (McGregorin 2007). Since then, as we have seen above, the status of the dollar as a negotiable currency is a widespread intersubjective perception among financial elites, not only in China, but also in places such as Brazil.

With the coming of the financial crises in the US, Chinese criticisms and demands in relation to US monetary and fiscal policy, and its effects on the value of dollar-denominated assets, have become bolder. This watershed was especially evident when Geithner visited China in summer 2009. While in previous visits of US officials to China the issue of the future of the dollar was never high on the agenda (at least not publicly), this time Geithner's main goal during his trip was widely perceived among Chinese financial elites as an attempt "to reassure China of the safety of its investments in the US and resist the temptation of trade protectionism – crucial to woo further Chinese lending to the world's largest borrower" (Wang & Zhang 2009). Hence, we see here how the negotiated status of the dollar has gone beyond the implicit bargain in which China keeps buying US Treasury bills for access to the US market, to an explicit demand in which China wants further guarantees from the US about the safety of its assets. Chinese determination to influence US policymaking is exemplified by the tone of Yu Yongding, from the Chinese state sponsored CASS, in an interview given to *Bloomberg* just before meeting Geithner in Beijing. For Yu, either the US starts saving more or "another financial crisis triggered by a dollar crisis could be inevitable". In this regard, "Geithner can show us some arithmetic" on how the Obama Administration can reduce its fiscal deficit to roughly 3% of GDP from a projected 12.9% for 2009. "We need to know how the US government can achieve this objective". Yu also insisted that China needs to know how the US will withdraw its excess liquidity "in a timely fashion to avoid inflation" when its economy recovers. Finally, in this interview, Yu referred to the FED "as the world's biggest junk investor", and to chairman Bernanke as "helicopter Ben" who has dropped "tons of money from the sky since the subprime crisis" (Hamlin & Li 2009). These are certainly tough words from one of the leading financial elites in China, especially considering that they were published one day before meeting Geithner. They show how ideas can turn into weapons.

In the meeting that followed these remarks it is very likely that Yu put forward to Geithner some concrete proposals generated by his think-tank in order to protect China's dollar denominated assets (Yang & Chen 2009; Yu 2009). One option for China could be to ask the US to issue national debt in Chinese RMB as was the case in the 1960s with the Roosa bonds and in the 1970s with the Carter bonds when the dollar was also seen as a negotiable international currency. As Kirshner (2009:212-3) indicates, these RMB denominated 'panda' bonds would make it "more difficult to reduce the value of US debts via devaluation and inflation, devices that have served the US well in the past". A second option would be to oblige the US to anchor its debt-issuing to inflation levels. This could be achieved by asking the US Treasury to increasingly issue future debt to China only (or mainly) through so called TIPS (Treasury Inflation Protected Securities). This type of bond can be bought currently in the markets but its liquidity is too low for a big player such as China. Therefore Yu and others want this market either to be expanded substantially or that the Treasury offers special issuances to China. Incidentally, Chinese pressure on this second option has already yielded some rewards. Just a few weeks after Geithner's visit to China, the US started issuing more TIPS (Copeland & Randall 2009), in a clear indication that the dollar is increasingly becoming a negotiated currency. And, finally, the third option would entail converting US debt bonds into relevant American companies and/or bank shares. In this way, even if inflation would rise in the US, Chinese investments would not lose their value.

5.4.2 Dealing with US (Over)-Confidence in the 'Dollar Trap'

Although China feels that it has the right to demand from the US that the latter is constrained in its fiscal and monetary policies to safeguard Chinese interests, the view is different from Washington. Apart from the minor concession of issuing more TIPS, US officials have not shown any disposition to start negotiations on how the dollar should be managed.[91] Quite the opposite, in their view it is the US, as the leading nation in the system, which has the right and strength to demand from China changes to its monetary policy and appreciate its currency against the dollar. Here is where different perceptions of the reality of the IMS clash with each other and where agency can be constrained by structure. While in China the interpretation is that the US is becoming weak and thus the status of the dollar as the leading international currency should be discussed (He 2009; Shen 2009; X16; X-19 2009; Yu 2009), in the US the feeling is that China has driven itself into a 'Dollar Trap', as argued by Paul Krugman (2009). For him, Zhou's article calling for a super-sovereign reserve currency to replace the dollar "was actually an admission of weakness". To keep its currency devalued to gain market share for its exports, China has accumulated trillions of dollars by sterilising the new inflows of money. Hence, "China now owns so many dollars that it can not sell them off without driving the dollar down and triggering the very capital loss its leaders fear. So what Mr. Zhou's proposal actually amounts to is a plea that someone rescues China from the consequences of its own investment mistakes. That's not going to happen" (Krugman 2009).

If Krugman's analysis is shared by the political establishment in the US, which is very plausible, it is very unlikely that the current Administration will concede any further ground on China's proposals in managing the dollar. Hitherto, US policy actions point in the opposite direction. Despite increased Chinese and worldwide outrage about US profligacy, the Obama Administration has not shown any constraints in its lax economic policy. At the end of 2010 it expanded for another two years the tax cuts of the Bush era and, on top of this, it approved another small stimulus package. Thus, the US annual budget deficit will remain above the

[91] Nicolas Sarkozy has also made the reconfiguration of the IMS out of dollar unipolarity one of his high priorities during the French presidency of the G20 in 2011. But as of the time of writing, the US has shown little willingness to engage constructively in this type of reforms (See Chapter 7).

impressive sum of $1 trillion (above 9% of GDP) in the foreseeable future. The FED, on its part, as already mentioned, has extended its QE policy into 2011 without any consideration for Chinese or other countries' demands for a more restrained monetary policy. In a time of currency wars it seems that the US is confident enough to deploy all its structural weaponry to deflect the adjustment costs upon others, especially China. Martin Wolf explains what seems to be in the minds of US policymakers.

> To put it crudely, the US wants to inflate the rest of the world, while the latter is trying to deflate the US. The US must win, since it has infinite ammunition: there is no limit to the dollars the Federal Reserve can create. What needs to be discussed is the terms of the world's surrender: the needed changes in nominal exchange rates and domestic policies around the world (Wolf 2010b).

So from this point of view, it is not China who is in a position to tell the US how to implement its monetary policy, it is rather the US who will force China to appreciate its currency and consequently implement the internal adjustment process (from an export-led to a more domestic-driven economy), which the US requires to advance its own export industries. When confronted with this interpretation of the reality, most Chinese financial elites interviewed would regrettably accept this state of affairs. Again, this shows how agential perceptions are still confronted with structural conditions that are not easy to transform. They would not hide their unhappiness or even anger about this situation, but overall they would agree that, yes, unfortunately, China is in a dollar trap (Interviews X-6 2009; X-17 2009; X-18 2009; X-19 2009). Several would regret that China had not diversified out of the dollar and into the euro and other currencies earlier (Yu 2009), as Russia did (Johnson 2008). Others would say that all these dollar reserves should have been invested domestically (Zhang E. 2009). Overall, however, they would acknowledge that it is too late and that China is stuck with the dollar and now it needs to get the most out of this difficult situation. This is the view for example of Xu Sitao, chief representative of the *Economist* in Beijing. For him, as yet, there is no alternative to US Treasury bonds. However, this does also mean that China will continue to be pegged to the dollar. As China cannot change American monetary policy nor can it use its dollar assets to buy US companies because the Americans will block these purchases, 'which is unfair',[92] says Xu, then the most normal strategy to follow is to keep the peg and not let the Americans change Chinese monetary policy. 'Besides, there is no way that China can substitute exports with domestic demand in the short run'. Asked whether the peg will ultimately not end in US protectionism, Xu remains silent for several seconds. Then, he says: 'There is no solution to this' (Xu S. 2009).

Protectionism[93] seems to be the great worry of Chinese financial elites (Anderlini 2009; Pettis 2009a). The general feeling is that, given that protectionism is gaining momentum in the US, China is unlikely to move quickly enough to a domestic consumption-led economy. This might happen in the medium to long term. The Chinese government is actively promoting this adjustment, but as recognised by Governor Zhou (2011) in an article on savings patterns in China, this will take time. So the most normal outcome, in the short to medium term, is that China will continue to have its currency relatively pegged to the dollar. This in turn can lead to a protectionist backlash from the US. When this possibility came up in some of the interviews with some Chinese officials there would be an unsettling silence in the room (Interviews X-3 2009; X-12 2009), hinting that this is a big concern in China (Ding 2009; Xu S. 2009; Yu 2009). Prominent scholars on the Chinese economy such as Pettis (2009b; 2010) have persistently warned about this possibility, and so have financial policymakers in Brazil (Wheatley & Leahy 2011). This view is also widespread in the GCC (Interviews Y-11 2010; Yousef 2010; Zubair 2010).

Hence, China and the US are in a situation of dangerous stalemate, which can lead to tensions, as acknowledged by the Institute of International Finance, the mouthpiece of the global banking industry (Beattie et al. 2010). China is not able to change US monetary policy, but equally the US finds it hard to exert monetary influence upon

[92] Again we see how the US is criticised for its hypocritical attitude. It promotes free-markets around the world, but when it comes to its own market this rule is not always applied (Xue 2009). As explained in Chapter 3, this attitude undermines the Efficient Market Hypothesis ideology.

[93] The US Congress has already passed legislation that would punish China for its intentional devaluation of its currency by introducing countervailing duties on Chinese imports. Nevertheless, so far President Obama has not shown any signs to be willing to approve this type of legislation.

Beijing (Yao 2010).[94] As Helleiner and Chin explain, China shows that it is less vulnerable to the 'dollar weapon' than Japan in the 1980s.

> The fact that China does not depend on a US security umbrella, as Japan did, has enabled China to take a more independent stance. Moreover, the resulting accumulation of massive dollar reserves to prevent the RMB's appreciation… would normally have generated a domestic monetary expansion. But China's state-owned banking system has enabled it to sterilise the reserve growth more effectively than other dollar supporters [i.e. Germany and Japan] were able to in the past (Helleiner & Chin 2008:94, brackets mine).

Helleiner and Chin highlight here two aspects that are of great importance for the overall argument of this thesis. The first is that structural military power is a key factor in enhancing monetary power. This is where the EZ presents a clear weakness. Second, by not buying fully into the EMH and still applying capital controls and a tight financial regulatory system, China has been able to enhance its own monetary autonomy against the instabilities associated with the FDS. Given this state of affairs, the view in the GCC, the other big surplus region with a peg to the dollar, is that China will remain pegged to the greenback until it rebalances its economy and it develops its financial system (Interviews Y-16 2010, Y-11 2010; Tariq 2010). An official from one of the central banks in the GCC is convinced that for now it is in China's interest to keep pegged to the dollar, even if it depreciates. "The further it goes down, the more China penetrates other markets", he says. "What is better for them? Losing in the value of their reserves or maintaining their export advantage? If I were a Chinese leader, I would prefer to lose 20% in the value of my reserves than see a surge in my unemployment rate. They will accept a 20% decline or more in the dollar, like us" (Interview S-6 2010). While everyone in the GCC is looking closely at what China does with its peg (demonstrating the increasing importance of China in IPE), for now the general sense is that it will not move out of the greenback.

[94] US incapacity to force Beijing to change its policies was acknowledged in March 2009 by Secretary of State Hillary Clinton by asking the then Australian Prime Minister Kevin Rudd (in a conversation summarised by a US embassy cable leaked by WikiLeaks): "How do you deal toughly with your banker?" See MacAskill (2010).

Nonetheless, the possible freefall in the dollar engineered by Washington can be dangerous, as Eichengreen (2011a) has warned (see Chapter 3, p.112). Sfakianakis from Banque Saudi Fransi, for example, says that there is a limit. He concedes that the GCC region will accept a 20% depreciation of the dollar or similar, but he does also warn that his customers will not accept a decline of 60%. For him, the markets have shown that $1.60 to the euro is the bearable threshold. 'Once this is passed everyone starts to get nervous and there might be a run on the dollar' (Sfakianakis 2010). US unilateralism in bringing the dollar down is also repudiated in China. The same Yu Yongding recognises that China is in a dollar trap. As he puts it,

> There is a saying in Chinese which says that "never give up curing a dead horse". China knows that the horse is dead, that if it comes to the worst, it will probably take losses from its dollar holdings either via dollar depreciation or RMB appreciation. China will lose in any case. But that does not mean US policymakers can just ignore Chinese proposals and look down to us. As I said, the horse is dead. We cannot cure it. But we can still make a lot of harm. If they do not respect us, if they think we are just foolish Chinese that made our own trap then we can always overreact (Yu 2009).

A senior manager at one of the large state-owned commercial banks agrees that if the US does not come to the negotiating table, the outcome might be Chinese retaliation.

> Their [referring to the US] position is clear, right? They do not want to talk; they do not want to negotiate. But negotiating is not only talking. We can still take some actions. We can reduce our purchasing of US Treasury bills and then see what the US does.[95] We can also push for further currency integration in Asia. This is another move we can, and should, adopt. Action is certainly possible (Interview X-16 2009).

The possibility of greater regional monetary integration to confront the dollar weapon is precisely the theme covered in the next chapter.

[95] Speculation on how China can use the leverage of selling US treasuries in masse to punish US foreign policy is continuously a theme discussed by participants in the financial markets, see Alloway (2010).

5.5 Summary

The aim of this chapter has been to demonstrate how the dollar is increasingly becoming a negotiated international currency in the subjective perceptions of financial elites in China, Brazil and the GCC. In order to achieve this, the discussion has been organised from the abstract to the concrete. From how the system is built on ever expanding US debt, which generates financial crises and hence widespread discontent, to a detailed examination of how the US is able to (mis)use its central position in the system to delay and deflect adjustment costs upon others, and how in turn the financial elites of these countries are starting to get increasingly frustrated about this situation, demanding a change in the overall framework. The principal flaw in the system is that it generates by default unsustainable global imbalances. By being the issuer of the main international currency, the US has been able to live well beyond its means for decades. This does not mean that the system has been profitable only for the US. Over the years exporting champions such as Japan, Germany, the GCC countries, and, more recently Asia and especially China, have greatly benefited from the demand pull that voracious US consumerism has generated. However, the problem is that the system is based on excess liquidity which triggers destabilising boom-and-bust cycles, the ongoing financial crisis just being the biggest and most protracted boom and consequently also the most harmful bust. Here is where the impact of the euro comes into play. Ironically, by competing with the dollar as a very strong neutral international currency, the euro has in the past decade both highlighted and protracted the flaws in the system. Through its strong resilience to ever-increasing global demand up to $1.60, the euro has laid bare the weaknesses in the dollar, but equally by being able to absorb so much demand, and by playing by the 'rules of the game', it has been the focus point of all the tensions and contradictions accumulated during the latest boom in the system, as the current sovereign debt and banking crises in the EZ clearly show.

While the Europeans have suffered the most in this crisis from the inherent flaws in the system because they were the most exposed to them, financial elites in Brazil, China and the GCC have also been confronted with the unpleasant deflection power of the US. The GCC has had to cope with high inflation, losses in revenue and destabilising capital inflows for years, if not decades. Brazil, for its part, has been the second most exposed global player, and even the most since the euro sovereign debt crisis, by virtue of having a relatively flexible exchange rate (again by trying to follow the unstable rules of the game). The Brazilian real has risen so much that the Brazilian government had to intervene in the FX market and enforce controls and taxes on capital inflows. As a consequence, Brazil has also been one of the most outspoken countries in favour of renegotiating the FDS. While a reconfiguration of the IMS should be the end goal, the urgent task in the short run is to tackle global imbalances. But how can the international community achieve this? As in the 1970s with Germany, and in the 1980s with Japan, the US believes that it can force a devaluation of the dollar against all the other currencies, especially against the Chinese RMB, to rebalance. However, China is unwilling to follow the Japanese example, not least because it does not depend on the US for its security. With $3 trillion in its portfolio China has too much to lose, and more importantly, it feels too strong to bend to US pressure and accept the losses. We are therefore in a 'global dollar trap'. How can this be avoided? One option is through a global multilateral agreement on the reform of the IMS, a theme covered in Chapter 7. The other alternative is to find refuge from US monetary power at the regional level. As shown, the Europeans certainly have decades of experience in this area. How EMU is seen as a potential blueprint for regional monetary cooperation against dollar-shocks is the topic covered in the next chapter.

Chapter 6: The Euro's Ideational Challenge to the Unipolarity of the Dollar

After identifying in Chapter 4 the euro's main material, institutional and political weaknesses in relation to its potential challenge to the dollar, and subsequently, in chapter 5, exposing the flaws in the FDS and the increased desire for alternatives, in this chapter the attention will be drawn mainly on the ideational effects of the euro in 1) regional monetary cooperation and 2) the formation of a multicurrency IMS. In this regard, the main aim in this part of the thesis is to elucidate how the perceived success of the European currency has changed the views of these financial elites in relation to the feasibility of, on the one hand, regional monetary cooperation and monetary unions and, on the other hand, the emergence of an IMS that moves away from dollar unipolarity towards a multicurrency system. Faced with the Knightian uncertainty surrounding the FDS, financial elites in emerging markets are looking for possible blueprints (see Chapter 3, p.102) on how to cope best with dollar-shocks. In this regard, EMU functions as a good monetary laboratory to test new ideas.

The chapter is divided in 5 sections. The first shows how the euro is hitherto widely perceived (at least until the recent euro debt crisis) as a successful experiment and thus it is characterized as an epoch-making event in the history of monetary affairs raising considerable appeal for emulation. Seen against the incumbent dollar, the euro is still considered a young teenager, which still needs to arrive to maturity in order to be able to challenge dollar seniority, but assessed by its own merits the European currency receives considerable praise and admiration. EMU functions thus as a template for regional monetary cooperation and even monetary union in Latin America, the Arabian Peninsula and East Asia. The next three sections focus precisely on this ideational influence of the euro in the three regions. In the first part of every section, I will provide a summary of the main achievements towards regional monetary cooperation that have been completed in every region, while at the same time I will show how these arrangements have been stimulated by the apparent success of the euro, which functions to various degrees either as a harbinger, template or role model,[96] depending on each case. I will be arguing that in the case of Brazil

[96] The euro perceived as a 'harbinger' is here understood as a frontrunner experiment. It attracts attention while it is evolving but it is not seen as an example to copy as it stands. It is a source of study. In the 'template' function, its appeal is greater and it is seen as a positive and desirable development.

and Latin America at large, EMU is mostly interpreted as a source of inspiration. In the GCC it is definitely seen as a role model to emulate. In China it is considered a harbinger, in the sense that, if it succeeds, it will show the way forward, but if it fails (a possibility that cannot be discarded considering the still unresolved internal tensions in EMU), it might prove that monetary unions are very difficult to achieve, or at least they should not be achieved following the European path. In any case, successful or not in the long term, the European currency has developed another ideational effect. It has demonstrated to financial elites in emerging markets that an IMS with several international currencies competing for the top spot might be possible and even desirable to avoid the instabilities and misuses associated with the Triffin Dilemma. Following this logic, the last section of the chapter focuses on the gradual internationalisation of the RMB and the potential establishment of a tripolar IMS with the euro, the dollar and RMB sharing international usage.

6.1 The Ideational Impact of EMU

6.1.1 The Euro as an 'Epoch-Making Event' in the History of Money

Despite all the structural flaws highlighted in Chapter 4, when it comes to look back and assess slightly more than a decade of existence, the project of EMU receives considerable praise from an overwhelming majority of participants in this research (W-1; De Paiva Abreu 2008; X-3; X-6; X-28; Qin 2009; Y-9; Y-11; Z-6; Z-12; Yousef 2010).[97] The majority of interviewees in all three case study regions are particularly impressed by the political will that is behind the European single currency, epitomised by the pooling of different monetary sovereignties behind the creation of the euro. This is inspiring for them. As I have demonstrated above, when it comes to compare the European currency with the US dollar, these elites would point to the material and institutional shortcomings of the EZ. But asked about the

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Here it is a source of inspiration. Finally, in the 'role model' function, it is perceived as a project to emulate. Here it acts as a benchmark. Under this division, the level of attractiveness increases gradually from the harbinger to the role model appeal.

[97] It needs to be noted here that most of the interviews were conducted before the sovereign debt crisis in the EZ reached its peak. I realise that perceptions might have changed since then. In any case, the 'Laboratory' metaphor still holds. EMU is a test study. If it succeeds, it will increase it appeal, if it fails, it will provide lessons on how not to establish a monetary union.

performance and projection of the euro on its own, the overall consensus would be that the euro is a success story – so far. Two metaphors are repeatedly used by a large number of participants in explaining the trajectory of the euro: that it is an experiment, and that it is a young child or teenager, in reference to the short history of EMU (Bloom 2008; Leitão 2011; Interviews X-12 2009; X-16 2009; Y-11 2010). For a Chinese official, for example, the euro is a success story, 'especially considering that this is an experiment that has never been tried before in history of humankind.[98] The euro has had great symbolic effects in China' (Interview X-19 2009). For another, the euro is very attractive among the Chinese because people see it as a child. 'The ECB is only 10 years old. It is a child with vulnerabilities, as explained, but also with a lot of energy and vitality. Young is beautiful. Everyone here wants it to do well, to get to maturity' (Interview X-12 2009). The significance of the creation and consolidation of the euro for Chinese financial elites is summarised by Yu Yongding, from CASS. Echoing the words expressed before by Mundell (2000), he believes that the euro is an 'epoch-making event' that will help in creating a more stable international financial system. 'Before the euro we had a US hegemony based upon the US dollar but I see the euro as a clear challenge to the hegemonic power of the dollar' (Yu 2009). Similarly to many other Chinese financial elites, Yu does not believe that the euro will substitute the dollar as the top international currency, rather, when he says that the euro challenges dollar hegemony, he means that the success of the euro has shown that there can be a monetary system with different international currencies other than the dollar.

My research proves then that the euro's challenge to the dollar has hitherto been more ideational than material, although as explained in Chapter 3 (p.118) both are interlinked. However, it does also indicate that the euro vs. dollar debate in the literature has been too narrow. It has only focused on whether the euro will substitute the dollar. Nonetheless, if we want to grasp how the euro has changed the system

[98] It is here important to note that EMU is not the first monetary union among nation-states in human history. There were other previous examples, the most cited of which is the Latin Monetary Union, which brought together France, Belgium, Switzerland and Greece and at a later stage Romania, and which lasted from 1865 until 1927. Nonetheless, this union did not have the institutional underpinnings of EMU. It did not have a transnational central bank such as the ECB and it did not have a unique and exclusive legal tender. In that particular case different national currencies were accepted in the different member states as long as they had they same metallic weight and standards than the French coins. Considering the level of transnational institutionalisation, EMU is certainly a unique example in history. See John Chown (2003).

dominated by the dollar, we need also to focus on its ideational effects. The euro has not the overall structural capacity to de-throne the dollar, but it has built sufficient defences *to be perceived* as a protection shield vis-à-vis US monetary power. As a senior Chinese banker notes,

> The euro is not only an economic project. It has also a political motivation. A single currency brings countries closer together. It reduces possible tensions and conflicts. The Europeans have done an excellent job in this respect. Economically it brings also great benefits because you are more protected against external shocks. This is very different here in Asia. We are tremendously vulnerable to US monetary policies (Interview X-6 2009).

Given the apparent success story of the euro, regional monetary union seems to be a convenient way to avoid dollar shocks. This is certainly the view of Shi Jianhuai, Professor of Economics at Peking University. He says that Asian monetary cooperation has increased substantially in the past years, predominantly because of the weaknesses shown by the dollar. 'The creation of the euro has had a great impact in this regard. It has shown that you can create a regional single currency. This is the first time in history that something like this happens. A lot of Chinese academics and officials have been in touch with the ECB to learn more about this experience' (Shi 2009).

Praise on the successful launch of EMU and acknowledgment of the symbolic ramifications of the project are also widespread in the GCC and Brazil. In a similar note to his Chinese colleagues, Tarik Yousef, dean of the Dubai School of Government and policy adviser, thinks that:

> Overall the euro has been a grand success. Ten years on no single country has seriously considered the possibility of abandoning the single currency, even in difficult times as the present one [referring to the 2010 sovereign debt crisis in EMU]. On the contrary, there are a number of countries that want to join. I see EMU as an important experiment, and certainly the most important example of monetary unification in the past 50 years. There is here a lot of inspiration for other countries, including the GCC countries (Yousef 2010, brackets added).

An analogous response comes from the officials at the central banks in UAE and Saudi Arabia. A senior economist in one of them highlights how he had been travelling recently from Austria to Slovakia and how convenient it was to use the same currency across borders. He was also struck by how people in Central and Eastern Europe were particularly keen to join the single currency. For him, there is no doubt that the euro has had an enormous symbolic effect upon people, including him (Interview S-12 2010). This ideational impact is also to be observed among Brazilian financial elites. In fact, since it was the first country visited for this research, it was here where I discovered for the first time the intangible effects triggered by the euro. A good example is the view of Manuel Rebelo, President of the public innovation agency FINEP. When asked about his overall assessment of the trajectory of the euro he answered that the launch of the euro had two clear objectives.

> First, to advance in the integration process through monetary union, an audacious move because in the history the issuing of currencies has always been strongly linked to national sovereignty. Thus, that the European states have integrated their monetary policies voluntarily and peacefully is a remarkable example in the history of humankind. And, secondly, and this was not stated in any official document, to be a counter-hegemonic move to the absolute dominance of the dollar in the international monetary system. In both cases I think the experience has been quite positive (Rebelo 2008).

The success of the euro as a regional integration mechanism and defensive shield against the dollar is not only acknowledged by Brazilian interviewees with positive inclinations towards EMU. Even outspoken euro-sceptic participants such as Franklin Serrano, IPE Professor at the Federal University of Rio de Janeiro, recognise that “the euro has been successful as a defensive strategy to avoid previous instabilities associated with different European countries having different exchange rates vis-à-vis the greenback” (Serrano 2008).

6.1.2 The Socially Constructed Achievements of the Euro

Asked about what they find most appealing about the EMU project in concrete terms apart from the general understanding that it has increased the integration process of EZ member states, financial elites in China, the GCC and Brazil would say that the single currency has enhanced intraregional trade, and trade with other parts of the world, especially with emerging markets; it has eliminated exchange rate volatilities; it has delivered price stability, and it has fiscally disciplined the historically profligate and inflation-prone countries from the south of Europe. The latter is interpreted as something remarkable, especially among Chinese participants (Interviews X-3 2009; X-10 2009; Ding 2009b) who were more inclined to praise German-style fiscal rectitude than their Brazilian and GCC counterparts (Rebelo 2008; Y-7; Yousef 2010), who showed more sympathy with what in Europe could be characterised as French-style government-led pro-growth policies (which are underdeveloped in the EZ, as shown in Chapter 4, p.148). Nonetheless, GCC policymakers at the central banks would praise the disciplinary character of EMU too. As one participant in one of the central banks said,

> One positive aspect of EMU that we would like to emulate in the GCC is that it can bring in reforms. It can force countries to introduce painful structural reforms which they would otherwise not implement: first to meet the entry criteria, and then to remain in the Union. The best example of this is now the PIGS [Portugal, Ireland, Greece and Spain], who need to introduce reforms if they want to get help from Germany (Interview S-11 2010).

