The impact of the euro on transatlantic relations

Steven Everts

ABOUT THE AUTHOR

Educated at the universities of Grenoble and Leiden, Steven Everts joined the CER as a research fellow in April 1999. Previously he was a lecturer in International Relations at Oxford University, where he is finishing his PhD. He has written a number of articles on transatlantic relations and British foreign policy, as well as on various aspects of European integration.

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Economic and monetary union is beginning to have a profound impact on the international commercial environment. Unfortunately its consequences are not sufficiently understood by the vast majority of businesses and governments. This paper aims to explain one set of issues which will have far-reaching consequences for European and US business: the implications of EMU for the transatlantic relationship.

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We are delighted to be associated with the Centre for European Reform and the German Marshall Fund of the United States in producing this paper, and welcome the debate which it will stimulate.

Ray Nulty

EMU Global Service Head
PA Consulting Group
Embassy House
Herbert Park Lane
Ballsbridge, Dublin 4
Ireland

00 353 1 668 4346
ray.nulty@pa-consulting.com

John Ryan

Euro Centre of Excellence
PA Consulting Group
Embassy House
Herbert Park Lane
Ballsbridge, Dublin 4
Ireland

00 353 1 668 4346
john.ryan@pa-consulting.com

1 EMU: a test for transatlantic relations

The relationship between the United States and the European Union is, almost by definition, subject to strain and tension. During the Cold War some stability was maintained by the common external threat that bound the NATO allies together under US leadership. But in the past ten years, despite the fundamentally pro-European outlook of successive US administrations, relations have been deteriorating. The collapse of the Soviet bloc has created uncertainty about NATO's future. Trade wars are worsening, in part because of a growing divergence of public attitudes on issues of food safety and the reliability of scientific evidence. And sharp disagreements between France and the US are still able to poison the overall transatlantic relationship, for example on farm subsidies or the politics of the Middle East.

These tensions have been exacerbated by the manner in which governments handle transatlantic disputes. Experts on trade, finance and security seldom think about, or make links between each others' problems. They meet in different organisations, such as NATO, the finance G-7 and the World Trade Organisation (WTO). Occasionally, in a crisis, they do make connections, such as in the spring of 1999, when the Clinton administration softened its stance on several trade disputes with the EU during the Kosovo war.

Yet the trend has been for American attitudes to international affairs to evolve in unhelpful ways. US legislators are becoming increasingly unilateralist and scornful of international law and norms, preferring to rely on America's pre-eminence. The US Senate's refusal in late 1999 to ratify the Comprehensive Test Ban Treaty, with scant regard to the views of America's allies, is just one manifestation of this shift. America's plan for a national missile-defence system is, potentially, another.

Europe, too, is shifting the terms of the transatlantic relationship, particularly with the arrival of the euro and the EU's initiative to build a defence capability. Both are making the US reassess its view of the EU. In the long run, these powerful forces for change should lead to a more coherent and effective European political identity. That, in turn, should produce a more balanced relationship, in which the Americans are more willing to consult before acting, and the Europeans can act more decisively and responsibly. In the shorter term, however, these two changes risk destabilising already-fragile relations. For the EU's efforts to construct a defence capability are causing some American policy-makers to worry about the Europeans' commitment to NATO. And the euro threatens the dollar's role as the dominant global currency. It is the impact of the euro on the transatlantic relationship that is the subject of this pamphlet.

A global role for Europe

The start of economic and monetary union (EMU) is the most important event in international monetary affairs since the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s. 'Euroland', a new entity made up of the 11 countries that have adopted the euro, has entered the vocabulary of foreign-exchange traders, fund managers, company executives, trade diplomats and foreign-policy strategists. This entity is, moreover, poised to become one of the most influential actors on the global stage, primarily but not exclusively in the field of financial diplomacy.

EMU will transform the existing dollar-centred global financial system, replacing it during the next decade with a bipolar dollar-euro financial order (the yen coming a distant third). The unique advantages that the US has enjoyed from the dollar's status as the world's only global currency will face challenges. And the Europeans can expect significant economic and political benefits from the global role that their new currency is likely to acquire.

The US and Europe are now of roughly equal economic weight. The Euroland population of 290m is larger than that of the US (270m), making the euro the currency of the world's largest group of affluent customers. Euroland's total merchandise trade with the rest of the world is about 25 per cent larger than that of the US (and more than double Japan's).[1] When more countries enter EMU, and its poorer members catch up economically, the euro-area will have a larger GDP than the

[1] Speech by Christian Noyer, Vice-President of the European Central Bank, 'The euro-area in the global economy', London Business School, 19 July 1999

US. Fred Bergsten, a leading US international economist, argues thus: 'Euroland will equal or exceed the US on every key measure of economic strength and will speak increasingly with a single voice on a wide range of economic issues... Economic relations between the US and the EU will rest increasingly on a foundation of virtual equality.'[2]

[2] *Fred Bergsten, 'America and Europe: Clash of the Titans?', Foreign Affairs, March-April 1999*

EMU, therefore, will have a profound impact on transatlantic relations. Its effects will be felt most directly in the monetary and financial spheres. But there will also be consequences for trade, foreign policy co-operation and security policy. Overall it will tend to make the EU a more cohesive and probably more assertive international actor, especially if EU and EMU membership become congruent. But even without that congruence, EMU will enable Euroland to sharpen its profile on the global stage. Europe's bargaining strength will increase and its partners, particularly the US, will have to take European preferences more seriously.

Whether Euroland will take up this enhanced role remains unclear. The answer will depend on whether it chooses to do so, and on whether it can get away with not doing so. It may well be, for instance, that future crises will act as catalysts for further integration and force Euroland to develop its international role, just as other recent internationally disruptive events (German unification and the war in Kosovo, for example) have been catalysts for closer co-operation. When such moments arise, important and sometimes painful reforms will be necessary. Euroland's politicians will need to recognise that power is linked to responsibility; greater power to greater responsibility. The Europeans will also need to accept that their enhanced global influence will bring them a different balance of advantages and obligations to that enjoyed by the US during the Cold War. Then, the superpower status of the US allowed it, in the words of a senior French official, 'to get away with monetary murder'. In a bi-polar monetary world neither the US nor the EU will be able to act without due regard to the effect on the other.

Whether Euroland and the EU become the same entity will make a big difference. The assumption of this pamphlet is that three of the four non-participating member-states—Sweden, Denmark and Greece—will all join in 2002, or shortly thereafter. Trends in public opinion, macro-economic performance and shifts in government attitudes make this a likely scenario.

The situation of Britain is less clear-cut. The odds are that it will also join EMU after a positive result in a referendum in or around 2002. But because British membership is not a foregone conclusion, this pamphlet generally maintains a distinction between the core of the euro-11 and the wider EU 15. (EU enlargement, eventually taking in up to 12 countries in Eastern and South-Eastern Europe, will probably ensure that the euro-area and the EU remain different.) A special note on the question of UK membership and its consequences is included at the end of Chapter 5.

Why bother with EMU's external implications?

Everyone accepts that the stakes of monetary union are extraordinarily high; hence the intense debate the issue has generated. Thus far, however, that debate has focused mainly on EMU's *internal* workings: its effects on Europe's economies and political structures. Though understandable, this focus has come at a price: the neglect, or at least an underestimation of EMU's external ramifications. In the coming years the EU will no longer be able to avoid this dimension. Whereas during the last 15 years the EU has focused on internal projects, such as bringing about the single market and a single monetary policy, the next 15 will be mainly about external projection. The next phase of European integration will be about how Europe relates to the wider world.

If this is the ambition, then Europe's governments should tackle the diplomatic incoherence and the lack of military capabilities that have thus far beset the EU's efforts to frame and conduct its Common Foreign and Security Policy (CFSP). To be fair, the provisions of the 1997 Treaty of Amsterdam and the decisions taken at the EU's Cologne and Helsinki summits do start to address these weaknesses. In particular the appointment of Javier Solana as the EU's High Representative (also known as Mr CFSP), and the plan to merge the Western European Union (WEU) with the EU, should put the Union's foreign policy on a firmer footing. But these days external relations involve much more than gunboats and planning cells, with financial and economic policy as increasingly important components.

Up to now, the examination of the strategic implications of EMU has been a minority interest. This is in part because the two groups that have considered the issues—international economists and foreign-policy strategists—have done so with little or no interaction between them. It is also because, by their very nature, the strategic implications will take time to work through and become apparent. Policy-makers are often locked into what the former US Secretary of State Henry Kissinger has called the 'endless battle in which the urgent constantly gains on the important'. There is always a good reason not to think about EMU's long-term effects today. But a careful analysis of the trends underlying the dynamics of EMU and their international effects is required.

2 The euro: what kind of currency?

The launch of the euro has been accompanied by intense discussion among analysts about the currency's long term prospects. In particular: will the euro's exchange rate go up or down; and when, and by how much? And to what extent will the euro come to be used globally as a unit of account, a means of payment or a store of value? Though linked, these two questions are very different, and should not be confused. The first asks whether the euro will be weak or strong in relation to other currencies, principally the US dollar. The second queries whether the euro will be a 'big' or a 'small' currency, used by many agents or by few. To make any sense of the possible answers to both questions, we need to address a third: which of these scenarios would be preferable, and to whom? In other words, who benefits?

Weak euro, strong euro

Politicians, journalists, business leaders and investors constantly fret over exchange-rate developments. A currency's exchange rate is its most visible and politically most sensitive indicator. Thus the euro's fall against the dollar during 1999 attracted a great deal of headline attention, and an outbreak of *Schadenfreude* among Eurosceptics who were already convinced that EMU was the height of folly.

Many commentators had predicted that the euro would be strong from the start. Indeed, one slogan used prominently in Germany to convince a sceptical audience of the virtues of EMU was the promise that the euro would be *Stark wie die Mark* (as strong as the Deutschmark). Almost immediately after its launch, though, the euro's exchange rate started to fall against the dollar and, to a lesser degree, the pound. British Eurosceptics claimed loudly that this depreciation somehow 'proved' the foolishness of EMU. The matter of the euro/dollar exchange rate rapidly became synonymous with the wisdom of EMU per se. It is necessary, therefore, to establish some facts. First, by how much has the euro really fallen? And second, does its performance prove that EMU cannot work?

The comparison most often quoted is between the exchange rate of the euro against the dollar of $1.17 at its introduction on 1 January 1999, and its fall on 3 December 1999 below 'parity' to $0.99. This represents indeed a stark drop of 15.3 per cent. However, both 1 January and the euro/dollar rate are questionable benchmarks by which to assess the relative strength of the euro. They obscure more than they reveal.

The Bundesbank's president, Ernst Welteke, has, for instance, told traders to ignore the launch rate of $1.17 as a reference level for the new currency. He argues that they should focus instead on the value of the euro's component parts at the start of 1998. Back then, it would have taken $1.08 to buy one euro, had it existed. Set against that benchmark, even parity is hardly dramatic. In other words, the fall in the euro mainly rebalanced the surge in the value of its constituent parts in the last quarter of 1998. Moreover, to look in isolation at the euro/dollar rate exaggerates the impression of a frail currency. On a trade-weighted basis (which takes into account how much of Euroland's trade takes place in a particular currency), the euro fell by much less during 1999 (around nine per cent).

Leaving aside the extent of the decline, a weakening euro may have been a blessing in disguise for Euroland. The last thing it needed in 1999 was a 'strong' euro hitting its exports and hampering its economic upturn. And Euroland's interest rates are low, both historically and relative to those in the UK and US. If the area's growth prospects continue to improve, against the backdrop of a massive and still growing US trade deficit, a strengthening of the euro will no longer be a distant prospect but an unavoidable reality.

The very least one can say about the euro's apparently dramatic falls is that they offer proof of it behaving as a normal currency, with its exchange rate roughly reflecting divergent economic patterns and prospects. It is therefore misguided to claim that the euro's decline 'proves' that EMU is a flawed endeavour. As the veteran *Financial Times* columnist Samuel Brittan concluded in June 1999:

> …the debate on the so-called weak euro has produced many contenders for the prize for economic nonsense. The common fallacy is that a low value of the euro on the foreign-exchange markets means that it is a bad currency and a high value that it is a good currency… It is not a sign of disaster if it falls; nor is it a sign of triumph when it rises…markets can be wrong and are prone to overshooting and undershooting. But not nearly as wrong as politicians and commentators speaking from the sidelines.

In the future the euro will invariably alternate between being weak and strong against other currencies, including the dollar. Ultimately, the relative strength of any currency is very much like beauty: in the eye of the beholder. It depends largely on one's expectations. Whether a weak or a strong euro is preferable will depend on the exchange-rate exposure of a particular firm's operations and on which currency it trades in.

Big euro, small euro

More important and fruitful than trying to second-guess the markets and predict the euro's future external value is to gauge whether it will become a 'big' or a 'small' currency. After all, EMU's medium-term impact on monetary, trade and foreign policy will depend heavily on whether the euro has managed to become a global currency rather than remain a regional one. The 'larger' the euro as a currency, the more serious a challenge it will pose to the dollar and the US government's freedom of manoeuvre.

