

# The international monetary system: diffusion and ambiguity

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Ample evidence exists to suggest that the distribution of power in international monetary affairs is changing. But where does monetary power now reside, and what are the implications for governance of the international monetary system? On these questions, uncertainty reigns. The aim of this article is to shed some new light on the dynamics of power and rule-setting in global finance today.

I will begin with a brief discussion of the meaning of power in international monetary relations, distinguishing between two critical dimensions of monetary power: autonomy and influence. The evolution of international monetary power in recent decades will then be examined. Major developments have dramatically shifted the distribution of power in the system. Many have noted that power is now more widely diffused, both among states and between states and societal actors. Finance is no longer dominated by a few national governments at the apex of the global order. Less frequently remarked is the fact that the diffusion of power has been mainly in the dimension of autonomy, rather than influence—a point of critical importance. While more actors have gained a degree of insulation from outside pressures, few as yet are able to exercise greater authority to shape events or outcomes. Leadership in the system thus has been dispersed rather than relocated—a pattern of change in the geopolitics of finance that might be called *leaderless* diffusion.

A pattern of leaderless diffusion generates greater ambiguity in prevailing governance structures. Rule-setting in monetary relations increasingly relies not on negotiations among a few powerful states but rather on the evolution of custom and usage among growing numbers of autonomous agents—regular patterns of behaviour that develop from longstanding practice. Impacts on governance structures can be seen at two levels: the individual state and the global system. At the state level, the dispersion of power compels governments to rethink their commitment to national monetary sovereignty. At the systemic level, it compounds the difficulties of bargaining on monetary issues. Formal rules are increasingly being superseded by informal norms that emerge, like common law, not from legislation or statutes but from everyday conduct and social convention.

## Monetary power

For the purposes of this article, the international monetary system may be understood to encompass all the main features of monetary relations across national frontiers—the processes and institutions of financial intermediation (mobilization of savings and allocation of credit) as well as the creation and management of money itself. As Susan Strange once wrote: ‘The financial structure really has two inseparable aspects. It comprises not just the structures of the political economy through which credit is created but also the monetary system or systems which determine the relative values of the different moneys in which credit is denominated.’<sup>1</sup> Both aspects are influenced by the distribution of power among actors.

And what do we mean by power in monetary relations? To summarize briefly an argument that I have developed at greater length elsewhere,<sup>2</sup> I suggest that international monetary power may be understood to comprise two critical dimensions, autonomy and influence. The more familiar of the two is the dimension of *influence*, defined as the ability to shape events or outcomes. In operational terms, this dimension naturally equates with a capacity to control the behaviour of actors—‘letting others have your way’, as diplomacy has jokingly been defined. An actor, in this sense, is powerful to the extent that it can effectively pressure or coerce others; in short, to the extent that it can exercise leverage or managerial authority. As a dimension of power, influence is the essential *sine qua non* of systemic leadership.

The second dimension, autonomy, corresponds to the dictionary definition of power as a capacity for action. An actor is also powerful to the extent that it is able to exercise operational independence: to act freely, insulated from outside pressure. In this sense, power does not mean influencing others; rather, it means not allowing others to influence you—others letting *you* have your way.

The distinction between the two dimensions of power is critical. Both are based in social relationships and can be observed in behavioural terms; the two are also unavoidably interrelated. But they are not of equal importance. Logically, power begins with autonomy. Influence is best thought of as functionally derivative—inconceivable in practical terms without a relatively high degree of operational independence first being attained and sustained. First and foremost, actors must be free to pursue their goals without outside constraint. Only then will an actor be in a position, *in addition*, to exercise authority elsewhere. Autonomy may not be *sufficient* to ensure a degree of influence, but it is manifestly *necessary*. It is possible to think of autonomy without influence; it is impossible to think of influence without autonomy.

For state actors in the monetary system, the key to autonomy lies in the uncertain distribution of the burden of adjustment to external imbalances. National economies are inescapably linked through the balance of payments—the flows of money generated by international trade and investment. One country’s surplus is another country’s deficit. The risk of unsustainable disequilibrium represents

<sup>1</sup> Susan Strange, *States and markets*, 2nd edn (London: Pinter, 1994), p. 90.