Overall, the influence of German-style discipline is also underpinning the reputation of the ECB as a successful guarantor of price stability in the EZ. This is one of the reasons why the euro has appreciated against the dollar in the past decade and why, despite the recent debt turmoil, it has not collapsed vis-à-vis the greenback (Interviews W-10; Eduardo 2008; X-6 2009; X-12 2009; Y-9 2010). Yet again we see here how the appreciation bias of the euro is attracting a lot of admiration. What most participants in this research do not realise is that this strength undermines the growth prospects of EMU. This is where my analysis differs from Cohen's (2010) anti-growth bias argument. The anti-growth bias enhances, it does not curtail the international attractiveness of the euro. International investors like to hold an international currency that appreciates against the rest of currencies. In their investment calculations, they are relatively unconcerned whether EZ annual GDP growth is 2% lower than in the US, as long as the euro appreciates more than 2% against the greenback in that same year. The anti-growth bias does not weaken the euro externally; it weakens it internally by eroding competitiveness and fostering unemployment in the EZ. International investors profit from this set up. Those who suffer are the European workers.

Having said this, what is interesting is that the strength in the exchange rate value of the euro has fostered great symbolic effects in the three case study regions. As Mundell once said, “great powers have great currencies” (cited in Kirshner 2003a:15). In chapter 4 I have already explained that the euro is politically and militarily too weak to threaten the prominence of the dollar, but this does not mean that the exchange rate strength of the euro vis-à-vis the greenback has not increased the role and presence of Europe in the world. Ironically, a large number of participants, most of them with PhDs in Economics, still equate exchange rate strength with monetary power. They are not aware that monetary power is at its full potential when a country is able to manipulate its exchange rate to its favour (see Chapters 3, p.91; 5, p.182).

Nonetheless, what is also true is that money is based on trust, and if a currency is persistently strong, then that means that the holders of this currency believe in its creditworthiness and in the underlying political structure that underpins it. This logic sits at odds with the EZ since as yet it has no political authority to back it up. But here is where perceptions matter. The perception of many international investors is that the EZ is a political construct in the making. It is convenient to paraphrase here the remarks of the FX head of one of the largest financial institutions in the GCC with a balance sheet in the hundreds of billions of dollars. His interpretation of the reality of EMU coincides with that of the majority (note that where there is a majority, there is a minority) of financial elites interviewed for this research and is a powerful indication of the hitherto mostly ideational effects of the euro. For this participant, with decades of experience in FX trading in the City of London,

> People in the markets have since the mid 1990s started to see Europe as the United States of Europe.[99] The speculative attacks in 2010 against the single currency and the sovereign debt bonds of weak EZ member states are just a way to test this hypothesis. In general most of the participants in the markets assume that there is an underlying political will to support the euro. If not this project would never have started. This is what brings investors such as China to see the euro as a solid asset, which no doubt speaks in favour of the success of the euro. European political union is down the road, it is just that policymakers do not tell it to their citizens, but it is certainly in the back of their minds. As Winston Churchill said, political union in Europe is the only way to avoid war among Europeans. There is only one solution: The United States of Europe (Interview Y-9 2010).

With this rather optimistic (and for many euro-critics naïve) perspective on the future of EMU in mind, most financial elites interviewed see the EU as an important pole in an increasingly multipolar and multicurrency IMS. In their view step by step, crisis after crisis, the EU is acquiring greater strength and independence, the consolidation of the euro being just the monetary representation of this development (Interviews W-1 2008; Rebelo 2008; X-6 2009; X-16 2009; X-19 2009; Ding 2009b; Aluwaisheg 2010; Yousef 2010; Zubair 2010). This newly acquired independence and autonomy in monetary affairs is appealing for these elites. They see how currency union in Europe has protected weaker economies with weaker currencies from major swings in the exchange rates and how an internationally accepted euro is able to absorb shocks (either appreciation or depreciation) much easier than the previous national currencies. Of course, they are well aware that there is a price to pay for this stability. Weaker countries[100] cannot devalue their currencies as they did before EMU to come out of recessions more quickly, but for the majority of interviewees this will have two positive outcomes: on the one hand, it will show the necessity to coordinate further European economic and fiscal policies, inching towards political union, and, on the

[99] This explains in part the, for many puzzling, convergence of government bond yields between the core and periphery of the EZ in the first decade of the single currency (See Chapter 5).

[100] A number of participants stated that one of the main worries for the future of EMU is how the enlargement to Central and Eastern Europe of the EZ will play out (Yu 2009; Interview Y-3 2010). Some of them think that the inclusion of Greece, Portugal and other weak countries should not have happened in the first place but now it is too late and it needs to be managed. However, they recommend EZ policymakers to delay the entry in the euro of the new and poorer EU member states until further convergence is achieved.

other, it will force these countries to introduce the necessary structural reforms to regain competitiveness (Interviews X-6 2009; Ding 2009b; Y-11 2010; Y-12 2010).

As will be explained in more detail in the next section of this chapter, EMU works as a possible blueprint for regional monetary integration in the GCC, East Asia and the Mercosur regions. My research results coincide thus with Marsh's statement that "in Asia, Latin America and the Middle East, the euro supplies a template for a wide range of regional monetary unions that may be established in coming years" (2009:2). The idea of creating something similar to EMU is therefore one of the most significant effects emanating from the euro, which the literature focused on the euro vs. dollar debate has not covered. Ironically, my research proves that Cohen was right when he speculated, at the theoretical level without any evidence to support his claim, that "EMU is clearly viewed as a test case for a strategy of pooling, rather than surrendering, monetary sovereignty. If Europe's experiment comes to be seen as a success, it could have a powerful demonstration effect, encouraging similar initiatives elsewhere" (2008a:231). My empirical findings show that many financial elites in the three case study regions consider the euro a success and would like to see something similar in their regions (Interviews W-1 2008; W-10 2008; Rebelo 2008; X-3 2009; X-6 2009; Shi 2009; Qin 2009; Yu 2009; Zhou H. 2009; Y-13 2010; Yousef 2010; Z-5 2010; Z-6 2010; Aluwaisheg 2010). Thus, the effects of the euro in the reconfiguration of the IMS appear to have been above all intangible, at the level of ideas, a realm widely overlooked in the literature. This line of enquiry started in summer 2008 during the fieldwork in Brazil and it has gradually been confirmed in the course of more evidential triangulation collected through further interview material during the fieldwork in China in 2009 and the GCC in 2010, and an examination of the literature covering monetary cooperation in these regions (Gao 2008; Arraes 2009; Rutledge 2009; Saucedo 2009; Zhang Y. 2010).

6.2 The Euro and Monetary Cooperation in Latin America

6.2.1 EMU as Source of Inspiration for Monetary Cooperation in Latin America

The role model effects of EMU in relation to creating a successful regional monetary union in Latin America surfaced in a number of interviews in Brazil (Interviews W-1 2008; W-10 2008; Chami 2008). The insights of a senior banker are relevant here. Asked whether one day Europe will speak with one united voice in international monetary affairs, he says that "there are still many obstacles to get there, but who would have thought in the 1950s that the Europeans would achieve today's degree of integration? We here in Mercosur mirror ourselves on the EU; we want to create something similar here" (Interview W-1 2008). European monetary cooperation as inspiration for further monetary union is also acknowledged by Maria Celina Arraes, former deputy governor for international affairs at the Central Bank of Brazil when she assesses the role of the euro in her continent. It is here worthwhile reproducing at length her conclusions because they summarise the ideational impact that the euro has produced upon Latin American initiatives towards fostering regional monetary cooperation:

> The rise of the euro is a unique, outstanding event and is an unparalleled model for Latin American countries' monetary integration ambitions. The European Payments Union inspired the creation in the 1960s of the Convênio de Pagamentos e Créditos Recíprocos (CCR), a regional payments system with multilateral settlement in South America. […] More recently, the central banks of Argentina and Brazil put in place on October 3, 2008, the Payment System on Local Currency (SML). This system allows the invoicing and settlement of exports by each country in its own currency. Both systems can continue to benefit from European lessons on monetary integration (Arraes, 2009:162-3).

As this passage shows, European monetary cooperation as inspiration for increased Latin American regional monetary integration is not a recent phenomenon. It dates back to the 1960s and the creation in 1966 of the CCR (or Agreement on Reciprocal Payments and Credits), a swap agreement between Latin-American national central banks, similar to the European Payments Union of the 1950s, which was designed from the start to make Europe less reliant on the dollar in intra-regional trade payments. Under the CCR agreement, importers and exporters pay or receive the payments stipulated in their intra-Latin American contracts in their own currencies through their national central banks and only the clearance among central banks is done in dollars. The CCR mechanism, which was set up by the Latin American Integration Association (ALADI),[101] was very useful in the 1980s when foreign reserves were scarce, it was largely neglected in the 1990s but it regained momentum during the Great Recession. In 2008, with the financial crisis again squeezing foreign currency stocks and trade flows declining, the CCR was regionally centralised and updated with a new electronic system that provides instant data flows to its clearing centre at the Peruvian Central Bank in Lima (ALADI 2011a; BCB 2011b). Brazil and Argentina were particularly interested in "an increase in the total amount of trade that is guaranteed between central banks under the CCR agreement. In April 2009 the CCR's guaranteed coverage was accordingly enlarged from $120 million to $1.5 billion" (Chin 2010:705). Brazil has been especially keen to avoid exposure to dollar volatility in recent years. It has been very active, for instance, in establishing, also in 2008, a Local Currencies Payments System (SML) with Argentina in order to invoice and settle export contracts between both countries in their own local currencies, in this case avoiding the use of the dollar completely (Arraes 2009; ALADI 2011b). One year later, trade in local currencies between Brazil and Argentina had steadily grown to 15%, and on the back of this relative success further steps were taken to expand the SML to all four Mercosur countries (Mercosur 2009). As the Argentinean Minister of Economy, Armando Boudou, stated at the end of 2009: "From now on we are going to give this proven initiative a great boost since our countries have been submitted too long to US dollar tensions" (*Mercopress* 2009). Brazil has also been pivotal, alongside Argentina and Venezuela (the three main financial contributors), in the launch in September 2009 in Caracas of the Bank of the South (Banco del Sur)[102]

[101] The Asociación Latinoamericana de Integración (ALADI, Latin American Integration Association) has currently 13 members of which 12 are subscribers of the CCR agreement. Only Cuba is not included. The 12 members are: Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

[102] The Banco del Sur (Bank of the South) is primarily a project pushed forward by the Venezuelan President Hugo Chavez in order to diminish the influence of the IMF in the region. The launch of Banco del Sur, which started with an initial capital of $20 billion for development projects, occurred the 26 September 2009 in Caracas (location of the headquarters) and so far only Argentina, Cuba,

which attempts to be a regional counter-hegemonic source of finance for development projects less reliant on the US-led IMF and the dollar.

All these steps towards regional monetary cooperation have always been surrounded in Latin America by the longstanding debate centred upon the question of whether the region will one day have sufficient political integration to form a union of states with a single currency and a single central bank, similarly to the EZ. On the political front, apart from the regional bloc of Mercosur[103] (encompassing Argentina, Brazil, Paraguay and Uruguay, with Venezuela still pending accession), in recent years there was also the creation in May 2008 of the Unión de Naciones Suramericanas (UNASUR, Union of South American Nations) which brings together the Mercosur members plus Bolivia, Colombia, Chile, Ecuador, Guyana, Peru, Surinam and Venezuela. Just a few days after the signing of the UNASUR agreement in Brasilia, President Lula acknowledged that the long term goal of the recently formed union was to "work towards a central bank and a single currency" (*El Espectador* 2008). This is an objective that Brazil has been aspiring to for some time and in all the different phases of this process the euro has always been seen as a model to follow. As early as in 1997, economists from the influential Brazilian development bank BNDES proposed a monetary union for the Mercosur bloc based on "an agreement similar to Maastricht" (Giambiagi 1997). In 2000, Ian Goldfajn, who later became the head of research and member of the monetary policy committee (Copom) of the Central Bank of Brazil, put forward a similar proposal, and yet again the European experience would also be the template to follow. In his words, "the central problem in Mercosur today is to design a mechanism by which the bloc can, in the future, coexist with a single currency…as in the example of the euro" (Goldfajn 2000, cited in Giambiagi 2001). There is not enough space here to summarise with more length all the works by Brazilian and other Mercosur countries' scholars who have studied the feasibility of monetary union in Mercosur and Latin America in the past decade. It suffices here to say that the literature is vast (Giambiagi 1997, 2001; Bertella 2000;

Bolivia, Nicaragua, Ecuador and Venezuela have joined. As of the time of writing there is no information on what type of projects the Banco del Sur is financing.

[103] The Mercado Común del Sur (Mercosur, Common Market of the South) was launched the 26 March 1991 in Asunción (Paraguay). Apart from establishing a common market, Mercosur, similarly to the EU, wants also foster political union among its member states. For that purposes Mercosur has established a "mechanism for political consultation". However, Mercosur still lacks the institutional framework of the EU. It does not have a Mercosur Parliament, neither a Mecosur Court of Justice.

Ferreira de Mendonça & Da Silva 2004; Chagas & Baumann 2007; Da Silva Bichara et al. 2008; Saucedo 2009) and that in all these studies references to the euro as harbinger, template or role-model are ubiquitous. In this sense the review of this literature coincides with the findings from my interviews pointing to the ideational impact of EMU upon Brazilian financial elites. Furthermore, it needs to be highlighted here that this influence is not only reduced to the passive mode of appeal and attractiveness. The European Commission (EC), through high profile conferences such as the one organised in São Paulo in March 2008 in collaboration with the Central Bank of Brazil, entitled: "The Euro: Global Implications and Relevance For Latin America", is actively promoting regional monetary cooperation in Latin America on the basis of the perceived success of the European experience.

6.2.2 Latin America has No Bundesbank to Replicate EMU

Despite the aforementioned longstanding efforts to deepen monetary, and in the long term, political union in Latin America, so far this process has been slow and mired in set backs. In this regard, this is yet another example of how ideational aspirations are constrained by material limitations. Brazilian financial elites would like to create a monetary union in Latin America or at least at the Mercosur level in the future, but they acknowledge the huge obstacles that they face. As a senior banker recognises,

> Economically, we need more integration in macroeconomic indicators and politically we need more political determination to come together, but this is difficult, the cultures here are so different. A Brazilian is so different from an Argentinean or from a Paraguayan. The Brazilian economy is also too big in relation to the rest of Mercosur nations. We believe in the Mercosur project and we want to integrate further but we will not achieve this in 10, 20 or even 30 years. It is a very long process. The EU itself, with its differences and internal tensions, shows that it is a long journey (Interview W-10 2008).

Virgílio Arraes, Professor of International Relations at the University of Brasilia, agrees with this statement. He reckons the single currency will come, but only "in the very long term". Nonetheless, he is convinced that it will happen, since, in a similar fashion to the EU, "it will become a necessity for the survival of [Latin] America"

(Lacerda 2008). Others are not so convinced about this outcome. The majority of the literature that has studied the feasibility of a currency union in the Mercosur region focuses on the OCA theory, and in most cases the conclusion is that hitherto this regional bloc "is not an OCA, and, therefore, it is too premature to consider in the short run the formation of a union out of the currencies of the four countries" (Chagas & Baumann 2007:106). One macroeconomic factor that stands out when comparing Latin America with the EZ is that until now "Latin American countries have very low levels of trade with the rest of Latin America" (De Grauwe 2009a:98) due to the fact that still most of their imports and exports are coming from or going to the US, China and the EU. This is a factor that reduces the desire for a common currency among Latin American countries given that the reduction of transaction costs in intra-regional trade has been one of the main factors that convinced the Europeans to establish the euro. Another incentive which was present in Europe and is not applicable to Latin America, and concretely to Mercosur, is that in Europe several countries such as Italy, Belgium or Spain were able to "buy" through EMU the reputation of the German Bundesbank in its hawkish approach to inflation (Ferreira de Mendoça & Da Silva 2004:127). As De Grauwe explains, "one of the main driving forces for the popularity of a monetary union is to be found in the fact that it allows high-inflation countries to import price stability" (2009a:99). However, given that almost all central banks in Latin America, including Brazil (Leitão 2011), have had serious problems to control inflation in the past decades, this institutional benefit does not apply to this region – at least not yet.

This very brief summary shows that there are a number of economic indicators that create obstacles to the creation of a Latin American or Mercosur monetary union. Nonetheless, drawing precisely on the lessons of EMU, which is not an OCA either, the majority of Brazilian elites would certainly not disagree with Chagas and Baumann's statement that when it comes to establishing a monetary union "political reasons might be more important than economic reasons" (2007:97). This is valid for all monetary unions. But even on the political front, the path for further unity is not clear. Despite the creation of UNASUR, there appears to be a multiple split in the continent between a first group of countries such as Bolivia, Ecuador and Venezuela that compose the *Alianza Bolivariana para los Pueblos de Nuestra América*[104] (ALBA, Bolivarian Alliance for the Peoples of Our America), an association led by the Venezuelan President Hugo Chávez. There is another bloc of countries such as Chile, Peru[105] and Colombia that have closer diplomatic and economic relations with the US and therefore are more reluctant to engage with any association that might undermine these privileged ties (showing here that the US is still a powerful external factor). And finally there are the countries that form the Mercosur bloc who are still uncertain whether it is a good idea to allow Venezuela to be a full member of Mercosur (the Paraguayan Congress has still to ratify Venezuela's entry) and who show certain unease about Hugo Chávez' anti-imperialist rhetoric and his desire to be seen as the main leader of South America.

These political divisions are also mirrored in the monetary sphere. While Mercosur is increasingly trying to use the SML system based on the use of national currencies, the ALBA bloc agreed in April 2009 the creation of the *Sistema Único de Compensación Regional* (SUCRE, Unified System for Regional Compensation), which consists in the establishment of a virtual currency in order to "decouple progressively from the US dollar" (Martínez Puñal 2009:80) in the settlement of regional trade. By the end of 2010 around $40 million worth of trade between Venezuela and Ecuador (the two biggest economies in ALBA) was settled in this currency. This is still a very small figure considering that the overall trade volume between the two countries was $1 billion for the same year.[106] Given these divisions, the likelihood of these sub-regional monetary agreements consolidating and merging in one South American monetary bloc is doubtful. UNASUR is still a loose agreement with no institutional structures, something that seems to be absolutely required to establish a monetary union. In the medium to long term everything is possible. The ideational can certainly

[104] ALBA was established as a counter-agreement to the Free Trade Agreement of the Americas advocated by the US. It was established the 3 November 2005 in the Argentinean city of Mar del Plata. Its objective is to enhance not only the economic, but also the cultural, political and social ties of the people's of the Americas. Its member states are: Bolivia, Cuba, Dominica, Ecuador, Nicaragua and St. Vincent and the Grenadines. Honduras was part of ALBA but the latest Government has decided to withdraw its membership.

[105] At the time of writing the left leaning politician, Ollanta Humala, has just won the Peruvian Presidency. This might potentially move Peru closer to the other sub-blocs in Latin America.

[106] Pedro Páez Pérez (2011), one of the intellectual and technical architects of the SUCRE project, and currently high representative of Ecuador to the Bank of the South, claims that currently one third of trade between the Banco del Sur countries is invoiced in Sucres. It has not been possible to corroborate these figures with further evidence.

crystallize in the material. What is perceivable for now is that a large number of financial elites in Brazil think that regional monetary cooperation will be a logical evolution from a monetary system dominated by the dollar to a multipolar monetary system with different monetary blocs. This is the view of Jorge Chami, Economics Professor at the Federal University of Rio de Janeiro.

> The euro will not surpass the dollar as the main international currency. This is very unlikely. What will happen is that more such regional currencies will emerge: one more, maybe even two. The creation of several monetary blocs is a real possibility. There will be more regional cooperation and integration; something totally understandable. The world is now a much smaller place. Therefore, the blocs will be the future, in economic matters, in political negotiations etc (Chami 2008).

6.3 The Euro and Monetary Cooperation in the GCC Region

6.3.1 EMU as a Role Model for Monetary Union in the GCC

While the euro functions primarily as a source of inspiration for Latin American monetary union, it can safely be argued that EMU is considered the role model for the proposed monetary union among the Gulf Cooperation Council (GCC) countries. This was made clear by King Abdulah of Saudi Arabia at the launch of the project during the 2001 GCC Summit in Muscat (Oman) when he stated that EMU was the "model to follow" (cited in Rutledge 2009:5). In this particular case, the evidence collected throughout the fieldwork is conclusive. For an overwhelming majority of interviewees there is no doubt that EMU has served as the example to follow in the gestation of the project of creating a monetary union among GCC states. This is the view among the participants interviewed both at the central banks of UAE and Saudi Arabia. One senior official was particularly straightforward. For him, 'it is clear that the proposal of creating a monetary union in the GCC would not have emerged without the realisation of EMU' (Interview S-12 2010). Following the logic of the three faces of power explained in Chapter 3 (p.95), it can be argued that EMU intentionally or unintentionally has *influenced*, *shaped* and even *determined* the behaviour of policymakers in the GCC. For this same official, 'EMU has given the ruling elites in the GCC the confidence that monetary union is possible, not only from a political point of view, also from a technical standpoint, because they know that they can count with the expertise and know-how of the Europeans if anything goes wrong along the way' (Interview S-12 2010).

In other words, GCC policymakers believe in the feasibility of monetary unions because the Europeans have gone through all the different steps, and the experiment has been successful – so far. This view has not even changed amidst the recent sovereign debt turmoil in the EZ, which could potentially trigger a break-up of EMU. In a speech delivered in February 2011 in Europe, the Governor of the Saudi Arabian Monetary Authority (SAMA), Muhammad Al-Jasser, recognised that he was following events in the EMU very closely. 'On the one hand', he said, 'I hate to see you struggling with the current configuration of your monetary union; but, on the other hand, I have to say that I am learning a lot from your experience. You are certainly the laboratory for other monetary unions around the world' (Al-Jasser 2011b). From this statement it becomes clear that as long as the EMU harbinger progresses in its journey its appeal as a blueprint will be maintained in the GCC.

Nonetheless, the role-model function of EMU upon GCC monetary union (GCC MU) is not limited to the ideational appeal from the distance. European policymakers have actively influenced the establishment of MU in the GCC. As Rutledge (2009:5) indicates, the ECB "has provided direct assistance to the GCC by providing a 'draft monetary agreement' for the GCC MU [and] the ECB has also run a series of workshops with the GCC Secretariat's MU technical committee". This active cooperation between GCC and European officials has also been confirmed by different participants at the central banks and the GCC General Secretariat headquartered in Riyadh. One senior official from one of the central banks said that 'cooperation with ECB staff is very close' (Interview S-13 2010), while the following is what Abdelaziz Aluwaisheg, Director General of International Economic Relations at the GCC Secretariat, had to say about the euro and European assistance to the creation of GCC MU.

> The euro is a role model. It is the only model. This is the first such an attempt in history. This is a common currency, something unique. We are taking from the experience of the ECB. We have consulted with them from the beginning. I visited the ECB in February 2002 right after the GCC monetary union project was agreed. I sought their assistance. They provided all sorts of help. We have taken advantage of that (Aluwaisheg 2010).

While the ECB's draft monetary agreement for the GCC MU delivered in 2005 is not publicly available, an investigation of the ECB's data base is sufficient to demonstrate empirically through documents that the ECB has cooperated closely with the GCC Secretariat and the GCC member states on this project. Alongside the IMF staff (Jadresic 2002), the economists of the ECB have concluded over the years a number of studies on the feasibility of GCC MU and the GCC economic evolution (Sturm & Siegfried 2005; Sturm et al. 2008). In addition to these concrete studies, as of 2008 there is also a regular framework of cooperation through high level seminars between the Eurosystem network (comprising the ECB and the 17 national central banks of the EZ) and the central banks and monetary agencies of the member states of the GCC. These seminars, which bring together the governors of the central banks and senior staff from the European Commission and the GCC General Secretariat, are currently conducted every two years (ECB 2008, 2010b).[107] There is no doubt that this European advice over the years has had considerable impact in the formulation of the guidelines and convergence criteria for GCC MU. This is recognised by Mohsin Kahn, who until 2008 was the director of the Middle East and Central Asia Department at the IMF. In a 2009 study on the most suitable exchange rate regime for the GCC he writes that the "ECB has provided the GCC with a draft Monetary Union Agreement (MUA) and statutes on the Gulf Monetary Council (GMC) and the Gulf Central Bank (GCB)… [and] a set of five convergence criteria (on inflation, interest rates, reserves, fiscal balance, and public debt), similar to those used in the run-up to the EMU" (Kahn 2009:3). European influence in the construction of the legal framework of the prospective GCC MU was confirmed by a senior official at the GCC General Secretariat. During the interview, he handed me a document entitled

[107] Seminars of this type between Eurosystem and GCC staff have been occurring since earlier but since 2008 the seminars are attended by high level officials such as the governors of the different central banks. The last seminars were held in Mainz (Germany) in 2008 and in Rome (Italy) in 2010.

"Agreement Establishing the Monetary Union of the Cooperation Council for the Arab States of the Gulf" (GCC 2010), and as he handed it over he said: 'This is the GCC equivalent of the Maastricht Treaty' (Interview Z-12 2010). The content of the document certainly proves this point. The independence of the future Gulf Central Bank (GCB) is legally ring-fenced, mirroring the ECB's legal status, and there is also a specific article (Art.21) that prohibits the GCB to lend to public entities, a provision mirroring the 'no bail out' clause of the Maastricht Treaty, which has been so controversial (and partially infringed) during the recent sovereign debt turmoil in the EZ.

6.3.2 The Difficulties of not having a Counterweight to Saudi Arabia

At first, GCC monetary union, merging the currencies of Saudi Arabia, UAE, Kuwait, Qatar, Bahrain and Oman, was set to start by the 1 of January 2010, but at the time of writing (August 2011) the prospects for the successful completion of this project remain doubtful (Bitar 2010). A series of setbacks have occurred along the way. In 2006 Oman declared that it was not ready to join the union. The reasons are not totally clear. Officially, Oman stated that it was unhappy about the lack of progress, although Rutledge (2009) argues that the real reason has to do with the divisions between different member states in relation to the peg to the dollar. While oil and gas exporting countries such as Kuwait and Qatar have been advocating a de-pegging from the ever-depreciating and inflation-importing greenback, less oil-rich "Oman (and probably Bahrain) see advantages in a weak currency, as it makes their non-oil manufactured goods more internationally competitive" (Rutledge 2009:8). These divergences are also behind the pulling out of Kuwait in 2007 of the GCC fixed peg to the dollar agreement (see Chapter 5, p.174), which signified the second blow to the GCC MU project. Finally, the latest major setback for GCC MU came in May 2009 when UAE declared that it would drop out of the project after Saudi Arabia, the main economic and political power in the GCC, announced that the Gulf Monetary Council (GMC), the precursor of the future Gulf Central Bank (GCB), would be headquartered in Riyadh and not in Abu Dhabi or Dubai as was expected. This decision might potentially jeopardise the whole plan. As the economists of the Riyadh based Samba Financial Group point out, the UAE's announcement:

> Is a serious jolt to the project. The Federation is the GCC's second-biggest economy, accounting for around 25 percent of regional GDP. It is also the region's commercial hub, serving as a vital link between the GCC and the rest of the world. Politically, a GCC single currency without the UAE might proceed, but its economic value and credibility would be questionable (SAMBA 2009).

