CHAPTER THREE

Domestic Sources of International Monetary Leadership

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Currency leaders enjoy various forms of influence and power. The "exorbitant privilege" of currency leaders, above all the ability to finance external deficits by issuing IOUs and thereby to delay adjustment, has in particular received great attention in the literature. But what produces currency leaders? What, in other words, are the sources of this central aspect of international monetary power? In the preceding chapter, Benjamin Cohen outlines the macrofoundations of international monetary power—that is, the general characteristics of states that allow them to delay payment of the continuing costs of adjustment or to deflect the transitional costs thereof. Cohen locates the principal sources of the Power to Deflect in states' fundamental economic characteristics, in particular in their relative economic size and openness. He goes on to identify the primary sources of the Power to Delay in states' overall liquidity position (the sum of their foreign reserves and access to international credit).

In this chapter, I build on this contribution while drawing attention to other elements of the literature on monetary policy. I do so in order to argue that there are two additional prerequisites of international monetary leadership, having to do with domestic policies and institutional arrangements. First, currency leadership requires a relatively conservative monetary policy from the leader that is credibly embedded in its domestic political and economic institutions. This credible policy framework helps to produce willing followership on the part of the key audience, private market agents, as well as other national monetary authorities. Second, currency leadership also depends on a related set of institutional arrangements that facilitate the emergence of highly developed financial markets. I dis-

I thank Eric Helleiner, Randy Henning, Jerry Cohen, Jonathan Kirschner, Scott Cooper, Bob Hancké, and various other participants at the Florence conference for their very helpful comments on an earlier draft. Special thanks are due to David Andrews for his detailed comments. None are responsible for any remaining errors.

cuss other prerequisites for monetary leadership also, but the main focus is upon these two.

Currency leadership is a form of monopoly power, and the leader may try to exploit this power to achieve particular ends. In the short run, an established leader may use this monopoly power to exert substantial influence over other states' policies, even if this attempt is seen as illegitimate by followers. For example, the United States was able to exploit its currency leadership position in the 1960s and 1970s, delaying the continuing costs of adjustment and deflecting the adjustment's transitional costs on to others. In the long run, however, the persistent exploitation of monopoly power may undermine the foundations of currency leadership itself. For example, excessively expansionary U.S. monetary policy in the late 1970s threatened to undermine the willingness of private market agents to continue to hold dollar assets, requiring a shift back to a more conservative and credible U.S. monetary policy after 1979. The British case in the early twentieth century also demonstrates that fundamental shifts in the leader's domestic institutional framework can result in a rapid erosion of the status of the lead currency, particularly when potential rival currencies exist. Hence, monetary leadership can only be sustained through the ongoing persuasion of market agents. A corollary of the argument is that international currency promotion is extraordinarily difficult and is an option available only to very few states.

The rest of this chapter is organized around three main questions. First, what is the nature of international monetary leadership? This section is mainly concerned with definitions and in situating the argument in relation to the existing literature on leadership and hegemony. Second, what is the nature of monetary followership for both other states and private sector actors? Third, what are the limits to monetary leadership, and, as regards the theme of this volume, to the power that monetary leaders enjoy? A final section concludes.

What Is Monetary Leadership?

Monetary power has long been associated with the role of dominant or hegemonic countries in the international political economy.[1] This idea has a longer heritage than so-called hegemonic stability theory, but it achieved its fullest expression in this theory from the mid-1970s. Charles Kindleberger himself, on which much of this literature draws, employs the term leadership rather than hegemony.[2] He argues that international monetary leaders, such as pre-1914 Britain and the post-1945 United

1. See, for example, Robert Gilpin, *US Power and the Multinational Corporation* (New York: Basic Books, 1975); *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987). For a critical review of this literature and its empirical claims, see Barry J. Eichengreen, "Hegemonic Stability Theories of the International Monetary System," in *Can Nations Agree? Issues in International Economic Cooperation,* ed. Richard N. Cooper, 255–98 (Washington D.C.: Brookings Institution, 1989); Andrew Walter, *World Power and World Money* (New York / London: Harvester Wheatsheaf, 1993).

2. Charles P. Kindleberger, *The World in Depression, 1929–1939* (London: Allen and Unwin, 1973); "International Public Goods without International Government," *American Economic Review* 71, no. 6 (1986): 1–13.

States, provided a collective good in the form of a common currency and a countercyclical monetary stabilization policy at the international level. As David Lake observes, collective goods or leadership theory is more applicable to international money than to trade, where, he argues, hegemonic coercion is more relevant.[3] Here, I follow Lake and Kindleberger in employing the term international monetary leadership rather than hegemony. Nevertheless, I argue that the foundations of such leadership can also create the preconditions for the exercise of coercive, exploitative hegemonic power.[4]

Most now accept that hegemonic stability theory erred in overlooking domestic factors, not least in the hegemon itself. However, leadership theory also typically ignores domestic factors, making it poorly equipped to explain the nature and sources of monetary leadership.[5] First, such models exclude private-sector actors, a key constituency among monetary followers that has received surprisingly little attention in the hegemony/leadership literature.[6] Second, such models omit the domestic political and institutional factors that are basic preconditions of monetary leadership.[7]

I explore both of these issues in the following section and argue that these aspects relate to an important element of *legitimacy* enjoyed by the leader that helps explain why followership can be largely voluntary in nature. Persuasion is more typical of monetary leadership than is explicit (hegemonic) coercion. Market agents, in particular, are difficult to coerce and must generally be persuaded of the advantages of using and holding the lead currency. However, the dividing line between persuasion and coercion, particularly of other states, is often difficult to draw in practice.

Despite some similarities, my argument differs in emphasis from that of John Ruggie[8] and John Ikenberry and Charles Kupchan,[9] who argue that authoritative leadership of the Weberian variety derives from normative convergence between the leader and its followers. Although some degree of intellectual and normative convergence was evident in the British and U.S. cases of international monetary leadership, I argue here that an element of divergence is essential to successful monetary leadership. A successful monetary leader needs, among other things, to be *more* conservative in its monetary policies and financial institutions than most other countries.

3. David A. Lake, "Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?" *International Studies Quarterly* 37, no. 4 (1993): 459–89, especially 460. On international leadership and trade, see Stephen D. Krasner, "State Power and the Structure of International Trade," *World Politics* 28 (1976): 317–47. On public goods approaches, see Duncan Snidal, "The Limits of Hegemonic Stability Theory," *International Organization* 39, no. 4 (1985): 579–614.