<sup>2</sup> Benjamin J. Cohen, ‘The macrofoundations of monetary power’, in David M. Andrews, ed., *International monetary power* (Ithaca, NY: Cornell University Press, 2006), pp. 31–50.

a persistent threat to policy independence. Excessive imbalances generate mutual pressures to adjust, which can be costly in both economic and political terms. Deficit economies may be forced to curtail domestic spending or devalue their currencies, at the expense of growth and jobs; surplus economies may experience unwanted inflation or an upward push on their exchange rates, which can threaten international competitiveness. No government likes being compelled to compromise key policy goals for the sake of restoring external balance. All, if given a choice, would prefer to see others make the necessary sacrifices. For states, therefore, the foundation of monetary power is the capacity to avoid the burden of adjustment required by a payments imbalance.

The capacity to avoid the burden of adjustment is fundamentally dual in nature, subdividing into what I have characterized as the two 'hands' of monetary power.<sup>3</sup> These are the power to delay and the power to deflect, each corresponding to a different kind of adjustment burden. One burden is the continuing cost of adjustment, defined as the cost of the new payments equilibrium prevailing after all change has occurred. The power to delay is the capacity to avoid the continuing cost of adjustment by *postponing* the process of adjustment. The other burden is the transitional cost of adjustment, defined as the cost of the change itself. Where the process of adjustment cannot be put off, the power to deflect represents the capacity to avoid the transitional cost of adjustment by *diverting* as much as possible of that cost to others. The power to delay is largely a function of a country's international liquidity position relative to others, comprising both owned reserves and borrowing capacity. A particular advantage is enjoyed in this respect by the issuers of currencies that are widely used by others as reserve assets, since these can finance deficits simply by printing more of their own money. The power to deflect, by contrast, has its source in more fundamental structural variables that determine an economy's relative degree of openness and adaptability.

For societal actors in the monetary system, the key to autonomy lies in the uncertain relationship between relevant market domains and legal jurisdictions. In an increasingly globalized world, the reach of financial markets is persistently growing. Yet political authority remains rooted in individual states, each in principle sovereign within its own territorial frontiers. Hence a disjuncture prevails between market domains and legal jurisdictions that creates ample room for opportunistic behaviour by enterprises or private individuals. The very policy independence that is so prized by governments tends to create differences in market constraints and incentives that may well be exploited to advantage. For societal actors, the foundation of monetary power is the ability to navigate successfully in these interstices between political regimes.

Autonomy, in turn, is the key to influence. Because monetary relations are inherently reciprocal, a potential for leverage is automatically created whenever operational independence is attained. The question is: Will that potential be actualized? Two modes are possible in the exercise of monetary influence: passive and active. Autonomy translates into influence in the accepted sense of the term—a

<sup>3</sup> Cohen, 'Macrofoundations'.

dimension of power aiming to shape the actions of others—only when the capacity for control is deliberately activated.

The requirement of actualization is often overlooked. The potential for leverage that derives automatically from autonomy—the passive mode of influence—is another way of describing what economists call externalities. At best, it represents a contingent aspect of power, exerted without design and with impacts that tend to be dispersed and undirected. Only when the potential for leverage is put to use with self-conscious intent do we approach the more common understanding of influence: the active mode, involving sharper focus in terms of who is targeted and to what end. Unlike the passive mode, the active mode implies a ‘purposeful act’. Both modes begin with monetary autonomy as a basic and necessary condition, and in both cases other actors may feel compelled to comply. But in the passive mode externalities are incidental and unpremeditated, whereas in the active mode pressure is applied directly and deliberately. The active mode, in effect, politicizes relationships, aiming to translate passive influence into practical control through the instrumental use of power. From a political economy point of view, as we shall see, the difference between the two modes is critical.

## **Diffusion**

For both states and societal actors, the distribution of monetary power has shifted dramatically in recent decades. Not long ago the global system was dominated by a small handful of national governments, led by the United States. Most countries felt they had little choice but to play by rules laid down by America and, to a lesser extent, its partners in the Group of Seven (G7); markets operated within strict limits established and maintained by states. Today, by contrast, power has become more widely diffused, both among governments and between governments and market agents. The diffusion of power, however, has been mainly in the dimension of autonomy, rather than influence—a pattern of leaderless diffusion in financial geopolitics. The days of concentrated power in a largely state-centric system are now over.