The size and significance of the euro will be determined by two different types of response to it: that of the world's public central bankers; and that of the world's companies and institutional investors. The first subject is concerned with the point at which central banks around the world decide to hold (large) parts of their foreign-exchange reserves in euro. At the end of 1998, 61 per cent of global currency reserves was held in dollars, compared with 14 per cent for the euro's constituent parts.[3] This level of dollar reserves is disproportionate to the US share either of world output or trade, which are 27 per cent and 19 per cent respectively. Will this change, and if so, when? The second subject relates to how far the euro will be used on international capital markets as the preferred currency to raise equity, finance debt or invest in.

[3] *IMF Annual Report, 1999*

Reserve currency status

The more flamboyant predictions about the euro's expected share of global foreign exchange reserves have thus far remained unrealised. While central bankers outside the euro-zone have repeatedly professed their enthusiasm for the new currency in principle, they are hanging on to their dollar reserves, at least for the time being.

The euro's performance has done nothing to persuade risk-averse central bankers to diversify their reserve holdings. As Chris Stals, the former central-bank governor of South Africa, put it in April 1999: '…[it's] not that we have anything against the euro, but we're also a central bank that is trying to make money'. Until central-bank governors become convinced that the euro really is a sound alternative to the dollar, they will not diversify significantly their portfolio of currency reserves.

There are, however, two caveats to this argument. First, reserve currencies are not always 'strong'; indeed the dollar has frequently been very weak. Second, although bankers (like investors) do not like to buy a currency if its value is falling, the fact that the euro seems weak could provide them with an incentive to diversify into a currency which must sooner or later rise.

Quite apart from intangible factors such as 'market confidence'—which is often code for the whims and vagaries of capital markets—the euro's status as a reserve currency will also be determined by economic fundamentals. Textbook economics tells us that the amount and composition of a country's currency reserves should reflect two factors: first, the nature of its currency regime (managed float, fixed or crawling peg, currency board and so on) and second, its trading patterns. If you link your currency to the dollar, or if most of your trade is in US dollars, you need dollars to defend that link and facilitate those trade flows.

Looking just at exchange-rate considerations, you would expect that Asian economies such as China, Hong Kong and Taiwan, which have pegged their currencies to the dollar, should keep their reserves primarily in dollars. But to the extent that trading patterns (and in China's case possibly geo-strategic considerations) come into play, a diversification of these reserves will probably occur over time. For example, Euroland accounts for roughly 15 per cent of exports from Hong Kong and Taiwan. Thus a significant rise in their respective euro-holdings would be logical, assuming that the current trend for the invoicing of their trade with Euroland to switch into euro continues. Indeed, in December 1999 the Hong Kong Monetary Authority announced that it would increase the euro's weighting in its reserves from ten to 15 per cent. The same diversification logic applies to South American countries with sizeable currency reserves, such as Brazil and Argentina, which have even stronger trade links with Europe (about 25 per cent of their total trade is with the EU). Other countries and regions with similar economic orientations, such as Turkey and North Africa, could be expected to do the same.

The fact that other countries already link their exchange rates in some way to the euro will, over time, boost its role as an anchor currency. Links with the euro fall into four categories:

★ the 'peggers': Greece and Denmark (members of the exchange rate mechanism II) have a bilateral agreement with the EMU bloc; Cyprus and Macedonia peg unilaterally;

★ countries that have a currency board based formally on D-marks which in practice means a euro link (Bosnia-Herzegovina, Bulgaria and Estonia);

★ countries that track a currency basket which includes the euro as its largest element (such as Poland and Hungary); and

★ countries which have an informal managed float, using the euro as a reference value (including the Czech Republic, Slovakia, Slovenia and Croatia).

Most Central European countries, therefore, and especially those that are candidates for accession to the EU, have established a formal link with the euro. As most of their trade is also with the euro-zone, a further shift in favour of euro holdings is plausible. Indeed, some countries, such as Croatia, are even considering adopting the euro as their formal currency, before they join the EU.

In sum, an assessment of the likely long-term trends suggests it will be a matter of time, rather than of principle, before the euro achieves the status of a serious reserve currency.

A currency for the capital markets

While the composition of official national reserves does matter, it is less significant than often believed. In recent decades holdings of public funds have been dwarfed by the explosive expansion of private capital markets (including international investors such as pension and insurance funds). This trend has had significant consequences for public policy.

In the 1960s, current-account deficits were largely financed by movements of official reserves.[4] So when France faced a current-account deficit, as it repeatedly did, it had to use its scarce reserves of gold and foreign currencies to balance its books. Such was the reality of the international monetary system. The US, however, had the more attractive option of printing dollars which were simply added to the reserves of other countries. In this way the Americans obtained real goods in exchange for a cheque they knew would not be cashed. This practice induced President Charles de Gaulle to decry the 'exorbitant privilege' of the US dollar, and others to speak of the US levying an 'imperial tax' on its allies.

[4] Robert Solomon, 'International effects of the euro', policy brief 42, the Brookings Institution, Washington DC, January 1999

Today, payment imbalances are easily financed by flows of private capital, for example, in international bond markets. As a result, the political and strategic importance of the composition of reserve holdings has declined. In April 1997 the then US Deputy Treasury Secretary, Larry Summers, made the same point. Actions by official authorities, he said, will count for much less than those of private investors in determining the 'size' of a currency. To underline his argument, he stressed that the combined reserves of the US, Japan and the EU were less than five per cent of total outstanding government debt of these three, and an even smaller proportion of total global financial assets.

To answer the crucial question of how big the euro will be, one has to look at private-sector perceptions and actions, and in particular at the size, nature and development of capital markets. Randall Henning of the Institute for International Economics in Washington argues convincingly that 'since for more than a century the leading international currency (sterling, then the dollar) was underpinned by the broadest and deepest capital market in the world, [this] lends credence to the importance of capital markets in determining the roles of currencies in the future.'[5]

[5] Randall Henning, 'Co-operating with Europe's monetary union', Institute for International Economics, Washington DC, May 1997

On this count the available evidence is mixed, although there is a discernible trend towards a 'big' euro. European markets remain substantially smaller than those in the US. EU equities amount to roughly 55 per cent of US stock-market capitalisation. There are also differences in structure. In the US securities markets are more important, whereas in Europe banking dominates: it is estimated that in continental Europe the capital markets supply 25 per cent of corporate finance, compared with more than 75 per cent in the US.[6] Another limitation on the size of the euro comes from the fact that Britain, with its very large capital market, has chosen to remain outside EMU for the time being.

6 Solomon, op cit, 1999

Yet European capital markets are changing rapidly. In terms of structure, it is clear that equity, shareholder value and corporate restructuring are on the rise. Moreover, despite the alarmist headlines about the euro/dollar exchange rate, in capital markets the euro has been a runaway success. In 1999, euro-denominated bonds accounted for slightly more than 46 per cent of world-wide bond issues, compared with 45 per cent for the dollar. Clearly bond traders are already operating in a dual-currency world. Since the start of 1999 there has also been a three-fold expansion in the size of the euro corporate bond market, compared to the individual markets of the euro's constituent currencies. A number of US issuers have been active in the euro-denominated bond market, including well-known names such as Ford and Philip Morris. And within six months of the launch of the euro twice the number of emerging-market bonds were issued in euro as in dollars. These are impressive figures by any standard: there is no doubt that the euro-denominated bond market has become much greater than the sum of its parts.

Spurred on by EMU, the stock exchanges of Frankfurt, London, Paris and other financial centres have tentatively agreed to link their trading systems by November 2000, and to harmonise trading rules. Although this falls short of initial (and preferable) plans for a single electronic share-trading platform, it is an important step forward. The 'TARGET' system introduced at the start of 1999 provides an efficient, real-time gross settlement system for payments in euro. And all outstanding government debt in the euro-zone countries has been redenominated into euro, which, together with common issuing standards, should create a large, uniform market for government bonds.

But European exchanges cannot afford to be complacent, for US companies and institutions are eager to profit from the recent changes in the financial landscape. Nasdaq, the US high-tech stockmarket, has announced plans to start trading shares in European companies in October 2000. But this kind of competition is welcome: it should keep the Europeans alert and may help them overcome national rivalries.

European capital markets will not become seamless over night. More work needs to be done to harmonise regulatory frameworks, accountancy standards and trading rules. Nonetheless, the sense of direction is clear, and it promises huge benefits. European firms will be greatly helped by a more integrated, liquid and efficient capital market that is able to offer tailor-made corporate finance arrangements more cheaply than before. The explosion of the euro-denominated bond market is helping corporate Europe to restructure, forge global alliances and become a far more competitive force on the world stage.

EMU has given an enormous boost to European efforts to create a single capital market, which will in turn help to consolidate the euro's international role. The roles of European authorities such as the European Central Bank (ECB), the European Commission and national finance ministries are particularly important for the creation of an integrated capital market. One positive step would be the creation of a single European regulator, modelled loosely on America's Securities and Exchange Commission (SEC). A EURO-SEC would put an end to the complexity which investors and companies have to face in dealing with 15 different national regulators.

The ECB has adopted a neutral stance on the euro's international role. Its official line is that it 'neither promotes nor hinders the development of the euro as an international currency'.[7] Yet ECB officials concede that the euro is becoming a 'big' currency. And since the citizens of the euro-area stand to gain considerably from it, the ECB would do better to make a gentle shift of emphasis in support. While markets will decide the size of the euro as an international currency, the accompanying rhetoric from the ECB could become more favourable.

[7] *Noyer, op cit,1999*

Admittedly, an international role for a currency is not without its potential downside. Rights and responsibilities tend to come together. The Oxford economist David Vines, for instance, has concluded that the euro-area '…is likely to find that increased global influence (of the kind France has long sought) brings uncomfortable responsibilities (of the kind which Germany has long appeared to want to avoid).'[8] More specifically, a substantial international role, such as that played by the US dollar, 'may reduce the domestic monetary control, to the extent that policy changes provoke greater capital movement and authorities have less influence over foreign holders than domestic residents.'[9]

[8] *David Vines, 'EMU and the global environment', Balliol College, Oxford, 1999*

[9] *Henning, op cit, 1997*

It is probably this fear of losing control over monetary policy that has led the ECB to adopt its equivocal position. And it happens to dovetail perfectly with German preferences. For decades the Bundesbank systematically discouraged an international role for the D-mark out of the same fear of loss of control. On several occasions it was only after considerable political pressure that the Bundesbank yielded and accepted international obligations such as those of the European Monetary System (EMS).

Although German views have not changed fundamentally, the greater economic size and weight of the euro-area should assuage German concerns. External trade is a much smaller proportion of the euro-zone economy than it was of the German economy. And whilst it was just possible for the D-mark to avoid a significant international role, for the euro it is no longer a realistic option. Furthermore, the benefits of a global role for the euro—lessening the Europeans' dependence on the dollar and enhancing the efficiency of its capital markets—far outweigh the possible costs.

As early as May 1997, Randall Henning had concluded that:

> …the long-term possibilities for the euro to play a large international role are substantial. However, the new European currency will probably grow into this role only gradually over time. There will be no precipitous displacement of the dollar by the euro at the outset of EMU. Depending on the integration of the European capital market, the euro might in the long term come to play a role that would equal that of the dollar, not surpass it. This limiting case would nonetheless represent a significant decline in the use of the dollar.

This estimate is still valid. The potential and the trajectory are undeniable, but the realisation of a global role will take time. The weight of the evidence supports the notion that the euro will, despite the loudly voiced scepticism of its detractors, over time become a 'big' currency with a significant international role.

The consequences of a global euro

Does a global role matter very much, and if so, to whom? The first positive consequence for the members of the euro-area comes via a small but not insignificant benefit called seigniorage (the fact that anyone who holds a foreign-currency banknote is in effect making an interest-free loan to the issuing central bank). For decades foreigners have been willing to hold US currency in large quantities (the consensus estimate is 60 per cent of total stock). Most of that money will never return to the US or be used to purchase US merchandise, giving rise to the best known source of seigniorage. The UK-based economists Richard Portes and Hélène Rey put its annual value to the US at 0.1 per cent of GDP, or $20 billion.[10]

At least in part, the European challenge to US seigniorage may come in an embarrassingly unattractive form. For a long time, international drug traffickers and money launderers have dealt mainly in $100 bills. They may well in future switch to the greater value €500 notes, for convenience.

Portes and Rey have also identified a less well-known form of seigniorage: a liquidity discount, which has reduced the effective yields that the US has to pay on its debt. Yields are lower on debt that is traded in larger volumes. They calculate that this additional benefit is worth 25 to 50 basis points, or $10 billion a year to the US Treasury.