Nevertheless, despite UAE's withdrawal, Saudi Arabia has not changed its plans to create a GCC MU in the future (the new proposed date is now 2015). If anything, with the drop out of UAE, Riyadh now has fewer obstacles to implement the project given that the remaining Kuwait, Qatar and Bahrain have little political weight in the GCC (Interview Z-5 2010). In March 2010 the Gulf Monetary Council was officially established in Riyadh and unsurprisingly the first chosen chairman has been Al-Jasser, the governor of SAMA (Rasooldeen 2010). The GMC is now in the phase of enhancing its own staff and in trying to harmonise the macroeconomic policies of the four countries that comprise the GMC (Al-Jasser 2011b). Nonetheless, despite these institutional advances, and the progress achieved in adopting the European inspired economic convergence criteria (Khan 2009), the reality on the ground is that GCC MU is still very distant. The large majority of financial elites interviewed in Saudi Arabia and the UAE are very sceptical about the success of the project (Interviews Y-3 2010; Y-7 2010; Y-12 2010; Y-16 2010; Z-4 2010; Zubair 2010). Officials in public positions in the UAE would declare that the main problem is that the requirements and the convergence guidelines set out by the EMU experience are very tough. They demand transparency, and proper independent statistical data and this is very difficult to implement in the GCC (Rutledge 2009). The ruling elites are zealous in keeping state revenue figures to themselves.[108] On top of this comes the problem that in the GCC there is only one big country: the Kingdom of Saudi Arabia. It is not like in EMU where France and Germany balance each other out. When looking at the European experience, the small states of the Gulf realised that the Europeans deployed cohesion funds to converge. In principle, the same should happen in the GCC but 'states such as UAE or Kuwait do not want to invest considerable amounts

[108] The Governor of the Saudi Arabian Monetary Authority (SAMA), Al-Jasser (2011b) has publicly recognised that he has no access to the accounting books of the ruling Saud family.

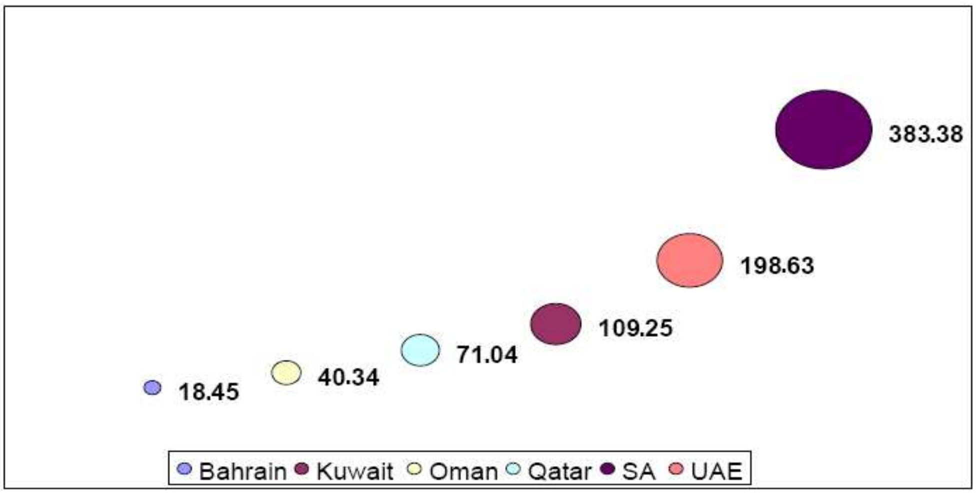
of money in neighbouring countries such as Oman only to see later that the country that will benefit most is Saudi Arabia because it is the biggest economy in the region' (Interview S-12 2010). Again, here we can see how certain ideational aspirations are to a certain extent constrained by structural factors.

For a western adviser to the government of UAE the realisation of GCC MU is very dubious because there is no institutional framework to support it. Making again the analogy with EMU, he would point to the fact that the Europeans started their integration process with trade and then they moved on to money.

> Here, however, they want to create a monetary union before even having a free trade union. On paper they say they have a common market, but the reality is that trucks are stuck for days at the borders, GCC citizens need passports to cross to another GCC country… any diplomatic spat can stop the free mobility of goods and people (Interview Y-7 2010).

This same policy adviser would also consider the absence of a counterweight to Saudi Arabia as one of the main obstacles for GCC MU. The UAE is too small to take this role. Saudi Arabia's GDP is almost twice that of UAE (see Figure 6.1) and while Saudi Arabia has a population of over 25 million, the UAE does not reach 5 million (SAMBA 2009) which shows clearly how disproportionate the balance of power is.

Figure 6.1: GCC countries GDP in 2007 (Billion US$)



Source: National Central Banks.

Source: BIS (2008)

Had the Saudis given up the headquarters of the future GCB to the UAE the situation might have been different. For UAE policymakers, this would be a clear message that Riyadh is serious about establishing an independent organ, but with the GCB located in Riyadh there is fear among policymakers of other GCC countries, especially the UAE, that GCC MU does not mean monetary sovereignty pooling, as is more or less the case in EMU,[109] but rather monetary sovereignty submission to the mandates of Riyadh. For all these reasons there is no real political will among the smaller GCC member states to establish a common currency (Bitar 2010). And if there is one lesson that the GCC can definitely draw from the experience of EMU it is that the establishment of independent supranational institutions and the generation of great amounts of political will in favour of political unity are absolutely necessary conditions for the success of monetary unions (De Grauwe 2008; Buiter 2008).

Asked about the future of GCC MU and presented with the complaints about Saudi over-influence in monetary matters coming from the interviewees in UAE, financial elites in Saudi Arabia would justify the decision of locating the GCB in Riyadh on the grounds that SAMA has a strong reputation in delivering macroeconomic stability (Interview S-6 2010). In their logic, if the Europeans decided to put the ECB in Frankfurt because the German Bundesbank had a strong reputation, what is wrong with doing the same in the GCC? For one of the officials interviewed, the dropping out of UAE is not definitive. For him, “the important thing is to show that the GMC (and hopefully later the GCB) can be independent bodies. Once this is achieved, then the UAE will at some point join in again” (Interview S-6 2010). As to the exchange rate regime that the future GCB will adopt, the answer is that at the beginning the idea is to continue with the peg to the dollar (Ali 2010), but then “everything is open to discussion: a continuing peg, a basket-peg, a managed floating and even a complete floating”. The crucial aspect, for this senior Saudi official, is that “when the time comes to take this decision the GCB should decide this independently, out of the influence of national policymakers” (Interview S-6 2010). As mentioned above, for

[109] While there is no doubt, especially after the recent sovereign debt crisis, that Germany is the main power in the EZ, its economic might is not as overwhelming as that of Saudi Arabia in the GCC. A look at the ECB’s capital distribution which mirrors roughly the GDP share of every EZ country shows that Germany provides 19% of the capital, while France, Italy and Spain are responsible for 14%, 12% and 8% of the total, respectively. In the GCC Saudi Arabia’s GDP is close to 50% of the total while that of the UAE is slightly over 25% and that of Kuwait falls short of 14% (SAMBA 2009).

officials like Aluwaisheg (2010), from the GCC Secretariat, the end goal of GCC MU should be to de-peg from the dollar and have an independent and autonomous monetary policy away from the FED like the ECB has. The economic logic would point towards that direction in the long run, once the GCC financial system is more integrated and developed and once the GCC economies diversify away from oil, but as was explained in Chapter 4 (p.156), in the GCC region, political influence on monetary issues does not only come from within but also from outside. It is clear that the EZ would welcome a GCC MU; it is doubtful, however, whether the US would be as enthusiastic about the idea.[110]

6.4 EMU and Monetary Cooperation in East Asia

6.4.1 The Euro as a Harbinger for ASEAN+3 Monetary Cooperation

In China and East Asia at large EMU is also seen as a possible example for regional monetary cooperation, as acknowledged by Eichengreen (2007c). EMU is constantly referred to in conferences, seminars and articles covering issues of monetary cooperation in East Asia either as an example to follow or as a model not suited for the Asian context. In both cases the ideational impact of the euro is unquestionable. The vast literature focused on "lessons for East Asia from Europe" (Park & Wyplosz 2008:7) on monetary cooperation supports this argument. As Gao Haihong, one of the leading Chinese scholars in regional monetary cooperation, notes, the euro's consolidation can be seen as an example for Asia, among other reasons, because "the rise of the euro provides a successful regional solution to the problems of the current dollar standard" (Gao 2008:381). Here we see how the euro is seen as a potential blueprint in Blyth's fourth ideational step towards institutional change (see Chapter 3, p.103). The euro's template role surfaced in a number of interviews in China (Interviews X-6 2009; X-19 2009; Qin 2009; Ding 2009b). In this regard, the words

[110] Geopolitical considerations are common place among GCC financial elites that do not hold public positions. One of the geopolitical rumours in Dubai is that the UAE did not drop out of the GCC because of the future GCB location in Riyadh, but rather because of US pressure to abandon a project that could lead to a more independent GCC monetary policy and therefore to the de-pegging from the dollar. In a region washed with conspiracy theories, this might be possibly another one. Nonetheless, it is worth here noting it. Several participants would refer to it and others, asked about it, would consider it as perfectly plausible given that dollar hegemony depends to a large extent on the GCC region remaining pegged to the dollar (Interviews Y-3; Y-8; Z-13 2010).

of He Liping, Professor of Finance at Beijing Normal University, provide a good summary of the ideational effects of the euro upon Chinese policymaking circles.

> The creation of the euro has sent a strong message to Chinese policy-makers and academics in relation to increasing the regional integration process. The euro is certainly an example for regional integration and cooperation beyond the economic sphere, hence touching other areas like overcoming regional disputes and political and historic tensions. The euro has provided more security for Europe and also more protection against dollar shocks (He 2009).

While the euro has been perceived in China as a good protection mechanism against the instabilities of the FDS, especially in the years between the Asian financial crisis in 1997-1998 and up to the global financial crisis of 2007-2009 (Xu 2000, 2007), with the coming of the sovereign debt crisis in the EZ in 2010, some of this enthusiasm has receded. The euro functions thus as a harbinger for regional monetary integration. When things go well, it is increasingly seen as a blueprint, but when it stumbles the feasibility of currency unions is seen with more caution (Grimes 2011). The fact is that in today's unstable IMS, mired in Knightian uncertainty, policymakers around the world try to look at possible systemic alternatives. They try to figure out what a different IMS would look like and the only alternative in sight is EMU, with its positives and its negatives. With this alternative scenario in mind, Asian monetary integration has not stopped since the signing of the Chiang Mai Initiative (CMI) in 2000, shortly after the Asian financial crisis and the creation of the euro. The CMI brings together the 10 members of the Association of South East Asian Nations (ASEAN)[111] plus China, Japan and South Korea, in what is known as the ASEAN+3 framework. The first step of the CMI was to set up a system of bilateral currency swaps (BSA) and bond repurchase arrangements to provide liquidity to member states in need. Seven years later, in 2007 the finance ministers of ASEAN+3 agreed to streamline the decision-making process of the BSAs through a more multilateral approach in what is called a self-managed reserve pooling arrangement (SRPA). "The SRPA, which is meant to replace the BSAs, essentially replicates the model of the European Monetary Cooperation Fund" of the 1970s (Park & Wyplosz 2008:78) and

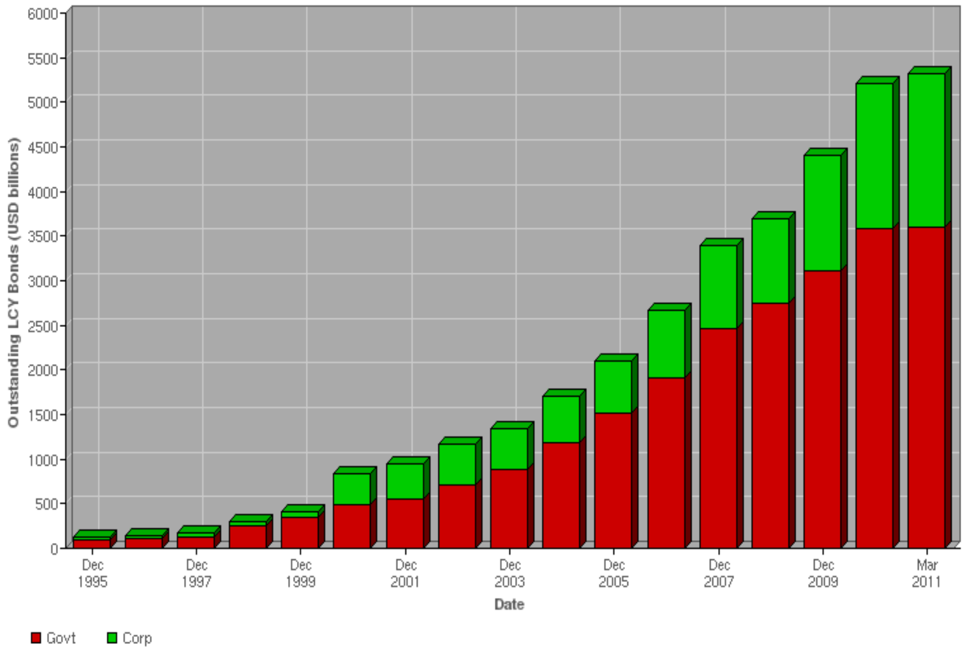
[111] The ten countries forming ASEAN are: Brunei, Burma (Myanmar), Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand and Vietnam.

thus could possibly be seen as the foundation for an Asian Monetary Fund (Zhang Ming 2009) and a regional single currency in the long term.

Nevertheless, the possible outcome of emulating EMU is still quite distant. The creation of supranational institutions and mechanisms is only in its infant stages in East Asia and it seems that it only accelerates after serious financial crises when Knightian uncertainty makes its presence. Thus, against the backdrop of the global financial crisis, the CMI member countries agreed in 2009 to increase the liquidity fund from $80 to $120 billion, with South Korea, Japan and China providing 80% of the funds, and to establish "an independent regional monitoring body to ensure effective management and use of the cooperative reserve pool" in future crises (Zhang Ming 2009:29). This reform was officially ratified in March 2010 with the signing of the Chiang Mai Initiative Multilateralization (CMIM) Agreement which includes the creation of the ASEAN+3 Macroeconomic Research Office (AMRO). This is a considerable step forward in East Asian regional monetary cooperation since for the first time there will be an attempt to establish a supranational institution with macroeconomic surveillance responsibilities. AMRO's headquarters will be in Singapore (crucially, a neutral location out of the geographic influence of the two heavyweights: Japan and China) and it will count from the beginning of its operations (set to start in May 2011) with a total staff of around 50 (Grimes 2011). The main aim of this project, as explained by a Chinese official who was working on this scheme in 2009, 'is to create a structure similar to the IMF but in Asia. Until very recently most of the monetary supervision, monitoring and guiding was done by the IMF and the World Bank. This should be done by regional experts, not international experts' (Interview X-3 2009).

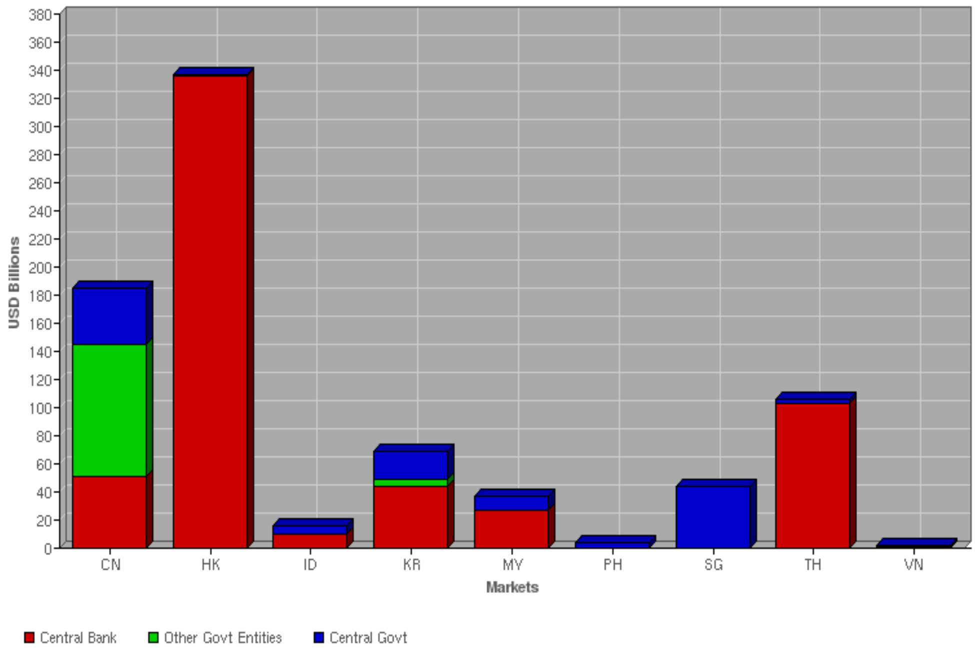
It is important to highlight here that in parallel to the CMI and CMIM initiatives, the ASEAN+3 countries have also put great efforts in establishing an Asian bond market. Significant is the creation of the Asian Bond Fund, which from 2005 onwards encouraged the issuance of Asian bonds in local currencies. China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand have been the first countries to issue bonds in their currencies. This development also needs to be seen as an important step towards regional monetary integration and out of dollar unipolarity. As Gao (2008:379) argues, "the importance of developing a regional financial market, in regard to the East Asian dollar standard, lies in its role of creating a fundamental regional need for local currencies and correspondingly the need to reduce over-dependency on the US dollar". The Asian Bond Market Initiative (ABMI) is a comprehensive project which tries to develop efficiency and liquidity in Asian bond markets (ASEAN 2011). Overall, the aim is to develop financial markets that can compete with the markets in the US and the EZ, where most economic agents are able to issue debt in their own local currencies (see Figures 6.2 and 6.3),[112] an important feature to avoid potentially destabilising currency mismatches.

Figure 6.2: Historical growth of East Asian (ASEAN+3) local currency bond markets



[112] The latest figures provided by the Asian Development Bank indicate that local currency issuance totalled $3.8 trillion in emerging East Asia in 2010, a 10.2% increase over 2009. Government bond issuance expanded 10.8% to reach $3.6 trillion (roughly 70% of outstanding government debt), while corporate issuance grew 1.1% to $634 billion (ADB 2011b).

Figure 6.3: Breakdown of local currency (ASEAN+3) government bond market issuance in USD



Source for both figures: AsianBondsOnline, Asian Development Bank (ADB 2011a)

6.4.2 Historical Tensions between China and Japan hinder Asian Monetary Union

Given the aforementioned advances in Asian monetary cooperation, the question to be asked is whether the Chiang Mai Initiative Multilateralization (CMIM) agreement and the Asian Bond Market Initiative (ABMI) will develop in an Asian Monetary Union (AMU), in resemblance to EMU? Certainly, the success of the euro is constantly a reference point that encourages this endeavour. As in the previous cases, the ideational impact comes through different direct and indirect channels. The ECB has also taken here a proactive role in organising seminars with the People's Bank of China on how to pursue best regional economic and monetary integration (McKay et al. 2004). The ECB has also produced papers on the possibility of a currency union in East Asia (Sánchez 2005). The different stages of European monetary integration are constantly seen as a template for Asian monetary union, especially when it comes to adopt an Asian Currency Unit (ACU), in similar fashion to the European Currency

Unit (ECU), precursor of the euro.[113] The introduction of an ACU has been encouraged by European financial institutions with influence in Asia such as Deutsche Bank (Becker 2008) and also by the Asian Development Bank (Kawai 2009; Girardin 2011). This proposal has also been picked up by Chinese scholars (Gao 2008), especially by those who believe that "Asian nations will surely come up with a win-win solution by drawing upon the success of the euro-zone and lessons in decades-long financial cooperation to forge a single currency" (Zhang Y. 2010:31).

Nevertheless, despite the genuine willingness among certain financial elites in China and other parts of East Asia to create an Asian single currency, this goal is still distant. As in the cases of Latin America and the GCC, a number of obstacles need to be surmounted in order to see a single Asian currency in the streets of Beijing, Tokyo and Seoul. The biggest hurdle in this particular case is the regional rivalry between Japan and China, as highlighted by the literature on this topic (Eichengreen 2007c; Grimes 2011) and confirmed by the financial elite interviews conducted in Beijing (Shen 2009; Yu 2009). Chinese officials recognise that Asian monetary union is difficult because of the economic and political tensions between China and Japan (Interviews X-3 2009; X-7 2009). As explained by Qin Yaqing, senior advisor to the Ministry of Foreign Affairs of China,

> European Montery Union is an example that has to be studied very carefully, but it cannot be copied. East Asia has many cultural differences with Europe. Here there are still big discussions on which will be the leading currency in the region, which will be the major power. There are still a lot of political divisions, especially between China and Japan (Qin 2009).

These words show how the complexity of politics makes it quite difficult to transplant one system from one region of the world to another. In principle, by having two counterbalancing heavyweights, East Asia would be closer to the European model than the GCC, where there is an overwhelming dominance by Saudi Arabia. But the

[113] The ECU was a synthetic "basket" currency composed by the weighted average of ten EU currencies. The ECU was used by EU institutions as a unit of internal account (as of 1975) and as yardstick for fixing the parities and fluctuation bands within the European Exchange Rate Mechanism (ERM). As explained by Becker (2008:22), "the ECU also played an important role on financial markets as a unit of account and a store of value, for instance for issuing government and corporate bonds".

counterbalancing of Germany and France is quite unique. After the horrendous experience of the Second World War, Germany has been content to be the economic superpower, leaving political leadership to France – at least up until now. The creation of the euro is a consequence of this division of labour. In Asia, however, it is hard to see either Japan or China letting the other take this leadership role. This leads Eichengreen to conclude that:

> Europe's monetary union works because the political context makes it possible. But the political context is different in Asia (2007:97) […] Fifty years of Japanese occupation led China, Korea and other countries to see a strong nation, free from outside interference, as the best guarantee of security. The result is a reluctance to interfere with the sovereign prerogatives of other countries […] Meaningful regional surveillance and policy conditionality not being possible, financial supports are never actually extended. The result is that the CMI is an empty shell (2007c:96-7).

These sweeping comments about the unworkable nature of CMI, and the newly created CMIM, are common place among Western observers (Batson 2009; Pettis 2009a). Jamil Anderlini, correspondent of the *Financial Times* in Beijing, does also state that "the Koreans, the Japanese and the Chinese cannot work together, that is why the American troops are in Korea and Japan: to maintain stability. True, EMU has made them think about this option [AMU], but it is unlikely" (Anderlini 2009, brackets added). Given this state of affairs, US hegemony is not only palpable in the military sphere, but also in the monetary realm. American scholars such as Grimes (2011) are quick to point out that in 2008, when the Korean central bank was short of dollars due to the credit crunch provoked by the meltdown of Wall Street, Korean officials were happy to accept a $30 billion swap line offered by the FED. The CMI liquidity mechanisms, on the other hand, were not utilised despite the central bank of China offering a similar bilateral swap line. Grimes does also point out that the newly created $120 billion multilateralised CMI (CMIM) fund is not under the control of a multilateral institution. "Although procedures and conditions for releasing funds have been standardized and streamlined, each participating government or central bank is still responsible for releasing funds from its own reserves" (2011:94). For Grimes, the CMIM is "just a more elegant version of the ungainly CMI swap mechanism"

(2011:95), and consequently the idea of the CMIM being an Asian Monetary Fund, independent of the IMF, which would put the Asians even in front of the Europeans in pooling together regional funds, is misleading. Essentially, due to the lack of regional conditionality procedures for future debtor nations, and the zeal for sovereignty preservation that exists among the ASEAN+3 nations, even in the CMIM framework "appealing to the IMF remains an essential precondition for even triggering the vote to release the bulk of the CMIM funds" (2011:95).

It is worth noting here that this configuration is very similar to the arrangements that have emerged between the IMF and the provisional European Financial Stability Facility (EFSF), and the future permanent European Stability Mechanism (ESM), the closest in Europe to a European Monetary Fund. Policymakers in Europe and East Asia seem to be favouring in their regional arrangements the inclusion of the IMF as this external actor that can impose with more ease conditional structural reforms to borrowing states in financial distress. Of course, there seems to be an important difference between the European and the East Asian arrangements. In the former, the appeal goes first to the EFSF/ESM, and then the IMF's help is automatically activated (showing a higher degree of regional integration), while in the latter it seems that it is the other way round, although this is a feature that could be changed in the future as Asian regional monetary cooperation deepens, a possibility that cannot be totally excluded.

6.5 The Euro's Lessons for the Internationalisation of the Renminbi

6.5.1 Asian Monetary Regionalism with Chinese Characteristics

Given that East Asian monetary cooperation proceeds in very small steps due to the political tensions that exist between Japan and China, the Chinese authorities have started to take unilateral steps to escape their 'dollar trap'. As explained, for policymakers in Beijing one suitable blueprint to avoid overexposure to dollar shocks would be to create a regional single currency, as the Europeans have done, but if this is not possible, another solution is to start internationalising the Chinese currency, the Renminbi (RMB). This is precisely what China has started to do in the past years, especially since the eruption of the global financial crisis (2007-2010). In 2008, just after the collapse of Lehman Brothers, China signed a bilateral swap agreement (BSA) in RMB with South Korea (Rmb180bn). One year later it did the same with Hong Kong (Rmb 200bn) and Malaysia (Rmb80bn). Also in 2009 the People's Bank of China (PBoC) took its first step, from the mere goal of regionalising the RMB to the internationalisation of it, by signing a BSA with the central bank of Belarus (Rmb20bn). Shortly afterwards, China signed also BSAs with Indonesia (Rmb100bn) and Argentina (Rmb70bn), and in 2010 with Iceland (Rmb3.5bn) and Singapore (Rmb150bn). These agreements put the total amount of China's BSAs settled in RMB as of the end of 2010 in the order of a little over Rmb800bn, which is roughly $120bn (See Table 6.1). It is important to stress here that apart from the FED and the ECB, the PBoC was the only other central bank in the world that opened swap lines during the global financial crisis (Bénassy-Quéré & Pisani-Ferry 2011), although the majority of them have not been used.