Three major developments share principal responsibility for this change: (1) the creation of the euro; (2) the widening of global payments imbalances; and (3) the globalization of financial markets. Each of these developments has effectively added to the population of actors with a significant degree of autonomy in monetary affairs.

### *The euro*

The creation of the euro in 1999 was always expected to have a major impact on the geopolitics of finance. Even without the participation of Britain and some other EU members, Europe’s economic and monetary union (EMU) was destined to become one of the largest economic units in the world, rivalling even the United States in terms of output and share of foreign trade. A shift in the balance of power

across the Atlantic thus seemed inevitable. Europe's new money, building on the widespread popularity of Germany's old Deutschmark, would pose a serious threat to the predominance of America's greenback as an international currency. The euro area—Euroland, as some call it—was bound to become a leading player on the monetary stage. Robert Mundell, a Nobel laureate in economics, voiced a widely held view when he expressed his conviction that EMU would 'challenge the status of the dollar and alter the power configuration of the system'.<sup>4</sup>

To a significant degree, those early expectations have been realized. A decade on, Europe's monetary power has clearly been enhanced. The euro has smoothly taken over the Deutschmark's place as the second most widely used currency in the world. Euroland itself has grown from eleven members to 15, with as many as a dozen or more countries set to join in future years. Some measure of power has indeed shifted across the Atlantic.

Europe's gains, however, have been mainly in the dimension of autonomy, rather than influence. Currency union has manifestly reduced the area's vulnerability to foreign exchange shocks. With a single joint money replacing a plethora of national currencies, participants no longer have to fear the risk of exchange rate disturbances inside Europe and, in combination, are now better insulated against turmoil elsewhere. For a continent long plagued by currency instability, that is no small accomplishment. Moreover, with the widespread acceptability of the euro, EMU countries now enjoy a much improved international liquidity position. Deficits that previously required foreign currency may now be financed with Europe's own money, thus enhancing the group's power to delay. Operational independence plainly is greater now than it was before.

So far, though, Europe has conspicuously failed to convert its enhanced autonomy into a greater capacity for control in monetary affairs.<sup>5</sup> Contrary to the predictions of many, the euro has yet to establish itself as a truly global currency, and this has deprived participants of an instrument that might have been used to help shape behaviour or outcomes. Nor has membership in EMU yet enabled European governments to play a more assertive role in world monetary forums such as the IMF or G7. Though freer now to pursue internal objectives without external constraint, Euroland has yet to actualize the potential for overt leverage that monetary union has created.

The euro's weaknesses as an international currency are by now familiar. The new money did start with many of the attributes necessary for competitive success, including a large economic base, unquestioned political stability and an enviably low rate of inflation, all backed by a joint monetary authority, the European Central Bank (ECB), fully committed to preserving confidence in the currency's value. But, as I have argued previously,<sup>6</sup> the euro is also hampered by several critical

<sup>4</sup> Robert Mundell, 'The euro and the stability of the international monetary system', in Robert Mundell and Armand Cleese, eds, *The euro as a stabilizer in the international economic system* (Boston: Kluwer Academic, 2000), p. 57.

<sup>5</sup> Benjamin J. Cohen, 'The euro in a global context: challenges and capacities', in Kenneth Dyson, ed., *The euro at ten* (Oxford: Oxford University Press, forthcoming 2008).

<sup>6</sup> Benjamin J. Cohen, 'Global currency rivalry: can the euro ever challenge the dollar?', *Journal of Common Market Studies* 41: 4, Sept. 2003, pp. 575–95.

deficiencies, all structural in character, that dim its attractiveness as a rival to the greenback. These include limited cost-effectiveness, a serious anti-growth bias and, most importantly, ambiguities at the heart of the monetary union's governance structure. Not surprisingly, therefore, experience to date has been underwhelming. Only in the EU's immediate neighbourhood, where trade and financial ties are especially close, has the euro come to enjoy any special advantages as the natural heir to the Deutschmark. That is EMU's natural habitat—'the euro's turf', as economist Charles Wyplosz calls it.<sup>7</sup> Elsewhere, Europe's money remains at a distinct disadvantage in trying to overcome the incumbency advantages of the already well-established dollar.