4. In developing a theory of international monetary leadership, I also fill a gap in my own earlier work *World Power and World Money,* 249–57), which argues that hegemonic stability theory cannot explain the historical cycle of international monetary stability and instability.

5. See, for example, Snidal, "Limits of Hegemonic Stability Theory."

6. Joanne S. Gowa, "Hegemons, IOs and Markets: The Case of the Substitution Account," *International Organization* 38, no. 4 (1984): 661–83, and Benjamin J. Cohen, *The Geography of Money* (Ithaca: Cornell University Press, 1998), are exceptions.

7. For a similar argument, see J. Lawrence Broz, "Origins of the Federal Reserve System: International Incentives and the Domestic Free Rider Problem," *International Organization* 53 (1999): 39–70.

8. John G. Ruggie, "International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36, no. 2 (1982): 379–415.

9. John G. Ikenberry and Charles A. Kupchan, "Socialization and Hegemonic Power," *International Organization* 44, no. 3 (1990): 283–315.

It is also necessary to distinguish between two aspects of international monetary leadership: currency leadership and liquidity leadership.[10] Currency leadership occurs when a national currency plays a dominant role as an anchor, vehicle, and investment currency for international transactions among actors, both public sector and private sector, in the world economy.[11] Liquidity leadership occurs when one or more countries provide short- and longer-term liquidity to the world economy in a stabilizing, countercyclical fashion. The consensus now differs from Kindleberger's original contention that there could be only "one stabilizer" in the area of liquidity provision.[12] Liquidity leadership tends to be provided collectively rather than singly, in contrast to currency leadership.[13] Given the primary focus of this volume on monetary rather than financial issues, and that currency leadership is logically prior to liquidity leadership, I focus here on currency leadership.[14]

Why Follow the Leader?

The literature has tried to explain currency followership in two main ways, which roughly correspond to rationalist and constructivist approaches. The first and most common approach focuses on the material incentives for followers that the leader directly or indirectly provides. The second focuses on the way in which followers, through a process of normative socialization, come to accept the leader's economic policy preferences as being in their own interest. I focus here on followership by other major states because once they decide to follow the leader, the remaining smaller countries have little choice.[15]

10. Charles P. Kindleberger sees both of these as important aspects of international monetary leadership, but places most emphasis on the second; see his *The World in Depression, 1929–1939* (London: Allen and Unwin, 1973); "International Public Goods without International Government." See also, Lake, "Leadership, Hegemony, and the International Economy," 462–63.

11. For an extensive treatment, see Benjamin J. Cohen, *The Future of Money* (Princeton: Princeton University Press, 2004).

12. Kindleberger, *World in Depression,* 305. There was no good theoretical foundation for this argument; see, for example, Russell Hardin, *Collective Action* (Baltimore: Johns Hopkins University Press, 1982); Snidal, "Limits of Hegemonic Stability Theory."

13. J. Lawrence Broz, "The Domestic Politics of International Monetary Order: The Gold Standard," in *Contested Social Orders and International Politics,* ed. D. Skidmore (Nashville: Vanderbilt University Press, 1997), 53–91; Eichengreen, "Hegemonic Stability Theories."

14. When follower countries hold a center country's liabilities as foreign exchange reserves, producing international currency leadership, they are also likely to favor liquidity provision in this currency. There can be reverse linkages between the two. As I argue later in this chapter, collective liquidity provision in the British case before 1914 and the U.S. case in the 1960s helped to maintain a single-currency leadership.

15. Cohen, *Future of Money,* distinguishes between tighter and looser forms of state followership, from "dollarization" to simple pegging to an anchor currency. Here, for simplicity, I focus on the latter because it is the most common form of followership by other major states. For a discussion of dollarization, see Eric Helleiner (chap. 4 in this volume).

Material Incentives

Standard leadership theory has not explored why states follow the leader. Indeed, this is a trivial question in a public goods framework because follower countries have no material incentive not to consume the public good. The nature of the exchange-rate system, the mode, degree of institutionalization and conditionality attached to international liquidity provision, and so on are all second-order questions for public goods theory.[16] However, these kinds of details matter considerably for followership in practice. Britain and the United States both provided currency leadership in their respective eras of preeminence, but the much greater role for key currencies in the post-1945 period produced a more highly skewed distribution of adjustment costs than under the pre-1914 gold standard.[17] Similarly, any government that has accepted conditions on borrowing from a major creditor country or through the International Monetary Fund (IMF) and World Bank can tell us that the details matter greatly.

Allied to public goods theory is the idea that the use of a single money, like the spread of English as a global language or eBay as an Internet auction platform, has positive network externalities: the more actors that use it, the greater the benefit to all users.[18] This has some important implications. First, it usefully emphasizes the benefits of a single international currency to *private*-sector agents, not other states. Indeed, it is typically private market agents, rather than public authorities in other states, that confer key currency status on a particular currency. Second, because money has some of the qualities of a natural monopoly, it suggests that monetary leadership may persist even when the original conditions producing it have changed. As with all monopolies, there exists an ever-present temptation for the monopolist to exploit its position. This potential for abuse helps to explain why most followers tend to diversify their currency portfolios somewhat rather than relying completely on a single international currency.[19]

Still left unanswered, however, is why a particular currency and country come to lead in the first place. There are two main kinds of material incentives to followers: those that derive from the fundamental economic characteristics of states relative to one another and those that derive from the perceived relative monetary advantages of domestic policies and institutions in the leading country itself.

In terms of international incentives, the size of a particular country, its importance in international trade, and its initial ability to run current-account surpluses provide incentives for other countries and private-sector agents to use its currency

16. Lake, "Leadership, Hegemony, and the International Economy," 484.

17. A gold-exchange standard, in contrast to a gold standard, allows key currency countries to delay adjustment and to deflect costs on to other countries.

18. Charles P. Kindleberger, "The Politics of International Money and World Language," *Princeton Essays in International Finance* 61 (1967); Paul De Grauwe, *International Money: Post-War Trends and Theories,* 2nd ed. (Oxford: Oxford University Press, 1996), 2.

19. See Cohen, *Geography of Money;* Peter Lindert, "Key Currencies and Gold, 1900–1913," *Princeton Essays in International Finance* 24 (August 1969).

in third-party transactions and to hold assets denominated in its currency.[20] A substantial export dependence on the leader's market may provide a powerful material incentive to follow the leader generally on economic policy matters. However, trade patterns are not the only factor in currency leadership. In the later stages of the British and U.S. leadership eras, other countries came to challenge their dominant international trading positions, but the challenge to their currency leadership role was in both cases much less severe. Hence, some countries are much more important in international trade than in international money, notably Germany before 1914 and Japan since the 1970s.