Leaving seigniorage aside, it is also clear that the sheer status of the dollar as the only global currency has allowed the US to build up massive international liabilities in its own currency and at lower interest rates than it would otherwise have had to pay. This advantage should erode over time as euro assets develop into a real alternative. As Fred Bergsten noted in the Washington Post at the launch of the euro: 'The euro may make it costlier for the United States to borrow the huge amounts of foreign capital needed to finance our chronic external imbalances.' The bottom line is that the US may find the price of money going up.

[10] *Richard Portes and Hélène Rey, 'Euro vs dollar. Will the euro replace the dollar as the world currency?', in David Begg (ed), 'EMU: Prospects and challenges for the euro', Blackwell, 1998*

Thus a second and probably more important consequence of the euro's global role is that America's freedom of manoeuvre in the macro-economic sphere will be limited. To an increasing extent, the US economy and its government will be subject to the same competitive pressures as everybody else.

The US Treasury Secretary, Larry Summers, is fond of saying that the fate of the dollar is still largely in US hands. He is essentially right, yet international investors may become less forgiving of America's economic policy mistakes, such as a repeat of the excessive fiscal loosening of the early 1980s. EMU offers international investors an alternative to dollar-denominated or US-linked assets. As Asian, South American, and indeed West European economies have found out in the past few years, if institutional investors are unimpressed, they will simply take their business elsewhere. EMU will thus impose constraints on US policy-making that it has so far managed to escape.

Incumbency and inertia favour the dollar, so for the time being investors are inclined to give the dollar and US assets the benefit of the doubt. But sources of inertia (such as the home bias of institutional investors) tend to erode over time. And when that happens, the euro and euro-linked investments will grow into an attractive alternative.

The third consequence of a 'big' euro is that the US government will be less able to manage the dollar's exchange rate to suit its domestic circumstances—notwithstanding that in the past the outcomes have not always been exactly as intended. Either way, other countries have often been landed with the negative side-effects of gyrations in the dollar's exchange rate, in the face of supreme indifference by the US authorities to the external consequences of their actions.

Indicative of this stance was what John Connally, US Treasury Secretary under Richard Nixon, used to say to Europeans: 'The dollar is our currency, but your problem.' Because the dollar was the system's only anchor currency, the US could get away with such an attitude. As Henning says: 'When clashing with European governments over macro-economic policies or the balance of payments, American officials often took advantage of this asymmetry. In several instances, the threat of a precipitous exchange-rate movement pressed European governments to reflate or dampen their economies in accordance with American preferences.'[11]

[11] *Randall Henning, 'Europe's monetary union and the United States', Foreign Policy 102, spring 1996*

This is what happened, for example, in 1978 when the US, which had a massive trade deficit, put enormous pressure on West Germany to make its economy the 'locomotive' of the West by adopting a policy of strong fiscal expansion. US policy-makers added that if the Germans refused to comply with their demands, they would do nothing to prevent the dollar from falling against the D-mark. Predictably the dollar plunged from DM2.50 in the autumn of 1976 to DM1.70 in October 1978. Chancellor Helmut Schmidt deeply resented the Americans using the dollar as a weapon to squeeze West German exporters, which Schmidt relied upon to keep down unemployment. He later said that the 'reckless conduct' of the US had hurt the European economy because of the Europeans' strong dependence on the dollar.

Indeed, throughout the 1980s and 1990s Europeans and Americans have repeatedly clashed over the consequences of US action (or inaction) in the macro-economic and monetary spheres. On every occasion the Americans' superior economic clout and the ability to use the dollar as a weapon has strengthened US leverage. While the importance of this extra leverage should not be exaggerated, it is true, as the European Commission noted in 1990, that 'to some extent, the US can exploit this asymmetry by making its policy choices in a non-co-ordinated fashion without suffering much from a similar behaviour of European nations.'[12] EMU will largely eliminate this asymmetry. It will reduce US leverage and make 'dollar diplomacy' harder to pull off.

[12] *'One market, one money', European Commission, October 1990*

A fourth consequence of EMU is that Europeans will no longer have to struggle with the havoc that large swings in the dollar have wreaked on European foreign-exchange markets. In the past these gyrations often sent the German mark in the opposite direction to the Italian lira and French franc, putting great strains on the Exchange Rate Mechanism (ERM) and the single market.

Europeans and Americans alike should realise that EMU does not signify the end of US economic strength or the dollar's prominence. But the euro will increasingly constrain and challenge US pre-eminence. The dollar, dollar-denominated assets and the US government will have to live by the same rules as everybody else. What is more, as the Europeans' dependence on the dollar declines, they will collectively recapture a degree of sovereignty previously lost.

3 External policy-making for the euro-zone

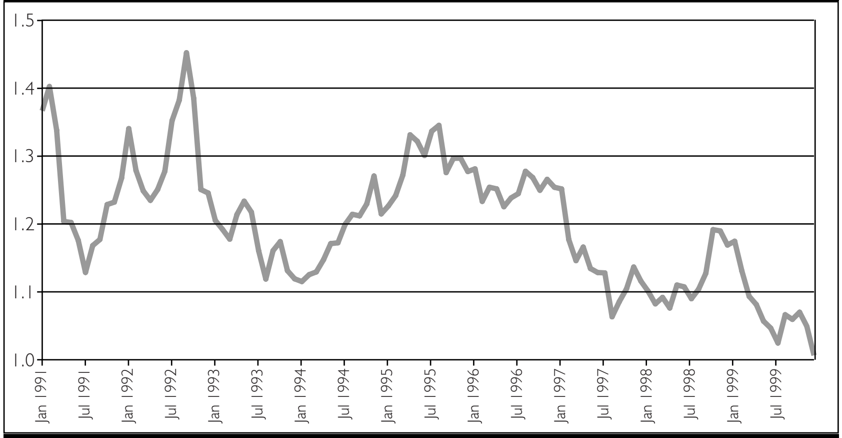
While market forces will largely determine the shape of the euro, EMU does raise issues of public policy for officials and politicians. The two most important are exchange-rate policy and the external representation of the euro-zone.

It is reasonable to expect that the euro/dollar exchange rate will be increasingly volatile and perhaps comparable to the sharp movements of the dollar/yen exchange rate. The absence, until now, of massive euro/dollar fluctuations is no guarantee of future developments. And there is a danger that the indifference of Euroland policy-makers towards exchange-rate gyrations may exacerbate them. Indeed, the British press—much of it pursuing its own agenda—was exceptional in expressing alarm at the euro's post-launch fall in value. To many inside the euro-zone, the euro's decline is of little consequence, provided inflation remains subdued.

The fashionable attitude among policy-makers towards exchange-rate policy can perhaps be summed up as 'studied indifference', or even 'benign neglect'. Indeed, there is something of a consensus on both sides of the Atlantic in favour of floating exchange rates combined with a passive acceptance of the likelihood of greater and potentially harmful movements in the dollar/euro exchange rate. In the past ten years, as Graph 1 (below) shows, the dollar and the euro (or its constituent parts) have already experienced swings of up to 45 per cent. These swings go well beyond the short-term and more easily explicable decline of the euro during 1999.

Moreover, large swings in the dollar/yen rate have, historically, preceded swings in the dollar/D-mark rate. The dollar rose from Y78 in April 1995 to Y145 in late 1998, a rise of more than 75 per cent, only to fall back to Y102 in November 1999. Such movements are clearly not justified by the economic fundamentals, not even by the profound trough and subsequent recovery of the Japanese economy in this period. And these

VALUE OF THE EURO AGAINST THE US DOLLAR
JAN 1991-DEC 1999



SOURCE: PAINE WEBBER

excessive swings could well spill over into the euro/dollar rate. Large and sustained misalignments could cause considerable economic damage to firms that are dollar-sensitive, especially those that have most of their inputs priced in euro and most of their outputs priced in dollars, or vice versa.

Any country (or currency zone) with an independent central bank faces the classic dilemma of exchange-rate policy: whose job is it to intervene? On the one hand, the central bank has responsibility for domestic monetary policy. And the authority to set interest rates strongly influences the exchange rate in today's world of open markets and capital mobility. But on the other hand, the government controls a broad range of domestic and international economic and financial policies, in addition to foreign policy, from which exchange-rate policy can hardly be separated.

While there is, therefore, an inherent tension between central banks and governments, the latter must retain ultimate responsibility over exchange-rate policy and international monetary commitments. After all, only governments are members of the International Monetary Fund (IMF), and only US Treasury officials—rather than the Chairman of the Federal Reserve—make official pronouncements on the dollar. However, close co-operation with the central bank (which in both the US and Euroland has been given an inflation target) is vital because the central bank controls the main instruments for influencing the value of a currency, namely the power to set interest rates and the capacity to conduct market interventions.

This dilemma is inevitable but it can be managed. A *modus operandi* needs to be established under which the government and the central bank can co-operate at the policy level, while operational authority is delegated to the central bank. The precise nature of the co-operation will vary, depending on countries and historical periods.

Article 109 (now 111) of the 1991 Treaty of Maastricht attempted to clarify the dilemma for the euro-area (see box). It stipulates that the Council of Ministers can act, unanimously, to establish a formal exchange-rate agreement with other currencies, subject to two conditions: the

Article 111

1. By way of derogation from Article 300, the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, conclude formal agreements on an exchange-rate system for the ECU in relation to non-Community currencies. The Council may, acting by a qualified majority on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the ECU within the exchange-rate system […]

2. In the absence of an exchange-rate system in relation to one or more non-Community currencies as referred to in paragraph 1, the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange-rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of price stability […]

Commission or the ECB must have recommended such action; and any agreement must be compatible with the objective of internal price stability. The same conditions apply to a decision to change or abandon the central rates within a formal exchange-rate system, which may be taken by a qualified majority vote in the Council.

The treaty notably fails to specify who (the Council of Ministers or the ECB) decides what constitutes a threat to price stability. Since an agreement to establish a system of fixed exchange rates with the dollar or the yen is highly unlikely, this calculated ambiguity may well be academic. However, it is of direct relevance to the 'general orientations' for exchange-rate policy described in paragraph 2, which stand a much higher chance of being agreed and implemented.

Ultimate responsibility for exchange-rate policy must rest with the Council; after all, governments retain control over exchange-rate matters elsewhere in the world. And simply handing over exchange-rate policy to the ECB would also create problems of democratic legitimacy. But who, in reality, would negotiate informal international agreements on behalf of the euro-zone? Unlike formal exchange-rate regimes, informal agreements are very much the stuff of contemporary financial diplomacy. In the finance G-7, made up of finance ministers and central bank governors, the multilateral surveillance of global macro-economic and exchange-rate trends takes up much of the meetings. In particular, the G-7 has periodically attempted—with some degree of success—to achieve exchange-rate stability in line with economic fundamentals. Informal international monetary accords include the Plaza and Louvre agreements of the 1980s and the G-7's successful effort from mid-1995 to 1996 to raise the value of the dollar. Although central bankers were present at these meetings, the agreements were negotiated and concluded by finance ministers, motivated at least in part by political concerns.

Negotiations of this type require someone to do the negotiating. But the question of 'who speaks for Euroland?' is contentious. Member-states have long side-stepped this issue. Only at the Vienna summit in December 1998, just before EMU's launch, did EU leaders reach a tortuous compromise. After an acrimonious discussion it was agreed that the euro-zone would be represented in all finance G-7 negotiations by the finance ministers and central bank governors of the three European members

(France, Germany and Italy), plus the president of the ECB, plus the finance minister of whichever country is holding the rotating presidency of the euro-11, plus the commissioner in charge of monetary affairs 'to lend assistance'. (The 'euro-11' is the informal forum for finance ministers from EMU-participating nations that discusses euro-related matters. At British and German insistence it has no formal decision-making powers.)

This solution of 'national representation-plus' was deeply unsatisfactory—a classic EU decision not to decide. The larger states were unwilling to relinquish their national representatives, the smaller states refused to have the euro-zone represented by one of the big three, and neither group was prepared to give the task to the Commission.

The Americans, keen to preserve the informal nature of G-7 deliberations, and knowing that not all Europeans were fully behind these cumbersome arrangements, immediately objected. Why was it, they pointed out, that despite constant EU rhetoric about ever-closer integration, the numbers of Europeans present at the table seemed to increase with every meeting? Some of them would have to go.

So after further negotiations the finance ministers of the G-7 reached a compromise, effective from their meeting at Frankfurt in June 1999. Their meetings are now split into two sections. The first part deals with the global economy and exchange-rate developments. Here, the president of the ECB and the country holding the rotating presidency of the euro-11 represent the euro-zone. The finance ministers of Germany, France and Italy do attend, although their central bank governors drop out. In the second part, all other international financial issues are discussed. The president of the euro-11 is not present, but the governors of the central banks of Germany, France and Italy are, together with the finance ministers of those countries. The Commission is only invited to participate for those topics in the second session where it plays a direct role, such as aid to Russia.