Equally obvious by now are Euroland's weaknesses as a political actor. Joined together in EMU, one would have thought, European states would surely have more bargaining power than if each acted on its own. Europe's voice would be amplified on a broad range of macroeconomic issues, from policy coordination to crisis management. Yet here too experience to date has been underwhelming. In practice, membership of EMU has not enabled EU governments to play a more influential role in the IMF or other global forums, mainly because no one knows who, precisely, speaks for the group. Since no single body is formally designated to represent EMU in international discussions, the euro area's ability to project power on monetary matters is inherently constrained. Fred Bergsten, a euro enthusiast, laments that EMU 'still speaks with a multiplicity, even a cacophony, of voices . . . Hence it dissipates much of the potential for realizing a key international role.'<sup>8</sup>

Overall, therefore, the power configuration of the system has been altered far less than Mundell or others anticipated. The Europeans clearly are now better placed to resist external pressures. Their collective autonomy has been enhanced. But Europe is still a long way from exercising the kind of leverage that monetary union might have been expected to give it. Influence has not been effectively actualized. Monetary power, on balance, has been dispersed rather than relocated from one side of the Atlantic to the other.

### *Global imbalances*

A second major development in recent years has been the emergence of unprecedented global imbalances—most particularly, a wide gap in the balance of payments of the United States, matched by counterpart surpluses elsewhere, particularly in East Asia and among energy-exporting nations. (Notably missing is Euroland, which has maintained a rough balance in its external accounts.) In 2006 America's deficit swelled past \$850 billion, equivalent to some 6.5 per cent of US GDP. Although it is now shrinking a bit, the shortfall continues to add to an already record level of foreign debt. Net of assets abroad, US liabilities reached \$2.6 trillion at the end of 2006, equal to roughly a fifth of GDP. Correspondingly,

<sup>7</sup> Charles Wyplosz, 'An international role for the euro?', in Jean Dermine and Pierre Hillion, eds, *European capital markets with a single currency* (New York: Oxford University Press, 1999), p. 89.

<sup>8</sup> C. Fred Bergsten, 'The euro and the dollar: toward a "finance G-2"?', in Adam Posen, ed., *The euro at five: ready for a global role?* (Washington DC: Institute for International Economics, 2005), p. 33.

reserve holdings of dollars in surplus countries have soared, having risen to above \$3 trillion by 2006. For many, imbalances on this scale seem certain to alter the balance of monetary power between the United States and the larger surplus countries. The only question is: How much?

In terms of the autonomy dimension of power, the impact is obvious. With their vastly improved international liquidity positions, countries in surplus are now much better placed to postpone the process of adjustment when they wish: their power to delay is clearly enhanced. A decade ago, when financial crisis hit East Asia, governments in the region—under intense pressure from the United States and the IMF—felt they had little choice but to initiate radical economic reforms, backed by tight monetary and fiscal policies. Resentful of being forced to pay such a high transitional cost of adjustment, they were determined to insulate themselves as much as possible against similar pressures in the future. The result today is a greatly heightened capacity for operational independence.

The most notable example of this phenomenon is China, whose currency reserves are now above \$1.4 trillion and continue to grow by as much as \$20 billion each month. China has been the target of a determined campaign by the United States and others to allow a significant revaluation of its currency, the yuan (also known as the renminbi). Beijing, however, has stood firm, resisting all pleas. Since a well-publicized switch from a dollar peg to a basket peg in mid-2005, the yuan has appreciated in small steps by little more than 15 per cent—far short of what most observers think is needed to make a real dent in China's trade surplus. Plainly, the world's largest stockpile of reserves gives China more room for manoeuvre than it might otherwise enjoy.

But does enhanced autonomy translate into greater influence? Certainly there is an increase of influence in the passive mode. Simply by exercising their power to delay, surplus countries have placed more pressure on the United States to do something—or, at least, to *think* about doing something—about its deficits. But are we witnessing an increase of influence in the active, purposive mode? There the outlook is more ambiguous.

Indirectly, influence might be increased through the operations of the newly fashionable sovereign wealth funds that many surplus countries have created to generate increased earnings on a portion of their reserves. Already there are more than 30 such funds controlling assets in excess of \$2.5 trillion, a figure that could grow to as much as \$15 trillion over the next decade. In principle, it is possible to imagine that at least some of these funds might be deployed strategically to gain a degree of leverage in recipient states. Investments might be carefully aimed towards institutions that are known to have privileged access to the corridors of governmental power—institutions like Citibank and Merrill Lynch in the United States, which in the midst of the recent credit crunch together attracted more than \$20 billion from wealth funds in Asia and the Middle East. In practice, however, potential target states are not without means to monitor or limit politically risky investments within their borders. The balance of power has by no means tipped as much as might appear.