A similar incentive for currency followership is produced by the asymmetries of financial development in the world economy. The existence of relatively deep, stable, efficient, and open financial markets in one country will encourage both public- and private-sector agents to have confidence in transacting in and holding assets denominated in its currency. Of course, the role of London and New York in the respective currency leadership of Britain and the United States has long been recognized, and currency leadership contributed to their financial development. However, we still need to explain why these countries achieved relative financial development prior to their currency leadership.

Before turning to this, there is a third, noneconomic incentive for monetary followership. International security relationships may create supplementary incentives for followership by states (although not for private-sector agents, or at least not directly). Although security factors tend to receive attention mainly in the literature on hegemony and international trade,[21] U.S. currency leadership in the 1950s and 1960s cannot be understood without them. West Germany's commitment to the U.S. dollar was substantially reinforced by its dependence on the U.S. security umbrella. The Blessing letter of March 1967, in which the Bundesbank's president pledged not to convert Germany's dollar reserves into gold (as the disloyal French had been doing with their own dollar holdings), must be understood in this context. The Atlantic alliance subsequently became less of a constraining factor, as détente was consolidated and as German fears of the inflationary consequences of a pure dollar standard (from 1968) came to the fore.

Still, although security incentives for followership may help when economic incentives are weak or diminishing, they are unlikely to play a central role for long. Although it is difficult to imagine how a country could attain international monetary leadership without playing an important role in international trade, security incentives for followership may not be necessary. The British-led international gold standard before 1914 owed little to security alliances. Indeed, ad hoc central bank cooperation during this era seemed relatively insulated from the more fluid great-power alliances of the time. French and Russian financial assistance to the Bank of

20. Broz, "Origins of the Federal Reserve System," 48; Cohen, *Future of Money,* 11; Cohen (chap. 2 in this volume).

21. Joanne S. Gowa, *Allies, Adversaries and International Trade* (Princeton: Princeton University Press, 1994); Krasner, "State Power"; Lake, "Leadership, Hegemony, and the International Economy," 470–72.

England in the Barings crisis of 1890, despite their unresolved imperial rivalries with Britain, is indicative.[22] Like trade incentives, security incentives provide insufficient explanations of monetary leadership and followership.

In the absence of supportive domestic monetary policies and institutions, the economic factors already discussed are not sufficient to produce willing followers of potential monetary leaders. As Cohen notes, a viable lead currency must have a "proven track record of relatively low inflation and inflation variability."[23] But what assures market agents that such a track record will be reproduced in the future? There is now a good deal of literature, much of it stemming from the seminal article by Douglas North and Barry Weingast,[24] that focuses on the domestic institutional foundations of financial development. In this view, the founding of institutions of limited government in late-seventeenth-century Britain, by substantially reducing the likelihood of default against private-sector creditors, was a key step in the development of deep money and capital markets in London.[25] The implication of this argument is that in the modern world, international monetary leaders are likely to arise only under conditions of limited, constitutional government. A complementary theory is that financial development is a product of a society's legal institutions.[26] These authors find from cross-country evidence that English common law, with its bias in favor of creditor rights, is most conducive to financial-sector development and that the French civil law system is least conducive.[27] Although this legal origin theory has been subject to criticism, the point that financial development is favored by strong protection of creditor rights is less controversial.

For monetary followers—the willing users of another country's currency—it is not only the potential for outright default that matters but also the potential for partial default via inflation. The use of fiat money creates a potential for inflation, and a commitment to a low-inflation monetary policy is unlikely to be credible in the absence of institutional factors that constrain its use.[28] This could include the delegation of monetary policy to an independent central bank or the support of a dominant political constituency for conservative monetary policies.[29] Either way, private-sec-

22. Charles P. Kindleberger, *A Financial History of Western Europe* (London: Allen & Unwin, 1984), 282, claims that the Bank of England's refusal to accept the Prussian National Bank's offer of financial assistance in 1873 was driven by strategic or political sensitivities. This remains an underexplored aspect of international monetary cooperation and conflict.

23. Cohen, *Future of Money,* 10.

24. Douglass North and Barry Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *Journal of Economic History* 49, no. 4 (1989): 803–32.

25. For a further development and modification of this argument, see David Stasavage, *Public Debt and the Birth of the Democratic State: France and Great Britain, 1688–1789* (Cambridge, UK: Cambridge University Press, 2003).

26. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Law and Finance," *Journal of Political Economy* 106, no. 6 (1998): 1113–55.

27. The German and Scandinavian legal systems occupy an intermediate position.

28. Finn Kydland and Edward S. Prescott, "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy* 85, no. 3 (1977): 473–92.

29. On the former, see Kenneth Rogoff, "The Optimal Degree of Commitment to an Intermediate Monetary Target," *Quarterly Journal of Economics* 100, no. 4 (1985): 1169–89; on the latter, see Adam

tor agents must be assured that institutional mechanisms that assure policy consistency are in place. Britain's limited government and limited franchise helped to entrench the position of those in society who favored a relatively conservative or "hard" monetary policy, reinforced by the adoption of the gold standard in 1713. This conservative financial clique also dominated the Bank of England, a crucial institutional development that preceded the emergence of deep financial markets in Britain. As a result, the credibility of Britain's commitment to a conservative monetary policy, except during emergencies such as the Napoleonic Wars, was largely unquestioned until World War I.[30]

By extension, this argument might apply to the case of U.S. financial development, given the way in which its institutional framework famously decentralizes political power.[31] However, without a central bank until 1914, the decentralized political institutions of the United States and its much larger economy could not alone foster financial development.[32] Despite a very shaky start by the Federal Reserve, the design of the U.S. central banking constitution also served, if not always consistently, to put into place a monetary framework that offset political pressures for inflation.[33] It also helped to stabilize a previously volatile domestic financial sector and, in particular, to provide New York bankers with the short-term discount market they needed to assure liquidity for international holders of dollars, as the Bank of England had long done for London's financiers.[34] Of course, the disruptive effects of World War I also played an important role in accelerating the rise of New York relative to London.

In the early twentieth century, the domestic political and institutional framework that had facilitated Britain's adherence to the gold standard began to change.[35] This eventually proved disastrous for Britain's position, given the emergence of a serious challenge to its monetary leadership by the United States. In a series of related de-

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Posen, "Central Bank Independence and Disinflationary Credibility: A Missing Link?" *Oxford Economic Papers* 50, no. 3 (1998): 335–60.