Table 6.1: China's bilateral currency swap agreements since the collapse of Lehman Brothers

Country	Date	Amount
South Korea	12 December 2008	Rmb180bn
Hong Kong	20 January 2009	Rmb200bn
Malaysia	8 February 2009	Rmb80bn
Belarus	11 March 2009	Rmb20bn
Indonesia	23 March 2009	Rmb100bn
Argentina	29 March 2009	Rmb70bn
Iceland	9 June 2010	Rmb3.5bn
Singapore	23 July 2010	Rmb150bn

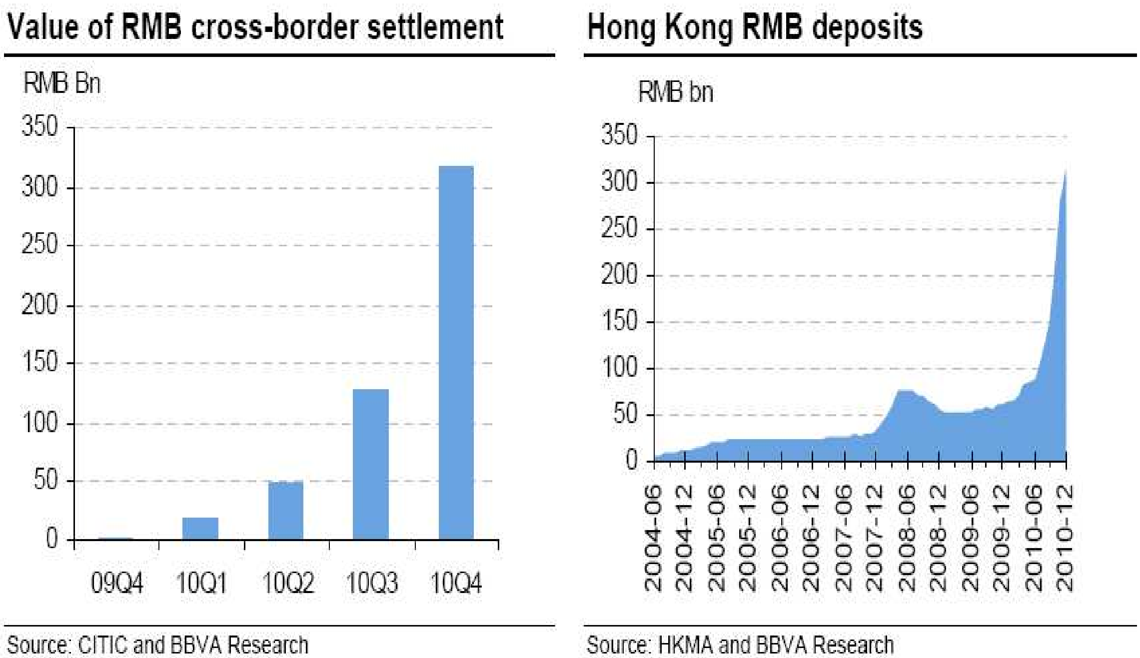
Source: Own summary from press reports

Apart from these official agreements, in the private realm the availability of RMB denominated bonds started gradually in 2005 under the Asian Bond Market Initiative (ABMI). Two years later, in 2007, the Chinese government gave the green light to Chinese banks to issue RMB-denominated bonds in Hong Kong, which from this moment starts to be the laboratory for the RMB internationalisation strategy (Subacchi 2010). Since February 2010 this issuance is not only limited to Chinese financial institutions. Under the strict regulation of the Hong Kong Monetary

Authority (HKMA), international banks and companies have also started gradually to issue these bonds. Among foreign banks, the most active in this market are Deutsche Bank, Citigroup, JP Morgan Chase, Standard Chartered and HSBC. Some of the international private companies that have started to issue so called 'dim sum' bonds through these financial institutions are: Caterpillar, McDonalds, Ikea and Nokia (Cookson & Dyer 2010).

The issuance of these bonds represents the building of the second track in the internationalisation strategy of the RMB. The first track relates to the use of the RMB in international trade which is partly promoted by the BSAs and specially by allowing Chinese traders (exporters and importers) to invoice their products in RMB. However, these two tracks are intrinsically related (Subacchi 2010). Overseas goods producers and service providers that use the RMB with their Chinese customers need a supply of RMB-denominated products to invest their RMBs. Since China still applies strict capital controls on short term capital inflows (Gao & Yu 2009), until very recently there were limited options to use these RMBs and therefore no real incentive to acquire them in the first place.

Figure 6.4: RMB international trade settlement and Hong Kong deposits (the two tracks)



Source: BBVA (2011)

Now, however, this supply is partly provided by the second track and is concentrated in Hong Kong with the opening of bank deposits in RMB and the controlled issuance of dim sum bonds. With these new options, slowly traders and investors are starting to store their RMBs in Hong Kong in order to invest in RMB-denominated bonds (see Figure 6.4). The latest figures at hand show that as of December 2010 total RMB deposits in Hong Kong stood at over Rmb300bn (BBVA 2011), averaging an exponential annual increase of roughly 450 percent. This trend is very likely to continue in the foreseeable future (see Figure 6.4). Economists at Goldman Sachs predict that RMB deposits in Hong Kong will reach Rmb2 trillion ($300bn) by 2015 (Cookson & Dyer 2010).

This sudden surge in RMB deposits is consequence of the strengthening of the first track of the internationalisation strategy, namely to increase the use of the RMB in international trade. This aim started in earnest in April 2009[114] with the establishment of a pilot programme designed to encourage Chinese exporters to settle their international trades in *hongbis* (redbacks). At the beginning the programme was confined to five major trade cities (Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan) and later, once it was assessed as successful, it was expanded to 20 provinces. Here again the projection is impressive. RMB denominated trade totalled Rmb440bn in the second half of 2010, which is six times the Rmb70bn settled in the first half, making the annual total over Rmb500bn (see Figure 6.4). This evolution in the first track coincided with another milestone in the second track. In July 2010 the PBoC and the HKMA signed a "Memorandum of Cooperation on Renminbi Business" which expands considerably the financial trading services in Hong Kong, including spot and forward RMB trading. On the basis of this agreement by the end of 2010 the Foreign Exchange (FX) market in RMB had grown from almost no trade to a daily turnover of $400m (Chen & Cheung 2011). With these new gradual steps, in 2011 the trade settled in RMB is very likely to continue its upward trend. Just in January, the Industrial and Commercial Bank of China (ICBC), the largest bank in the world by market value, has handled on its own Rmb150bn in RMB trade. If this pace continues, economists at HSBC expect that within three to five years around half of

[114] 2009 was not the first year that RMBs were used in cross-border trade. In 2003 the Chinese State Administration of Foreign Exchange (SAFE) encouraged for the first time the use of RMBs in border trade with the neighbouring regions of Russia, Mongolia, Cambodia and Vietnam (Chen & Cheung 2011).

China's trade flows with emerging markets will be settled in RMB from today's 3% (Anderlini & Cookson 2011).

The question that is now debated among a number of Chinese policymakers and scholars is whether the internationalisation of the RMB restrains the possibilities of a future East Asian monetary union (Zhang Y. 2010). This has been a concern that came up in a number of interviews in China (Interviews X-3 2009; X-7 2009; Shen 2009). Under this assumption, China's unilateral approach will undermine the multilateral option. However, for some participants both possibilities are compatible. Here again, the lessons drawn from the European experience might be of great significance. As Shen Minggao, chief economist of the business magazine *Caijing*, points out, 'the euro is a good study for Asian monetary union, but it is also interesting in relation to establishing the RMB as an international currency. Chinese policy-makers can learn from the European experience' (Shen 2009). One of these lessons, as mentioned by Gao and Yu (2009), is that similarly to Germany in Europe, China's regional power and strength is seen with suspicion by its neighbours. In this regard, to avoid future confrontations, the ideal for China would be to establish a regional monetary union. This is why it has increased its efforts towards AMU in the past years (Yu 2009). However, this agreement seems unlikely in the foreseeable future. As explained above, the political differences between Japan and China are insurmountable right now. Given these circumstances, Chinese policymakers believe that it is better to achieve an Asian monetary union bottom-up (Interviews X-3 2009; X-7 2009; He 2009; Shen 2009). The idea is to promote the RMB regionally. To penetrate increasingly the streets of neighbouring countries, and once the population of these countries accepts the economic might and hegemonic status of China, the hope is that these same populations might be forthcoming in accepting a monetary union dominated by China, as is the case with Germany in Europe.

The RMB's penetration of neighbouring countries has already started (Gao & Yu 2009; Park & Song 2011), and as it could not be otherwise it has attracted the attention of India, which is the other big political and economic powerhouse in Asia. A 2010 study by the Reserve Bank of India, the Indian central bank, acknowledges that:

> The Renminbi is being widely used in trade and other current account transactions with Vietnam, Laos, Myanmar, the Central Asian states, Russia and so forth […] China also has signed agreements with eight neighbouring countries, including Russia, Mongolia, Vietnam and Myanmar, to allow the settlement of bilateral trade payments in the Renminbi (Ranjan & Prakash 2010:7).[115]

All these developments show that the euro provides not only a good blueprint for Asian monetary union. It is also a source of inspiration for achieving Asian monetary cooperation, *the Chinese way*. As a harbinger, the euro can show one particular way to reach the end point, but based on its experience it might also open up new routes to get to the final destination.

6.5.2 From a One-and-a-Half System to a Tri-Polar Monetary System

As we have seen throughout this chapter, the apparent success of the euro has had considerable symbolic effects in the promotion of monetary cooperation and monetary unions. However, this has not been the only ideational impact of the European currency. It might even be the one with the least material legacy in the medium to long term. As stated above, the euro is a harbinger. As long as it is perceived as a successful experiment it will have a role model function. But if it fails, its ideational impact will discourage rather than encourage monetary unions. Nonetheless, the unquestionable rise of the euro as a competitor to the dollar in just 10 years has had another strong ideational impact in the mindsets of financial elites in emerging markets. It has shown them that a global monetary system with two or even three international currencies competing with each other might be possible and even desirable. This perception is in clear opposition to Kindleberger's (1986, 2000) view that "there tends to be a single dominant currency in the financial world - not two or more, just one" (Persaud 2004), and also in contrast to the network externalities theory which says that economic agents tend to favour one particular currency

[115] In relation to the RMBs penetration of neighbouring countries, Gao and Yu (2009) observe that in the neighbouring Republic of Mongolia 60% of the cash in local circulation is in RMBs. In South Korea the RMB is accepted in shops and restaurants and in Vietnam the RMB can be acquired through non-official banking circuits. The RMB has also penetrated the streets of Laos, Myanmar, Cambodia and Nepal.

(McKinnon 1998; Chinn & Frankel 2008). Contradicting these theories, a considerable number of participants, in all three case study regions, envisage the gradual move from the current one-and-a-half monetary system (with the dollar as senior pole and the euro as junior pole) to a tripolar system where the dollar, the euro and possibly the RMB or a common Asian currency compete against each other. In this regard, based on the sample of this research, the emerging consensus among financial elites in emerging markets tilts in favour of the tripolar scenario advanced, among others, by Cohen (2010) and Eichengreen (2011a). It is worth noting here that while in the Kindlebergerian view, a tripolar system would lead to tensions and conflict, for the majority of these elites international competition would bring a more stable and efficient system (W-1; W-8 2008; X-6; X-19; Cao 2009; Qin 2009; Shen 2009; Zhang E. 2009; Y-9; Y-16; Yousef 2010; Z-3; Aluwaisheg 2010; Chin and Wang 2010).

The words of Qin Yaqing, senior advisor to the Ministry of Foreign Affairs of China, are a good summary of the general view. Asked about the future prospects of the European currency, he answers as follows:

> I think the euro will become a leading currency with the dollar and I also think that this is a positive development. Only one currency can bring stability but also instability. I am of the belief that a few currencies can bring more stability to the system. This is what I would call the benefits of 'benign competition'. In my belief in the future we will have three major currencies: the dollar, the euro and a currency in Asia (either the RMB or a common currency). In East Asia there is now a strong commitment to use local currencies in order to avoid further exposure against the dollar, this shows that a multi-polar currency system is in demand (Qin 2009).

A similar response comes from Brazil. There too, the emerging view is that the euro is just the first of several competitors to the dollar and that in the medium to long term there will be several international currencies. This was officially stated in 2009 by Guido Mantega, the Brazilian Finance Minister, when he declared that "the US dollar will lose weight as the leading currency in the international market as a consequence of the crisis. Other currencies, such as the Brazilian real and the Chinese yuan will gain in importance" (*O Globo* 2009). China and Brazil are particularly keen to promote their own currencies in international trade. In the aftermath of the current crisis and as a consequence of their discontent with the underperformance of the greenback, both countries have been working closely together to establish bilateral trade in their local currencies, cutting off the dollar. The political commitment to reach such an agreement was sealed in May 2009 when President Lula da Silva visited President Hu Jintao in Beijing (Wheatley 2009). Just one month later there was a meeting at the BIS headquarters in Basel between Henrique Mereilles, Governor of the Brazilian central bank, and his Chinese counterpart, Zhou Xiaochuan, to study the technicalities of the agreement (Hughes & Vidaillet 2009). By the end of the same year, for the first time a Brazilian company was able to pay for goods imported from China in Brazilian reals (Trevisan 2009). This is a trend which is set to continue and, if successful, will certainly change the configuration of the IMS. In a further development, at the April 2011 meeting in the Chinese city of Sanya, the leaders of the BRICS (including for the first time South Africa), stated that in recognition of how "the international financial crisis has exposed the inadequacies and deficiencies of the existing international monetary and financial system, we support the reform and the improvement of the international monetary system, with a broad-based international reserve currency system providing stability and certainty" (Sanya Declaration 2011). In this same meeting the development banks of these five countries agreed "to establish mutual credit lines denominated in their local currencies, not the U.S. currency" (Neogy & Anishchuk 2011).

Finally, the multicurrency framework is also gaining momentum in the GCC region. While in this particular region there is no strategy as yet to internationalise any of the local currencies, and as I have explained, the prospects for a future monetary union are still doubtful, for a number of interviewees the possibility of selling oil in the future in several currencies is not inconceivable (Interviews Y-7 2010; Y-9 2010; Y-16 2010; Z-5 2010; Zubair 2010). As shown in Chapter 4 (p.135), this is already happening outside the international market circuit. The general sense is that the use of several currencies is positive because it promotes diversification and competition and it eliminates overreliance on the dollar. Here the words of Al-Jasser, the influential Governor of the Saudi Arabian Central Bank, are representative of the general mood in the region. In his view, "one should expect competition with the dollar in the future…A multipolar system is the ideal and I think the euro is moving in that direction" (*Arabian Business* 2010). Yet again, the European currency is here understood as just the first of several competitors to the greenback. In this regard, the euro has just started a race out of dollar unipolarity. As yet, this race is mostly in the minds of the financial elites, but at some point it might become a tangible reality.

6.6 Summary

The main aim of this chapter has been to bring to the fore an aspect of the euro vs. dollar debate that has hitherto been overlooked by the literature, namely the ideational impact of the euro in its challenge to the dollar. This chapter shows that the European currency has triggered considerable symbolic effects in two areas: 1) in stimulating the creation of monetary cooperation and monetary unions and 2) in enhancing the desirability for the establishment of a multicurrency system that can overcome the flaws inherent to dollar unipolarity. The first section has provided a general overview of the ideational effects of EMU. Measured against the greenback, the euro has a number of shortcomings, but assessed on its own merits the European currency receives significant praise. For a considerable number of participants the euro is an epoch-making event. It is a historic experiment in monetary sovereignty pooling that, if successful, will increase its role model appeal in the years to come. Thus, the evidence collected in this chapter suggests that the euro can be classified as a blueprint for prospective institutional change in Blyth's fourth ideational category (see Chapter 3, p.103).

In the interpretation of the financial elites interviewed the euro has brought a number of advantages to the EZ: it has increased intraregional trade and trade with the rest of the world, it has eliminated exchange rate risks, it has secured price stability, it has forced profligate member states to control their budgets, it has provided better protection against the instabilities of the dollar and it has integrated further the continent, politically and culturally. Of course, as mentioned several times throughout this thesis, the possibility of an EMU break-up is real, especially after the recent sovereign debt crisis in the EZ. This is why the euro is not best conceived as a role model which needs to be copied, but rather as a harbinger which can show the way forward but also the paths to avoid.

The three sections devoted to the role of the euro in the promotion of monetary cooperation in Latin America, the GCC and East Asia elucidate the different appeals that the European currency has triggered in these regions. While in Latin America, the euro template is mostly an inspiration, in the GCC it is more than that. In this region it can be classified as a role model for GCC monetary union. In East Asia, by contrast, the euro eminently plays a harbinger role. It functions as a source of interest, but there is also an acknowledgement that its success is not definite and cannot be transplanted to East Asia. The second parts of all three sections explain why EMU is difficult to emulate. Its special features are in some cases unique and therefore difficult to repeat. Latin America does not have a central bank matching the strong reputation of the Bundesbank. The GCC, by contrast, has a central bank with strong reputation, SAMA, but it lacks the political counterweight scenario that exists between France and Germany. Finally, in East Asia, this counterbalance exists, but Japan and China do not share the political-economic division of labour characteristic of the Berlin-Paris axis.

This regional stalemate has encouraged Beijing to internationalise its own currency and achieve regional monetary cooperation the Chinese way. But even in this strategy there are lessons to be drawn from the euro. The embeddedness of Germany in EMU can also be interpreted as a template for a future Asian monetary union dominated by Beijing. Until this moment comes, which is as questionable as the survival of the euro, the European currency has triggered another ideational effect. Its successful consolidation as the second most used international currency has shown financial elites in all three case study regions that an IMS with several international currencies might be more efficient and stable than dollar unipolarity. In other words, what the euro has done is start a race of different international currencies for the top position. The dollar might continue to be the dominant one, but its predominance is assumed to be in decline and thus its position will increasingly slip further from top to negotiated status.

Chapter 7: The Eurozone's Monetary Power in Reforming the Dollar-Standard

At this point in the discussion, once the three empirical chapters have been presented, it is convenient to summarise briefly the main argument put forward in this thesis. After presenting the literature review on the euro vs. dollar debate in Chapter 2, and my conceptual and methodological underpinnings in Chapter 3, in Chapters 4, 5, and 6 I have demonstrated empirically how the euro is, on the one hand, incapable of challenging dollar-unipolarity materially, but, on the other hand, how its legacy is increasingly challenging the US monopoly in shaping preferences around the best possible IMS. The euro has several structural weaknesses that make it unfit to topple the dollar. For that to happen, the EZ would need a single debt market, a fiscal union and the political and military capacities to be the *guarantor* of the IMS. These developments are very unlikely, if not impossible. However, the euro has exposed the flaws in the FDS. It has shown that the lax monetary and fiscal policies of the US are profoundly unstable. The creation of EMU is the first attempt to mitigate these instabilities. Through the euro, the EZ member states have tried to develop more autonomy and hence more protection against dollar-shocks. This strategy has stimulated policymakers in Brasilia, Beijing and Riyadh to do the same. Either through regional monetary unions or through the promotion of their currencies, the aim now is to move away from dollar unipolarity.

In this chapter I want to explore on a more analytical level how this evolution in the field of international currencies translates into the global governance of the IMS. The aim here is to capture to what extent the consolidation of the euro has enhanced Europe's monetary power. In order to provide a full account, I will make use of Lukes' three faces of power, as explained in Chapter 3 (p.95). Lukes' division into preference-shaping (3rd face), agenda-setting (2nd face) and decision-making (1st face) is extremely useful here because it delineates clearly where European monetary power reaches and where it ends. The EZ is able to assert considerable influence in the 3rd and 2nd faces of power, but as yet, it is incapable to make any significant impact in the 1st face where the final decisions on the governance of the IMS are actually made. Following this overall logic, the chapter is divided in four parts. The first section describes the EZ's influence in the 3rd face of power. Apart from being a blueprint for regional monetary cooperation, and an ideational stimulus for a multicurrency system (aspects covered in Chapter 6), EMU is also seen as a potential blueprint to create a more multilateral and coordinated IMS. EMU has not only shown that monetary sovereignty pooling is desirable, it has also demonstrated that it might be achievable. The ideational effects of EMU go as far as seeing the euro as a possible embryo for the creation of a global multilateral currency. The rationale is clear, if the euro proves to be successful (still a big if), then the possibility of Keynes' 'bancor' idea (Skidelsky 2010) is not so farfetched.

The second section focuses on the EZ's achievements in shaping the IMS's governance agenda. Here it will be shown how France has been able (despite US reluctance) to make the reform of the IMS the highest priority for its 2011 G20 presidency. In this regard, the Europeans, through the French, have shown that they have greater influence than the Chinese, who were the first to call for the start of a debate on reform but were unable to initiate it. France and China are certainly the two countries most interested in reforming the IMS. Both favour a more *dirigiste* and less market-led system. France would certainly be in favour of China joining the G7, until now the main forum for exchange rate coordination. France knows that China favours a managed-floating exchange rate regime with ceilings and floors in exchange rate movements and this suits Paris well since an overvalued euro hampers the competitiveness of French exporters. Nonetheless, China is still reluctant in taking an active role in shaping the IMS. It wants to know whether the French position is shared by the other European states, especially Germany, which has since the early 1970s steered away from applying interventionist policies in exchange rate movements. The lack of unity among the Europeans is precisely the theme of the third section, focused on how the EZ is not able to exercise influence in the 1st face of power. As long as the Europeans do not act in unison in reforming the IMS, their influence will be limited. Here the key player is Germany. If it considers that the FDS is unstable and it should be reformed in a more interventionist fashion, then there might be a chance that the US will concede change. Otherwise it is very unlikely that the US will accept a more managed exchange rate regime. Nonetheless, as will be shown in this chapter too, the US is also increasingly incapable of imposing its will in the 1st face of power. Capital controls and FX interventions are now commonplace. The US is also not able to force the Europeans and the Chinese to change their policies. This is provoking frustration in Washington and generating a situation of stalemate in the governance of the IMS.

Given this state of affairs, the last section of this chapter focuses on three possible future scenarios: the formation of a multicurrency system with increased competition among different currencies, a return to the gold standard, or the creation of a global currency as envisioned by Keynes.

7.1. The Eurozone's Influence in the Third Face of Monetary Power

7.1.1 The Success of the Euro and the Feasibility of the SDR Proposal

As has been discussed in the previous chapters, I argue that the euro symbolises a move away from the instabilities of the FDS. The creation and consolidation of EMU has had three layers of ideational effects in the minds of the financial elites investigated throughout this research. The first two have been covered by the previous chapter while the third will be presented here. First, it has shown them that regional monetary cooperation is a good protection mechanism against the volatilities associated with the FDS. EMU is hence seen as a possible template for regional monetary cooperation and even monetary union in different parts of the world. Second, given that EMU is still a harbinger in relation to regional monetary cooperation (it has been successful so far, but its long term feasibility is not assured), policymakers in the three case study regions are looking at how the euro has been able to become an international currency in less than a decade and they would like to emulate this (so far) successful trajectory with their own currencies. The rise of the euro has taught them that an IMS with several international currencies is possible, and perhaps even desirable. Thus, with the coming of the euro, the common sense perception, promoted from Washington, that the most efficient IMS is one where only one currency is dominant (Kindleberger 1986, 2000), is put into question. Third, and this is the focus of this chapter, the success so far of the euro has shown them that peaceful and voluntary sovereignty-sharing in monetary affairs is feasible. Something that before was seen as impossible, is now perceived as a possibility, not only at the regional level, but even at the global level. The utopia of establishing one day a global currency as Keynes suggested with his Bancor idea remains a dream, but the *idea* of the euro brings this dream closer. The creation of a supranational global currency might be very difficult to achieve. Recent tensions within the EZ show how difficult it is to have a monetary union, without a fiscal and political union to sustain it. But one does not need to go this far to acknowledge the ideational effects of the evolution of EMU. The more mundane goal to reach monetary cooperation at a global level to avoid the problems associated with the Triffin Dilemma seems to be sufficient progress in the right direction for a great number of participants in this research (Interviews W-1 2008; Rebelo 2008; X-3 2009; X-6 2009; He 2009; Ding 2009b; Qin 2009; Yu 2009; Y-7 2010; Z-5 2010; Yousef 2010). Thus, the European experience in multilateral negotiations is a good basis and possible blueprint upon which to move this process forward. In this regard, although still far from its potential, European monetary influence might be greater than widely acknowledged in the literature.

The euro has provoked a mind change on the possibility of establishing multilateral cooperation in an increasingly multi-currency system, not only on a regional level, as shown in the previous chapter, but also at the global level. For certain interviewees in China, Zhou Xiaochuan's (2009a) proposal in favour of SDRs is partly based on the success of EMU (Interviews X-10 2009; X-17 2009; Ding 2009b; Zhou H. 2009). As explained by Blyth (see Chapter 3, p.99), in situations of Knightian uncertainty, after using ideas to interpret the reality, to build coalitions in favour of this interpretation and as weapons to legitimise the status quo, economic agents start looking for possible blueprints on how to establish a new system. In this regard EMU can be seen as this regional blueprint with the potential to become the basis for a new international institutional setting. Ding Yifan, Director of the Development and Research Centre, a think tank directly funded by the State Council, the Chinese cabinet, explains this argument.

> Zhou Xiaochuan's proposal of a supranational currency has the euro as reference. If you can achieve regional monetary integration, then you can also achieve world monetary integration. The euro is a role model. If the euro succeeds, then the idea of a world currency will get even stronger (Ding 2009b).

Further evidential triangulation strengthens this argument. Another researcher, this time from the Chinese Academy of Social Sciences (CASS), a think tank close to the

Chinese government, who asked to remain anonymous (Interview X-25 2009), confirmed that for several years an Italian central banker (whose name cannot be disclosed) would constantly speak about SDRs with researchers at CASS and that more recently he had entered into contact with the Chinese central bank to explain the proposal. For Jamil Anderlini, correspondent of the *Financial Times* in Beijing, the connection makes sense. “The euro is the only super-sovereign currency that is around, so I guess this must have had some influence on [Governor] Zhou” (Anderlini 2009). There is also evidence that Robert Mundell has been advising China on the reform of the IMS (Webb 2008), and as is widely known Mundell was also influential in the creation of the euro. Other participants in China would agree on the likelihood of this European ideational influence on Zhou, even though the majority of them did not position themselves on the matter. Interestingly, evidence collected in Brazil and the GCC speaks in favour of the ideational link between EMU and the SDR proposal or any other global currency project (an option seen by many participants in all three case study regions as the ideal long-term solution to current exchange rate volatility, see below). In a large number of interviews the issue of creating a global currency to stabilise the international system emerged right after discussing what has been the most important effect of the euro in the reconfiguration of the IMS (Interview W-1 2008; Rebelo 2008; Sfakianakis 2010; Zubair 2010) .