Clearly this unwieldy arrangement is unsustainable. There are still too many Europeans present to be a match for the nimble and effective US double act of Larry Summers and the Federal Reserve Chairman Alan Greenspan. And it is unacceptable that the euro-11 president simply reads out statements that have been carefully prepared in prior consultations and from which he cannot depart. Unsurprisingly the Americans have reiterated their unhappiness with the situation.

It could be argued that the entire debate about appropriate representation is irrelevant, given the near-universal support for flexible exchange rates. If the euro's rate is to be determined simply by the market, there is no need for forums and structures within which to discuss the matter. But this conservative position is misguided. First, the agenda of global financial diplomacy encompasses a host of non-exchange rate issues, such as multilateral macro-economic surveillance, international rescue operations and the reform of international financial architecture. In these contexts Euroland would benefit greatly from a simplified dialogue with other political authorities. It has to find a way of streamlining its external political representation.

Second, it is always dangerous to assume that the current system is the only sensible or possible way of doing things. A system of floating exchange rates carries costs and often leads to sustained misalignments. These costs should be tested against the pros and cons of alternative systems.

The downside of floating exchange rates

The catechism of floating exchange rates holds that any attempt to limit bilateral swings is doomed. That would include the setting of exchange-rate zones around an agreed equilibrium parity (a rate at which the underlying economies will be in balance). These zones, it is argued, are either set so wide as to be irrelevant, or so narrow that they cannot be sustained. Thus the idea of 'target zones' for the euro/dollar rate, as proposed by the former French prime minister Edouard Balladur, the former Federal Reserve chairman Paul Volcker, the former German finance minister Oskar Lafontaine and others, would only prolong and amplify differences in the business cycle across the Atlantic, while giving speculators, such as George Soros, a target to bet against.

This argument has merits. To start with, it would be madness for a central bank to raise interest rates just to prop up an ailing currency because of perceived weaknesses in an economy's underlying performance. This was what happened in the UK on Black Wednesday in September 1992: the pound, which had entered the exchange rate mechanism at an unsustainable rate for which it had not secured Bundesbank backing, was ejected, despite repeated interest-rate rises by the Bank of England. Equally, it would be unwise to jeopardise domestic price stability for the sake of exchange-rate stability: it is too high a price to pay.

But so unswerving has been the commitment within the euro-zone to floating exchange rates that it led, in the first half of 1999, to a bizarre situation. Euro-zone finance ministers (who, according to the treaty, retain ultimate control over exchange-rate policy) decided not to talk about it. When pushed really hard, they simply stated their support for the ECB line. The ECB, for its part, stressed that it only has a mandate to keep average inflation in the euro-area below two per cent.

Not everyone, however, is convinced about such a total attachment to floating exchange rates. Willem Buiter, who sits on the Bank of England's monetary policy committee, has questioned the supposed perfect efficiency of foreign exchange markets on which the case for flexible exchange rates largely rests, noting that they are 'often driven more by asset-market fancies than by fundamentals.'[13] Fred Bergsten, similarly, has noted that 'G-7 currency gyrations in recent years have far exceeded any conceivable shift in economic fundamentals.'[14] And Pierre Moscovici, the French minister for European affairs, has reiterated his government's desire for more political co-ordination among the euro-11, not just on budgetary and fiscal policy but also on the exchange rate.[15]

Opposition to the neo-liberal orthodoxy has also come from other quarters. Randall Henning, for example, has lamented the 'strong bias' in the Maastricht treaty *against* exchange-rate stabilisation and in favour of flexible exchange rates. Combined with the closed nature of Euroland, this could, he argues, lead to excessive volatility and sustained misalignments, with damaging consequences, notably for transatlantic trade and investment relations.

These objections carry weight. It is clear that businesses abhor uncertainty and unpredictability. Wide fluctuations in the

[13] Financial Times, 16 June 1999

[14] Fred Bergsten, testimony to the committee on banking and financial services, US House of Representatives, 21 May 1999

[15] Entretien avec Pierre Moscovici, Les notes de la Fondation Jean Jaurès, Paris, June 1999

euro/dollar rate make it harder for them to plan. After all, one of the main rationales for a single currency was to eliminate that sort of exchange-rate risk within the European economy. Why accept it so readily for the euro/dollar relationship?

Because the EU and the US maintain such close trade links, fluctuations in their exchange rate could have severe consequences in, for instance, highly dollar-sensitive sectors such as the oil or aerospace industries. Currency fluctuations affect not only export markets, but also competition at home and in third markets. German exporters, for example, are still very sensitive to dollar movements, not only because of sales to the US, but also because their main competitors in capital goods are dollar-based firms. So when the euro rises, companies based in Germany are at a disadvantage in Euroland as well as in third markets such as East Asia.

Increased dollar/euro fluctuations could also harm the US-European investment relationship, which is even larger than the trade link. In 1998 US trade with the EU 15 was worth $325 billion whereas EU investment in the US totalled $482 billion. Investment by Europeans is also becoming increasingly important in relative terms. In 1998 European companies accounted for more than 90 per cent of new foreign direct investment in the US, compared to just seven per cent for Asian companies.[16] Nor are the repercussions of large and repeated swings limited to the US and the EU. They could well be felt more strongly by countries that have tied their currencies to the euro (such as many Central and Eastern European countries) but which have neither influence over exchange rates nor the protection against exchange-rate risks that EMU membership offers.

[16] *US Department of Commerce, Bureau of Economic Analysis*

A proposal to end misalignments in the euro/dollar rate

Is there a way of eliminating the excessive currency misalignments that come with floating rates, while preserving the goal of domestic price stability? One answer would be for the finance ministers of Euroland and the US to specify exchange-rate reference ranges, beyond which fluctuations would be regarded as clearly not justified by fundamentals. These ranges would not be rigid target zones, but intended, rather, to ‘guide’ the markets and strengthen existing efforts at international co-operation on exchange-rate developments.

The reference ranges could be communicated to the markets as the informed opinion of the relevant authorities, thereby sending a powerful signal from the combined might of the US and Euroland. This could only work, though, with whole-hearted support from both sides. Should Japan, Canada and Britain agree with these ranges, they could be published as the official stance of the G-7. When exchange rates reached their stated limits, the G-7 would be bound to review the situation and make whatever concerted interventions and changes in macro-economic and monetary policy it deemed appropriate.

The establishment of such a system would be very likely, as a self-fulfilling prophecy, to reduce the incidence of excessive fluctuations. It would ensure that policy-makers retained the choice to act—or to decide not to act if doing so would threaten price stability. It would build on previous ad hoc interventions and statements that the G-7 has made in attempts to 'guide' the markets, but do so in a more systematic fashion. This system is thus broadly similar to the proposals advanced by Henning, Bergsten, Balladur, Volcker and others. Yet it contains one important difference: unlike rigid target zones, it offers an escape clause to safeguard the price stability concerns of central bankers. For example, were the euro to strengthen beyond the stated ranges, the ECB would not automatically have to cut interest rates if such a reduction jeopardised its inflation objective. But in any event, the system would rely mainly on other policy instruments (official statements, macro-economic co-ordination and interventions in the foreign exchange markets) to avoid excessive exchange rate instability.

What should be the reference range for the euro and dollar? To reach a workable consensus on the long-term fundamental equilibrium rates, the G-7 should prepare technical reports on reference ranges, drawing on the expertise of the IMF, private-sector analysts and university experts. For the sake of argument, a sensible range might be €1=$0.95 to €1=$1.30. This would contain both the potentially inflationary pressures of an excessively weak euro *and* the anti-competitive consequences of extravagant euro appreciation. This range is wider than the one proposed by Bergsten but close to that advocated by the leading French economist Christian de Boissieu.[17] Note also that the euro's decline in 1999 falls comfortably within this range. These zones would need to be monitored constantly against cost and price levels in the currency

[17] *Le Monde, 22 June 1999*

blocs, and they would have to take account of the different phases of the economic cycle. They would also need to be re-examined in the light of developments such as possible UK entry into the euro-zone.

The instinctive reaction of finance-ministry officials and central bankers will be to dismiss this kind of proposition. After all, most US Treasury and European officials are adamant that they see no future in anything other than floating exchange rates. But there are at least four reasons why these sceptics should pause to reflect.

★ *This is not a proposal to implement formal, rigid target zones.* Policy-makers would be able to exercise discretion about how and whether to act, when currencies moved out of range. The presumption would be strongly in favour of interventions, public statements or corrective policy adjustments from the central bank or the governments, but an errant currency would not trigger an automatic response. They may choose to do and say nothing. And the fact that there would be no automatic outcome could act as a stabilising force on the markets, which would have to adapt to this 'certainty of the uncertainty'.

★ *The zones would be fairly wide*, say plus or minus 15 per cent around a central equilibrium rate of €1=$1.12. The aim is to avoid bubbles and misalignments rather than short-term volatility. These wide bands would dramatically reduce the chances of a conflict between exchange rate and domestic monetary policy. And central banks would retain day-to-day responsibility for monitoring and managing the regime, a pivotal role that would allow them to safeguard their concerns for price stability.

★ *Private speculation could become a stabilising rather than a destabilising influence*. 'As a rate approached the edge of a range,' Bergsten states, 'little money would be made by pushing further in the same direction because the markets would know [or speculate] that the authorities would not permit the limits to be breached. In contrast, considerable profit could result from reversing the rate back toward (or beyond) the mid-points. Both theory and empirical evidence from similar regimes, such as the EMS since 1993, demonstrates that such 'mean reversion' can be expected with some confidence.'[18] It is for this reason

[18] *Bergsten, testimony to the US House of Representatives, May 1999*

that the alternative suggestion of setting zones, but keeping their limits secret, is less attractive—although it is worth considering as a fall-back option.

★ *Finally, there is high convergence between the respective currency blocs.* It is often overlooked, or conveniently forgotten, that there is far greater macro-economic convergence, at least as defined by the Maastricht criteria, between the US and Euroland than there was among EU states when they embarked on their journey to EMU. The gap in 1991 between Italy and Luxembourg in terms of budget deficits was almost 13 per cent (an 11 per cent deficit for Italy; a 1.9 per cent surplus for Luxembourg); while the difference between Euroland and the US in 1999 stands at 3.5 per cent (a two per cent deficit for Euroland; a 1.6 per cent surplus in the US). Interest-rate differentials were also much wider in the early 1990s inside the EU than they now are between the US and Euroland.

The Europeans nonetheless managed to bring about EMU, so the proposal for closer but flexible co-operation, which is far less ambitious, should be perfectly feasible. And it should be attractive to US policy-makers too. It is certainly worth the effort: it charts a workable course between the damaging misalignments that are caused by herd behaviour and market bubbles, and the pitfalls of potentially unworkable target zones.

Financial diplomacy: the case for Mr Euroland

Exchange-rate policy aside, there are many other dimensions to external policy-making, or the 'financial diplomacy' of Euroland. Many expect that the euro will enhance Europe's stature, boosting its role in co-managing the global economy and helping it to develop a more strategic outlook. But is there sufficient support on either side of the Atlantic to promote co-ordination on, say, the next Russian default? Sceptics believe not: Euroland will, they wager, maintain its tightly domestic orientation, coupled with serious internal divisions. But it is far from clear that such a stance will be sustainable. Will increased international demands and new financial crises not force Euroland's politicians to try and adopt common positions on international financial issues? Or will the conduct of geo-economics forever be an American preserve?

To throw light on these questions it is worth returning to the Asian crisis of 1997-98. Each side of the Atlantic remembers this episode very differently. The Americans recall how Larry Summers shuttled around the region while his department provided the intellectual input for the IMF policies designed to tackle the crisis. The Europeans were conspicuously absent, blissfully unaware of the gravity of the situation, clinging to their traditional inward-looking stance and obsessed with their parochial concern of bringing about EMU—an adventurist project of dubious economic merit. And all this despite the fact that European banks were far more exposed than US ones.

Europeans recall how they were expected to pay handsomely for US-inspired rescue packages without having had much say in their conception (a classic case of taxation without representation). IMF policy at the time was orchestrated by Larry Summers and the IMF's deputy managing director, Stanley Fischer, following their own themes. Furthermore, most Europeans reckoned that the IMF packages were fiscally too restrictive. And in the case of Russia, they add, IMF policies manifestly did not work.

How can one avoid a repeat of that situation? Nearly all US policy-makers, to their great credit, are demanding that Euroland develop a more strategic view of its wider responsibilities in co-managing the global economy. Quite a few would like to see the Europeans overcome their internal divisions and develop a single political point of contact who could speak for the euro-zone in international monetary and financial negotiations. Although US support for such an authoritative EMU spokesman would, as always, depend on what that voice were saying, such a spokesman would on balance increase the chances of striking broad and sustainable bargains.

Two months before EMU's launch, Larry Summers sought to assuage US concerns that a Euroland speaking with one voice on international financial issues would be harmful to non-Europeans. 'Some have argued that a Europe with a single number in the global directory might ultimately pose a threat to the US. But in a global economy the US has infinitely less to fear from an open and integrated Europe.'[19] Hence one of the most pressing US complaints is the absence of a political voice for Euroland, a figure who could operate alongside ECB President Wim Duisenberg.