Alternatively, influence might be increased directly through the use of newly acquired reserve stockpiles to threaten manipulation of the value or stability of a key currency such as the dollar. There is nothing complicated about the option. Indeed, as Jonathan Kirshner reminds us, 'currency manipulation is the simplest instrument of monetary power and . . . can be used with varying degrees of intensity, ranging from mild signaling to the destabilization of national regimes'.<sup>9</sup> Yet the results could be devastating for the issuer of a key currency, such as the United States. If any nation is in a position to use its newly acquired influence in this manner, it is China. At any time, Beijing could undermine America's money by dumping greenbacks on the world's currency exchanges or even simply by declining to add dollars to China's reserves in the future. Such threats would take little effort on China's part and could be carefully calibrated for maximum effect. The advantages for China are enormous.

But there are also disadvantages, as the Chinese themselves well understand. Beijing's dollar hoard could hardly be sold all at once. Hence any depreciation of the greenback would impose costs on China as well, in the form of capital losses on its remaining holdings. China's dollar reserves today are equal to about one-third of the country's GDP. For every 10 per cent depreciation of the greenback, therefore, China would lose something in excess of 3 per cent of GDP—no small amount. In addition, dollar depreciation would greatly erode the competitiveness of the exports that are so vital to China's economic growth. In reality, currency manipulation is a two-edged sword that could end up doing China far more harm than good—a kind of 'nuclear option', to be used only *in extremis*.

Here too, then, it is not at all clear that the balance of monetary power has tipped as much in favour of China and other surplus countries as might appear to be the case. Indeed, now that dollar holdings have grown so large, it actually makes more sense for China and others to support rather than threaten the greenback, whether they like it or not, in order to avert a doomsday scenario. Some see this as nothing more than enlightened self-interest. Others see it as more akin to the notorious balance of terror that existed between the nuclear powers during the Cold War—a 'balance of financial terror', as former US Treasury Secretary Lawrence Summers has described it.<sup>10</sup> Neither side wants to risk a MAD (mutually assured destruction) outcome.

In short, global imbalances too have caused a shift in the balance of monetary power—but, as in the case of EMU, mainly in the dimension of autonomy. Reserve accumulations have not clearly amplified the influence, whether direct or indirect, of the large surplus countries. Here too, power has been largely dispersed rather than relocated.

<sup>9</sup> Jonathan Kirshner, *Currency and coercion: the political economy of international monetary power* (Princeton, NJ: Princeton University Press, 1995), p. 8.

<sup>10</sup> Lawrence H. Summers, *The US current account deficit and the global economy* (Washington DC: Per Jacobsson Foundation, 2004).



### *Financial globalization*

Finally, there is the change in the international monetary environment that has been wrought by the globalization of financial markets. The story is familiar. Where once most financial markets were firmly controlled at the national level and insulated from one another, today across much of the globe barriers to the movement of money have been greatly reduced or effectively eliminated, resulting in a scale of financial flows unequalled since the glory days of the nineteenth-century gold standard. One consequence, observers agree, is a distinct shift in the balance of power between states and societal actors. By promoting capital mobility, financial globalization enhances the authority of market agents at the expense of sovereign governments.

Key to the shift is the wider range of options made available to privileged elements of the private sector with the integration of financial markets: a marked increase of autonomy for those societal actors in a position to take advantage of the opportunities now afforded them. In effect, financial globalization means more freedom for selected individuals and enterprises—more room for manoeuvre in response to actual or potential decisions of governments. Higher taxes or regulation may be evaded by moving investment funds offshore; tighter monetary policies may be circumvented by accessing external sources of finance. Ultimately, it means a fading of the strict dividing lines between separate national moneys, as weaker domestic currencies are traded in for more attractive foreign moneys like the dollar or euro—a phenomenon to which I have previously referred as the new geography of money.<sup>11</sup> No longer, in many places, are societal actors restricted to a single currency, their own domestic money, as they go about their business. Now they have a choice in what amounts to a growing competition among currencies. The functional domain of each money no longer corresponds precisely to the formal jurisdiction of its issuing authority. Currencies have become increasingly *deterritorialized*, their circulation determined not by law or politics but by the preferences of market agents.