30. Barry J. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992), chap. 2; Giulio M. Gallarotti, *The Anatomy of an International Monetary Regime: The Classical Gold Standard, 1880–1914* (New York: Oxford University Press, 1995).

31. See Kenneth A. Schultz and Barry R. Weingast, "The Democratic Advantage: Institutional Foundations of Financial Power in International Competition," *International Organization* 57, no. 1 (2003): 3–42.

32. Broz, "Origins of the Federal Reserve System"; Daniel Verdier, "Capital Mobility and the Origins of Stock Markets," *International Organization* 55, no. 2 (2001): 327–56. The U.S. public debt market was still very small in 1914, casting doubt on the applicability of the North and Weingast thesis.

33. Jon Faust, "Whom Can We Trust to Run the Fed? Theoretical Support for the Founders' Views," *Journal of Monetary Economics* 37, no. 2 (1996): 267–83.

34. Broz, "Origins of the Federal Reserve System."

35. Some earlier works on sterling's decline tend to emphasize economic factors or international political factors. For the former, see, for example, Benjamin J. Cohen, *The Future of Sterling as an International Currency* (London: Macmillan, 1971); for the latter, see, for example, Susan Strange, *Sterling and British Policy: A Political Study of an International Currency in Decline* (London: Oxford University Press, 1971).

velopments, the extension of the franchise after World War I, the rise of the trade union movement and the Labour Party, and the rise of Keynesian economic ideas eventually threatened Britain's political commitment to the gold standard.[36] Furthermore, the loss of outright veto power by the House of Lords in 1911 centralized political power in the hands of the British prime minister and Cabinet. In combination with a wider franchise and the rise of the unionized left, the potential for inflation was now much greater and sterling's credibility as an international currency was undermined.[37] Capital controls, imposed in the name of national macroeconomic stabilization during and after World War II, reflected this new reality and were another blow to sterling's international role. Allied with Keynesian economic policy ideas and a now wholly subordinate Bank of England, successive British cabinet governments after 1945 pursued macroeconomic policies that by the 1960s had almost completely undermined Britain's pretensions to currency leadership. Nevertheless, although Britain no longer satisfied the first domestic prerequisite of monetary leadership (that is, as a provider of relatively conservative monetary policy), the second (as a provider of conservative financial institutions) remained largely intact. London subsequently flourished as an open center for international finance, but only by specializing in offshore finance conducted in other currencies, above all the US dollar. Despite the City of London's position as a global financial center, Britain was no longer a global currency leader; a small if lingering international role for sterling was confined to the remnants of the British empire and some overly loyal former dominions.

The erosion of the credibility of the U.S. commitment to a stable currency after 1945 was much less marked than in the British case. The monetary link to gold, albeit in altered form, remained important for U.S. policy, in marked contrast to Britain. By the end of the war, the United States owned about three-quarters of the world's monetary gold, and the Franklin D. Roosevelt administration wanted to preserve the "economic power" this represented.[38] The U.S. domestic institutional structure was also a crucial aspect of the comparative resilience of its monetary leadership. In the New Deal years and in the immediate postwar years, the U.S. Federal Reserve had been politically subordinated to the government.[39] From the time of the U.S. Treasury–Federal Reserve Accord of March 1951, the latter was able, with the support of the Treasury, to regain independent control over interest rates.[40] The result was low levels of inflation relative to those in most other major economies (see fig. 3.1). The Federal Reserve's conservative stance was generally supported by suc-

36. Eichengreen, *Golden Fetters;* Beth A. Simmons, *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years* (Princeton: Princeton University Press, 1994); Robert Skidelsky, *John Maynard Keynes: Vol. 2. The Economist as Saviour, 1920–1937* (London: Macmillan, 1992).

37. Alec Cairncross and Barry Eichengreen, *Sterling in Decline: The Devaluations of 1931, 1949 and 1967,* 2nd ed. (Houndmills, UK: Palgrave, 2003), xv, xx.

38. Robert Skidelsky, *John Maynard Keynes: Vol. 3. Fighting for Britain, 1937–1946* (London: Macmillan, 2000), 317.

39. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: Princeton University Press, 1963), 532–33.

40. Ibid., 610–26.

Figure 3.1 Average inflation differential of ten major economies (Canada, Japan, Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland, and the United Kingdom) average inflation differential over the United States, 1949–200. CPI, consumer price inflation. (*Source:* International Monetary Fund, *International Financial Statistics,* CD-ROM, consumer price inflation.)

cessive administrations. Congress was relatively inactive during this period in monetary and exchange-rate policy because of the low incentives for collective action in these policy areas; this, too, favored monetary conservatism.[41] In the Dwight D. Eisenhower years, the fixed gold price was seen by the administration as one of the foundations of good economic housekeeping. In the 1960s, beginning with John F. Kennedy, the commitment to the fixed \$35-per-ounce gold price became a matter of high politics.

However, from the mid-1960s, with productivity growth falling, political pressure on the Federal Reserve to deliver on jobs and growth increased. With the steady erosion of the external gold constraint on U.S. policy, successive administrations from 1962 onward were accused of exploiting their ability, due to the international reserve role of the dollar, to export inflation abroad and to shift the costs of adjustment to others.[42] The Federal Reserve Board remained committed to the fixed gold price and to a low inflation policy, but by the early 1970s it had well and truly lost this battle.[43] U.S. willingness to exploit its powerful position increasingly alienated loyal allies of a more conservative monetary bent, with the Germans floating the deutschmark against the dollar in March 1973. By 1978, the steadily falling dollar suggested that financial markets had also lost confidence in U.S. macroeconomic policy. Only Paul Volcker's dramatic reassertion of the U.S. Fed's autonomy and a policy of mon-

41. As Joanne S. Gowa argues, in "Public Goods and Political Institutions: Trade and Monetary Policy Processes in the United States," *International Organization* 42, no. 1 (1988): 15–32, this contrasts with greater political activism in finance.

42. See De Grauwe, *International Money,* 32–39.

43. Charles A. Coombs, *The Arena of International Finance* (New York: John Wiley, 1976).

etary conservatism from 1979 succeeded in restoring the underpinnings of the dollar's international position.[44]

To summarize the argument of this section, monetary followership by private- and public-sector agents occurs in part because of the monetary policy credibility and the high financial development that flow from the leader's domestic institutional arrangements. Of course, domestic institutions for monetary and financial conservatism are unlikely to produce international monetary leadership without sufficient economic size and an important international trading position; Switzerland since 1945 is a case in point. Furthermore, as the Volcker shift demonstrates, individuals as well as institutions matter.[45] However, even though domestic political, legal, and economic institutions are not determinant, they nevertheless give greater purchase on why, during the past two centuries, Britain and then the United States were the countries both able and willing to provide international monetary leadership and why others were bound to follow. Indeed, if we accept that financial development helped to promote the general preeminence of the large Anglo-Saxon countries in both the economic and security realms, domestic institutions should be seen as all the more crucial.[46]

Normative Convergence through Socialization

Material incentives for followership, both international and domestic in origin, can only get us so far in explaining the details of international monetary organization and followership. Such theories lack an account of the economic and political ideas that give substantive content to the preferences of actors and to the institutional particularities of the day.