[19] *'Transatlantic implications of the euro and global financial stability', speech at the Transatlantic Business Dialogue, 6 November 1998*

Such a figure would indeed be desirable, and not just because he or she would help to deal with the perennial American complaints of European division and provincialism. Many Europeans also believe that divisions among themselves are a licence for continued US hegemony on the global financial scene. Regardless of recent experience, the benevolence of US leadership cannot always be relied upon. The combination of Europe's domestic orientation and internal discord could become costly, even unsustainable.

While EU ministers and officials have already attempted to forge common understandings on international financial questions, co-operation remains slow, reactive and non-committal. The results are bland compromises, pleasing neither friend nor foe. The Italians' executive director at the IMF, for instance, has criticised their 'lowest common denominator' character. Something bolder is needed.

So who exactly should be the political voice of Euroland? The Commissioner in charge of EMU (now Pedro Solbes), according to many Euro-enthusiasts. But any commissioner, however brilliant, lacks the necessary political legitimacy. The larger member-states, in particular, would simply not accept a commissioner speaking for the euro-zone. Nor does public opinion seem ready for such a step. Besides, the fact that four out of 15 EU members are not yet in EMU makes it harder for a commissioner to speak authoritatively on behalf of a subset of the Union.

Euroland's external representative will have to deal with matters such as exchange rates, financial crises and international financial institutions. These are primarily the competence of the member-states, rather than of the EU itself. So the Council of Ministers, rather than the Commission, should be responsible for Euroland's financial diplomacy. But the problem remains of the 'ins' and 'outs'. And more importantly, the revolving presidency of the Council means that it lacks continuity, expertise and political credibility. In the eyes of the outside world, the EU presidency (like that of the informal euro-11, which also rotates) simply lacks clout, particularly when it is held by one of the smaller countries, or indeed a larger one that happens to be holding elections during its presidential term. No matter how able the relevant minister, the fact is that not all financial heavyweights, and especially not the US Treasury Secretary, will accept the finance minister of Luxembourg, or even Ireland, as a serious interlocutor.

In sum, the EU needs a finance supremo, a 'Mr Euroland', appointed—by unanimity—on the basis of merit and answerable to the finance ministers of the euro-zone. The job would be comparable to the new post of EU High Representative for foreign and security policy (Mr CFSP). The US Treasury Secretary or the IMF's Managing Director could contact Mr Euroland if, say, Russia defaulted or if they simply wanted to review developments in the global economy. The post-holder should be located in the Council secretariat with a small supporting staff to help him with policy development.

To be effective, Mr Euroland should be given mandates to negotiate formal and informal agreements with other political authorities. The euro-11, not Ecofin, should then quickly ratify or reject any negotiated agreement. For the system to work, the euro-11 should be given the authority to make binding decisions on matters that are relevant to the management of EMU, including external policy-making. In the finance G-7 and other international forums, a common position voiced by a single person would bring credibility and strength to European positions, characteristics which they conspicuously lacked in the Asian crises of 1997-98.

It is likely that the EMU 'outs', Britain in particular, would object strongly to the creation of an authoritative spokesperson for the euro-area, not least because the outside world would be bound to turn to Mr Euroland as the voice of 'Europe' on international financial questions. While the concerns of the 'outs' should be handled carefully, they should not be allowed to block further integration among the members of the euro-zone. Co-ordination between EMU participants and the other EU member-states will have to be intense. But self-exclusion comes at a price. Moreover, an enlarged and diversified EU will have to rely increasingly on operating 'flexibly', which means not all member-states participating in all EU policies.

EMU and the IMF

Having the euro-zone represented by a single politician would also help to address the—justifiable—complaint of Europe's over-representation at the IMF. The Americans have often stated that the Fund's 'constituencies' are overdue for consolidation. A single Euroland representative would reflect the reality of EMU and also make room for emerging economies.

Moreover, as IMF quotas (which determine different countries' voting weights) are calculated on trade and financial flows, the fact that EMU has made a large chunk of European trade domestic should affect quota allocation. Now that EMU members are bound by a single monetary policy, exchange rate and external trading position, the case for consolidating their IMF voice becomes overwhelming. Would it not make sense for Mr Euroland to represent the euro-area at the IMF?

Predictably, there is strong resistance to this kind of idea from national central bankers and finance ministries. Many, keen to maintain their national seats, argue that the only sensible solution is to give the ECB observer status in the IMF and the OECD. Nevertheless both the arguments and the structural trends strongly support the advocates of reform. And in secret negotiations, the finance ministers of France, Germany and Italy have discussed, but not agreed on, a merger of their national seats at the IMF and World Bank.[20]

[20] *International Herald Tribune, 19 October 1999*

It may be possible to strike a new bargain on Europe's role in the IMF. The Europeans should allow the consolidation of their quotas (something the US clearly favours) but insist that Euroland retain at least the same voting weight as the US (EU states collectively hold many more votes at the moment, so this would be a considerable concession). In return, the US would agree to a significant enhancement in the legitimacy of IMF work and policy-making. The way to do this would be through the Fund's 'interim committee', which is currently an annual meeting of finance ministers. The former French finance minister, Dominique Strauss-Kahn, proposed at the end of 1998 that the interim committee should take on a much more prominent role, meeting twice a year to set out the Fund's policy priorities. Its managing director would then implement these in close co-operation with countries' ambassadors at the IMF, the 'executive directors'.

This reform would benefit all non-Americans in a forum dominated informally but effectively by the US. It should, in particular, help to avoid a repeat of the Europeans' complaint about the Asian crisis: that they had little say over the content of IMF policies for which they were expected to pay. A single Euroland seat at the IMF would not only increase European coherence but also give Europe a de facto veto and much of the agenda-setting influence that the US alone currently enjoys.

Opponents of streamlining are convinced that Mr Euroland will never take his seat at the tables of global finance. After all, national central-bank governors are still attending parts of finance G-7 meetings, even though their presence is increasingly irrelevant. If the central bankers Ernst Welteke or Jean-Claude Trichet do not give up their G-7 seats, why should the ministers Hans Eichel or Christian Sautter? And when it comes to IMF rescue packages, it is the member-states which still provide the cash. Moreover, the opponents point out that the Europeans seldom have a consensus on international financial issues which an individual could represent.

These obstacles are, no doubt, real and significant. But similar objections were raised at the start of the process of European integration in the early 1950s, and again a few years ago about EMU. Indeed, at every step along the path of the European project, sceptical doomsayers have predicted confidently that the member-states would never be able to agree on anything serious—and that even if they did, the results would be a disaster.

History has proved them wrong, time and again. So once more the Europeans must face the same question: can they muster the political will to transcend the barriers to further integration, in order to secure common objectives? If the EU can speak with one voice in trade matters, despite the sometimes strong disagreements between advocates and opponents of free trade, why cannot Euroland speak with one voice on monetary and financial matters? Non-Europeans are asking for it. Structural forces favour it. From the analysis presented here, such a reform would yield considerable benefits. The question of who speaks for Euroland must be answered, preferably before the next crisis strikes.

4 The trade dimension

EMU will have a significant impact on transatlantic trade. Perhaps the clearest connection runs via the exchange rate. For decades, trade talks have been heavily influenced by the dollar's strength or weakness, and the consequent pressures this put on trade balances in Europe and the US. This situation will not improve; indeed, as indicated in Chapter 3, it may get worse if, as is likely, fluctuations in the euro/dollar exchange rate accentuate.

A second way in which EMU may have a bearing on transatlantic trade is via the costs of US deficit financing. The US has for decades turned its position of global financial pre-eminence to its advantage, for example through its ability to borrow abroad on a large scale at relatively low rates of interest. With its uniquely dominant status under threat, the US may have to reduce its trade deficit as the burden of debt-financing rises. Although the bulk of the US trade deficit is with Asia, the difficulties of deficit financing could put more pressure on an already troublesome trade relationship with the EU.

The third reason is that EMU has given a fresh impetus to Europe's trade diplomats to adopt a more independent and assertive stance. European and US officials alike confirm that EMU has strengthened European self-confidence: the EU is ubiquitously described as the world's premier trading bloc, and is recognised as having the only alternative global currency to the dollar. So far this is mainly a psychological change, but it is no less important for that.

The fourth reason will come from the gradual switch in the invoicing of Euroland exports and imports from dollars to euro. This trend could stretch beyond Euroland imports and exports. For instance, the German car-maker BMW has already told UK suppliers to its Rover factories that it will make payments only in euro. The possibility for euro-zone companies to operate and trade in euro is a significant advantage, for the costs of hedging the exchange-rate risks can be passed on to others.

The final and perhaps the simplest way in which EMU has an impact is that it has made imbalances in the transatlantic trade relationship more directly 'visible'. EMU has not only created a huge quantity of domestic (intra-European) trade, but it has also reduced the practice of providing separate figures on, say, the US-German or US-Italian trade balance. From now on the key data on policy-makers' radar screens will be the US-Euroland figures, not the bilateral balances of the past.

EMU will thus transform transatlantic trade ties. On the face of it, the euro ought to be unambiguously good news, providing a welcome boost to transatlantic trade flows. Agile American companies that operate across EU internal borders profit in the same way as European firms from the removal of exchange-rate uncertainty. And because EMU is a great liberalising force, encouraging Europeans to do away with economic rigidities, spurring corporate restructuring and lifting economic performance and competitiveness, EMU should be welcomed by Americans and Europeans alike.

An unhappy relationship

Yet thus far, EMU has not lived up to its promise. On the contrary, in 1999 there were an unprecedented number of trade disputes, which have rapidly degenerated into unilateral actions and megaphone diplomacy from both sides. Although these trade rows are not directly linked to the introduction of the euro, there is a distinct risk that they will negatively affect broader US attitudes to EMU. Likewise, the failure to launch a Millennium Round of trade liberalisation at the WTO ministerial meeting in Seattle in December 1999 may heighten transatlantic tensions in areas other than trade. A broader analysis of transatlantic trade relations is therefore required.

Transatlantic trade disputes are, of course, nothing new. They should also be viewed in the context of an otherwise highly successful $1,400 billion relationship (figures for 1998, counting two-way trade and investment).[21] This is by far the largest trade and investment relationship in the world. Nonetheless, confidence in an open, multilateral, rule-based trade framework managed by the WTO has been severely damaged in recent years.

[21] US Department of Commerce, Bureau of Economic Analysis

One hit came in 1996 when the US Congress passed two pieces of legislation, directed against Cuba, Iran and Libya, that contained extra-territorial provisions. In a crude attempt to coerce the Europeans into accepting and implementing US trade sanctions against 'rogue states', the Helms-Burton and D'Amato laws enabled the US authorities to take punitive actions against European companies for trading activities that were perfectly legal. These clauses infuriated the EU, which decided to mount a challenge in the WTO. When President Clinton, who had signed both laws, realised they would be struck down in the WTO, an uneasy compromise was worked out. Both laws remain on the statute book, but the US administration waives the application of the extra-territorial sanctions every year.

Trade relations deteriorated sharply in the first half of 1999, when a number of—sometimes very old—disputes rapidly escalated, producing a vicious circle of threatened sanctions and retaliations. In rapid succession, the EU and the US clashed on Caribbean banana imports, US hormone-injected beef and data-protection standards, to name just three of many issues. Common to all these disputes was the US claim that the contested EU measures were designed to protect European markets; while the Europeans countered that they were all about protecting consumers or vulnerable societies. In fact, both sides' behaviour revealed unhealthy doses of mixed motives and short-term politicking.

Trade disputes may not be new, but their nature is changing. Increasingly, their origins lie in health, environment and safety regulations. Seemingly arcane or technical regulatory differences often reflect far deeper cultural divisions between Europeans and Americans: in the trust they place in regulatory agencies, and the reliability and independence of their scientific advice; and in the kinds of trade-offs they are prepared to make between commercial interests and environmental or social protection. As these issues become more hotly contested, public attitudes in the US and Europe are drifting further apart.

To this tense atmosphere has been added the divisive issue of the growing US trade deficit. Consider, for instance, the remarks made by Edwin Truman, US Assistant Secretary for International Affairs, in April 1999. After noting that the deficit had increased by almost $100 billion between 1996 and 1998, he criticised 'Europe's reliance on export-led growth', which had contributed 'an additional $5 billion to its external surplus over the same period.' Despite the corresponding figure for Japan being $55 billion, the Europeans were singled out and told to 'promote domestic demand, investment and structural reform.' Whether there was anything the US could contribute, Truman did not say. Driving home his message, he added that it was '…disconcerting that many of Europe's most persistent and troubling problems are—to borrow a term from medicine—iatrogenic, physician-induced…Europe has relied too much and too long on policies that to some extent have aggravated the very problems they were meant to address.'[22]

[22] *'The single currency and Europe's role in the world economy', speech to the World Affairs Council, 6 April 1999*

When the euro fell against the dollar in 1999, it made a bad situation worse. The US trade deficit soared further, bringing it to a monthly record high in October 1999 of $25 billion. On current trends the annual deficit could well exceed $325 billion in 1999, double the record of $161 billion in 1998.