Mirroring the increased autonomy of societal actors is a loss of some measure of operational independence by states. Financial globalization has forced governments into a trade-off between exchange rate stability and autonomy in monetary policy. Some still prioritize the external value of their currency, resigning themselves to a loss of control over domestic monetary aggregates and interest rates. Many others have moved towards some form of inflation targeting, substituting this for exchange rate targeting as a monetary rule. Either way, state authority is compromised. The essence of the challenge has been captured by David Andrews in what he calls the capital mobility hypothesis: 'The degree of international capital mobility systematically constrains state behaviour by rewarding some actions and punishing others . . . Consequently, the nature of the choice set available to states . . . becomes more constricted.'<sup>12</sup> Governments are compelled to tailor their policies, at least in

<sup>11</sup> Benjamin J. Cohen, *The geography of money* (Ithaca, NY: Cornell University Press, 1998).

<sup>12</sup> David M. Andrews, 'Capital mobility and state autonomy: toward a structural theory of international relations', *International Studies Quarterly* 38: 2, June 1994, pp. 193–218.

part, to what is needed to avoid provoking massive or sudden financial movements. Market agents gain leverage in relation to public officials.

Here again, though, we must note that the influence gained is largely passive rather than active. Few knowledgeable observers of the decentralized decision processes of the marketplace would argue that the pressures now exerted on governments are somehow designed with conscious political intent. An informal kind of veto over state behaviour has emerged. But it is a power that is exercised incidentally, through market processes, rather than directly in pursuit of a formal policy agenda. State autonomy is threatened, but not from a design that is purposive or hostile. Here too the pattern is essentially one of a leaderless diffusion of power.

### Ambiguity

All these developments are having a profound impact on governance structures in the monetary system. The greater the population of actors with a significant degree of autonomy in monetary affairs, the harder it is to reach any sort of consensus on critical questions. By definition, autonomous agents can more easily resist pressures to conform. Hence a greater degree of ambiguity is introduced into the way the system is run. Increasingly, structures of governance are being remoulded in an evolutionary fashion through the gradual accumulation of custom and usage. Formal rules (specific prescriptions or proscriptions for behaviour) are being superseded by more informal norms (broad standards of behaviour defined in terms of rights and obligations), in a manner not unlike that of English common law—unwritten law (*lex non scripta*) in lieu of written or statute law (*lex scripta*).

The impact on governance structures can be seen at two levels: the individual state and the global system. At the state level, the dispersion of power compels governments to rethink their historical commitment to national monetary sovereignty. At the systemic level, it compounds the difficulties of bargaining on international monetary issues.

### National sovereignty

Tradition has long assigned the primary role in monetary governance to the sovereign state. As a matter of practice, governments have been assumed to enjoy a natural right of monopoly control over the issue and management of money within their borders. Ever since the seventeenth-century Peace of Westphalia, the conventions of standard political geography have celebrated the role of the nation-state, absolutely supreme within its own territory, as the basic unit of world politics. By the nineteenth century, the norm of national monetary sovereignty had become an integral part of the global governance structure. Just as political space was conceived in terms of those fixed and mutually exclusive entities we call states, currency spaces came to be identified with the separate sovereign jurisdictions

where each money originated. With few exceptions, each state was expected to maintain its own exclusive territorial currency. I have labelled this the Westphalian model of monetary geography.<sup>13</sup>

Though never written down anywhere, the norm of monetary sovereignty was of such long standing that by the mid- to late twentieth century it had taken on the legitimacy of a formal rule. Today, however, that old tradition has been shaken by the new growth of competition among currencies across national borders, resulting from financial globalization. As currencies become increasingly deterritorialized, governments find themselves driven to reconsider their historical attachment to the Westphalian model. The monetary sovereignty norm is gradually being eroded by changes of practice and circumstance.