7.1.2 EMU’s Experience in Multilateral Monetary Sovereignty Sharing

Overall, the sense is that before the existence of the euro the *idea* of sharing willingly and peacefully monetary sovereignty was a desirable but unfeasible objective, while with the consolidation of EMU this utopia might be less impossible. The set of possible preferences has been widened. Thus, the hitherto success of the euro represents a challenge to the monopoly of the US in the ideational third face of preference-shaping. Over the years, the Europeans have developed considerable experience in monetary sovereignty sharing. This provides them with more leverage in re-shaping the IMS. As Yu Yongding (2009) explains, ‘the European model of multilateral cooperation is certainly a model to work on. They have shown that it is possible’. This has encouraged policymakers in China to ask the Europeans to go beyond the realm of the third face and, on the basis of their regional success in dealing with the instabilities of the FDS, start actively cooperating with China in the reform of the IMS (Interviews X-3 2009; X-12 2009; X-19 2009). The feeling is that "Europe should join in the efforts to create a more balanced and fair economic system […] excessive dependence on the US dollar makes all of us very vulnerable […] If Europe and emerging economies cooperate on the issue [of promoting the use of SDRs], it will at least put pressure on the US to be more prudent with its monetary policy. We can put the issue on the agenda, rather than leaving it up in the air" (Wang Xu 2009b, brackets added). As explained above, in general, "the consensus Chinese view is that a multi-reserve currency era is coming, even if only gradually, and that it would be in China's strategic interests to promote such a scenario" (Chin & Wang 2010). For that China needs to find alliances and the best partner would be the EZ. As Chin and Helleiner (2008) explain China has certainly acquired a higher degree of monetary autonomy with its immense foreign reserves. As the main creditor nation of the world, surpassing even the World Bank in international aid in 2010 (Dyer et al. 2010), China has been able to exercise more influence and political leverage than scholars such as Cohen (2008a) acknowledge. However, similarly to Europe, China has not been able to convert this increased monetary influence in changing the rules of the game of the IMS. This is partly because China has followed Deng Xiaoping's advice of keeping a low profile in international negotiations, but also partly because "of the enduring underdeveloped, overly regulated and fragile nature of China's domestic financial system" (Chin & Helleiner 2008:99). The lack of expertise in financial matters in China (Interview X-3 2009; Zhang E. 2009) is reflected in the fact that the debate on how to establish an alternative IMS is still in its infant stages (Chin & Wang 2010). This is why China has been looking to Europe to help it to bring the reform of the IMS onto the G20 agenda. A senior Chinese official interviewed in March 2009 would especially count on French collaboration, since in his opinion 'the French have always been very keen to move away from dollar hegemony', he would also say that 'both the BRICS and the Europeans need to do more work on keeping the US under check in relation to its [loose] monetary policies. We have to coordinate more' (Interview X-19 2009). As will be shown below, his predictions about French activism in the IMS reform process were accurate.

However, one must say that the Europeans responded lukewarmly to Chinese calls for the end of the FDS. When Zhou (2009) published his article on the reform of the IMS, while all other emerging markets and several IMS experts applauded the idea (Bergsten 2009b), the response from Europe was muted. The then EU Commissioner for Monetary and Economic Affairs, Joaquin Almunia, commented that he did not see "major structural changes in the role the dollar plays today as a major reserve currency" (*Deutsche Welle* 2009). A similar response came at the time from the Office of the European Commission in Beijing. One official there would state that the official guideline from Brussels about Zhou's proposal was to say that "Europe takes note of the proposal, but nothing more" (Interview X-10 2009). At this point in time, it seemed that the Europeans were happy to leave their monetary power restrained to the third, more ideational, face of power. The view among the Europeans was that it would be unwise to side with China and the BRICS on this highly sensitive issue because it could alienate the Americans. Nonetheless, in April 2010 when asked about Europe's muteness on this topic EC President José Manuel Barroso replied that it was not true that Europe did not have a position on this issue and that it was not working on it. His response was that Europe has consistently called for more coordination in the exchange rates of the major currencies. Europe has also always said that the IMS should not be dominated by one single currency, such as the dollar, but be formed by several international currencies, the euro being one of them. He did also say that the European Troika (consisting of the head of the EZ Group, the Commissioner of Monetary and Economic Affairs and the President of the ECB) was working with all the trading partners on this issue and that this topic was high on the policymaking agenda (Barroso 2010). Further evidential triangulation confirms this statement. It appears that the members of the European Troika and their Chinese counterparts have been meeting since November 2007, under the umbrella of what is now called the EU-China High Level Economic and Trade Dialogue (HED), with the objective to "take comprehensive measures to step up economic structural adjustments and *prevent big fluctuations in the foreign exchange rates*, while at the same time make a contribution to the orderly adjustment of global imbalances" (*Xinhua* 2007b, emphasis added).

However, despite these diplomatic encounters, up to 2010 Europe's role in the reform of the IMS was certainly disappointing from the point of view of the financial elites of China. The EU's mantra about seeking further coordination in the exchange rate regime was seen more as a cover-up for siding with the US in demanding an appreciation of the RMB. This appeared to be the main goal of the Euro Troika when it visited China in November 2009 (Waldmeir 2009). Europe's subordination to the US is something that is continuously criticised by a number of policymakers in the three case study regions (Interviews W-1 2008; X-19 2009; Z-5 2010). The vast majority of participants interviewed would like to see a more independent and assertive Europe that can act as a counter-balance to the US.[116] The same demand comes also from European figures such as Jacques Delors, former EC president, who states that at least the Chinese have started the debate on reform, "it is time that the leaders of EMU live up to their responsibility, not to see the euro substituting the dollar, but rather in contributing to create a more balanced international monetary system" (Vidal-Folch 2009). A similar complaint also comes from Cao Honghui, director of the Financial Markets Division of the Institute of Finance and Banking at CASS. He also wants the Europeans to be more proactive in helping China to reform the IMS. 'The IMF is totally controlled by the US', he argues, 'they have veto power because of the voting system, but even leaving the voting system aside, the truth is that the IMF is completely controlled by the US. We do not trust the IMF at all. As for the Europeans, yes, they appoint the Managing Director, but this is only to save their face. They need to do more' (Cao 2009).

At this point it is convenient to remember that Chinese frustration about the Europeans' incapacity to convince the Americans to establish a more coordinated IMS goes as far back as to the times of the creation of the euro. In 2000 Xu Mingqi, a prominent Chinese scholar in financial matters from the Shanghai Academy of Social Sciences, with good connections both in Europe and in the US, wrote:

> Since the launch of phase three of the euro, the US government has repeatedly rejected the call for quick reform of the international monetary system and has denied the need for an international management of exchange rates. Many Americans think that the birth of the euro will not change much of the pattern of the current international monetary system. In the near future, the US dollar will still hold its dominant position. So they do not care about the need for coordination and cooperation in managing the exchange rates

[116] It is worth here mentioning that in most official Chinese school textbooks on World History it is said that Europe has obtained through the consolidation of the EU a certain degree of independence from the US. See Spakowski and Thies (2011).

> and they are opposed to measures against speculative capital flows. Europeans show the desire to coordinate more closely with the US. Officials from EU member states as well as from the ECB appealed on several occasions that there should be a mechanism for stabilizing the exchange rate between the dollar and the euro (Xu 2000:264).

It is unclear whether European officials have continued since 2000 with their efforts of trying to convince the Americans to establish a more ‘managed’ and ‘regulated’ IMS, but, if they have, their efforts have been unsuccessful.

7.2 The Eurozone´s Influence in the Second Face of Monetary Power

7.2.1 Sino-French Collaboration in Reforming the Flexible-Dollar-Standard

Coming back to the current crisis, even though the Europeans as a united bloc have not come out with a clear position on China’s calls for the reform of the IMS, the French government has had a different approach. In July 2009 at the G8-G5 meeting in Italy, President Sarkozy supported Chinese attempts to reform the FDS (Thomas 2009). Six months later at the 2010 World Economic Forum in Davos the French President announced that “we need a new Bretton Woods. We cannot preach free trade and tolerate monetary dumping [in a clear allusion to what later would be called Currency Wars, see Chapter 5, p.188]. France, which will chair the G20 in 2011, will place reform of the monetary system on the agenda” (Tett & Hall 2010, brackets added). After seeing how Chinese calls for reform were hardly addressed during the 2009 G20 presidency held by the United Kingdom, a country outside the EZ that has never hidden its reluctance to change the status quo (See Chapter 3, p.102), the French seemed to be determined to push the reform of the IMS on to the G20 agenda. For this they knew that they could count on Chinese support given that both countries have similar aims when it comes to reforming the current system.

Both France and China have always favoured the implementation of “mechanisms for avoiding excessive exchange rate volatility”, they have persistently called for a “debate on the international doctrine of capital movements” and they have always sought to "curb commodity speculation", precisely the three main themes that Sarkozy put on the table when he proposed the French 2011 G20 agenda in August 2010. In this same presentation there was also a hint that France and China were working together on the formulation of this agenda. Sarkozy made clear that there is the need for a "new framework for consultation of exchange rate developments" and that China should join the G7 meetings of finance ministers in this area (Hall 2010, all quotes in this paragraph). From these statements it can be inferred that France would be happy to see China on board given that in the current configuration of the G7 its influence is curtailed. The US, the UK, Canada and Germany are all countries which are sceptical about state dirigisme in the foreign exchange markets, Japan is more inclined to favour the idea, but it does not have the diplomatic clout to challenge the US on this issue. This leaves only Italy as a potential ally to France. With the entry of China in the G7, however, the balance of power would be quite different.

Given that France and China prefer a more managed and multi-polar exchange rate regime than the FDS, it is no wonder then to discover that diplomatic cooperation has been close in the past years. French and Chinese officials have been meeting for some time to design strategies to reform the IMS. "The talks and their content have been kept secret, in an attempt to draw China into a discussion on global currency coordination, a subject that Beijing has been reluctant to countenance in the past" (Hollinger & Giles 2010). Again here the important issue is to define what currency coordination means for the different parties involved. This is why China is very sceptical about French woos of letting it join the G7. If coordination means that the Chinese need to fully float their currency, then the conversation ends right there for Chinese policymakers. The Chinese government is firmly opposed to completely flexible exchange rates determined only by market forces (Hu 2010a, 2010b). This is perceived to be too unstable. The boat cannot be left to its own mercy against the waves of possible storms. It needs to be steered by the public hand. As a senior official disclosed, the Chinese proposal to avoid international exchange rate disruptions is as follows:

> The US, EMU, Japan and the UK should agree to a managed-floating exchange rate band. The Chinese RMB would remain more or less pegged to the dollar. This would hold until China develops its financial markets. Once

> this is achieved, the RMB will start gradually its floating process, join the other strong currencies in the established band and consequently be part of the IMF SDRs basket, which hopefully will become the future reserve currency (Interview X-3 2009).

It is striking how this proposal resembles the European Exchange Rate Mechanism (ERM) of controlled-floating adopted by the European countries in the late 1970s to avoid the instabilities emanating from the collapse of the Bretton Woods System. Incidentally, the ERM arrangement, based on the ECU (a similar multilateral account unit with different currency weights as is now the SDR), was the precursor of the future single European currency (Marsh 2009). Yet again we see here how previous European experiences in managing exchange rate policy are carefully studied in China and serve as a blueprint for contemporary proposals.[117] From the onset this proposal would certainly find the favour of the French who have always advocated a managed floating exchange rate regime in order to avoid an over-appreciation of the euro. Nonetheless, it is very doubtful whether the US, the UK and Germany would accept such a proposal. As mentioned above, at the moment none of them seems to be willing to have an interventionist approach.

7.2.2. The Topic of Reforming the Monetary System Makes it onto the G20 Agenda

Despite US and UK unwillingness, and German reluctance, to change the status quo, what is by now confirmed is that the French have been able to impose their agenda on the workings of the G20 for 2011. The reform of the IMS is now one of the most important topics discussed at the G20 and the IMF. This proves that the EZ has enough overall structural, including ideational, power (in the realms of production, finance and ideas, see Chapter 3, p.89) to leverage certain influence in the second face of power focused on the ability to shape the policymaking agenda. Here it is important to highlight that the Europeans find themselves very much at ease with the G20 structures of permanent multilateral-negotiating and consensus-building. This gives them a structural advantage in generating what Joseph Nye Jr. (1990, 2004) has

[117] It is here worth mentioning that in the run up to the creation of the euro, the then German Minister of Finance, Oskar Lafontaine, advocated the creation of "target zones for exchange rates" and "constrained flexibility" among the major currencies (Henning 2000:39). This is the same framework now proposed by Chinese policymakers.

labelled: soft power. As Gideon Rachman, the *Financial Times* chief foreign affairs columnist, noted after coming back from a G20 gathering.

> The surroundings and atmosphere were strangely familiar. And then I understood; I was back in Brussels, and this was just a global version of a European Union summit. It was the same drill and format. The leaders' dinner the night before the summit; a day spent negotiating an impenetrable, jargon-stuffed communiqué; the setting-up of obscure working groups; the national briefing rooms for the post-summit press conferences. All of these procedures are deeply familiar to European leaders – but rather new to the Asian and American leaders whom the Europeans are carefully entangling in this new structure (Rachman 2009).

While for many commentators, especially for US experts, Sarkozy's campaign to reform the FDS is mainly political theatre to gain public support in France before the presidential election in 2012 (Beattie 2011), it would be disingenuous to overlook the accomplishments of the French government. Right after the G20 meeting in Seoul in November 2010, Sarkozy (2010) was keen to highlight these (so far minor) achievements. He confirmed that France, despite considerable opposition (especially from the US), had been able to make the reform of the IMS the most important point in the G20 agenda. France was also able to convince China to hold a high level conference on the reform of the IMS in Beijing in March 2011. That China has agreed to this is already an achievement. As the same Sarkozy would recognise, "it was already not that easy – to be absolutely frank – to get the organization of a seminar on the international monetary system in China" (Sarkozy 2010). In spring 2009 when I did my fieldwork in Beijing, a number of participants would state that China did not want to take the responsibility of hosting any G20 gatherings because it did not have the capacity, expertise or the diplomatic clout to organise such an event. Thanks to French persuasion, this seems to have changed slightly since the interviews, although it needs to be noted that the Chinese Government made sure that the March 2011 Nanjing meeting was as low profile as possible (Rabinovitch 2011).

The French zeal to initiate the debate (and thus spread ideas) on the future reconfiguration of the IMS has produced a number of meetings and reports at the multilateral level. It is worthwhile highlighting here the Palais-Royal Initiative (PRI 2011), which was set up to achieve two concrete objectives: 1) to agree a multilateral consensual assessment on the current problems of the IMS; and 2) to come up with solutions to tackle these problems. It is interesting to see how the French focus is to arrive on a common narrative on the problems of the FDS. As Blyth explains (see Chapter 3, p.103), in every systemic reform of the world economy, the first battle of ideas lies in winning the argument on what is wrong with the current system and why it needs to be reformed. Once this is achieved, the next step is to come up with ideas on how to reform it. The PRI has been led by Michel Camdessus, Alexandre Lamfalussy and the recently deceased Tommaso Padoa-Schioppa, all high-profile former European officials in financial affairs. This expert group counted on the participation of Edwin Truman and Paul Volcker, former US policymakers, and a wide range of former and current officials from emerging markets, including Hu Xiaolian, currently the vice president of the China Society of Finance and Banking; Hamad Al Sayari, former governor of the Saudi Arabian Monetary Authority; and Arminio Fraga, former governor of the Central Bank of Brazil.

These experts, who can be described as an epistemic community (Adler 1997), have identified several flaws in the FDS: the lack of mechanisms to deal with global imbalances; the financial excesses in certain countries and the creation of destabilizing capital flows (a criticism of US monetary policy); excessive exchange rate fluctuations deviated from fundamentals and driven by speculation (a factor consistently highlighted by China, see [Zhou 2011]); and finally the excessive accumulation of reserves and how the diversification of these out of the dollar can provoke financial havoc (the current Knightian uncertainty in the IMS, see Chapter 5, p.188). Matching these flaws in the system, the blueprints proposed by the members of the IMS to the G20 member states are: to increase the multilateral mechanisms of adjustment and surveillance; to adopt benchmarks based on macroeconomic fundamentals in order to avoid instability and misalignment in the exchange rates; to consider the adoption of capital controls when incoming flows are too destabilising (something that until very recently was considered heresy [Abdelal 2007]) and, finally, to promote the use of the SDRs as an alternative multilateral reserve currency (PRI 2011). So far it is too early to assess the impact of these proposals upon the G20 policymaking process. Nonetheless, it is significant to see how these reform initiatives have gained momentum in recent times.

After political pressure from France and China, the promotion of SDRs is now a topic that not only attracts the interest of expert groups, academics (Julius 2010; Bénassy-Quéré et al. 2011) and UN agencies (Stiglitz Commission [UN 2009]; UNCTAD 2009), it is an issue that has been debated again also by the executive board of the IMF after receiving several technical reports (Cooper 2011; IMF 2011d). While acknowledging the technical and political challenges that SDR promotion faces, the directors of the board agreed to consider "ways to encourage the development of the SDR as a unit of account for private and official transactions, particularly the potential for developing a market for SDR-denominated assets" (IMF 2011e), certainly a prerequisite if the SDRs want to have any chance to be globally appealing (Eichengreen 2011a). One source of contention regarding the SDR is whether the Chinese RMB will be included in the basket soon. In this respect, the position of France is that this issue should be debated and studied. It has even established a task force with China to achieve this goal (Fletcher 2011). The US, however, has clearly stated (under the implicit threat of its veto power at the IMF) that this can only be achieved under three conditions: full convertibility of the RMB, full independence of the Chinese central bank and full opening of the Chinese capital account (Anderlini 2011b). It is needless to say that China will not accept these conditions in the foreseeable future.

7.3 The Eurozone´s Limited Impact in the First Face of Monetary Power

7.3.1 The Lack of a Cohesive Position Reduces the Eurozone´s Monetary Power

Whether the aforementioned efforts to reform the current FDS will bring some tangible results is to be seen. There are many analysts sceptical about any substantial overhaul of the current system (Cooper 2010; Eichengreen 2011a) as long as the US, still the most powerful country, with more relational (see Chapter 4, p.153) and structural power than any other, sticks to its beliefs that it has more to lose than to win from these reforms. The exorbitant privilege is not something that any country is willing to give up easily. Recent events have just shown how advantageous such a privilege is. While Europe, lacking a fiscal union to support its monetary union, needs to impose painful austerity programmes of adjustment in the EZ periphery to please the 'markets', the US has been able to overcome one of the fiercest recessions in its history with an unprecedentedly loose fiscal and monetary policy (see Chapter 5, p.188). Certain critics of the current IMS such as Stiglitz and Greenwald (2010) repeatedly state that the current IMS is unfair because the burden of adjustment falls upon deficit countries. Stiglitz considers the current IMS as deflationary. This is certainly correct for the rest of the deficit countries in the system but not for the US. Some Europeans, especially the Germans, and the Chinese would certainly want the US to adjust through deflation, similarly to the EZ periphery, but the reality is that the US is unlikely to accept the same destiny as Greece. Rather, it will inflate its way out of its debt and so continue to deflect some of the adjustment costs upon others. As Ocampo (2010) correctly explains, Stiglitz's analysis is only half right. The real problem is that the current system is inflationary in boom times (see Chapter 5, p.169) and deflationary (for the rest, not for the US) in crisis times. This asymmetry provides the US with an enormous advantage, which it is unwilling to relinquish.

So, while the Europeans through EMU and the consolidation of the euro have gained autonomy and leveraged certain influence up to the second face of power in the form of spreading ideas about possible alternatives to the FDS and shaping the agenda to reform it, they are still a long way from making any significant impact in the first face where the rules of the game of the IMS are actually decided. One of the main reasons for that is that they do not have the political unity to go beyond the second face. Sarkozy (2010) has stated that he counts on the support of Germany in his reform efforts, but until the Europeans speak with one united voice at the global stage their position will be too weak to impose any substantial change to the status quo, as has been acknowledged before by Bini-Smaghi (2006), Executive Director at the ECB, and the European Commission (2008) in a special report on EMU. As stated above, it is doubtful whether Germany would back French and Chinese attempts to establish a more managed exchange rate regime since the current status quo of an overvalued euro seems to work to its favour. The US deflection strategy of letting the dollar fall to regain competitiveness, which can be traced back to the year 2002 (McKinnon 2010, see Chapter 5, p.185), has hurt especially Germany's main European exporting rivals, Italy and France, who have struggled with a euro above $1.30, but for German companies an overvalued euro has been less harmful. This intra-European competition is certainly a handicap in constructing a united European monetary diplomacy able to counterbalance US monetary power. In this regard, Franco-German collaboration is here essential. If these two countries can work closer together and pull the rest of the EZ behind them, then the Europeans can exercise some leverage, but until then their influence in the first face will be limited. A good example of this can be seen in the French efforts to reform the IMS. As long as Germany does not stand side-by-side with France, key emerging markets such as China and Brazil will be sceptical about any substantial outcome. This is why French attempts to reform the IMS during the 2011 G20 Presidency are likely to produce minor achievements. As one former finance senior official in Saudi Arabia commented, "the French bring up topics to debate but then they do not follow up on them. They don't have credibility. Sarkozy will do the same" (Interview Z-5 2010). For him, the French tend to promise a lot but, in the end, do not deliver. When the Germans join in, though, then the scenario is very different. The credibility of European diplomacy is regained.[118]

Nonetheless, before the Europeans aim to act united at the global level, they need first to sort out their internal problems within the EZ. Only a united EZ at home will have any chance to assert power globally. Integration has accelerated recently. Confronted with the sovereign debt crisis (2010-2011), European policymakers have agreed a series of reforms to integrate further the EZ's economic governance. In this respect, they have shown that they can work together once the pressure is on. In less than a year they have agreed to establish a European Stability Mechanism, which is a de facto European Monetary Fund; a 'European Semester' procedure to coordinate national budgets; and a European Systemic Risk Board (ESRB), with three subordinated pan-European regulation agencies for banking, insurance and equity markets. On top of this they have also strengthened the Growth and Stability Pact with more semi-automatic sanctions and they have signed the so-called Pact of the Euro, which calls for structural reforms to regain competitiveness (Papantoniu 2011). However, despite all these efforts, and despite the introduction of an Excessive

[118] At the time of writing it has transpired that in 2012 Germany will lead, alongside Mexico, a G20 working group concerned with the reform of the international monetary system. This is the first time that German diplomacy takes such a high profile role on this matter.

Imbalance Procedure (EIP) with a scoreboard of macroeconomic indicators to avoid future internal imbalances (Wolff 2011), it is not clear how the systemic internal imbalances between the exporting nations of the core (especially Germany, but also Austria, Finland and the Netherlands), and the less competitive nations of the periphery (Portugal, Greece and to some extent Spain and Italy) will be unwound. It is also not clear how the austerity conditions attached to any future ESM rescue package will allow debt-laden countries to generate growth (De Grauwe 2011). One long-lasting solution would be to establish a political union with a federal fiscal budget able to finance demand-pull and growth in the periphery. This option is totally opposed by Germany, which does not want to see the EZ become a 'transfer union'. The other option, which is favoured by the countries from the north, is that the EZ periphery becomes more competitive so that they can export more to the EZ and the rest of the world. Essentially, the strategy favoured by Berlin is that the whole EZ should follow the export-led growth pattern of *Modell Deutschland* and increasingly export to the emerging markets, which will become the new demand pull.

Nonetheless, even if this were possible, which is doubtful, at least in the short run, the EZ would need to develop a much more active exchange rate policy. If Germany is committed to help its weaker EZ partners to export themselves out of their debt burden it must understand that the euro is consistently overvalued for the EZ periphery. As De Grauwe explains (2010), while the US and the UK have, via quantitative easing, intentionally devalued their currencies between 20% and 30% to increase their exports and so mitigated as much as possible the effects of the Great Recession, the EZ has taken most of this adjustment upon its shoulders. The price of this is that the recession will be deeper and more protracted for the EZ periphery, while it will eliminate the possibility to substantially reduce the internal imbalances. As the same De Grauwe (2010) notes, in a certain way Germany is trapped in sticking to today's economic orthodoxy which "says that the foreign exchange market is better placed than the central bank to decide about the appropriate level of the exchange rate. A central bank should be concerned only with keeping inflation low and not with meddling in the forex market". In essence, Germany still clings to the increasingly questioned Efficient Market Hypothesis (EMH) of the FDS. The irony here is that the overvalued euro is not determined by market forces, but rather by the *visible hand* of the FED and the Bank of England.

7.3.2 US Leadership in the First Face of Power under Question

Overall then, considering the unstable configuration of the current FDS, the deflection mechanisms used by the US and the desire of major dollar holders to diversify into the euro (see Chapters 4 and 5), it can be argued, as Savona (2010) does, that in the past decade "the EU did not understand that the euro needed a different external exchange rate regime – fixed or pegged – instead of floating, to protect itself from the conversion of the dollar-denominated official reserves of other countries into euros". While it is true that with the consolidation of the euro, the absorption capacity of the EZ has been much greater, this capacity has been driven to the limits. France has never hidden its unease about a persistently overvalued euro, it needs to be seen whether Germany will at some point accept this view and actively encourage a more interventionist exchange rate policy. The intellectual support in favour of this policy is again provided by Robert Mundell, widely considered the intellectual father of the euro. Mundell has in the past years actively encouraged the Eurogroup and the ECB to intervene in the market every time the euro goes beyond the $1.40 mark. As a matter of fact, he also advocates an exchange rate fluctuation band between the $1.30 and $1.40 marks to avoid destabilising and damaging volatility between the world's two major reserve currencies (Rushton 2011). It is important to mention here how Mundell's proposal coincides with that put forward by Chinese officials. This is no coincidence. Mundell is a primary adviser to China's economic policymakers (Webb 2008). Yet gain we see here how agency and ideas are important factors in reforming the IMS.

Increasingly, the core pillars of the FDS (US economic and financial leadership, free market economics, flexible exchange rates and free capital movements) are starting to be questioned around the world, even in Germany. In 2008, in the midst of the global financial crisis the-then German Finance Minister, Peer Steinbrück, declared that "the US will lose its status as the superpower of the world financial system. This world will become multipolar" (Benoit 2008). In 2010 the German Economy Minister Rainer Brüderle declared that the FED's QE policy was a manipulation of the exchange rate (*Reuters* 2010b) and his colleague, the Minister of Finance, Wolfgang

Schäuble, defined it as "clueless", and warned that the US was putting its leadership role in jeopardy by applying double standards. In his words: "It is not consistent when the Americans accuse the Chinese of exchange rate manipulation and then steer the dollar exchange rate artificially lower with the help of their printing press" (Beattie 2010a). Similar criticism has also come from emerging markets, especially China and Brazil, two countries that have never been at ease with the US promotion of free floating exchange rates and free movement of capitals. The recent questioning of the FDS and US leadership around the world, including Europe, has naturally reinforced this view. China has been reluctant to bow to US pressure to appreciate its currency, and Brazil has started to regulate and tax short term capital flows more heavily (Wheatley 2010). That the US is incapable of imposing its policies upon China in the first face of power, and that the current FDS is not operating smoothly, has even been acknowledged by the FED's chairman Ben Bernanke. In 2010 he declared that "as currently constituted, the international monetary system has a structural flaw: It lacks a mechanism, market based, or otherwise, to induce needed adjustments by surplus countries, which can result in persistent imbalances" (Bernanke 2010). That the head of the FED acknowledges in public that the FDS is structurally flawed is a significant development. It shows how policymakers in Washington are increasingly frustrated about not being able to deflect the adjustment costs upon China. As was explained in Chapter 3 (p.113), in the past when Germany and Japan were in the same situation as China, the US was able to use the 'dollar weapon' to impose adjustment upon them, not least because it provided them with a security umbrella. Today, however, China is in a much stronger position.