Thus the trade agenda has become a political hot potato. Protectionist forces in Congress have scored easy hits, adding to the already considerable pressure on the US administration to provide 'relief measures' for groups ranging from farmers to steel producers. The mood on trade, both in Washington and across the US, has become defensive, if not hostile. The Europeans are charged with erecting a 'fortress Europe', with EMU as the prime building block. That the accusation is unjustified does not matter: the perception is enough to produce real consequences.

Analysts and business leaders alike have criticised the Clinton administration for its 'wariness of free-trade initiatives that promise no instant domestic political pay-offs,' as Jeffrey Schott of the Institute for International Economics in Washington has put it. He comments that the US is 'sitting back and saying to other countries: 'What are you going to do for us?' But it is unwilling to offer anything that would get them to accept its demands.'

And it may yet get worse. It is quite likely, for instance, that protectionist sentiments in Congress will rise as the 2000 presidential race draws near—especially if the US economy slows and unemployment rises. Even Alan Greenspan, not prone to alarmist statements, has warned against an encroaching protectionism in the US and has criticised the adversarial style of bilateral trade relations.

There are, thankfully, three countervailing pressures to set against the deteriorating transatlantic trade relationship.

First, a spate of transatlantic mergers—such as Daimler-Benz-Chrysler, BP-Amoco and Deutsche Bank-Bankers Trust—points to a deeper integration of the North American and European markets. They will also change attitudes to trade rules and disputes in a more fundamental way. Such transatlantic giants are unlikely to support either side. Instead, they have a real incentive to support free-traders on both sides and resist the siren songs of mercantilism.

Second, the appointment of Pascal Lamy as the new EU trade commissioner is a source of hope. The Americans will find that Lamy is a tough negotiator, but essentially pro-free trade and well-placed to sell a deal to those parts of French society that are sceptical of trade liberalisation.

Third, at the June 1999 biannual EU-US summit, leaders agreed to set up an early warning system with the laudable aim of preventing or resolving conflicts 'before they risk undermining the broader EU-US relationship'. This system is supposed to identify and trigger 'rapid consultations on policy, legislative and regulatory proposals by one side which threatened to create problems for the other'.

Welcome though this last initiative is, much of the effort to set up an early warning system will be channelled through existing institutions. Yet many of the most serious issues, such as deep divisions over genetically modified (GM) organisms in food, are not readily susceptible to traditional trade remedies. If the early warning system is to work, it must involve not just the seasoned trade diplomats, but also the key players in the respective legislatures (the European Parliament and the US Congress) where many of the problems originate. In future, both sides should ensure that new legislative proposals are compatible with WTO rules.

On one issue, even these efforts may prove insufficient. In recent years, as the American commentator Jim Hoagland has put it, 'Food has become a new transatlantic battleground on which science, theology, superstition and trust in government are clashing forces.'

A resolution of this battle urgently requires a common scientific base. At the moment, Americans and Europeans both reject the other side's scientific work as politically or commercially biased. It would be far better if the EU and US could jointly conduct the necessary scientific experiments to evaluate the effects of GM products. The regulatory bodies could then agree to evaluate *in parallel* the outcome of these joint studies.

To prepare for this joint approach, it would help if the Europeans accepted the suggestion of the Commission President Romano Prodi to establish a European Food Agency (EFA), styled loosely on the American Food and Drug Administration. This would immediately provide the US agencies with a credible and effective interlocutor. An EFA would have to be truly independent to win back European consumer confidence; the lack of public trust in regulatory agencies has been extremely damaging. (It is a mirror image of the situation in the US, where confidence in government is very low, but in health and safety agencies high.) This approach should be combined with labelling agreements, to enable consumers to exercise choice.

Picking up the pieces after Seattle

Supporters of a multilateral, rule-based, trade framework had put their hopes for decisive progress on plans for a Millennium Round of trade liberalisation. This round of global trade talks was supposed to have been launched in December 1999 at the WTO ministerial meeting in Seattle. But sharp and persistent disagreements between the EU, the US and developing countries about the agenda for a new trade round proved ultimately fatal. The meeting, which took place against the backdrop of sometimes violent demonstrations by opponents of further trade liberalisation, ended in stalemate and acrimony. Although attempts will be made to re-start the trade round during the coming year, few expect any serious results before the US election. The Seattle fiasco represents a major setback to the WTO's authority as well as to the broader cause of trade liberalisation. The task ahead is to rescue something positive from the ruin.

The EU carries a special responsibility for developing a post-Seattle strategy, given America's involvement in presidential elections. In an attempt to rebuild some momentum for the talks, the EU should flesh out its commitment to negotiate a far-reaching compromise on agricultural subsidies. The Europeans will stand a greater chance of securing US agreement on a 'comprehensive' agenda for further trade talks, encompassing global rules on anti-dumping, competition and investment, if they demonstrate first that their efforts at agricultural reform are substantial and genuine.

The EU also needs to remove the suspicion that surrounds its broader commitment to the WTO process. It has twice failed to comply with decisions of the WTO's arbitration system, once in relation to Caribbean banana producers, and once on hormone-injected beef. Regardless of the common-sense desire for consumer protection, the bottom line is that the EU's import regime clashes with WTO rules. Instead of accepting the punitive tariffs levied by the US like a badge of defiance, the EU should urgently make the necessary internal reforms so that it is WTO-compliant. It would be disastrous for Europe if the US became disillusioned with the WTO.

The US for its part should urgently rethink its minimalist approach to further trade liberalisation talks. Its insistence on keeping environmental rules and labour standards on the agenda, but anti-dumping, competition and investment rules off, was a product of US domestic, even party political concerns.

The failure of Seattle should perhaps not come as a real surprise, given the prevailing political climate in Washington. During the past few years the Clinton administration has been distinctly reluctant to exercise leadership in countering the protectionist camp. In Seattle, the US delegation talked a lot about the virtue of trade liberalisation but, fearing a political backlash, failed to make any concession that could have smoothed the path to an overall agreement.

More worrying are the omens for future US attitudes to trade liberalisation. Despite the exceedingly strong performance of the US economy, an unholy alliance has sprung up, joining the left of the Democratic Party and the trade union movement with the Republican right. How strong will that alliance become if the US economy slows down? Congress is due to review America's membership of the WTO in March 2000. Bolstered by their apparent successes, the protectionist and the unilateralist camps could join forces in a vote on withdrawal. While all four leading presidential candidates—Al Gore and Bill Bradley for the Democrats, and George W Bush and John McCain for the Republicans—have declared their support in principle for free trade, the record of the Clinton administration shows that there can be a sizeable gap between rhetoric and reality.

In summary

EMU could and should produce an era of deeper and more rewarding trade and investment relations between the US and Europe. Yet so far, strife and recriminations have had the upper hand. American policy-makers insist that the US cannot remain the world's 'importer of last resort' and that Europe should pull its economic weight. These claims are often combined with aggressive attacks on 'sclerotic' European economic systems, especially those of France and Germany. EMU itself is sometimes fingered as a tool for protecting these inefficiencies, rather than as a force for promoting reform and innovation.

An easing of the tension will come about with the cyclical recovery in Euroland. This recovery is now under way and will drive the euro up and the US trade deficit down. But the underlying hostilities will be harder to resolve. It will require sustained political commitment and statecraft by both sides to ensure that EMU inaugurates a new and auspicious era for transatlantic trade relations.

5 The intangible link: EMU and EU foreign policy

For many, EMU has always been about more than just money. The French, in particular, have seen the euro as an instrument of European self-assertion. For most French politicians EMU has always had a geostrategic rationale. Never convinced of the British view of politics as the art of adapting pragmatically to external change, the French maintain that EMU is a tool for change, not merely an answer to it. For Hubert Védrine, the French foreign minister, the arrival of the euro has 'a rebalancing virtue' in the global game dominated by the dollar. French politicians habitually describe the euro as the manifestation of Europe's 'common destiny'; and EMU is the means to fulfil that old dream of '*l'Europe puissance*' (Europe as a power).

The French are not alone in their wider view of EMU. Italian politicians and commentators also frequently stress that EMU will not be just a catalyst for political integration but that it will also increase the number of foreign-policy options available to the Europeans. Even such a down-to-earth politician as the Dutch prime minister, Wim Kok, has taken this view: 'EMU can develop into a cornerstone for Europe's further political integration—forming the foundation for Europe's increased power in the world.' And the former German chancellor Helmut Kohl has frequently defended EMU for its expected impact on Europe's global influence.

These political aspirations find ready resonance in academia. Academic analysts have long agreed that a currency with a global reach is a source of political power as well as economic benefits. The US academic Diane Kunz writes: 'Geo-political power depends on financial power, each of which supports the other…the death of the dollar order will drastically increase the price of the American dream while simultaneously shattering American global influence.'[23]

[23] *'The fall of the dollar order: the world the United States is losing', Foreign Affairs, July-August 1995*

She may overstate her case, but few dispute her conclusion. The US economist Benjamin Cohen makes the same point in less cataclysmic terms: 'At home, the country should be better insulated from outside influence or coercion in formulating and implementing policy. Abroad, it should be better able to pursue foreign-policy objectives without constraints as well as exercise a degree of influence or coercion over others.'[24]

Some US policy-makers have also noted the potential for EMU to enhance Europe's leverage on the global scene. But if the people who are paid to think about money have acknowledged it, Washington's foreign-policy strategists have, by contrast, maintained a studied silence. It was Larry Summers, not Madeleine Albright, who argued that: 'With a successful move to EMU, and the integrating forces that EMU could unleash, many Europeans look forward to the day when Europe will fully punch its weight in international policy-making, not merely on economic issues but in the broader global arena.'[25]

American conservatives broadly share this assessment, while deploring its consequences. They argue that 'a major motivation behind the euro was to increase European independence from the United States and to improve prospects for a more independent global political role for Europe.'[26]

But what does this 'enhanced global role' add up to? Apart from the obvious psychological effect of the euro boosting European self-confidence, how might EMU affect the EU's external policy and its Common Foreign and Security Policy (CFSP) in particular?

The principal reason to expect EMU to affect EU external relations is that the nature of politics and power is changing. In part this is a result of economic issues gaining in importance as states cede power to the markets. But it is also because states rely increasingly on financial instruments and their influence in the world's international financial institutions (IFIs) to further their political goals that there has been an "economisation" of foreign policy. A good recent example is the use of heavy financial pressure on the Indonesian government in September

[24] *'The political economy of currency regions', in H Milner (ed), 'The political economy of regionalism', Columbia University Press, New York, 1997*

[25] *Larry Summers, 'Transatlantic implications of the euro', 6 November 1998*

[26] *Kim Holmes, 'US-European strategic bargains: old and new', Heritage Foundation lecture, 13 November 1998*

1999, including the threat of withdrawal of IMF support, to secure Indonesian assent for a multinational peace-keeping force in East Timor.

A gradual convergence among EMU participants of their external financial and economic interests is likely. As they share not only an aspiration but also a currency, euro-zone members have a major collective interest in the euro's exchange rate. From this it follows that EMU participants will have a heightened sensitivity to each other's foreign and security policy disputes.

Potential and actual foreign policy disputes will increasingly affect all EMU states, if they threaten a capital flight from the euro. A very modest example of this link was the temporarily depressive effect of the war in Kosovo on the euro's exchange rate. But it could go further. One senior British official has suggested that before EMU, Russia would have had to have invaded or blockaded Finland before the economic impact of a bilateral dispute went beyond the local. But now that Finland is part of EMU, even the movement of a few Russian divisions to the Finnish border could conceivably precipitate a flight from the euro. While this scenario might be extreme, the general point is that economic sanctions against one EMU state would affect others more directly. Financial markets would now assess the consequences of sanctions for the entire euro-area.

One implication of this is that in future crises, economic self-interest would trigger support for another euro-zone member involved in a foreign-policy dispute at an earlier point than in the past. This should increase intra-EMU solidarity. But it could also mean member-states applying pressure to curb the more extreme idiosyncrasies of a member's foreign-policy stance.

Prior to EMU's launch, commentators in both the US and Europe voiced concern that the single currency could unleash important centrifugal forces in foreign policy. Countries caught in a single monetary straitjacket might seek, by way of compensation, to assert their national identity and sovereignty on the international stage. This has not happened. Instead, EMU, and more strongly yet, the war in Kosovo, seem to have convinced most Europeans that they have more interests and values in common than they previously realised.