Ruggie, together with Ikenberry and Kupchan, is most often associated with the theory that leadership is based on normative convergence between elites in the major countries.[47] Following Polanyi,[48] Ruggie argues that British leadership in the nineteenth century was founded on the then dominant norms of laissez-faire and monetary discipline. This consensus broke down in the interwar period, but the ex-

44. Paul Volcker and Toyoo Gyoten, *Changing Fortunes: The World's Money and the Threat to American Leadership* (New York: Times Books, 1992), chap. 6.

45. In this case, ideology probably did not play an important part. It is clear from Volcker's memoirs that he was not an ideological monetarist but, rather, a pragmatic central banker determined to put an end to the inflationary psychology that had become entrenched in the United States in the 1970s; ibid., 163–77.

46. Schultz and Weingast, "Democratic Advantage."

47. Ruggie, "International Regimes, Transactions and Change"; Ikenberry and Kupchan, "Socialization and Hegemonic Power." By contrast, Gramscians tend to talk less about "norms" than of "hegemonic ideologies" and emphasize the coercive aspects of ideational power. See Stephen Gill, "Globalization, Market Civilization, and Disciplinary Neoliberalism," *Millennium* 24, no. 3 (1985): 399–423; Robert W. Cox, *Production, Power, and World Order: Social Forces in the Making of History* (New York: Columbia University Press, 1987).

48. Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944).

periences of depression and war eventually resulted in a "shift in what we might call the balance between 'authority' and 'market' [that] fundamentally transformed state-society relations, by redefining the legitimate social purposes in pursuit of which state power was expected to be employed in the domestic economy."[49] For Ruggie, this "embedded liberal" compromise fundamentally distinguished U.S. leadership from the British version that preceded it.

Nevertheless, it remains the case that British and U.S. monetary leadership in their respective periods rested on *relative* monetary conservatism. Britain, or more specifically the Bank of England, the City, and the Treasury, adhered more strictly to monetary orthodoxy before 1914 than did the governments of Germany and France, whose much wider electoral franchises made them more sensitive to the real economic consequences of strict monetary orthodoxy.[50] The reason for this asymmetry is obvious: if a prospective monetary leader were not relatively conservative in orientation, it is unlikely private-sector agents would be willing to follow in the initial stages. Money is, after all, a social convention whose value in exchange and as a store of value depends on it being in comparatively short supply relative to other goods, services, and assets, including other monies.

Given the less conservative monetary reputation of the United States after 1945, this argument may seem surprising. But after the war, the relative inflation performance of the United States was exceptional for a few decades, particularly in the 1950s. It was comparable with that of West Germany and Switzerland until the late 1960s and much better than Britain's (see fig. 3.2). Nor should the degree to which the United States in the 1960s achieved this good performance by exporting some of its monetary inflation abroad be exaggerated. After all, the Swiss and West Germans, whose currencies tended to bear the brunt of dollar weakness, enjoyed good inflation performance through the mid-1960s despite rapid growth and considerable resistance to currency revaluation.[51]

Certainly, there was a general deterioration in inflation performance in the mid-1960s, but it is not until the late 1960s that U.S. inflation began to look "out of control" by comparison with the low-inflation Germans and Swiss (if not by British standards). By the early 1970s, the U.S. reputation for relative monetary conservatism had well and truly been squandered, and the Swiss and Germans broke away from their inflationary dollar pegs. Surprisingly for many at the time, however, there was no general private-sector (or public-sector) abandonment of the dollar. In the late 1970s, with the U.S. currency depreciating quickly and with the U.S. government offering foreign currency–denominated bond issues and pondering (only to reject) the possibility of a Substitution Account, the dollar's international position appeared to many to be under serious threat.[52] This perception was surely correct

49. John G. Ruggie, "International Regimes, Transactions and Change," 386.

50. Broz, "Domestic Politics of International Monetary Order."

51. The burden of inflation in the Bretton Woods system fell largely on the commodity money, gold, the dollar (and deutschmark) price of which came under growing pressure in the late 1960s and soared in the 1970s.

52. Gowa, "Hegemons, IOs, and Markets," 664.

Figure 3.2 U.S., West German, Swiss, and UK inflation, 1949–2000. (*Source:* International Monetary Fund, *International Financial Statistics,* CD-ROM, consumer price inflation.)

because a shift to foreign currency borrowing by the United States would have undermined a key aspect of its monetary power: its ability to borrow, well beyond the capacity of any other country, enormous amounts of money cheaply from foreigners in U.S. dollars, the repayment of which can take place (if necessary) in currency that the government can print.

However, the dramatic tightening of monetary policy undertaken by a new Federal Reserve chairman, Paul Volcker, in retrospect proved sufficient to restore both the conservative monetary reputation of the Fed in the eyes of international financial markets and the international role of the dollar. By 1983, U.S. inflation was back down to near-Germanic levels and has more or less stayed there since, despite periodic bouts of fiscal profligacy. The role of the dollar in private international financial markets has since undergone a minor secular decline, but it remains by some margin the leading international currency; I have more to say on this subject in my concluding remarks. The dollar continues to be the preeminent international currency, I might add, in spite of considerable swings in its external value over time vis-à-vis other major currencies.

Not only do private-sector agents tend to expect relative (although not excessive) conservatism from monetary leaders; the monetary authorities of the follower states do as well. British governments fulfilled such expectations before 1914 and tried, at great cost to the domestic economy and ultimately in vain, to do so again over the years 1925–31. Those countries that followed the United States after 1945 also expected conservatism from the center country. This was obscured during the period of the postwar "dollar shortage," but from around 1951 other governments came to rely heavily on relative U.S. monetary conservatism. Indeed, in the debates over the problems of the gold-exchange standard in the 1960s, it often seemed as if the Europeans expected the United States to sacrifice its own domestic growth and employment goals in order to shore up both the system and their own economic strategies.[53] This may seem hypocritical because most European countries were at the time engaged in full-employment and high-growth policies that also had inflationary consequences. Ruggie is right that the end of gold-dollar convertibility was consistent with the maintenance of embedded liberalism,[54] but followership in the Bretton Woods system was also based on a U.S. commitment—and a related follower expectation—precisely *not* to exploit the full possibilities of U.S. monetary autonomy.