Increased US incapacity to impose its will in the first face of the governance of IMS can be illustrated by other examples. In mid 2010, in the run up to the G20 Toronto meeting, the Obama Administration tried to persuade the Europeans to stimulate their economies further to come out of recession. The proposal failed (Beattie & Barber 2010; Trichet 2010; Rove 2010). On this occasion the Europeans showed that when France, Germany and the UK defend the same position, the US is not able to bend them. This clash was a good example of the different macroeconomic interpretations (and hence ideational understandings) on both sides of the pond. While in Europe the priority appears to be financial stability, and therefore reducing the debt levels through fiscal consolidation is the primary task, in the US the main concern is to reestablish growth as soon as possible to avoid being in a recessionary spiral.[119] It needs to be said that in this debate, the US counts with a great advantage, it still benefits from the exorbitant privilege, an option that is not available to the Europeans (or at least not to the Europeans of the periphery). In any case, the US deficits have also a limit. They cannot go on forever without major disruption as the global financial crisis has shown. The US is also aware of this and this is why Treasury Secretary Geithner proposed before the G20 meeting in Seoul in November 2010 to establish an indicative 4 percent-of-GDP threshold for surplus and deficit countries in order to tackle global imbalances. This was one of the first times in recent history that the US proposed a multilateral and interventionist mechanism to govern the IMS. However, this proposal was also rejected by some of the Europeans and the Chinese. On this occasion, it was Germany and China, the two main exporting nations of the world, which led the charge (Beattie 2010b). Following its orthodox approach, Berlin rejects anything that might be seen as "command economy". Beijing, on its part, might be more inclined to start negotiations, especially given that it has repeatedly stated that it wants to restrain its own surplus to below 4 percent of GDP, but in order to accept such a proposal multilaterally, China would like to see more concessions on the part of the US in other areas. The feeling in Beijing is that if there is a will to establish ceilings for systemically destabilising current account imbalances, why not do the same for highly volatile and speculative exchange rate movements and short-term capital flows?

All this adverse reaction to US policies and proposals shows that the US has difficulties in determining the rules of the game. As Cohen (2010) argues, this is a 'leaderless' IMS (see Chapters 2, p.70; 3, p.105). We are increasingly entering into a transition phase in which the old institutional order is contested and it is difficult to envision what the new one will look like. What is clear is that certain policies that have been defunct for three decades have now become legitimate. Foreign exchange

[119] Two contemporary financial leaders that epitomise this cultural debate are Jean-Claude Trichet, head of the European Central Bank, and Larry Summers, until very recently chief economic adviser to President Barack Obama. For the first "the success of a fiscal consolidation strategy strongly depends on its design. Adjustment on the spending side, accompanied by structural reforms to promote long-term growth, has typically been the best strategy, especially when combined with a credible long-term commitment to fiscal consolidation" (Trichet 2010). The latter's response is as follows: "I find the idea of expansionary fiscal contraction in the context of the world in which we now live to be every bit as oxymoronic as it sounds ... [I]f Britain enjoys a boom over the next two years ... I would be required ... to be quite contrite about the seriousness of the misjudgments that I am making" (Wolf 2011c).

intervention, macroeconomic thresholds and reestablishment of capital controls were considered heresies in most capitals of developed and emerging countries up to 2008. In this regard, the IMF's u-turn on the desirability and efficiency of capital controls under certain conditions is quite significant (Ostry et al. 2010). As of the time of writing, several themes related to reforming the IMS such as the effective use of capital controls, the rebalancing of the global economy through multilateral assessment mechanisms, the avoidance of disorderly movements in exchange rates and the composition of the SDR basket, are hotly debated in the G20 framework presided by France.[120] Whether these debates will bring an overhaul of the system is unknown. However, if the eurozone experience is any guide, it can safely be argued that guidelines drawn from mutual assessment processes have rarely any power to change national macroeconomic policies. For multilateralism to work it needs to be embedded in international law.

7.4. The Future of the IMS: Three Possible Scenarios

7.4.1 The Emergence of a Tripolar Monetary System

Considering the current state of affairs, in which a comprehensive and coordinated overhaul of the FDS is difficult to achieve, looking at the medium to long term, the most probable scenario envisioned by the financial elites investigated throughout this research is the emergence of a multipolar monetary system in which the dollar, the euro (if it survives) and possibly the RMB, leading an Asian bloc, will compete for

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[120] It is worth reproducing here extracts of the relevant points concerning the reform of the IMS of the latest G20 finance minister's meeting which took place the 15 April 2011. In the official communiqué point 3 reads as follows: "In order to enhance our mutual assessment process to promote external sustainability, we agreed on a set of indicative guidelines that complete the first step of our work to address persistently large imbalances. We now launch the second step of this process with an in-depth assessment of the nature of these imbalances and the root causes of impediments to adjustment…" Point 4 continues like this: "To strengthen the international monetary system, we agreed to focus our work, in the short term, on assessing developments in global liquidity, a country specific analysis regarding drivers of reserve accumulation, a strengthened coordination to avoid disorderly movements and persistent exchange rates misalignments, a criteria-based path to broaden the composition of the SDR, an improved toolkit to strengthen the global financial safety nets, enhanced cooperation between the IMF and regional financial arrangements, the development of local capital markets and domestic currency borrowing, coherent conclusions for the management of capital flows drawing on country experiences. We also agreed on the need to strengthen further the effectiveness and coherence of bilateral and multilateral IMF surveillance, particularly on financial sector coverage, fiscal, monetary and exchange rate policies".

international usage share. This prediction coincides with that of Eichengreen who also thinks that a tripolar monetary system is the most probable outcome, while stating that it is a welcoming evolution. [121]

> Once upon a time, there was room for only one international currency, the dollar. But now, because switching and interchangeability costs have fallen, there is room for several international currencies. We are heading, in other words, toward a world in which several currencies will share the international stage. I want to suggest that this change is to be welcomed, not feared. Our multipolar world economy will be more stable and smoothly functioning with a compatible multipolar monetary and financial system (Eichengreen 2011b).

That a tripolar system will bring more competition and therefore more self-correcting discipline and stability to the system is a feeling shared by a great number of Chinese and Brazilian financial elites (Eduardo 2008; Rebelo 2008; Cao 2009; Qin 2009; Zhang Ming 2009; Chin & Wang 2010). The general understanding is that with more competition the US will not be able to misuse, as it is doing now, its exorbitant privilege. The Kindlebergerian notion that the IMS needs one leading hegemonic nation, both in economic and political terms, to be stable is rejected, and so is the economic theory of network externalities which states that economic agents are as inclined to use one international currency as they are to speak one international business language. By contrast, the counter-argument put forward is that in today's world there is a need to diversify investments, and this is not only valid for equities and bonds, it holds also for currencies. David Bloom, a South African who is FX chief strategist of HSBC in London, epitomises this perception. In his view, "with the size of the FX market [with a daily turnover of $4 trillion (BIS 2010)], the dollar and the euro can cohabit without any problems. We can even cope with another two reserve currencies. This would be even better. The more I can diversify the better. They all complement each other" (Bloom 2008, brackets added).

[121] Eichengreen leaves the internationalisation door open to other currencies such as the Brazilian Real and the Indian Rupee. However, he thinks that, if at all, this will only happen in the very long term. I would agree with Eichengreen on this possibility, although I would disagree with him in relation to the possibility of further monetary unions around the world. As argued throughout this thesis, if the euro is successful, more such experiments might occur, some might fail, but some might crystallize. A common currency in East Asia, South America or the GCC is not totally impossible (see Chapter 6).

Other experts, however, disagree on this supposedly benign competition between international currencies. Avinash Persaud, a former currency strategist in the City of London and now an academic, sees it more the Kindlebergerian way.

> At any time, there tends to be a single dominant currency in the financial world - not two or more, just one. Some people believe that while the euro may not topple the dollar, it will at least share the spoils of financial hegemony. History suggests not. In the currency markets, the spoils go to the victor, alone – they are not shared (Persaud 2004).

This leads him to predict that the prospective decision "by China to move from a peg to a float will mark the beginning of the end of the dollar's reserve currency status" (Persaud, 2004). In this regard, the transition out of dollar unipolarity will not be smooth, but rather abrupt. The independent and liberal minded Chinese economist, Andy Xie, comes forward with a similar analysis. He predicts that the loose monetary policy of the FED and sluggish growth in the US will bring stagflation, and that this in turn, "will force China to accelerate its reforms to float its currency and create a single, independent and market-based financial system. When that happens, the dollar will collapse" (Xie 2009). While a minority, several interviewees would also point to the risks ahead if a multipolar monetary system finally materialises (Belluzzo 2008; Serrano 2008; Chen 2009; Xu Y. 2009; Xue 2009; Interviews Y-1 2010; Y-9 2010). These voices are specially to be found in the GCC region, where fear about possible instability is more palpable, especially among analyst that take both an economic and political-military approach. Here the words of a senior researcher at one of the think tanks in the UAE are quite illustrative.

> History tells us that the international currency is that of the biggest economy and military power, if that is not so, you have a phase of instability until a new power emerges to replace the other. In any case, one power, one leader is better. The best analogy is the car. You can only have one driver. If you have two, one wants to go right, the other left, and you have an accident (Interview Y-1 2010).

Incidentally, given these two opposing views, one favouring Kindleberger's hegemonic stability theory, and the other striving for a multipolar monetary system, Bénassy-Quéré and Pisani-Ferry (2011) have recently studied which of the two is more likely to deliver the global public goods of economic growth, monetary stability and international equity in financial affairs. For them, the case for hegemonic stability is weakened by the fact that it is very likely that "the hegemon exploits its monopoly power – in other words makes use of its exorbitant privilege to bolster narrow national interests, at the expense of global stability" (Bénassy-Quéré & Pisani-Ferry 2011:20). This is precisely what financial elites in emerging markets are currently denouncing. These authors do also find that a multipolar system would favour diversification. This would mean that there would probably be more short-term volatility in exchange rate markets, but in their view this short-term volatility would be cushioned through hedging tools, while medium to long term misalignments would be reduced because the Triffin Dilemma would not fall upon one country but several.

Overall, they argue that a multipolar system would bring more economic efficiency because currency use would match economic transactions between the different currency blocs and therefore the large accumulation of reserves would not be needed. It would bring more stability because it would limit the causes of today's systemic imbalances and their possible unwinding in a disruptive way. And, finally, it would also be more equitable because, provided that all key currencies are allowed to float to the same extent (here the idea of establishing a band might be fitting), the asymmetries of adjustments would be reduced and the 'exorbitant privilege' would be shared. Nonetheless, while ultimately Bénassy-Quéré and Pisani-Ferry favour a multicurrency system, they are particularly keen to warn about the risks that a transition out of dollar unipolarity entails. A rapid diversification process out of dollars could trigger a run on the greenback and destabilise the whole system. That is why they call for cooperation among the FED, the ECB and the PBoC. However, whether this coordination will be possible is yet another uncertainty in the system.

7.4.2 The Revival of the Gold-Standard

While a possible multipolar and multilateral monetary system might be a future possibility, for a number of participants interviewed this is a long-term perspective that is difficult to foresee. They worry more about the short and medium term and in their calculations the most probable outcome is that the US will keep exploiting its exorbitant privilege by increasing even more its debt to promote growth and ultimately the debt overhang will be so large that the US will inflate away its debt (Ding 2009b; Xu Y. 2009; Y-9 2010; Zubair 2010). This will bring the end of the FDS and the era of fiat money and the world will go back to the historic normality of linking money to a metal, most probably gold. This view is especially widespread in China, including policymaking circles. This is partly due to the influence of the bestselling books by Song Hongbing *Currency Wars* (2007) and *Currency Wars 2* (2009).[122] In them, Song explains that the Rothschild banking dynasty has been in control of international money issuance since the Battle of Waterloo. Following Song's logic, the Rothschilds were the ones that introduced fiat money in the first place to increase their wealth and they will be the ones responsible for eliminating it. This will be done by triggering hyperinflation in the US in order to gain consensus to introduce a global currency. In the words of the author, "seeing that the US dollar is doomed, Federal Reserve bankers are backing plans for a currency based on gold reserves and greenhouse gas emissions credits, which may eventually leave China holding mountains of worthless dollars" (Buckley 2009). It is needless to say that the content of these books is highly conspiratorial. Nonetheless, the fact is that they have had major impact among senior government and business leaders in China (McGregor 2007). My fieldwork research in China proves this. Several interviewees would make references to Song's books (Interview X-6 2009; Xu Y. 2009; Pettis 2009a; Zhou H. 2009) and a researcher at CASS would acknowledge that 'unfortunately, it is true that these books have had influence among top Chinese policymakers' (Interview X-27 2009).

It is impossible to establish here a direct correlation between China's desire to accumulate gold and Song's books, but what is clear is that China has in recent years substantially increased its gold holdings. In April 2009, Hu Xiaolian, the head of

[122] Unfortunately, as of yet, these books are only available in Chinese.

SAFE, revealed that "China had boosted its gold reserves by 76 percent since 2003, making it the fifth largest holder of gold" (Zhang R. 2009). This hoarding of gold continued in 2010 as an insurance policy against possible dollar devaluation. As Ferguson (2011:312) notes, "even with the price of an ounce of gold at an unprecedented $1,400, the Chinese began to buy it in 2010 as a time-honoured hedge against inflation". The rush for gold is not only restricted to governmental levels, fears of inflation have made the Chinese public the second biggest consumer of gold after India and experts say that it will become the largest import market in a few years (Hook & Farchy 2011). Chinese exponential demand and fears among international investors that quantitative easing (QE) by the FED will trigger widespread inflation have pushed the price of the ounce of gold to historic levels at over $1,900 an ounce (a long way from the $35 of the Bretton Woods period). Here we see again that we are in a situation of Knightian uncertainty. Since the effects of QE are unknown, international investors try to make sense of this unknown by interpreting it through a series of ideas. The idea that dominates is that QE is essentially printing money, and that printing money leads to inflation. What is the best remedy against inflation? Gold! This interpretation is not only common among ordinary investors. Since 2010 the so-called "official sector", which includes central banks and sovereign wealth funds, has started a bullion buying spree not seen since the collapse of Bretton Woods in 1971 when Nixon closed the gold window. The biggest buyers are China, Russia and India, but smaller countries such as Mexico, Thailand, Sri Lanka and Bolivia have also made substantial purchases (Farchy 2011b).

The rise in the price of gold is a reflection of the lack of confidence in the dollar. Without any solid alternative, with the euro going through its own tough times, investors have no other choice than putting their money in commodities, gold being the safest haven. Hence, gold is seen as a potential new anchor in the increasingly unstable IMS. As a matter of fact, the President of the World Bank, Robert Zoellick (2010), has called for the creation of a multipolar monetary system involving all the currencies in the current SDR basket, plus the Chinese RMB, but he also stressed that the new system "should consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values". The proposal, which would have certain resemblance with the gold standard, was rapidly dismissed by a number of scholars, policymakers and commentators because it would have a deflationary bias, but that the President of the World Bank considers it as an option shows that gold is increasingly seen as a potential new anchor (Hinds 2010). As mentioned, in China fears about potential hyperinflation and the return to a metallic system are widespread. This is the view for example of Xu Yisheng, an opinion columnist for *China Business News*. In his opinion, the loose monetary policy of the FED will produce global inflation, which in turn will erode the confidence in fiat money. The final outcome will be the re-emergence of gold as the anchor of value. It is for this reason that China is trying to hoard as much gold as possible. If there is a return to gold, says Xu, 'Europe as a whole would stand quite strong because it has more gold than anyone else, even more than the US. China, on the other hand, would be hurt because it has only a relatively tiny amount. This is why the Chinese government is keen to buy more gold' (Xu Y. 2009).

When one looks at the official figures, Xu is right. As per May 2011 the EZ as a whole, including the ECB, had 10,792.4 tonnes of gold in its international reserves out of a world total of 30,574.9 tonnes. This means that the EZ has roughly 35% of the world's total gold reserves. The US, on the other hand, had 8,133.5 tonnes, which is the equivalent of approximately 25%, while China had only 1,054.1 tonnes, which is around 3% of the total (WGC 2011, see Table 7.1).

Table 7.1: World official gold holdings (May 2011)

Gold Holders	**Tonnes**	**% of Reserves**	**% of Total**
Eurozone (w. ECB)	10,792.4	61.1%	35.2%
Unites States	8,133.5	74.6%	26.6%
Germany	3,401.0	70.8%	11.1%
IMF	2,814.0	-	9.2%
Italy	2,451.8	69.2%	8.0%
France	2,435.4	64.9%	7.9%
China	1,054.1	1.6%	3.4%
Switzerland	1,040.1	17.1%	3.4%
Russia	811.1	7.5%	2.6%
Netherlands	612.5	57.9%	2.0%
World Total	**30,574.9**		**100.00%**

Source: World Gold Council (2011)

As mentioned above, the return to a gold standard seems at this point unlikely. The memories of the deflationary days of the Great Depression are still very present. However, it is important to note here that in the long history of money public faith in fiat money has been rather ephemeral. Sovereign nation states have periodically succumbed to the temptation of using their printing presses to inflate away their debt, triggering subsequent hyperinflation (Ferguson 2001, 2008). Given this historic record, that the US might resort to the same mechanism should not be discarded. It is for this same reason that Germany, which tried to eliminate its First World War debt precisely in this same way, holds now 3,401 tonnes of gold in reserves, over 10% of global stock (see Table 7.1). In this regard, Chinese and German policymakers, and the wider public, share a common historical, and hence, cultural concern: they are frightened about the possible return of hyperinflation.

7.4.3 The Case for a Global Currency

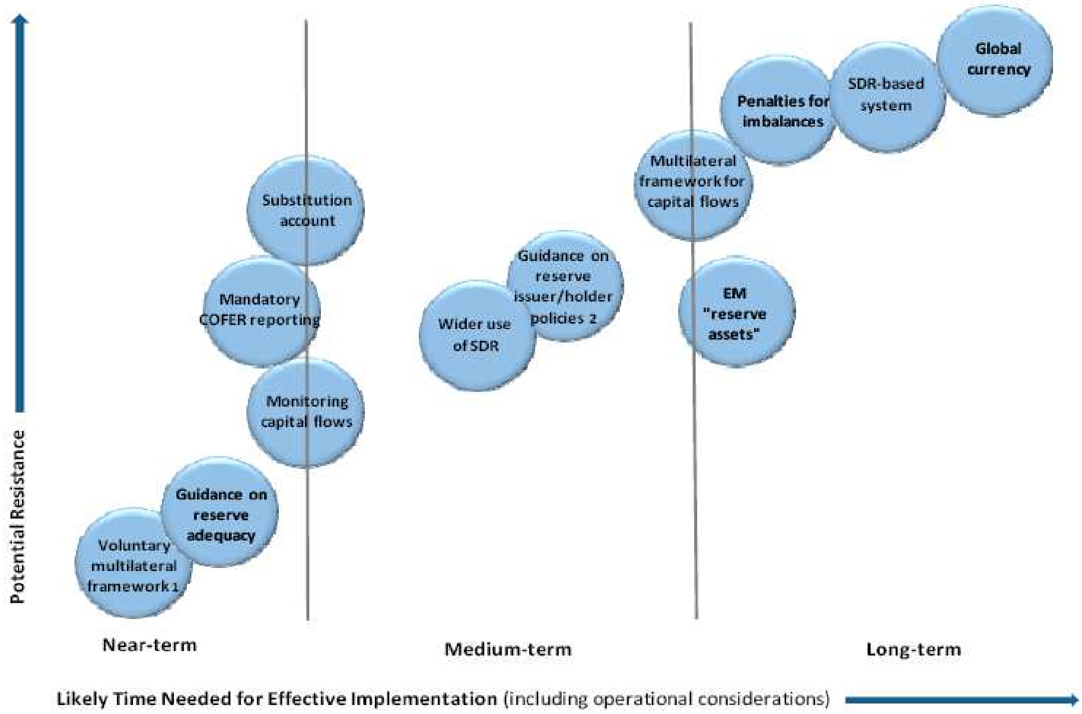
The third possible long-term scenario for the IMS is the materialization of a truly global currency, similar to the 'Bancor' idea proposed by Keynes in the run-up to the Bretton Woods agreement in the 1940s (Skidelsky 2010). As mentioned before in this chapter, the implementation of a global currency has always been seen as some sort of utopia. However, since the creation and consolidation of the euro, this dream seems more feasible. If it is doable to introduce a single currency at a regional level (notwithstanding all the obstacles for the survival of EMU covered throughout this thesis), then it might also be possible to achieve it at a global level. The special drawing rights (SDRs) of the IMF, which were introduced in 1967-69, when the Bretton Woods system was falling apart, are precisely pointing in this direction. As then, today the calls in favour of the SDRs are given by the instabilities associated with the Triffin Dilemma (Helleiner 2010). If the world wants to reduce the destabilising effects of this dilemma, the most effective long-term solution would be to introduce a global currency. Until this long term is achieved, for a number of prominent economists from the US, Europe and China, forming what is known as the Beijing Group (Stiglitz 2011), the best alternative to a global currency are the SDRs. Thus, they urge the G20 to show global leadership and increase the issuance of SDRs beyond the $250bn issuance already agreed in the 2009 London summit at the peak of the global financial crisis.[123] By issuing more SDRs, they reckon that the IMF "would reduce the problem of recessionary bias [during and after financial crises]…it would partially replace countries' need to accumulate reserves. Given its relatively small scale, more SDRs would also help to sustain and accelerate recovery of the world economy, without leading to inflationary pressure. And by reducing the need for countries to set aside foreign exchange reserves, it would also facilitate some reduction in global imbalances" (Stiglitz 2011, brackets added), which are partly a product of the Triffin dilemma.

After analysing in depth the defects of the current IMS, the economists at the IMF (2010b) agree with the Beijing Group that the SDRs should play a major role in reforming the IMS. Alongside the promotion of SDRs, the IMF also proposes to create a substitution account through which major foreign reserve holders would be able to exchange their reserves for SDRs without provoking a collapse in the value of the national reserve currencies. This would certainly be useful to avoid a run on the dollar in the transitional phase of dollar unipolarity to a multipolar system.[124] Interestingly, the economists at the IMF also do see the SDRs as a possible precursor for the long-term goal of establishing a global currency, which coincidently they would call 'bancor', in honour of Keynes (See Figure 7.1).

[123] This was the first issuance of SDRs since 1981 and the third in total (previous periods of issuance were 1970-2 and 1979-81). This one has been the largest issuance ever. As Helleiner (2010b) notes, it boosted the share of SDRs in the world's non-gold official reserves from less than 0.5% to around 5% overnight.

[124] For a thorough analysis on the advantages of a substitution account see Kenen (2010), for an analysis on the politics of its introduction, see Helleiner (2010b).

Figure 7.1: From the wider use of the SDRs to the creation of a global currency



Source: IMF (2010b)

It is interesting to see here how the European single currency functions again as a possible template. For these economists, in the long run the best "option is for bancor to be adopted by fiat as a common currency (like the euro was), an approach that would result immediately in widespread use and eliminate exchange rate volatility among adopters" (IMF 2010b:27). As in the case of EMU, the IMF economists envision also a global central bank which would be in charge of the global currency. Whether this arrangement is politically feasible is highly questionable. Eichengreen, for instance, is very sceptical towards this outcome.

> The case for a global currency issued and managed by a global central bank is compelling in the abstract […] But as a practical matter, so long as there is no global government to hold it accountable for its actions, there will be no global central bank. No global government, which means no global central bank, means no global currency. Full stop (Eichengreen 2011a:141).

What is surprising from this statement is that Eichengreen, unlike some of the participants in this research, does not seem to draw any parallels between the EMU experiment and the possibility of a global currency. As explained in several parts of this thesis, the euro is a regional currency which does not have a government but it has a central bank. If this is possible regionally, why should it be impossible globally? Unless Eichengreen believes that EMU has already a government, which is doubtful, his statement is unconvincing. The example of the euro shows that you do not need a centralised government at the beginning of the process to have a common currency. It can certainly be argued that in the *long run* the feasibility of EMU will only be assured through a political union to support it (I have argued in favour of this outcome in this thesis), but that does not eliminate the fact that the common currency predated the prospective creation of a centralised government. This sequence of events can happen also at the global level.

In any case, for a large number of participants the idea of having one day a global currency is certainly appealing (Interviews W-1; Belluzzo 2008; Rebelo 2008; X-6 2009; X-19 2009; He 2009; Ding 2009b; Sfakianakis 2010; Zubair 2010). In this regard, they agree with the Governor of the PBoC, Zhou Xiaochuan, when he backs the idea by saying:

> Back in the 1940s, Keynes had already proposed to introduce an international currency unit named 'Bancor', based on the value of 30 representative commodities. Unfortunately, the proposal was not accepted. The collapse of the Bretton Woods system, which was based on the White approach, indicates that the Keynesian approach may have been more farsighted (Zhou 2009a).

The attractiveness of the bancor idea is not only to be found among Chinese policymakers and financial elites. In the GCC and Brazil the case for a global currency is also strong, both in the public and the private sector. One aspect that is highlighted by a number of participants is that with the bancor the instabilities in the foreign exchange markets would be over once and for all. Intellectual support for this type of reasoning is again provided by Robert Mundell, who was consistently mentioned by a number of participants as the most inspiring scholar in this field. His statement that “the optimal number of currencies in the world is an odd number, preferably less than three” (Zubair 2010) has had considerable effects in the minds of these financial elites.

Mundell is certainly one of the strongest advocates for a global currency. In some of his latest work he even shows how to get there. He divides the journey to the global currency, which he calls Intor (a contraction of the world international and gold in French), in three stages. Stage 1 would entail the establishment of FX ceilings and floors for the major reserve currencies (the ERM scenario, as explained above). Stage 2 would involve converging monetary policy between the major central banks, eventually creating a multilateral joint monetary policy committee, the locking of exchange rates and the arrangement for the division of seigniorage. Finally, stage 3 would involve deciding the mechanism and agency by which the Intor would be introduced, the system and criterion for controlling its quantity, its backing in terms of currency or commodity reserves, and the location of its central authority (Mundell 2005). Needless to say that all of this is easier said than done. Making the ideational become reality is never an easy task. Nevertheless, it is not impossible. EMU proves that this sort of multilateral monetary arrangement can be engineered, although its experience to date does also show that many obstacles need to be overcome along the way to make it happen, and that there needs to be enormous political will behind the project in order for it to survive. Ultimately, as in the case of EMU, some sort of global political union might eventually be necessary in order to hold it together.

7.5 Summary

The principal aim of this chapter has been to determine to what extent the trajectory of the euro has enhanced Europe’s monetary power in the governance of the IMS. In order to capture these advances in a more systematic way I have used Lukes’ framework of the three faces of power. I have argued that the European experience of monetary sovereignty pooling has provided the Europeans considerable influence in the 3rd face of power centered on preference-shaping. EMU is seen as a desirable blueprint for the creation of a more multilateral and negotiated IMS. The experiment of the euro has shown financial elites in emerging markets that independent sovereign nation states can coordinate their monetary policies (including the management of exchange rates fluctuations) and that they can even create a single currency in order to avoid these destabilizing fluctuations once and for all. The EZ has in this regard considerable 'soft power' in Nye's understating of power (1990, 2004). This is ratified by looking at the successes of the Europeans in the 2nd face of power centered upon the capacity of being able to set the agenda in the governance of the IMS. Again, as in the late 1960s, French diplomacy has been able to bring the reform of the IMS into the public debate. The most important item in the G20 agenda during the 2011 French presidency has been the topic of reforming the IMS. Following Blyth's analysis, ideas have been playing an important role throughout this process. France has been active in generating a predominant interpretation on the flaws of the FDS. The Palais Royal Initiative points in this direction. France has also increased its efforts to build a coalition in favour of alternative proposals, not least by trying to persuade China to take a more active role in this process. Thus, through the activism of France, the Europeans have shown that they can leverage substantial influence in the 2nd face of power.