However, while EMU will influence the EU's CFSP, its effect should not be exaggerated. One such overstatement has come from the former British foreign secretary David Owen, who has expressed his fears that the EU's CFSP will be very different from British foreign policy over the last 1,000 years. 'Would a Britain operating within a single currency,' he asks, 'feel as free to support the United States when the rest of Europe did not? Would we have been able to have given the consistent support that we have given to American policy from the moment Iraq invaded Kuwait in 1990 to the present day?'[27] Lest the importance of this issue be lost, Owen stresses how 'the stance of various members of the EU has been neither coherent, consistent nor courageous'—apparently in contrast to the superior British position.

[27] *David Owen, 'Yes to Europe, no to federalism', The Economist, 24 January 1998*

But unless and until the EU moves substantially towards a single as opposed to a common foreign and security policy, Owen's fears are misplaced. For the foreseeable future the CFSP will develop in tandem with national foreign policies. Consequently no member-state will be compelled to amend its foreign-policy stance on highly salient matters. This is as true for neutral Austria as it is for Greece, with its pro-Serbian sympathies, or the UK, with its pro-American inclinations.

Nonetheless, co-operation among EMU participants has stepped up, noticeably in IFIs such as the IMF, the World Bank and the OECD—and it is to be encouraged. Non-Europeans are increasingly looking at Euroland as a whole and expecting a coherent policy from it. EMU is therefore a catalyst for further developments, such as a move towards a truly comprehensive and well co-ordinated EU external policy. If the trend to greater co-ordination of Euroland positions in the IFIs continues, then the euro should make it easier to ensure that the EU's political and economic external objectives are coherent. For it should be easier to co-ordinate one international economic policy with one foreign and security policy.

But greater policy coherence is not guaranteed. Clashes between the foreign ministers' General Affairs Council, Ecofin and the Development Council (the development ministers' meeting) about the size and prioritisation of financial aid will probably continue. Differences of political priority will continue to hamper efforts to construct an effective foreign-policy stance. For example, development ministers are likely to plead for continued financial support to African countries, while foreign ministers will argue for more financial assistance to Balkan countries. Similarly, finance ministers will stress the need for loans to depend upon economic reforms, while foreign ministers will tend to be more lenient, fearing that stringent conditions could provoke political instability.

The logical forum in which to determine EU priorities and ensure policy coherence is the European Council, made up of the EU heads of state and government. But the Council generally meets only four times a year. It would take more frequent meetings to guarantee the smooth co-ordination of external economic policy and the other dimensions of foreign policy. One method would be for the foreign ministers occasionally to join the finance ministers when the euro-11 meets, turning it into a 'super euro-11'.

This forum would fall short of the proposal of President Jacques Chirac to hold euro-11 meetings at the level of heads of government and state, but it would raise Euroland's international profile and consolidate informal external-policy co-ordination. This broader forum might also—depending on the issue—be best placed to formulate a mandate for the putative Mr Euroland, while ensuring that he worked closely with Mr CFSP (who might participate in some meetings).

The EMU 'outs' would no doubt to object that such meetings reinforced a harmful two-tier structure within the Union. True enough. But Britain, Sweden and Denmark chose not to take part in EMU, and the rationale behind the establishment of the euro-11 was to allow the other members to co-ordinate their policies on euro-relevant matters. Any proposals to increase the level of consultation among the euro-11 would merit serious consideration if one or more countries decided to remain outside EMU for a prolonged period. The prospect of being left out of this enhanced co-operation could encourage the EMU 'outs' to reconsider their stance.

Yet even if all four of the current EMU-outs were to join, it would not solve the problem of 'ins' and 'outs'. For EU enlargement will bring in new members who are likely to remain outside EMU during the first years of their membership. So, the need for euro-11 (or whatever it is called) to act as the key body for managing EMU issues will remain.

Euroland cannot, of course, determine the Union's CFSP in the absence of the EMU 'outs'. But it is perfectly legitimate for EMU members to discuss matters of external policy-making that necessarily impact on broader foreign-policy issues, in the same way that a particular country's finance and foreign ministries will hammer out a joint approach to, say, rescue packages for Russia. And foreign ministers will have to be involved in the finance ministers' talks when the subject is likely to affect the CFSP.

Defence

EMU may also exert an indirect impact on defence policy. The connections between these apparently unrelated dossiers can emerge in surprising ways. It is arguable, for instance, that the imminent launch of EMU prompted Tony Blair to initiate the Franco-British St Malo defence initiative of December 1998. Ever since coming to power, Blair has wanted a leadership role in the EU—difficult to achieve with Britain outside both the euro-zone and the Schengen rules on free movement of people. Defence, however, is a British strength, and Blair rightly presumed that Britain could take a lead in promoting EU defence co-operation.

EMU and defence policy connect in other ways, too. The cuts in public spending that flowed from the Maastricht convergence criteria led to governments trimming their national defence budgets, a point that was not lost in Washington. It may in part explain EMU's relative unpopularity among US security analysts.

Taking this argument a step further, some analysts, including Jonathan Eyal of the Royal United Services Institute, worry that EMU could jeopardise the US troop presence in Western Europe 'because many of the expenses for these troops are paid in the local currency'.[28] Traditionally this was not a problem, as the strength of one currency was often offset by the weakness of another. 'This will no longer be the case with the euro: a rise in its value could trigger a dramatic increase in the costs of basing American soldiers on the Continent.'

[28] *Jonathan Eyal, 'All is fair in competition and war', New Statesman, 17 May 1999*

These fears are exaggerated. Eyal concedes that a ten per cent shift in the dollar/euro rate would cost the Pentagon merely $1 billion—a manageable sum. And he neglects to mention that the number of US troops based in Europe has dropped dramatically from more than 350,000 during the Cold War to less than 100,000. He also fails to consider that modern financial instruments provide hedging possibilities for precisely these fluctuations. Still, such hedging operations would carry costs. And the cumulative effects of currency gyrations on Washington's internal politics could be considerable. As Eyal correctly points out, the US Congress is likely to want to spend the gains from a temporary weakness of the euro, 'while refusing to fund the shortfalls when the dollar is weak.' If so, then pressures to reduce the US troop presence in Europe could mount.

Eyal is on stronger ground when he expresses concern about the broader effects of EMU on transatlantic security links. Like many security experts, he is worried about the potentially negative consequences for the security relationship of greater European self-assertion and financial clout. The underlying argument is that the Europeans have for decades relied on American generosity in the field of defence in exchange for European acceptance of US 'leadership' across all dimensions of foreign policy. As Eyal says: 'It is frivolous to assume that US legislators would accept their diminished role in world markets while at the same time providing most of the military assets for European defence at subsidised prices.'

Charles Kupchan, of the Council on Foreign Relations, has echoed this sentiment in a different way. 'If Europe starts to throw its weight around on monetary issues or in trade, you will have to pay more on defence.' American commentators are thus making explicit links between EMU and security co-operation within NATO.

On the European side these sentiments are shared by German and Dutch officials who worry that transatlantic monetary rivalry could easily spill over and damage the security relationship. Ever fearful of the politicisation of monetary policy, they warn against the dangers of using the euro as a tool, as some French and other European politicians want, to distance Europe from the US.

Without doubt, the euro will be a real test for US-European relations. On balance it seems unlikely that the old Cold War pattern of competition in trade and partnership in military affairs is sustainable: EMU will require a new form of management which accepts the new policy connections and transcends the traditional compartmentalising of transatlantic relations. Both sides of the Atlantic have preferred to side-step these thorny issues. Yet the emerging links between EMU and other policy areas—once they have been recognised—may help to create a new system, in some ways akin to the EU itself, in which negotiations are concluded through comprehensive package deals.

UK membership of EMU

It is a commonly held view in the US that European monetary union will not be a really serious proposition until the UK joins. The argument runs that only then will EMU gain the critical mass which allows the euro to become a global currency and Europe to play a role commensurate with its economic and financial weight. And only then, therefore, will the many dynamics discussed above begin to reshape international relations.

This view is grossly exaggerated. Although British membership would certainly increase the scope and importance of EMU's external effects, it is not a critical factor. Indeed, some effects are already apparent: witness the explosion of euro-denominated corporate bonds, or the stepping-up of euro-11 consultations on a single position in the IFIs. Other consequences, such as portfolio diversification or the consolidation of European quotas in the IMF, are likely to occur with or without UK participation.

Senior British officials at the Treasury and Foreign Office do not hide their belief that EMU's external implications would probably be better managed if and when Britain joined. They point out that Britain and its Chancellor, Gordon Brown, have repeatedly demonstrated their genuinely global outlook. And Britain's strong Atlanticist credentials qualify it better than most to handle the fissures that EMU could create. But no one should be deluded into believing that the rest of the EU is waiting patiently while Britain makes up its mind.

Britain has much to offer its European partners. When it comes to EMU's external implications, British assets include policy expertise plus economic and financial clout. But time is working against Britain. There are signs of impatience in continental political circles, with increasing talk of a two-speed EU and of the 'price' Britain should pay to join, coupled with a growing indifference among those previously sympathetic to Britain's predicament. The assumption among the euro-zone participants is still that Britain will join before 2004. But British officials concede that if that timescale looks likely to slip, Britain may end up paying a high political price in being relegated to the periphery of EU affairs. Britain will, of course, remain a full member of the EU, but it will not be at the centre of the debate, let alone exercising a 'leadership role'.

6 Sharper rivalry or renewed partnership?

Like any ambitious political project, EMU is fraught with uncertainty, complexity and paradoxes. This should not deter us from trying to make sense of the big picture; in this case, whether on balance the euro is a help or a hindrance to effective transatlantic co-operation. One way of shedding light on the question is to consider it from the vantage point of US politics.

The first thing to note is that few American policy-makers have thought about EMU at all. European diplomats will readily vent their frustration at the lack of interest from their US colleagues, never mind Congress. Some detect a familiar pattern in US reactions to EU affairs in general: 'First inattention, then assertions that it cannot succeed, then warnings of danger once success appears imminent.'[29] One sympathetic analyst in Washington paraphrased the evolution of US attitudes thus: before January 1998 people said, 'it will never happen'. By the summer of 1998 it had become, 'this will never work'. Only from January 1999 onwards did people ask: 'Is this good for the US?'

[29] *William Wallace and Jan Zielonka, 'Misunderstanding Europe', Foreign Affairs, November-December 1998*

Moreover, it is striking that the foreign-policy strategists and security people are still largely absent from the debate, preferring to ignore EMU altogether. These are the old Cold War experts who now think about Kosovo, rogue states, 'bio-terrorism' and nuclear non-proliferation. Consequently the debate, such as it is, has been dominated, and its terms set, by the US Treasury.

Treasury thinking consists of two tendencies. On the one hand there is considerable scepticism as to whether EMU can work smoothly, given Europe's limited labour mobility and the absence of large-scale financial transfers to moderate regional inequalities. This is the familiar mantra of the neo-liberal school. The catchphrase one hears at the US Treasury is that 'the jury is still out on whether EMU will be successful'. On the other hand there is a group which argues that what is good for Europe is also good for the US. While true as a generality, this sentiment is pretty banal. As we have seen, EMU raises important policy challenges. Moreover, it is doubtful whether expressions of this attitude are 100 per cent sincere.

For decades the US position on European integration has suffered from a serious internal inconsistency. This is not cheap anti-American rhetoric: many Americans themselves recognise that while US governments have supported the idea of European integration from the beginning, they have reverted to a policy of divide and rule when expedient.

In addition, US leaders have often voiced their frustrations at the slow pace of the integration process and the unwieldy institutional arrangements of Brussels. 'Why can't they simply become like us?' is the underlying exhortation. Were a single European voice to arise, however, uttering views inimical to Washington, the US reaction would probably blend surprise with indignant disapproval. US attitudes towards European economic integration have for some time veered between proclamations of Europe's decline to complaints of European threats to American interests.

EMU will not and cannot change this underlying ambivalence. We are bound to continue to hear that EMU cannot work, that it is a distraction (from enlargement or from structural reform), that it is a threat to US interests and 'leadership'; and also that it is a positive if belated step towards a European unification which will strengthen the Alliance.

Dispelling the myth of EMU's anti-American origins

Peter Rodman, of the Nixon Center in Washington DC, stipulates that 'it is a commonplace that the EMU…reflects a new stage in the desire to build the EU into an economic and financial equal to the US.'[30] Its success will mean 'freeing Europe from disadvantageous subordination to the dollar and subjecting the US, finally, to some of the same financial discipline which it hitherto escaped.' On that point Europeans and Americans can agree.

[30] Peter Rodman, 'Drifting Apart? Trends in US-European relations', the Nixon Center, June 1999

Yet Rodman makes another, more contentious point, grounded in a long tradition of conservative American attitudes towards European integration.