This bargain broke down in the early 1970s as the Richard Nixon administration exploited the possibilities of monetary autonomy, but the asymmetry of expectations on which it was based persisted well after the demise of the gold-exchange standard system. It was evident in European support for a Special Drawing Rights (SDR) standard in the international monetary reform negotiations during 1972–74.[55] When European countries again tried to convince the United States to move toward an SDR standard via the Substitution Account proposal in the late 1970s, the emphasis was still on the need for the United States to adopt relatively conservative monetary policies for the general good. The views of a German economist writing at the time would have been widely shared by central bankers and finance ministers in other major countries: "Monetary stability . . . can only be achieved by an economic policy which engenders trust and convinces the market that the world's major currency is once again capable of exercising its function as a store of value."[56]

The international political economy literature has commonly seen Lyndon Johnson's Great Society program and pro-growth policies as the key reasons for the eventual breakdown of the system, even though they reflected a normative convergence on the part of the United States toward European policy objectives.[57] Ronald McKinnon, a U.S. economist and a proponent of a formal dollar standard in the 1960s, argues that "America's principal international monetary obligation was not the *pro forma* link to gold but rather to maintain stable dollar prices of internationally tradable goods as well as an open capital market."[58] This encapsulates well the conservative "obligation" of the currency leader from the point of view of the followers, public and private sector alike. What was so shocking to U.S. allies was that, after Eisenhower, the U.S. government increasingly seemed ready to abandon good economic housekeeping for objectives that the followers shared. By the time of Nixon,

53. President de Gaulle would have retorted that the United States needed only to scale back its imperialist ambitions abroad. However, most European governments strongly favored a continuing U.S. troop presence on their continent; this included France, albeit with reservations. Japan did as well.

54. Ruggie, "International Regimes, Transactions and Change," 408.

55. John Williamson, *The Failure of World Monetary Reform, 1971–74* (New York: New York University Press, 1977).

56. Dieter Gehrmann, "Substitution Account: No Solution for International Monetary System," *Intereconomics* 3 (May–June 1980): 114; cited in Gowa, "Hegemons, IOs and Markets," 665n.16.

57. See, for example, David P. Calleo, *The Imperious Economy* (Cambridge, Mass.: Howard University Press, 1982), 35.

58. Ronald I. McKinnon, *Money in International Exchange: The Convertible Currency System* (New York: Oxford University Press, 1979), 261.

the United States went to war on such double standards. As John Connally, Nixon's abrasive Treasury secretary, memorably said in 1971, "the dollar may be our currency but it's your problem."[59]

It might be argued that this interpretation is inconsistent with the West German position, especially that of the conservative Bundesbank. However, political resistance in West Germany to currency revaluation was strong, both in the Bundesbank and in the influential banking and industrial sectors. A majority on the Bundesbank council resisted pressure from the West German government in 1971 to move to a floating rate system instead favoring exchange-rate fixity with the dollar and capital controls as a means of remaining within the Bretton Woods system.[60] Even in the Bundesbank, then, the incentives to continue to follow the U.S. leader remained strong until the last great dollar crisis of the Bretton Woods system in March 1973.[61] By then, the United States had forfeited its claims to monetary conservatism in German eyes and had joined the ranks of the merely average Organization for Economic Cooperation and Development (OECD) country.

West Germany's role in subsequent moves toward European monetary integration also supports the argument made here. Through the "snake" and later the European Monetary System (EMS), West Germany made a successful bid for European monetary leadership that lasted for about two decades (although the precise number of followers fluctuated considerably during this time). Although other Europeans often complained about the Bundesbank's "obsession" with low inflation, the Bundesbank and the deutschmark increasingly consolidated their undisputed leadership positions within the European system. In the French franc crisis of 1982–83, President François Mitterrand finally opted to follow the German leader by reversing his earlier expansionary policies and pursuing a policy of convergence through the "franc fort" policy. In the absence of a deep elite commitment to the broader European integration process, this difficult choice may not have been made.

The main threat to the EMS came in the wake of German reunification, when a ballooning fiscal deficit threatened to undermine the Bundesbank's monetary conservatism. In 1993, in a moment of hubris or desperation, the French government made the mistake of suggesting that the French franc should succeed to currency leadership within Europe (the *grande gaffe*). The argument assumed that the French were now *more* monetarily conservative than the Germans. Private-market agents, the ultimate arbiters, did not agree, looking to Bundesbank leadership that the latter was willing to provide.[62]

59. Cited in Harold James, *International Monetary Cooperation since Bretton Woods* (Washington, D.C.: International Monetary Fund, 1996), 210.

60. Ibid., 214–16; David Marsh, *The Bundesbank: The Bank That Rules Europe* (London: Mandarin, 1992), 180–93.

61. Among these incentives, in addition to those already mentioned, may have been the deep acceptance by European elites of U.S. values that flowed from the postwar U.S.-dominated occupation and reconstruction of West Germany. See Ikenberry and Kupchan, "Socialization and Hegemonic Power," 304.

62. See Barry J. Eichengreen, *Globalizing Capital (Princeton: Princeton University Press, 1996),* 174. In the same manner as Paul Volcker during 1979–80, the Bundesbank successfully put down this challenge at considerable cost to the German and European economies.

This episode also suggests, as does the U.S. case of fiscal profligacy since the 1960s, that fiscal balance is less important to monetary leadership vis-à-vis market agents than is the absence of monetary accommodation. Indeed, currency leadership can make it easier for the leader to finance domestic dis-saving by borrowing from abroad. Fiscal deficits also deepen the bond market in the center country and hence promote followership. However, very large fiscal deficits in the center country, by raising real interest rates in the entire system, erode the legitimacy of the monetary leader vis-à-vis other countries. Thus, the first prerequisite of international monetary leadership might be extended to the pursuit of conservative macroeconomic policy in general, but, within the macroeconomic policy mix, monetary conservatism remains the most important element. It is also clear that monetary conservatism is a relative rather than an absolute concept—its meaning depends considerably on the intellectual climate and policy practices of the time.