However, the 2nd face of power is where Europe's influence ends. By being still politically divided, the EZ is not able to project its influence in the 1st face of power where decisions about the rules of the game of the IMS are actually implemented. As of yet it is not clear whether Germany is on the same page with France in creating a more coordinated and managed IMS. Germany is usually on the side of the US and the UK in opposing any attempt to have a more interventionist global economic governance. The status quo is quite beneficial for Germany. With its high export competitiveness it can cope much better than France, Italy, let alone the EZ periphery, with the appreciation bias of the euro. It is for this reason that it opposes any attempt by France to intervene in the FX market to stop the appreciation of the euro. As long as these divisions persist, Europe's monetary power will be curtailed. Nonetheless, as has also been shown in this chapter, this does not mean that the US is in total command of the 1st face of power. Increasingly, the US is losing its monopoly power in all three faces of power and this is reflected in its inability to impose its will upon the rest of the big players. The EZ has generated enough power in the 3rd and 2nd faces of power to have sufficient autonomy in the 1st face of power to avoid being bullied by the US. In the stimulus vs. consolidation debate on how to overcome the consequences of the global financial crisis, Europe has shown that when it acts together it can get its own way. China, on the other hand, has also shown that it has enhanced its influence, and more importantly, its autonomy. With $3 trillion in foreign reserves and a military capability second only to the US, it has resisted US attempts to make it appreciate its currency. The adjustment process is now very different from the late 1960s and beginning of the 1970s when Germany had to absorb a great part of the adjustment costs or the mid 1980s when Japan was in a similar situation. Today the US does not provide a security umbrella to China; hence its monetary power is weaker. This means that we are increasingly in a leaderless IMS. How this will play out in the future is tackled in the last part of this chapter. Three possible scenarios have been put forward: 1) The formation of a tripolar monetary system around the dollar, the euro and possibly the RMB, which can lead to 'benign' competition, more geopolitical tensions or ad hoc coordination; 2) the return to the gold standard due to the collapse in faith in relation to the dollar; and 3) the creation of a global currency to avoid destabilizing exchange rate movements as dreamed by Keynes and envisioned by Mundell. Given the degree of uncertainty that is today in the IMS, it is difficult to predict which of these scenarios is most likely. The first seems to be the most plausible. However, the other two cannot be discarded. History favours the second. The euro shows that the third is difficult, but not impossible.

8. Conclusion

The present study, focused on whether the euro is challenging the dollar as the main international currency, has been developed against the backdrop of the greatest financial and economic crisis since the Great Depression. The consequences of the so-called Global Financial Crisis, which started in the summer of 2007 with the collapse of the real estate subprime mortgage market in the US, and its aftermath, the Great Recession, are still visible at the time of writing. Official unemployment figures are over 9% both in the Eurozone (EZ) and the United States (US) and growth patterns in the two currency blocs are anaemic. The recovery from the crisis has been so far slow and painful on both sides of the pond, and it is difficult to know what will be the new growth strategy in both regions. The current context can easily be classified as one of Knightian uncertainty, in which economic agents struggle to decide how to best safeguard their interests. This is especially true when it comes to invoice trade and store value in a particular international currency. The weaknesses in both the dollar and the euro are of such magnitude that euro vs. dollar competition resembles more a 'less-ugly contest' rather than a 'beauty contest' in Keynes' analogy.

European Economic and Monetary Union (EMU), a teenager with only 12 years of life experience, is going through an existential crisis. The external shock of the global financial crisis has brought to the fore all the institutional and structural weaknesses in its construction. At the time of writing, three EZ member states (Greece, Ireland and Portugal) had to be bailed out by the rest of the EZ to avoid a disorderly, and potentially devastating, default. If the contagion effects spill over to Italy and Spain, the third and fourth biggest economies in the EZ, the outcome could be catastrophic since both Italy and Spain are 'too big to fail', but also 'too big to bail'. The EZ is at a crossroads, either it establishes a fiscal union, even if it is only minimal, or it splits up into different parts, bringing enormous instability to the global financial markets and the world economy at large. The question is whether the EZ core, especially Germany, will be willing to share the adjustment costs of the EZ periphery.

The situation is not brighter in the US. As of the time of writing, the US government has just avoided at the 11th hour a technical default. It has again lifted its debt ceiling of $14.300 trillion to meet its obligations towards its people and its foreign creditors. As of yet, neither the White House nor the US Congress have come up with a credible plan to address the ballooning deficits of the US. US policymakers are also at a crossroads, they need to simulate growth to come out of a recessionary environment, but at the same time they cannot let their public finances explode out of control. A massive stimulus package and two rounds of Quantitative Easing (QE) by the FED have not been enough to spur growth. The usually voracious US consumer is literally exhausted and needs to deleverage. Painful structural adjustment seems to be the alternative solution, but given that the US holds the 'exorbitant privilege' of issuing the main international currency, it is unwilling to raise taxes and live again within its means. However, how long will foreign creditors tolerate bloated US indebtedness? How long will they keep their faith in the dollar? This is a question that has been around for some time, at some point there will be an answer.

Given this uncertainty in the international monetary system (IMS), it is no wonder that the euro vs. dollar debate continues up to the present (see Chapter 2, p.50). Euro-optimists and Euro-sceptics in the academic fields of International Economics and International Political Economy (IPE), in the financial markets, and the wider public at large, continue to present their arguments and counter-arguments in favour of one of these two currencies. Euro-optimists see this crisis as a springboard for the creation of a more resilient EMU. They point to the current exchange rate between the euro and the dollar and they see the single currency at over $1.40 even in the midst of the greatest existential crisis of EMU. If one sees it from this perspective, then one can confidently say, as Jean-Claude Trichet, president of the ECB does, that "there is no crisis of the euro" (Trichet 2011c). On the other hand, the current crisis has vindicated those euro-sceptics that warned before the creation of EMU that, as it was designed from the start, it was a project doomed to fail (See Chapter 2, p.46). With hindsight one can say that they were right. If EMU wants to survive it needs to move towards a fiscal union. There is no way around that.

This thesis provides evidential support in favour of this argument. By analysing the subjective perceptions on the euro and the dollar of financial elites in key emerging markets with huge foreign reserve holdings such as China, the Gulf Cooperation Council (GCC) region and Brazil it demonstrates that the euro is a long way from competing with the dollar for the position of top international currency. The views and interpretations of these elites are significant because how they interpret the reality of the IMS has great impact on how the reality of the IMS is shaped (See Chapter 3, p.118). By analysing their views it is also possible to discern the material but also the ideational effects of the euro. This is where this thesis provides a unique insight. While the results of this research demonstrate that the euro is incapable of challenging the dollar in a material sense, they provide evidence to claim that it does so from an ideational point of view. Thus this research offers two key contributions to the debate: 1) My fieldwork provides empirical evidence that the euro is not supplanting the dollar as the main international currency; and 2) It demonstrates the ideational effects of the euro in opening up preferences and the agenda of monetary governance at the regional and international levels. The existing literature in the euro vs. dollar debate (both in the fields of Economics and IPE) has been focused mainly in tracing the material trajectory of the euro vis-à-vis the dollar. Its use or non-use as an international currency in the three forms of money: as unit of account, medium of exchange and store of value; and the evolution of its economic fundamentals, its financial markets, its institutional governance and its military capabilities. If one limits the analysis to material conditions, then the euro is unable to challenge the greenback. In this regard, my thesis provides useful new evidence to support the euro-sceptic hypothesis (see Chapter 2, p.42).

However, the as yet limited material evolution of the euro has had important ideational effects that have hitherto been overlooked by the literature. This is due to the fact that the literature has been drawn into a 'winner-and-loser type' scenario. The focus has been on whether the euro will be toppling or substituting the dollar, and not on what the trajectory of the euro really means in the historic evolution of the IMS. Essentially, both euro-sceptics and euro-optimists have only been following the top of the currency pyramid. They did not pay sufficient attention to how the (non)challenge of the euro was affecting the other parts of the pyramid. In other words, the literature did not cover the ideational impact of the euro in emerging markets such as China, the GCC and Brazil. As has been shown throughout this thesis, these effects, which can be divided in three, have been substantial: 1) The experiment of the euro has stimulated regional monetary cooperation as a protection mechanism against dollar shocks; 2) The euro has shown financial elites in these regions that an IMS with multiple international currencies might be more stable than the current unstable Flexible-Dollar-Standard (FDS), which is prone to financial crises every few years; and 3) EMU provides a potential blueprint for how to establish a more coordinated and managed IMS based on monetary sovereignty pooling by different independent nation states. If this type of negotiated option is feasible at a regional level, it has the potential to also be effective at the global level.

8. 1. The Importance of Ideas in Understanding the IMS

On the basis of these ideational effects of the euro, and considering that we are in a context of Knightian uncertainty, I have argued throughout this thesis that ideas play an important role in the new institutional configuration of the IMS. As developed by Blyth (2002, see Chapter 3, p.96), in situations like the present, ideas function as tools to interpret the uncertain reality faced by economic agents. They are useful to establish coalitions in favour of a particular interpretation on the causes of the crisis and how to resolve them. They can become ideational weapons to discredit and delegitimize the status quo. They perform as blueprints for possible alternatives and, once these alternatives are in place, they are vital to underpin the new institutional configuration. Since we are not at this final stage yet, the latter, and fifth, effect of ideas is difficult to grasp in today's context, but the other four are certainly visible. This is not to say that the material reality does not matter. I agree with Blyth (2002:30) when he states that the world is not *ideas all the way down*, but it is *ideas all the way through*. Through the analysis of how key economic agents interpret the world, one is able to discern the material conditions that structure and shape the research problem. By using the qualitative and interpretative method of in-depth financial elite interviews, I have been able to identify all four pillars of Strange's (1987, 1988) structural power concept: security, finance, production and ideas and knowledge. These four realms are equally important in understanding monetary power. As Cohen (2006) has convincingly explained monetary power is about being able to delay and deflect adjustment costs in the balance of payments, through autonomy and influence. However, autonomy and influence are underpinned and strengthened by Strange's four pillars. Therefore, autonomy and influence are generated through a combination of both material and ideational elements.

8.2 The Euro's Material Advances and Limitations

Strange's four pillars are clearly identifiable in the evolution of the euro within the FDS. First of all, the creation of the euro is a consequence of a particular IMS, with a particular set of norms and modus operandi. Since the collapse of Bretton Woods in the early 1970s, the FDS has been based on the intellectual and ideological underpinning that flexible exchange rates and free capital flows are the most efficient devices to generate growth. The Efficient Market Hypothesis (EMH) has been at the core of the FDS (see Chapter 3, p.98). It is difficult to understand otherwise how a system as materially disruptive as the FDS has been able to be legitimised for so many decades. Well aware of the persistence of so-called dollar shocks in the system, European policymakers have been trying to be more protected, and hence, more autonomous from US monetary power by first establishing a series of exchange rate pegging mechanisms through the ERM and then by establishing the common currency (Jabko 2010). Autonomy has been enhanced. With the establishment of a European Central Bank, built on the hawkish reputation of the German Bundesbank, and the acceleration in the integration of European financial markets, the euro has become the second most used international currency worldwide. This increased absorption capacity has provided all members of the EZ, including the peripheral countries, cheaper credit for 10 years and less dramatic foreign exchange movements vis-à-vis the dollar. However, this autonomy came at a price. The persistent appreciation bias generated by the hawkish ECB has completely undermined the competitiveness of the EZ periphery. From 2002 until 2008, the euro appreciated 85% against the greenback. This has meant that the EZ, especially the periphery, has carried most of the adjustment costs deflected by the US. The EZ periphery was able to delay, but while it was delaying it was absorbing the deflection mechanism of the US. The EZ sovereign debt crisis is partly a consequence of this development. In this regard, my research shows that what curtails the ascendancy of the euro as an international currency is not the anti-growth-bias, as suggested by Cohen (2010). The conservative framework of the EZ stimulates the attractiveness of the euro vis-à-vis US profligacy.

Rather, the problem is that the appreciation-bias in the euro undermines the competiveness of the EZ periphery, making EMU internally imbalanced.

The crisis has also shown the other material weaknesses of the euro in its material challenge to the dollar, all covered in Chapter 4 of this thesis. First of all, the single currency is confronted with inertia in international currency use. The dollar has been the main reserve currency in China, the GCC and Brazil for several decades. It is very difficult for a teenager currency to undermine the reputation and weight of a currency that has been an international currency for almost a century (Eichengreen 2011a). Unless the issuer of the top currency underperforms substantially, its currency will always have a network-externalities advantage. This underperformance is actually happening right now, as explained in Chapter 5. The leadership of the US in the IMS is seriously questioned among financial elites in China, the GCC and Brazil. Calls for the end of dollar unipolarity in the IMS are widespread. In principle, this should be an ideal opportunity for the European currency to topple the greenback. Nonetheless, the euro is not able to grasp this opportunity for three main reasons. First, it does not have a pan-European debt market able to compete with the depth and breadth of the US Treasury debt market. Essentially, there is not enough liquidity in euro-denominated assets. If China or the GCC would like to transfer a substantial volume of dollars from their foreign reserve portfolio to euros, they would not be able to do it without sending the exchange rate value of the euro through the roof. The evidence provided throughout this research shows that they have tried to diversify further into the euro but they have found that there is a limit to this diversification. Demand for a pan-European debt market is proven by recent events. Every time the European Financial Stability Facility (EFSF) issues pan-EZ debt, the number of subscriptions is very high. This is in stark contrast to the increased aversion that exists to buy sovereign debt from peripheral countries. International investors want to hold debt issued by the EZ as a whole. They are less attracted by individual Spanish, Portuguese, or Greek debt. Here we see another paradox in the IMS. Because the dollar is so questioned, international investors have tried to diversify into the euro for over a decade. This is why sovereign debt yield spreads between German bunds and peripheral bonds were so narrow for so many years. In their eagerness to diversify out of the dollar, international investors treated Greek debt almost as safe as German debt. This behaviour was provoked by the understanding that the EZ was a *de facto* political union.

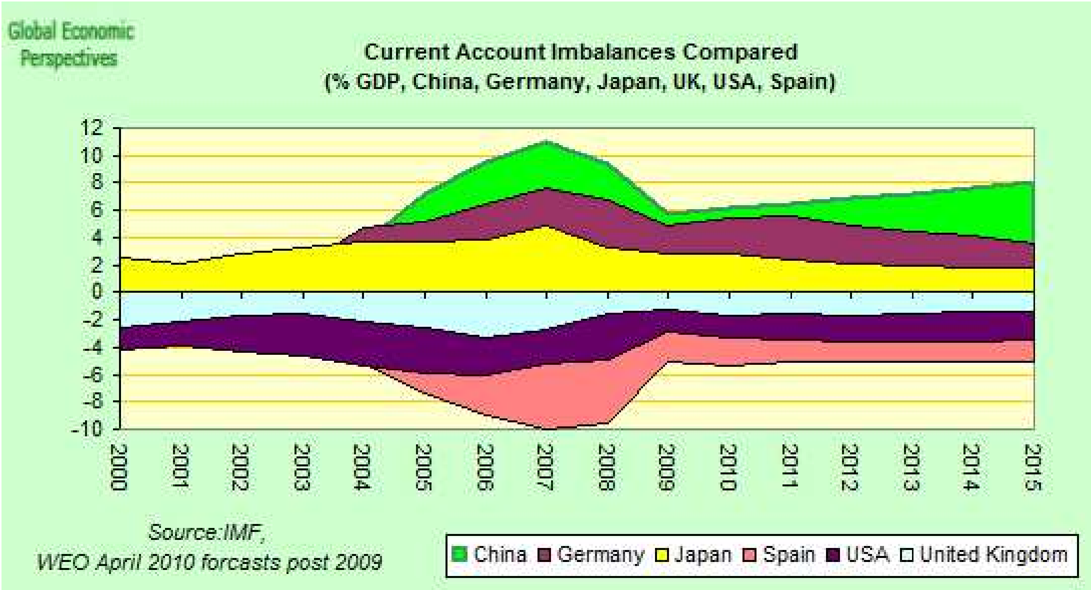
This was a huge error. As the crisis has shown, the EZ is far from being a political union. It is a monetary union without a political authority to underpin it. Here is when Ingham's (2004) understanding of money becomes so useful. If we conceptualise money through a 'nominalist' and state theory of money, in which money is principally a unit of abstract measure established by a political authority, then we realise that the euro, as it was conceived, is structurally flawed. In times of financial distress what secures the economic agents' faith in the real value of a currency is the political authority that underpins it. If this political authority is non-existent or unstable, then faith vanishes. This is precisely the battle that EMU is now fighting with the so-called 'financial markets'. The latter want to know whether behind EMU is effectively the 'United States of Europe'. Until they find out, they will continue to bet against the project. Luckily for the Europeans, financial heavyweights such as China do also believe that behind EMU there is a political unity. The concept of Knightian uncertainty is here again of importance. Is it in the best interest of China to buy Greek, Portuguese and Irish sovereign debt? At the outset it might not be rational at all? China might potentially incur a huge loss if there is a 'hair cut' or a default by any of these countries. But China's interpretation (and here is where ideas play a crucial role) is different. China wants Europe to unite, it wants Europe to be a counter-weight to the US, in an increasingly multipolar world, and it wants to have certain political leverage in Europe. Seen from this angle, the purchase of EZ peripheral debt makes more sense.

Nonetheless, even if Europe were to establish a pan-European debt market and a fiscal, or even a political union, to support it, the euro would still be unable to topple the dollar. History shows that usually the top international currency is issued by the main military power. Economic and military might tend to go hand in hand. Usually, the greatest economic power is also the greatest military power. This has been the case of the US since the Second World War. Following again Ingham's analysis of money, the US has been the political authority, with the monopoly on the legitimised use of violence, underpinning the international monetary space dominated by the dollar. Still today the US is the military guarantor of South American countries such as Colombia, East Asian countries such as South Korea and Japan and the GCC as a whole. Nonetheless, as my research also shows, the mismanagement of the Iraq war has disenfranchised the financial elites in the GCC. US unilateralism has shown them that maybe it is better to hedge with different security providers. Thus, the monopoly on the use of legitimised violence is starting to be curtailed. Again, there is an opportunity here for Europe, and consequently for the euro, to take the chance and play a bigger role. France has recently established a military base in the UAE, indicating that it is willing to share some of the burden of GCC military protection. However, it is very unlikely that Europe can substitute the US in this realm in the foreseeable future. As Cafruny and Ryner note (2007:118), "the EU remains politically fragmented and unstable, in the context of EMU and the adverse demographic and growth rates, to develop military capacities that would enable it to approach the United States on a remotely equal scale". Europe's incapability to provide protection even to its neighbourhood has been proven again with the more recent UN-backed intervention in Libya. While for the first time in years, Britain and France took the lead in a NATO operation, after only 11 weeks against a "poorly armed regime" the European powers ran out of ammunition and asked the US to step in, as lamented by US Defence Secretary Robert Gates (2011). This situation might change in the future, especially if the US withdraws its security umbrella from Europe, but this is still a distant future. In the near to medium term, China might be a safer bet in undermining US military control of the Gulf region. Pakistan's willingness to cede a naval base to China in the city-port of Gwadar, next to Iran, has certainly the potential of reshaping the geopolitical configuration of the Gulf region in a substantial manner (Pilling 2011). My research shows how Saudi Arabian officials are not excluding the possibility that China might at some point be their new security guarantor in case the US, because of its financial troubles, is unable to do it. It is important to highlight here that since 2010 China has substituted the US as the main importer of Saudi oil.

8.3 The Dollar as a Negotiated Currency

The GCC region demonstrates better than any other how the dollar is increasingly becoming again a negotiated, hence political, international currency. This happened before in the 1960s, just before the collapse of Bretton Woods, and in the 1980s, when Japan was threatening the dominance of the US in the world economy. In those two occasions, because the US provided the security umbrella for Europe and Japan, the adjustment costs fell upon the latter. Today we are in a different situation. Against the backdrop of the global financial crisis, the country that is threatening US economic might is China, which does not rely on the US for its security. The crisis has not only undermined the US in the fields of security, production and finance, most importantly perhaps, it has shaken the intellectual underpinnings of the FDS. The crisis has not only shown that the FDS is structurally flawed and prone to financial crises every few years. By acting exactly how it has always told other nations not to act in the face of financial turmoil, the US has lost a great part of its credibility as the leading nation in the system. The Efficient Market Hypothesis (EMH) upon which the FDS has been based has lost many followers in the capitals of emerging markets. The *public hand* in foreign exchange interventions and capital controls is now again accepted, and even encouraged, not least by international institutions historically controlled by the US such as the IMF. China has been at the forefront of criticisms directed against the FDS. From an early stage in the unfolding of the global financial crisis it has started a campaign to first spread its own interpretation of the causes of the crisis and then to delegitimize the FDS. During this process ideas have been playing an important role. While for US policymakers the crisis is a consequence of a savings glut generated in East Asia and the oil exporting countries, for China it is yet another example of how the unrestrained issuance of dollars is the most destabilising factor in the IMS. As the Chinese Minister of Commerce Chen Deming pointed out, “because the United States’ issuance of dollar is out of control and international commodity prices are continuing to rise, China is being attacked by imported inflation. The uncertainties of this are causing firms big problems” (*China Daily* 2010c). The devastating effects of imported inflation via US uncontrolled money printing, accentuated with the unorthodox policy of Quantitative Easing (QE), is not only to be seen in China. It has caused major disruptions along the years to the GCC region and Brazil too (see Chapter 5, p.172).

Figure 8.1: Major surplus and deficit countries in the global economy



Source: Hugh (2010)

In this regard, my research shows how the FDS is overly inflationary during the boom times, as acknowledged by Ocampo (2010). I would agree with Stiglitz and Greenwald (2010) when they state that it is deflationary in moments of crisis, especially in relation to deficit countries (apart from the US, of course), who have to take on their shoulders most of the adjustment process. But precisely because it is so biased in favour of surplus countries (and so favourable to the US), it stimulates every other nation but the US to be in surplus. This is now even the case for the UK and Spain, the other two nations which have run huge deficits until the global financial crisis (see Figure 8.1).

In the current FDS, the US functions thus as the main pull of demand. This is not negative *per se*. Many different nations (Germany, Japan, South Korea and now China) have profited from this configuration and have developed along the years an export-led growth strategy based upon the huge consumerism levels in the US. The problem is that this configuration is highly imbalanced as the recent financial crisis has shown. US indebtedness is reaching unsustainable levels. As the latest calculations of the Congressional Budget Office (CBO) show, if the US continues on this same path, US debt-to-GDP ratios of Federal US debt alone could rise to 150% by 2031 and 300% by 2047. Nonetheless, as Ferguson notes, these figures do not include the unfunded liabilities of the Medicare and Social Security systems, nor the debt of the federal states, nor the liabilities of public employees' pension schemes. "On this basis", Ferguson (2011:310) argues, "the fiscal position of the United States in 2009 was worse than that of Greece. With a debt-to-revenue ratio of 312 per cent, Greece was manifestly in dire straits. According to calculations by Morgan Stanley, however, the debt-to-revenue ratio of the United States was 358 per cent". This fiscal situation undermines completely the credibility of the three US based credit rating agencies Moody's, Standard and Poor's and Fitch, which have only threatened a downgrade to the US very recently. As the US Senator Tom Coburn has admitted: "I would downgrade us in a minute. I would, knowing what I know" (Crook 2011).

It is no surprise then that the Chinese government is extremely worried about the future value of its foreign reserves. History tells the Chinese leaders that profligate empires have always reduced their debt burdens through inflation. This is the biggest fear and this is why China is increasingly taking measures to try to come out of its dollar trap. It has asked the US to issue more Treasury Inflation-Protected Securities (TIPS) and it has tried to increase its overseas investments. China has also been hoarding gold, in a clear sign that it distrusts US policymakers (see Chapter 7, p.267). Repeatedly it has asked for more restraint in fiscal and monetary policy, but policymakers in Washington have continued to pay little attention to these demands. From the point of view of Chinese policymakers the centrality of the dollar in the system needs to be negotiated; for policymakers in Washington, there is nothing to negotiate. They continue to state that the dollar is a "strong currency" which performs its role as the main international currency well. It is needless to say that these two interpretations of the FDS are diametrically opposed.

8.4 The Ideational Impact of the Euro

In situations of Knightian uncertainty such as the current financial crisis, economic agents, including policymakers, look for possible blueprints for how to overcome their difficulties. It is only logical that they look to how other agents have coped with a similar situation before. The historic record shows that there were two other regions entangled in a 'dollar trap' previously: Europe and Japan. Both struggled, but in the eyes of the financial elites interviewed for this research, Europe's experience has been positive (so far) while that of Japan is considered negative. Europe at least has been able to enhance its autonomy through the internationalisation of the euro. Japan has not advanced in increasing its monetary power since its financial crisis in the early 1990s. Thus, as mentioned, EMU functions as a blueprint in three concrete areas. 1) It has stimulated regional monetary integration in Latin America, East Asia and the GCC; 2) It has shown that an IMS with several competing international currencies might be more efficient than the current dysfunctional FDS; and 3) It has shown that monetary sovereignty sharing among independent member states is possible. If monetary union can be achieved at a regional level, why not try it at a global level through the promotion first of the IMF SDRs, and later, maybe, through the creation of a genuine common global currency?

In all these levels EMU is seen as a laboratory. If it succeeds, then the idea of regional and global monetary cooperation will strengthen, if it fails, these hopes will receive a major blow. The euro is thus a harbinger, which can show the way forward, but which can also succumb during the journey. As of yet, the harbinger is still alive and progressing. Its footprints are visible in all three regions (see Chapter 6). In Latin America the euro has stimulated the use of local currencies for regional trade. The idea of a common currency is still distant, but it is regularly mentioned as a long-term goal by Brazilian policymakers and financial elites. If there is a country that can lead this process it is certainly Brazil, although for that it will have to cooperate closely with Argentina. In the GCC region there is no doubt that the euro has functioned as a role model since its creation. The GCC project of establishing a common currency among its member states follows the same path as EMU. The ECB functions here clearly as the main source of ideational inspiration and technical support. However, in order to be successful, Saudi Arabia will need to persuade its regional partners, especially the UAE, that it is also in their interests to have a common currency. Finally, the ideational effects of the euro are also to be seen in East Asia. Regional monetary cooperation is also perceived here as a good way to be better protected against dollar shocks. This region is the most advanced of the three studied, despite Chinese and Japanese political tensions. The ASEAN+3 Chiang Mai Initiative (CMI) of bilateral currency swaps has been substituted recently by the Chiang Mai Initiative Multilateralisation (CMIM) process, which has called for the establishment of a self-managed reserve pool of $120 billion and the creation in Singapore of the ASEAN+3

Macroeconomic Research Office (AMRO), which will be in charge of macroeconomic research and surveillance.