He claims that European policies in general and EMU in particular have been conceived, in part, as anti-American moves. In common with many conservative US analysts, he highlights the emerging threat of a new hegemony, with EMU being merely the latest tool that Europeans deploy to distance themselves from the US. He deplores the self-indulgent 'infantile disorder' of anti-Americanism and warns of the dangers it holds for Atlantic unity. The US commentator William Pfaff has echoed this analysis: 'It is interest, not volition, that will produce a deepening rivalry between Europe and the United States during the decades to come, with competitive searches for economic and political influence in the rest of the world.'[31]

31 William Pfaff, 'The coming clash of Europe with America', World Policy Journal, winter 1998-99

This view of EMU being actually or potentially anti-American is prevalent in the States, but largely untrue. Most Europeans—though many French people take a different view—do not conceive of EMU as an anti-American project, nor even one that aims to reduce the asymmetrical advantages the US has enjoyed. However, such a reduction may be the unintended by-product of a project whose origins lay in intra-European developments.

First among these was the aim not just to 'complete the single market', as Eurocrats often stress, but also to tackle the difficulty of combining the exchange rate mechanism (ERM—a system of fixed but adjustable currency pegs) with a free flow of capital. In 1987 Tommaso Padoa-Schioppa, a leading Italian economist, had predicted that this combination would lead to damaging speculative attacks on the weaker currencies in the system. In a seminal report that convinced the then Commission President, Jacques Delors, Padoa-Schioppa argued that the only way for the ERM to survive the liberalisation of capital flows was to move to full monetary union. The Delors report published in April 1989 set out how monetary union could be achieved if the member-states decided they wanted to go down that route. The next step on the path to EMU came with the Maastricht treaty, which contained the substance of the Delors report and added a concrete timetable and the 'convergence criteria' under which countries would qualify for EMU membership. Subsequent attacks on the Italian lira, the British pound and the French franc in 1992 and 1993 made it clear that Padoa-Schioppa had been right and that EMU was necessary.

Europeans had been talking about the merits of a monetary union since the late 1960s. But despite a steady stream of reports and blueprints, the project had lacked political commitment and therefore remained in the realm of academic aspirations. It was something people referred to at seminars, but was quite distinct from practical politics.

It became practical politics in November 1989. With the fall of the Berlin Wall, the imagination of the French political class was suddenly gripped by the prospect of a dominant, united Germany moving away from its commitment to the West and the European Community. True to the prevalent maxim of French foreign policy—that whatever the problem, the answer is always 'Europe'—President François Mitterrand offered the German Chancellor Helmut Kohl a *quid pro quo*. He traded his assent to German unification in return for a West German accord to fix a date for an inter-governmental conference to discuss monetary union. In that crucial phase, the US—or rather, the supposed need to challenge and check American pre-eminence—simply did not feature in the calculations of Europe's leaders.

Rather than turn a fiction into a self-fulfilling prophecy, the US should avoid paranoia and welcome Europe as a truly equal partner. On grand strategic issues the Europeans are closer to the US, and have more diplomatic and economic clout to offer, than any other country or regional bloc. As William Wallace and Jan Zielonka say: 'The Europeans—with all their evident flaws and weaknesses—are the US's only dependable partners, sharing America's values and burdens.'[32]

[32] *Wallace and Zielonka, op cit, 1998*

A more equal partnership would mean less boasting from the American side about alleged or real US successes, and less US lecturing on Europe's actual or imagined defects, such as this classic from the US journalist Mortimer Zuckerman: 'France had the 17th century, Britain the 19th and America the 20th. It will also have the 21st.'[33] This self-satisfaction sits uneasily alongside the incessant American hectoring that it can no longer bear the economic burden of global responsibilities and that 'Europe should pay more'.

[33] *Mortimer Zuckerman, 'A second American century', Foreign Affairs, May-June 1998*

Those commentators and politicians who expect or hope that EMU will finally determine whether the Europeans and Americans are 'really' partners or rivals are in for a disappointment. EMU will not end the ambiguous blend of co-operation and competition that characterises US-

European relations. Indeed, it is probable that the establishment of a new transatlantic bargain will be preceded by a bumpy ride. But EMU should overall prove a help, not a hindrance, to transatlantic co-operation, for at least three reasons.

First, by promoting the creation of a European capital market and by boosting the processes of innovation and reform, the euro will strengthen the European economy. A stronger European economy ultimately means a larger market for US exports and investments.

Second, by empowering Euroland, EMU will make the EU a potentially more influential global actor. For Americans who want to share the burden of managing the global economy, Euroland is their most logical ally.

Third, by removing the need for 'dollar-envy', EMU is eliminating an underlying cause of European anti-US resentment. The euro will thus help to put US-European relations on to a more balanced, healthier and sustainable basis.

The European viewpoint

It has been argued throughout this pamphlet that EMU is an enabling force in transatlantic relations. But in order to predict how the Europeans will exercise their increased capacity to act, we need to consider not just their capabilities but also their intentions.

The uncomfortable truth is that, when it comes to the external implications of the euro, Europe lacks a clear consensus. The mechanisms for achieving an exchange-rate policy, as we have seen in Chapter 3, rely on a precarious compromise. Some EMU members, such as Ireland, Belgium and Finland, would prefer EMU not to have any geo-economic or geo-political role. They see monetary union principally as the completion of the single market. Other countries welcome the prospect of a greater global role, among them France, Spain and Italy. Still other countries, such as Germany and the Netherlands, are not opposed to the idea of a global role, but worry that its pursuit could endanger EMU's internal stability or lead to undesirable conflicts with the Americans. In so far as there is no common understanding about what the external repercussions of EMU should be, the sceptics who emphasise European divisions do have a point.

It is likely that the existing combination of internal discord, domestic preoccupation and inexperience in financial diplomacy will persist for some time. Efforts to forge common positions within the IFIs will continue, but probably be ineffective. By the same token, EMU is setting in motion developments which will ultimately strengthen the hand of those who favour Euroland's active involvement in financial diplomacy. But it will take the drama of outside events, such as a serious financial crisis, to galvanise the Europeans into a more outward-looking and forward-leaning approach. Outside events have often been a catalyst for European integration to achieve new levels. Euroland will, most likely, have greatness thrust upon it.

At that point the Europeans will discover that greater influence breeds greater expectations, both at home and abroad. Rights and responsibilities, for example in dealing with a Russian collapse, are flip sides of the same coin. Coming to terms with the strategic implications of EMU could be as demanding for Europeans as for non-Europeans.

7 Summary of recommendations

This chapter summarises the specific measures and innovations that European governments and EU institutions need to implement in order to ensure that EMU is able to usher in an era of greater international co-operation.

But first, a more general point. Some Europeans are tempted to see the euro as the means to fulfil an old desire: the end of the EU as a pygmy of global power politics. There are, without doubt, some who see EMU as the opportunity for the EU to take on the status and attitude of a great power.

But this view is erroneous, and may lead to harmful consequences. EMU is undoubtedly in part about European self-assertion, and non-Europeans are bound to take the EU more seriously as a result. But it would be foolish for Europeans to attempt to exercise power in a blunt or arbitrary manner. They must avoid unilateralist temptations, and hold out for multilateral co-operation based on international norms.

The reason is straightforward: the EU's history and system of governance make it ill-suited to play power politics in the way that the US can and does. The EU is all about pluralism writ large. Admittedly this makes for slow decision-making and a curious dispersal of power that can have awkward consequences. But the benefits are that it avoids extremism and promotes predictability. This idiosyncrasy should be seen not as a weakness but as a quality that can be harnessed in pursuit of a grander objective.[34]

[34] *See Gilles Andréani's essay, 'Europe's uncertain identity', CER, London, 1999*

The EU is well placed to be the world's dependable actor. For the foreseeable future it is more likely to achieve success by deploying rewards and incentives than by issuing threats and punishments. Where it should be unyielding is in the promotion of international law and norms. Examples of the EU successfully following this approach include its stance in the negotiations at the UN's December 1997 Kyoto conference on climate change, and in those establishing the International Criminal Court in July 1998.

This is not a plea against ambition or in favour of abdicating responsibilities. Quite the contrary. But the EU must play to its strengths rather than chase possibly harmful chimeras. An enhanced role for the EU, based in part on the euro, could offer significant benefits to Europeans and non-Europeans alike. The contrast with American boasting about being the world's 'indispensable' nation will be satisfying. But the real prize will be the careful construction of an era of greater international co-operation.

On international financial and monetary issues:

★ to make European influence in global financial diplomacy fully reflect its economic and financial weight, EMU members should step up their efforts to create common positions in the major international financial institutions (IMF, World Bank and OECD). The outcomes of such consultations are currently too bland and reactive. As a result, the US dominates global financial negotiations more or less by default.

★ existing arrangements on the external representation of the euro-zone are unsatisfactory and need to be reshaped. Over time, the G-7 central bank governors of the EMU member states (France, Italy and Germany) should drop out of finance G-7 meetings. Only the ECB President need attend, to represent a single central bank perspective. All national central banks of the euro-zone should be involved in prior policy consultations, but their governors need not be physically present in the finance G-7.

★ to lend greater strength and credibility to European positions in financial and monetary affairs, a single *political* point of contact should be established. This person, perhaps called Mr Euroland, would speak officially for the euro-area in negotiations with other political authorities. He should be chosen unanimously by the euro-zone finance ministers and be based in the Council of Ministers' secretariat. He should be given a mandate to negotiate international monetary and financial agreements (formal and informal) which should then be quickly ratified (or rejected) by the euro-11. The euro-11 should gain the right to take decisions on the internal and external functioning of EMU.

- ★ in the IMF the Euroland constituencies should be consolidated around a single Euroland representative, whose voting weight should be at least equal to that of the American representative. (Voting weights would have to be further reconsidered to take account of EMU enlargement beyond the potential 15 current EU members.) The IMF should remain based in Washington, but the US should agree to restore the Fund's interim committee to its originally intended purpose: that of giving political leadership and direction to the IMF's activities. The new Euroland representative should expect to chair this committee.

- ★ national and European officials, including those at the ECB, should work together more closely with the private sector to create a seamless European capital market that can rival the US market in depth, breadth and liquidity. This will require further harmonisation of accountancy standards, listing rules and regulatory frameworks. Serious consideration should also be given to proposals to create a single European regulator along the lines of America's Securities and Exchange Commission, to end the existing complexity of 15 different national regulators.

- ★ to avoid excessive and harmful misalignments in the euro/dollar rate, the US and the Europeans should adopt reference ranges of 15 per cent around a central point of, say, €1=$1.12. US and European authorities would communicate to the markets that they considered swings exceeding these ranges to be unjustified by economic fundamentals. While the presumption would be in favour of corrective actions, policy-makers would retain discretion over policy adjustments and interventions. In doing so they would smother speculative movements and provide a boost to transatlantic trade and investment flows.

On trade policy:

- ★ as a matter of urgency the EU should bring its banana and beef import regimes into compliance with the rules of the World Trade Organisation. While domestic political concerns are important, the long-term viability of the WTO system should carry greater weight. Rule-based multilateralism is a goal worth making sacrifices for.

★ in order to shore up consumer confidence and provide an authoritative interlocutor for the Americans, the EU should enact the proposal of Romano Prodi, the Commission President, to create a European Food Agency.

★ the US administration should offer a more broad-based agenda for the Millennium Round of world trade talks, instead of the administration's apparent interest only in proposals that have an immediate political pay off. Moreover, the administration should provide greater leadership in reining-in protectionist tendencies in Congress, and in resisting sector-specific or even single-company lobbying.

Both sides should jointly:

★ expand the agreed early warning system for trade disputes beyond the existing format of regular meetings of trade diplomats. Legislators from both the European Parliament and the US Congress need to be included—not least because many of the recent trade fights have their origins in the legislative sphere;

★ agree on increased convergence of regulatory policies built on a common scientific base, in order to make progress in tackling the explosive disagreements about bio-safety. In addition, a compromise is needed on adequate labelling measures of GM products in order to give consumers in both the US and EU an opportunity to exercise choice;

★ concur that each other's legislation needs to be compliant with WTO rules ('proofing'), to prevent the escalation of conflicts. While WTO proofing is not an exact science, at present WTO obligations are generally ignored throughout both national and EU legislative processes.

On foreign relations and a recast transatlantic relationship:

More effective policy co-ordination is needed to ensure that Europe's economic, financial, political and security relations with the rest of the world are coherent and streamlined. The most important forum for achieving this co-ordination is the European Council. But it would also be beneficial for the euro-11 to hold joint meetings of both finance and foreign ministers. Mr CFSP could attend some of these meetings.

The creation of a genuinely balanced transatlantic partnership will require a reappraisal of the US attitude which assumes that its own role is to 'lead' in policy determination, while that of the Europeans is to be acquiescent and provide financial largesse (examples include Kosovo or the Middle East). Partnership cannot mean partnership only on American terms.

The Europeans for their part will need to take seriously the reality that with increased global influence comes greater responsibilities. This means making a greater effort to match rhetoric with deeds.

Finally, a more balanced relationship does not need grandiose new institutions or blueprints. The mechanisms for co-operation already exist, but they need to be made to work better. Both Americans and Europeans need to realise that they are, in a very real sense, condemned to partnership.