Monetary Leadership, Power, and Their Limitations

As the cases of the United States since the 1960s and Germany in the early 1990s suggest, established monetary leaders can exert substantial power in the international monetary system. Others have described how monetary conservatism, particularly in the German case, deflected adjustment costs on to others.[63] Such power derives primarily from the way in which private-market agents favor the lead currency. Here, I focus on another kind of monetary power—the ability of the leader to depart from the first prerequisite of monetary leadership (the pursuit of a credibly conservative monetary policy) for what Eric Helleiner (chap. 4 in this volume) terms "extractive" purposes. What are the limits to this kind of monetary power?

Once a currency leader is entrenched, the policy requirements for sustaining such leadership are less onerous than the initial prerequisites and the potential for exercising coercive power over other actors is greater. As indicated earlier, this amounts to a form of monopoly power because it is costly for other actors to shift from the use of the established lead currency to an alternative. The costs of switching are especially high if there are large asymmetries in financial development that favor the currency leader. This consideration helps to explain why, despite the large fluctuations in the value of the dollar since 1973, there has been only a minor erosion of its position as the lead currency in the contemporary system. Network externalities compound the advantages that accrue to the lead currency, not least because its use by specialized private financial intermediaries is likely to deepen the existing cost advantages of transacting in this currency. Entrenched monetary leaders are able to depart from a current account surplus position and to borrow extensively and cheaply in their own currency, something Charles de Gaulle referred to as the

63. See, for example, Jean-Paul Fitoussi, Anthony B. Atkinson, Olivier E. Blanchard, and John S. Flemming, *Competitive Disinflation: The Mark and Budgetary Politics in Europe* (Oxford: Oxford University Press, 1993).

leader's "exorbitant privilege." This is a central aspect of international monetary power and is the other side of the coin of the "original sin" literature in economics, which considers the implications of the fact that most countries are able to borrow from international capital markets only in foreign currencies.[64] Consistent with the argument made here, this literature suggests that the handful of countries that enjoy the privilege of borrowing in their own currencies do so partly because of domestic institutions and economic strength and partly because market actors prefer to hold only a few major currencies in their asset portfolios.

Clearly, the extent of the leader's monopoly power depends on the degree of currency rivalry. The emergence of the U.S. dollar in the interwar period as a serious rival to sterling substantially limited the ability of British authorities to exploit the monopoly power that derived from sterling's international position. Indeed, what is striking about UK policy in the 1920s is the extent to which policy makers felt constrained by their need to maintain market confidence in the peg with gold. In a sense, market agents were constraining the leader more than they did other countries, although much of this boiled down to a deep ideological attachment to gold among British political and financial elites.[65] As it became clear that Britain's political and economic institutions could no longer deliver a credibly conservative macroeconomic policy after the stresses of two major wars, sterling's international position rapidly eroded vis-à-vis the dollar. Cultural factors slowed the decline: even in the mid-1960s, formally independent countries such as Australia continued to hold substantial sterling reserves, but this could not halt sterling's overall decline.

By contrast, there were no real rivals to the U.S. dollar in the 1960s and 1970s. This, the large U.S. economy's relatively low dependence on international trade, and the position of the United States as alliance leader increased the ability of U.S. policy makers to depart from fiscal and later monetary conservatism and to deflect and delay the related adjustment costs. Similarly, the essentially unrivalled position of the deutschmark within the EMS increased Germany's ability to depart from fiscal conservatism after 1990. However, given that the deutschmark was not a real rival to the dollar, the Bundesbank could not afford a loose monetary policy of the kind the U.S. Federal Reserve pursued in the 1970s.

In the long term, the leader's continued exploitation of its monopoly power is likely to produce countervailing responses. As C. Randall Henning argues (chap. 6 in this volume), EMU can be seen in part as a European response to the perceived mismanagement of the U.S. economy and the U.S. attempt to deflect adjustment costs on to others. Although the euro is not yet a serious rival to the dollar,[66] the continued exploitation by the United States of its dominant monetary position could

64. See Barry J. Eichengreen, Ricardo Hausmann and Ugo Panizza, "Currency Mismatches, Debt Intolerance and Original Sin: Why They Are Not the Same and Why It Matters," NBER Working Paper no. 10036, National Bureau of Economic Research, Washington, D.C., October 2003.

65. Barry J. Eichengreen and Peter Temin, "The Gold Standard and the Great Depression," NBER Working Paper no. 6060, National Bureau of Economic Research, Washington, D.C., June 1997.

66. Benjamin J. Cohen, "Global Currency Rivalry: Can the Euro Ever Challenge the Dollar?" *Journal of Common Market Studies* 41, no. 4 (2003): 575–95.

eventually make it so. The time is long past when the United States can use political linkage to force its major allies to maintain allegiance to the dollar. As we have seen, in the long run it is private-market agents who are most important in terms of the maintenance of a lead currency's status. Financial liberalization in the major countries since the 1970s, encouraged by the United States, has increased the options available to market agents and thereby reduced U.S. monopoly power. Since the 1979 shift back to U.S. monetary conservatism, there has been no abandonment of this policy stance.[67] In Europe in the early 1990s, market agents similarly looked for confirmation from the Bundesbank that its conservative monetary policy was not in question. Thus, in the longer run, the maintenance of currency leadership requires the center country to pursue reasonably conservative monetary policies, even if not as strictly as at the outset of a bid for currency leadership.

Monetary power is also likely to be constrained in the longer run by the normative and institutional underpinnings of leadership itself. U.S. monetary leadership after 1945 was founded on a broad-based solidarity of western nations during the Cold War, as well as willingness of U.S. authorities to accept consensus language in the major postwar monetary and trade regimes and to manage disputes multilaterally. The implication of such U.S. leadership was clear to all because in playing this multilateral game the United States often found it had to foster followership by compromising on its initial demands. This also signaled to the followers that the United States would not overly exploit its enormous power.

The Nixon shocks of the early 1970s represented a clear step away from legitimate leadership based on persuasion within multilateral institutional frameworks toward hegemonic coercion, often undertaken outside the bounds of institutionally sanctioned practices. The acrimony that ensued over economic matters between the major countries reflected this shift. The United States blocked international monetary reform efforts in the 1970s and from the 1980s more actively used the IMF and World Bank to promote structural reform in the developing world. In the second half of the 1970s, the U.S. government showed a willingness to exploit, as it had never done before, the potentialities of the international role of the dollar, during the era of so-called "benign neglect." During 1977–79, the United States issued not-so-subtle threats to other G-7 countries that U.S. authorities would encourage further dollar depreciation if their partners failed to reflate their economies.[68] This threat, which fell clearly into the category of hegemonic coercion, was credible because of the sheer economic size of the United States, its relatively low trade dependence, and its ability to borrow enormous sums from abroad in its own currency, all of which meant that other economies lost more from dollar weakness than did the United States.