It is impossible to know whether these efforts will lead to common currencies in Latin America, East Asia and the GCC. What is without doubt is that the euro has functioned as a blueprint in the past 10 years and it has certainly the potential to continue to do so in the future if the integration process in EMU advances. As Rogoff acknowledges,

> The euro experiment has brought us to a crossroads in the whole international monetary system. Will our grandchildren inherit a world with a huge number of national currencies, or a very small number of multi-country currencies? If the euro survives and goes on to assume co-reserve status with the dollar, surely there will eventually be a strong trend towards consolidation elsewhere. Other blocs will form to mimic the euro's success. They will aim to enjoy lower interest rates, and greater resilience to financial crises (Rogoff 2011).

As far as I know Rogoff's predictions on the ideational influence of the euro are based on mere intuition and speculative prognoses. They are not based on any particular source of evidence. My research provides the empirical material to support his hypothesis. It does also show that the success of the euro has stimulated the debate about having a common global currency, as envisioned by Keynes, and lately proposed by Mundell. The Governor of the People's Bank of China (PBoC), Zhou Xiaochuan (2009a), believes that this should be the final aim in the reconfiguration of the IMS out of dollar unipolarity. The creation of a global currency would certainly eliminate the constant instabilities in the foreign exchange (FX) markets. Traders in the FX markets would potentially lose their jobs, but 'real' traders in goods and services would avoid a lot of headaches. This might sound for many farfetched. But as Mundell has noted, it is not that surreal. Effectively, until the collapse of Bretton Woods, the world has always had a universal unit of account fixed to a concrete level. This was the function of the British pound and the US dollar when they were pegged to a certain amount of gold. From this perspective, the past decades are

> Unique in the history of civilization when there has been no money that could even approximately be called a universal currency. What is even more unusual is that among the general body of economists and monetary officials, there seems to be no recognition that anything is amiss…What a contrast from the ideas of the classical economists who over the centuries were almost unanimous in favour of an international monetary system based on the gold or even a common currency (Mundell 2005:466).

Interestingly, my research shows that a great number of financial elites in the three case study regions are actually quite attracted by the idea of having one day a common currency (see Chapter 7, p.270). If there is a contemporary economist that is cited the most among the interviewees, this is certainly Robert Mundell.

Nonetheless, the idea of a global currency is still seen by most of these participants as a long-term project. In the medium term, the most likely scenario is the creation of a tripolar monetary system with the dollar, the euro and possibly the Chinese Renminbi competing for the top spot. This relates to the second ideational effect of the euro. Its success as the second most used international currency has stimulated the internationalisation of other currencies. For a number of interviewees, the trajectory of the euro shows that there is demand for more international currencies. A system based on the dollar alone is considered too unstable. The dollar needs competitors so that the US is not able to exploit its exorbitant privilege. China has started to make considerable efforts in promoting the use of its currency. Stimulated by the success of the euro, Chinese financial elites have realised during the global financial crisis that, if they want to come out of the dollar trap, they need to use their own currency. The international use of RMBs has increased exponentially in just two years, prompting scholars such as Eichengreen (2011a) to believe that in 10 years it will be at a similar level as the euro. A recent report by the World Bank (2011) reaches a similar conclusion.

Euro-sceptics might have noticed that I assume that the euro will be around in 10 or 15 years. They might think that this is a bold assumption given that at the time of writing its survival is certainly questionable. To my defence, I have to say that this is not only my opinion. It is the overwhelming assessment of the majority of participants interviewed. Their perceptions will be as valid today as in 10 years time, even if the euro is not around. They show that between 2008 and 2010, the predominant subjective perception of most of these financial elites was that the euro is in difficulty, but ultimately, it will come out of this crisis stronger and more resilient. This view is not unique. Wolfgang Münchau (2011) and Martin Wolf (2011d), two of the most influential financial commentators in Europe, have also indicated that the euro is here to stay. So does Barry Eichengreen (2011a), perhaps the highest scholarly authority on the study of the IMS. In November 2010, at the time when Ireland had to be bailed out, the Chinese state-owned news agency *Xinhua* published an editorial entitled: "Euro will not fail"; in it one can read the following:

> Contrary to the widespread claim that the eurozone is doomed to break up, the single currency will not fail, although it is facing the toughest challenge since its birth in 1999…As a major achievement of European integration, the euro is a landmark in the world's monetary history. It has become the second largest reserve currency as well as the second most traded currency in the world after the U.S. dollar. Despite its shortcomings, which have been exposed by the debt crisis, the euro has brought economic benefits and currency stability to its members. A breakup of the eurozone would be politically unacceptable (*Xinhua* 2010b).

The prognosis is very similar at Nomura, the biggest investment bank in Japan and Asia at large. In a report published in March 2011 with the title "Europe will work", Nomura's economists state that:

> The present crisis is unlikely to be the last to afflict Europe: it may take further crises to impel policymakers to enact the full set of policies needed to create a truly sustainable monetary union…This crisis may not be the last, but, provided that political will remains, we believe Europe will continue to advance, step-by-step, towards sustainability (Nomura 2011).

Euro-sceptics are right when they say that the euro is doomed to fail as long as there is no European ministry of finance with a federal budget to address asymmetric shocks in the Union. This is not going to happen tomorrow, many little steps will be taken to get there. But it is not impossible. European policymakers are already talking about it. The current President of the ECB, Jean-Claude Trichet (2011c), stated in June 2011, when he received the Charlemagne Prize, that the future Union "will be a confederation of sovereign states", and subsequently asked the audience: "in this union of tomorrow, or of the day after tomorrow, would it be too bold, in the economic field, with a single market, a single currency, and a single central bank, to envisage a ministry of finance of the Union?" Asked this same question and whether the EZ would soon issue Eurobonds, in his appointment hearing in front of the European Parliament, Trichet's successor at the head of the ECB, the Italian Mario Draghi, answered: "We are not ready yet, but in the future we might be" (Atkins 2011).

I need to repeat here that the survival of the euro is not assured. The possibility of a break-up exists. It cannot be discarded. Popular discontent against the austerity measures imposed by the creditor nations of the EZ upon the debtor nations is mounting, especially in Greece. But considering all the evidence at hand, my analysis tells me that a break-up is less likely than further political integration. Leaving the euro would just be too costly for any EZ member state, including Greece. As Eichengreen explains:

> The decision to reintroduce the national currency would presumably require a lengthy parliamentary debate. If the conclusion of that debate was to reintroduce the national currency and convert bank deposits, wage contracts, and other financial obligations into that unit, which would then be depreciated against the euro in order to restore competitiveness, then investors would be able to see what was coming. They would scramble out of local banks and markets in order to shelter their assets from depreciation, precipitating the mother of all financial crises (Eichengreen 2008:223).

The EZ core, with Germany at the front, will try to impose austerity and structural reforms in the EZ periphery. But they will not provoke widespread financial or social havoc. Before it comes to this, they will seek a compromise. As Angela Merkel, the German Chancellor, has put it: "If the euro collapses, then Europe and *the idea* of European Union will fail" (*Der Spiegel* 2010b, emphasis added). It is difficult to imagine a German Chancellor willing to see this outcome under her or his watch.

8.5 Towards a Leaderless Monetary System

If the euro survives it will become an even stronger blueprint for the creation of a more managed and coordinated IMS in which the different players concede a certain degree of their monetary sovereignty for the common good. So far we are not quite there yet. EMU has given the Europeans considerable leverage in the 3rd face of power of preference-shaping. EMU is seen as a good base on which to establish a multilateral monetary system, although it needs to be added here that is not seen as the ultimate model to follow. As Laïdi (2008:49) explains, "certainly the European model of governance cannot simply be transposed to the world scale. However, certain European collective methods of action might well prove useful for global governance. For this reason it seems more apt to talk about a European toolbox or laboratory rather than a European model". Other authors such as Calleo (2009) have also pointed to 'Europe's pluralist model' as a possible blueprint for a more integrated global monetary system without US hegemony. Whether this is possible is still in doubt. Europe, through the French diplomacy, has taken on board the Chinese call for reforming the IMS and it has been able to introduce it in the G20 agenda. In this regard, Europe has shown that it is also capable of projecting influence in the 2nd face of power focused on being able to set the agenda. However, up to the time of writing its successes in the 1st face of power where decisions are actually taken have been minor, if not inexistent. This is especially the case in the coordination of exchange rates, an issue of the utmost importance for the Europeans since the EZ has taken most of the adjustment costs deflected by the US in the past decade. European policymakers are constantly stating that they are working with their counterparts in trying to find mechanisms to avoid excessive exchange rate volatility. So far, these efforts, if existent, have been unproductive. The euro has appreciated more than 85% between 2002 and 2008, and if it were not for the current sovereign debt crisis, its nominal value would again be breaking historic records. This is rather unfortunate for the EZ, because as the same Mundell highlights "the swings in the dollar-euro exchange rate are big problems, and the problem is exacerbated by the fact that the Americans get the benefit of these swings and Europe gets the wrong end of the stick" (Webb 2008). The French seem to have recognised the deflection mechanism of the US, but so far they have been unable to convince the Germans to support them in making the case for a more coordinated exchange rate regime, as proposed by both France and China. Germany is reluctant to change the status quo. A strong euro is less damaging for its highly competitive export sector than for the rest of the EZ. Therefore, there is less urgency in Berlin to coordinate exchange rates. Thus, by not acting together, the Europeans are precluding the possibility of changing the rules of the game in their favour.

As a matter of fact, the US is not able to impose its will either (see Chapter 7, p.260). Policymakers in Washington have been trying for years to persuade China to appreciate its currency, but they have been unsuccessful so far. Here is where different ideas about the most efficient IMS clash against each other. In Beijing a regime based on free floating exchange rates is anathema, whereas in Washington it is perceived as the most efficient of all systems. The US is not willing to enter into any compromise in this regard. Its red lines are unambiguous, and so is its veto power in the IMF. When it comes to accept the RMB as part of the SDR basket, the position from Washington is clear, first China needs to let its currency float, it needs to open its capital account and it needs to make its central bank independent. This is pretty much the same as saying: "Either you play under my rules or you do not play".

This situation is dangerous, especially considering that there is an enormous overhang of dollars in the system, above all in China. The US should take a leadership role, as it did in the late 1960s when the SDR was created, and try to initiate a new reform process on how to deal best with the dollar overhang. The creation of a substitution account in the IMF for excess dollars, as discussed in the late 1970s, could be a start (Kenen 2010). The promotion of the use of SDRs worldwide could also be an option. As Stiglitz (2009) has warned, "whether the US likes it or not, the dollar reserve system is fraying; the question is only whether we move from the current system to an alternative in a haphazard way or in a more careful and structured way" (See Chapter 7, p.263). Zhang Ming (2009), a leading Chinese scholar on the reform of the IMS, agrees with Stiglitz. For him there are three potential adjustment routes to reduce the global imbalances of the FDS. The first one is what he calls a market driven solution whereby countries like China shift great amounts of their foreign reserve portfolios out of the dollar before it collapses. It is here worth highlighting that what he sees as a 'market led adjustment' is seen in the West as the 'nuclear option' (see Chapter 3, p.113). The second possibility is that surplus countries appreciate their currencies under US unilateral pressure (the US is attempting to do so, but hitherto it is not working). Finally, the third option would be to find cooperative cost-sharing mechanisms to smooth the adjustment costs. In his opinion the consolidation of the SDRs (with the inclusion of the RMB in the basket) as the super-sovereign reserve currency in global trade and investment activity could be the right consensual solution to this conundrum. It would eliminate the Triffin Dilemma at its root and it would create a competition mechanism for the issuing authorities of the main currencies which would force them to restrain their monetary policy excesses.

The problem is that the US has been reluctant to take a leadership role in this third option. Its behaviour has followed the unilateral route. At first it has tried to persuade Europe, especially Germany, to stimulate further to come out of the economic slump. Europe, however, has been unwilling to cooperate because it sees further indebtedness as reckless. In this regard, Europe has shown that it can resist US pressure if it stays united. Once this strategy failed, the US embarked in a new round of QE (more printing of money), which was received with widespread condemnation by policymakers in emerging markets and in Europe. This prompted the Brazilian Minister of Finance Guido Mantega to denounce that the US has embarked in a Currency War of beggar-thy-neighbour devaluations. Hence, increasingly, the role of the US as the main guarantor of the system is seriously questioned. We are thus gradually witnessing a leaderless system. As Roubini and Bremmer point out,

> We live in a world where, in theory, global economic and political governance is in the hands of the G-20. In practice, however, there is no global leadership and severe disarray and disagreement among G-20 members about monetary and fiscal policy, exchange rates and global imbalances, climate change, trade, financial stability, the international monetary system, and energy, food and global security. Indeed, the major powers now see these issues as zero-sum games rather than positive-sum games. So ours is, in essence, a G-Zero world (Roubini 2011).

This situation has the potential to end up in serious financial instability and increased geopolitical tensions. Currency Wars can easily end up in protectionism. If the major players in the system do not come up soon with a solution on how to share the adjustment costs and generate a system based on sustainable demand and supply, and less volatile foreign exchange markets, then the Great Recession might end up following the footsteps of the Great Depression. In theory the EZ is in a good position to act as a deal-breaker between China and the US, the major creditor and debtor in the system. It is relatively trusted by both parts and it has considerable experience in consensus-building. How it resolves its internal imbalances might also become a blueprint on how to resolve the global imbalances. This is an aspect highlighted by many financial elite interviews. The great fear is that Europe's pace of resolving its own internal problems might be too slow to provide any significant lessons for the global level. EMU is a blueprint, but it is a blueprint in the making. As of yet, no-one knows whether it will succeed.

8.6 Prospective Areas of Research

As with every investigation, this study has shed light on a number of questions, but at the same time it has also identified a number of areas that need to be investigated further. First of all, it would be interesting to see whether financial elites in the three case study regions have changed their perceptions on the dollar and the euro since the period of 2008-2010, when the interviews for this research were conducted. The conclusions drawn from this research are limited to the time span investigated. In a context of Knightian uncertainty ideas and reality are in constant flux, not least because the survival of the euro is still in doubt. It is also unclear how active Europe is in reforming the IMS. In the past year we have seen how the French diplomacy has been able to bring this issue onto the G20 agenda. We do also know that France and China have been in talks regarding this topic. What is unclear is the degree of cooperation that has been developed. In this regard, one area to investigate in the future is to look at possible EZ-China collaboration in the reform of the IMS. It would be interesting to know whether there are any concrete proposals put forward by these two actors. Here there are different sub-areas of investigation. One is to know what the actual cooperation is between France and Germany on this topic. My research has been focused on how financial elites in key dollar holding nations perceive the euro's challenge to the dollar. The approach has been from outside in. Another way to investigate this topic would be to study how financial elites within the EZ, especially in Germany and France, see the trajectory of the euro vis-à-vis the greenback. What is their perspective on the creation of Eurobonds, a European ministry of finance and the future of EMU and the IMS at large? Do the Germans and the French have a common strategy on the euro?

Another area of research that is worth exploring is the evolution of the financial markets in China. This includes the internationalisation process of the RMB. One of the conclusions of this study is that China will be a key player in the reform of the IMS. Its actions are followed very closely in all the capitals of the world, including Brasilia, São Paulo, Riyadh and Abu Dhabi. One cannot understand today euro-dollar competition and the future of the IMS without bringing China into the picture. If China is capable of internationalising its currency, develop its financial markets and rebalance its economy from export-led to domestic consumption driven growth, as its leadership proclaims, then it can easily become the new demand pull of the world, substituting the US. Whether such a transformation is likely or feasible is another area that needs to be studied. China's economic development is particularly interesting because its financial elites see capital controls and a managed exchange rate as vital tools in stabilising its financial markets. It needs to be seen whether China can internationalise its currency and develop its financial markets while maintaining capital controls and a managed exchange rate.

Finally, on the US side, further research needs to be undertaken on understanding what the US medium term plan is in relation to the reconfiguration of the IMS. We are witnessing how the US is starting to propose more interventionist policies in global economic governance such as the 4 percent-of-GDP current account deficit and surplus thresholds. It would be interesting to know whether this was a one-off proposal from Treasury Secretary Geithner, or whether some US policymakers are starting to favour a more managed IMS, including a more coordinated exchange rate regime. In all these different areas there is certainly the need to investigate how top policymakers and financial elites interpret the reality of the IMS and how they intend to shape it within their material constraints. The study of these perceptions can certainly shed some constructivist light on how the IMS works and in which direction it is likely to move. In this process material conditions will play a major role, but so will ideas.

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Appendix

Part A: Interview Material

List of key institutions that participated in this research with at least one participant:

Central Banks

Brazilian Central Bank (Brasilia, Brazil)

People's Bank of China (Beijing, China)

Central Bank of the United Arab Emirates (Abu Dhabi, UAE)

Saudi Arabian Monetary Agency (Riyadh, Saudi Arabia)

Public Agencies

Brazilian Development Bank (Rio de Janeiro, Brazil)

Brazilian Innovation Agency (Rio de Janeiro, Brazil)

Ministry of Finance of China (Beijing, China)

State Administration of Foreign Exchange (Beijing, China)

Abu Dhabi Investment Authority (Abu Dhabi, UAE)

Dubai Chamber of Commerce and Industry (Dubai, UAE)

Islamic Development Bank (Jeddah, Saudi Arabia)

Secretariat General of the Gulf Cooperation Council (Riyadh, Saudi Arabia)

Private or Semi-Private Financial Institutions

HSBC (London, United Kingdom)

Banco do Brasil (Brasilia, Brazil)

BRADESCO (São Paulo, Brazil)

Industrial and Commercial Bank of China (Beijing, China)

China Construction Bank (Beijing, China)

Bank of China (Beijing, China)

Agricultural Bank of China (Beijing, China)

Emirates National Bank of Dubai (Dubai, UAE)

National Bank of Abu Dhabi (Abu Dhabi, UAE)

Riyad Bank (Riyadh, Saudi Arabia)

National Commercial Bank (Riyadh, Saudi Arabia)

Banque Saudi Fransi (Riyadh, Saudi Arabia)

King Faisal Foundation (Riyadh, Saudi Arabia)

Research Institutions with Influence in the Policymaking Process

Economics Institute, Federal University of Rio de Janeiro (Rio de Janeiro, Brazil)

Development and Research Centre (Beijing, China)

Institute of World Economics and Politics, Chinese Academy of Social Sciences (Beijing, China)

Institute of Finance and Banking, Chinese Academy of Social Sciences, (Beijing, China)

Institute of European Studies, Chinese Academy of Social Sciences (Beijing, China)

China Foreign Affairs University (Beijing, China)

National Research Foundation (Dubai, UAE)

Institute of Social and Economic Research (Dubai, UAE)

Dubai Economic Council (Dubai, UAE)

Gulf Research Centre (Dubai, UAE)

Dubai School of Government (Dubai, UAE)

Emirates Centre for Strategic Studies and Research (Abu Dhabi, UAE)

College of Business Administration, King Saud University (Riyadh, Saudi Arabia)

List of Interviewees (non-anonymised)

Name	Position	Institution	Location
1. David Bloom	Head of Foreign Exchange (FX) Strategy	HSBC	London, United Kingdom
2. Luis Manuel Rebelo Fernandes	President	Brazilian Innovation Agency (FINEP)	Rio de Janeiro, Brazil
3. Francisco Eduardo Pires de Souza	Economics Advisor to the Presidency/Professor of Economics	National Development Bank (BNDES)/Federal University of Rio de Janeiro	Rio de Janeiro, Brazil
4. Luis Belluzzo	Chief Editor, and former Economics advisor to President Lula Da Silva.	Carta Capital Magazine	São Paulo, Brazil
5. Franklin Serrano	Professor of Political Economy (and Economics Advisor to the Partido dos Trabalhadores, PT)	Federal University of Rio de Janeiro	Rio de Janeiro, Brazil
6. Marcelo de Paiva Abreu	Professor of Economics	Catholic Pontificate University of Rio de Janeiro	Rio de Janeiro, Brazil
7. Jorge Chami	Professor of Economics	Federal University of Rio de Janeiro	Rio de Janeiro, Brazil
8. Yu Yongding	Director	Institute of World Economics and Politics, Chinese Academy of Social Sciences (CASS)	Beijing, China
9. Gao Haihong	Professor of Finance/Director of International Finance Division	Institute of World Economics and Politics (IWEP), CASS	Beijing, China
10. Zhang Ming	Deputy Director of International Finance Division	Institute of World Economics and Politics (IWEP), CASS	Beijing, China
11. Cao Honghui	Director of Financial Markets Division	Institute of Finance and Banking, CASS	Beijing, China
12. Zhou Hong	Director	Institute of European Studies, CASS	Beijing, China
13. Chen Xin	Associate Professor of European Studies	Institute of European Studies,	Beijing, China

		CASS	
14. Xue Li	Researcher at the Division of International Strategy	Institute of World Economics and Politics, CASS	Beijing, China
15. Ding Yifan	Deputy Director	Institute of World Development, Development Research Center of the State Council of China	Beijing, China
16. Qin Yaqing	Executive Vice President/Member	China Foreign Affairs University/Foreign Policy Advisory Group of the Ministry of Foreign Affairs of China	Beijing, China
17. Zhang Liqing	Dean of the School of Finance	Central University of Finance and Economics	Beijing, China
18. Liping He	Head of the Department of Finance	School of Economics and Business Administration, Beijing Normal University	Beijing, China
19. Shi Jianhuai	Professor of Economics	School of Economics, Peking University	Beijing, China
20. Michael Pettis	Professor of Finance	Guanghua School of Management, Peking University	Beijing, China
21. Xu Sitao	Chief Representative	The Economist Group	Beijing, China
22. Shen Minggao	Chief Economist	Caijing Magazine	Beijing, China
23. Zhang Ed	Senior Consultant and Economics Editor	China Daily	Beijing, China
24. Wang Xu	Finance and Economics Reporter	China Daily	Beijing, China
25. Xu Yisheng	Opinion Editor and Columnist	China Business News	Beijing, China
26. Jamil Anderlini	Beijing Correspondent	Financial Times	Beijing, China
27. Andrew Batson	Beijing Correspondent	Wall Street Journal	Beijing, China
28. Abdelaziz Abu Hamad	Director General of International	Secretariat General of the Gulf	Riyadh, Saudi Arabia

Aluwaisheg	Economic Relations	Cooperation Council (GCC)	
29. Mohammed Tariq	Advisor to the President	Islamic Development Bank	Jeddah, Saudi Arabia
30. Mohammed Ahmed Zubair	Senior Economist Economic Policy and Statistics Department	Islamic Development Bank	Jeddah, Saudi Arabia
31. Salman Syed Ali	Economist Islamic Research and Training Institute	Islamic Development Bank	Jeddah, Saudi Arabia
32. Anasse Aissami	Division Manager Evaluation Department	Islamic Development Bank	Jedddah, Saudi Arabia
33. John Sfakianakis	Group General Manager, Chief Economist	Banque Saudi Fransi	Riyadh, Saudi Arabia
34. Giyas Gökkent	Chief Economist and Head of Research	National Bank of Abu Dhabi	Abu Dhabi, United Arab Emirates
35. Tariq Yousef	Dean	Dubai School of Government	Dubai, United Arab Emirates
36. Nicolas Depetris Chauvin	Assistant Professor of Economics	Dubai School of Government	Dubai, United Arab Emirates
37. Christian Koch	Director of International Relations Research	Gulf Research Centre	Dubai, United Arab Emirates

List of Interviewees (anonymised)

Name	**Position**	**Institution**	**Location**
38. ---	Senior Executive Director, Treasury Department	One of the four central banks	---
39. ---	Principal Economist	One of the four central banks	---
40. ---	Investment Manager, Treasury Department	One of the four central banks	---
41. ---	Head of Division, Department of Economics	One of the four central banks	---
42. ---	Director, Research Department	One of the four central banks	---
43. ---	Economic Specialist, Research Department	One of the four central banks	---

44. ---	Executive Director, International Division	One of Brazil's largest commercial banks	Brazil
45. ---	Head, Department of Research and Economic Studies	One of Brazil's largest commercial banks	Brazil
46. ---	Senior Banker, Private Investment Division	One of Brazil's largest commercial banks	Brazil
47. ---	Senior Researcher, Department of Macroeconomic Analysis	One of Brazil's largest commercial banks	Brazil
48. ---	Head, FX Liquidity Management Division, Asset and Liability Management Department	One of China's largest commercial banks	Beijing, China
49. ---	Chief Economist	One of China's largest commercial banks	Beijing, China
50. ---	Deputy General Manager, Global Markets Department	One of China's largest commercial banks	Beijing, China
51. ---	Senior Researcher, Macroeconomic Research, Strategic Management Department	One of China's largest commercial banks	Beijing, China
52. ---	Junior Researcher, Macroeconomic Research, Strategic Management Department	One of China's largest commercial banks	Beijing, China
53. ---	Director, International Economic Relations Division, International Department	One of China's public financial institutions	Beijing, China
54. ---	Deputy Director, Policy Research Division	One of China's public financial institutions	Beijing, China
55. ---	Senior Official, Financial Section	Delegation European Commission to China	Beijing, China
56. ---	Senior Vice	One of Saudi	Riyadh, Saudi

	President, Assistant Treasurer	Arabia's largest financial institutions	Arabia
57. ---	Senior Economist, Economics Department	One of Saudi Arabia's largest financial institutions	Jeddah, Saudi Arabia
58. ---	Portfolio Controller, Investment Department	One of Saudi Arabia's largest financial institutions	Riyadh, Saudi Arabia
59. ---	Chief Operating Officer	One of Saudi Arabia's largest financial institutions	Riyadh, Saudi Arabia
60. ---	Former Deputy Minister of Finance	Ministry of Finance	Riyadh, Saudi Arabia
61. ---	Director of Finance and Monetary Integration	One of Saudi Arabia's largest research and policy advisory institutions	
62. ---	Chairman Finance Department	One of Saudi Arabia's largest research and policy advisory institutions	Riyadh, Saudi Arabia
63. ---	Professor of Economics	One of Saudi Arabia's largest research and policy advisory institutions	Riyadh, Saudi Arabia
64. ---	Head of FX Team, Treasury Department	One of UAE's largest financial institutions	Abu Dhabi, UAE
65. ---	General Manager, Global Markets and Treasury	One of UAE's largest financial institutions	Dubai, UAE
66. ---	Chief Economist	One of UAE's largest financial institutions	Dubai, UAE
67. ---	Director	One of UAE's largest research institutions	Dubai, UAE
68. ---	Director	One of UAE's largest research institutions	Dubai, UAE
69. ---	Director, Macroeconomic Forecasting	One of UAE's largest research institutions	Dubai, UAE

	Department		
70. ---	Director, Economic and Social Studies	One of UAE's largest research institutions	Abu Dhabi, UAE
71. ---	Economic Researcher	Dubai Chamber of Commerce	Dubai, UAE
72. ---	Financial and Business Reporter	Business 24-7 Newspaper	Dubai, UAE
73. ---	FX Trader, euro-dollar	HSBC	London, United Kingdom
74. ---	FX Trader, Asia and the Middle East	HSBC	London, United Kingdom
75. ---	FX Trader, Latin America	HSBC	London, United Kingdom
76. ---	FX Trader, Eastern Europe, South Africa and others	HSBC	London, United Kingdom

Part B: Published Works

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