However, the very credibility of the U.S. threat further undermined the legitimacy of its monetary leadership in the eyes of major follower countries. The grow-

67. Since 2002, U.S. monetary policy has been exceptionally accommodative, but inflation remains very subdued.

68. Walter, *World Power and World Money,* 216–23.

ing reluctance of Germany and Japan to accede to U.S. pressure in a range of policy areas was a consequence. Perceived U.S. coerciveness boosted Germany's desire to create with its European partners a "zone of monetary stability" that would deepen the process of political integration in Europe.[69] In the first half of the 1980s, the United States borrowed enormous sums (in dollars) from Japanese investors, who subsequently experienced massive portfolio losses when the dollar depreciated against the yen and other currencies after 1985. Even greater losses accrued to Asian central banks in 2004–5 as their accumulated U.S. Treasury bond portfolios suffered from dollar depreciation. Moves toward closer monetary and financial cooperation in Asia, although as yet with little effect on the position of the dollar, could in the long run further reduce U.S. monetary power. The various signs from Asian governments in 2005 of their displeasure at dollar depreciation and open hints that they may reallocate their portfolios toward other currencies also suggest growing limits to U.S. monetary power.[70]

To summarize, the power that accrues to monetary leaders changes over time. It is very limited in the initial stages of a leadership bid, when the position of the currency depends on self-constraint that is transparently embedded in domestic institutions. The leader's power peaks when its currency is successfully entrenched at the top of the currency pyramid, creating a temptation to exploit the possibilities of its monetary power. In a third phase, monetary power declines when the leader persists in exploiting its monopoly power, thus encouraging the emergence of rival lead currencies and associated financial centers. If, as did the British in the twentieth century, the United States persists in exploiting its monopoly power, this is eventually likely to prove fatal to the maintenance of its leadership and power.

Conclusion

I have argued that monetary leadership requires a relatively (but not excessively) conservative macroeconomic policy from the leader. Many leading theories of international leadership have failed to recognize both this systemic asymmetry and its origins in domestic politics and institutions. The leader's conservative policy needs to be credible, which means firmly embedded in domestic political and institutional arrangements. Fundamental changes in the nature of this domestic institutional framework can eventually undermine the foundations of successful currency leadership, as in Britain after World War I. Particular kinds of domestic institutions, including limited government and pro-creditor legal frameworks, also helped to foster highly developed capital markets, themselves a prerequisite for currency leadership.

69. Kenneth Dyson, *Elusive Union: The Process of Economic and Monetary Union in Europe* (London: Longman, 1994), 303–4.

70. Of course, the danger in pursuing a strategy of reserve diversification is the possibility of precipitating a collapse of the dollar and, hence, further deterioration in the value of their existing monetary reserves. See "Moves to Calm Markets as Koizumi Comments Send Dollar Falling," http://www.FT.com (accessed March 11, 2005).

These preconditions of currency leadership are very difficult to manipulate, except in the long run. Currency leadership also creates its own self-sustaining market logic, a point further examined by David Andrews (chap. 5 in this volume). In sum, few states are ever in the position to successfully promote their currency abroad, let alone to become monetary leaders.

The policy credibility of the monetary leader provides incentives on the part of both public-sector and private-sector actors to follow. Such followership creates substantial potential benefits to the monetary leader, although there are limits on its ability to exploit these hegemonically in practice without undermining the very foundations of its leadership. The implication of my argument is that the extent of these limits depends on the degree of asymmetry of financial development in the world economy, the existence of potential rival lead currencies, the intellectual attachment of the leader's political elites to relative monetary conservatism, and its ability to use political linkage to ensure its continued leadership.

Does the advent of the euro create a new challenge to the primacy of the dollar that will reduce the ability of the United States to exploit its dominant position? Cohen has argued that the euro does not represent a serious challenge to the position of the dollar.[71] In contrast to the argument made here, he suggests that the monetary conservatism inherent in the constitution of EMU will limit returns on euro assets, reducing the attractiveness of the currency and offsetting the benefits of holding a hard currency. He also argues that the ambiguous division of policy responsibility between the European Central Bank and the Council of Ministers reduces the euro's credibility.

However, as we have seen, relative monetary conservatism is an important prerequisite in a potential monetary leader. Also, it may be debated how much low long-run growth in Europe is due to its monetary constitution and how much it is due to other factors, including inflexible factor and product markets.[72] After all, pre-1914 Britain did not have a pro-growth monetary constitution, and nor did West Germany after 1949, which enjoyed high growth for decades. Even when German growth slowed substantially after 1980, the deutschmark remained the lead currency within Europe. Furthermore, the nature of the U.S. Federal Reserve System is itself not entirely transparent and unambiguous; some find its governance structure "bizarre."[73]

Nevertheless, as Cohen and others suggest, a number of other factors work against the euro, including inertia in international financial markets and relatively low financial integration in Europe. So far, and in spite of the impressive growth of euro bond markets, there is little evidence of a dramatic shift against dollars in favor of euros either in international financial markets or in central bank reserves.[74] What Europe still lacks is a truly European euro-based integrated financial market

71. Cohen, "Global Currency Rivalry."
72. Ibid., 585. Later, Cohen accepts that nonmonetary factors do matter (587–88).
73. Faust, "Whom Can We Trust to Run the Fed?"
74. Cohen, "Global Currency Rivalry," 580; International Monetary Fund, *Annual Report* (Washington, D.C.: IMF, 2003), app. 1.

that can rival those of the United States; London's common law system and its newly transparent, credible monetary and financial regulatory framework provide it with substantial advantages over the rest of Europe in this regard. Even if the United Kingdom joins EMU, however, the segmentation of government bond markets in Europe will remain a major constraint on the euro's international role for the foreseeable future and, hence, on Europe's ability to wield international monetary power beyond its borders.

In short, the relatively underdeveloped nature of financial markets in continental Europe generally—at least compared to those in the United States and United Kingdom—is a major and continuing obstacle to European monetary leadership. Although it is not the only such obstacle, it is the only one over which public authorities in European states have control. The euro area meets the economic criteria for Europe to assert international monetary leadership and enjoys a relatively conservative monetary policy framework—the first domestic prerequisite thereof. But the second domestic prerequisite for the realization of a global role—institutional arrangements that facilitate the emergence of highly developed financial markets—remain absent. As long as this is so, the dollar is likely to enjoy continued preeminence—despite the evident desire of both private- and public-sector actors for a more stable alternative.