National monetary sovereignty clearly does have its advantages, including the privilege of seigniorage (the ability to finance public spending via money creation) and the power to manage monetary conditions. But in a world where growing numbers of societal actors can now exercise choice among diverse currencies, there are also distinct disadvantages. Most notable is the need to prioritize the goal of preserving market confidence in the value and usability of the nation's money—the 'confidence game', to recall Paul Krugman's name for it.<sup>14</sup> The label is ironic because, as in any con game, the effort to play may prove an exercise in futility.

The dilemma is simple. To preserve confidence in its currency, a government must above all make a credible commitment to 'sound' macroeconomic management, meaning a strong emphasis on low inflation and financial stability. Monetary policy must not appear to be overused for expansionary purposes; fiscal policy must not be allowed to finance deficits via the printing press. Such policy discipline—what Krugman calls 'root-canal economics'—is of course by no means undesirable, as any victim of past government excesses can attest.<sup>15</sup> High inflation and financial instability can destroy savings, distort incentives and suppress productive investment. Conversely, if sustained, 'sound' management policies may indeed successfully enhance a currency's reputation. However, there is also a distinct downside. Root-canal economics can be extremely costly in terms of lost output or higher unemployment, owing to structural deficiencies that may inhibit an economy's ability to adjust to a constrained policy environment. Experience demonstrates that tight monetary and fiscal policies can in fact turn into dismal austerity policies, depressing growth for a prolonged period.

Faced with this dilemma, governments have three options. One is to continue playing the confidence game, whatever the cost. The other two would replace a country's national currency with a *regional* money of some kind.<sup>16</sup> Currency regionalization occurs when two or more states formally share a single money or equivalent. In one variant of regionalization, countries can agree to merge their separate currencies into a new joint money, as members of EMU have done with the euro. This is *currency unification*, a strategy of 'horizontal' regionalization.

<sup>13</sup> Cohen, *The geography of money*.

<sup>14</sup> Paul R. Krugman, 'The confidence game', *New Republic*, 5 Oct. 1998, pp. 23–5.

<sup>15</sup> Paul R. Krugman, 'Other people's money', *New York Times*, 18 July 2001, p. A23.

<sup>16</sup> Benjamin J. Cohen, *The future of money* (Princeton, NJ: Princeton University Press, 2004).

Alternatively, any single country may unilaterally or by agreement replace its own currency with the already existing money of another country, an approach typically described as full or formal *dollarization* ('vertical' regionalization). Both variants involve a delegation of traditional powers away from the individual state. Monetary sovereignty is either *pooled* in a partnership of some sort, shifting authority to a joint institution like the ECB, or else *surrendered* wholly or in part to a dominant foreign power such as the United States.

Already, under the pressure of currency competition, a number of governments have opted to abandon their traditional monetary sovereignty. In 2000 Ecuador adopted America's greenback as its exclusive legal tender; a year later El Salvador followed suit. In effect, both chose to become monetary dependencies of the United States rather than fight on to sustain a money of their own. Others have established currency boards—a more limited form of vertical regionalization—or have talked seriously about a monetary union of some kind. Tentative plans have already been drawn up for currency unification in West Africa and in the Gulf region of the Middle East and are under discussion elsewhere. In the opinion of many informed observers, it is only a matter of time before the universe of moneys will be radically shrunk.<sup>17</sup>

In reality, of course, it is easier to talk about currency regionalization than actually to do something about it. Giving up a national currency is not easy. As I have argued elsewhere, attachments to the tradition of monetary sovereignty remain strong in most parts of the world, however costly the confidence game may be.<sup>18</sup> But there is no question that for many governments, the stark choice must now be faced. The shift in the balance of power between states and societal actors has unquestionably undermined the foundations of the traditional Westphalian model. As a result, a previously clear norm is now increasingly clouded with uncertainty.

### *International bargaining*

Much the same is happening at the systemic level, where prevailing governance structures have also been brought into question by continuing shifts in the distribution of power. As a corollary of the traditional norm of monetary sovereignty at the state level, governments have long relied on formal or informal negotiations among themselves to lay down the rules of the game at the systemic level. As far back as the Genoa Conference of 1922, the dynamics of rule-setting have centred on hard-won bargains struck among a few leading states with the capacity to cajole or coerce others into agreement. That was the scenario at the Bretton Woods Conference of 1944, which was dominated by the United States and Britain. The pattern could also be seen in the negotiations that led up to the earliest amendments of the charter of the IMF, providing for the creation of special drawing rights (negotiated in the 1960s by the Group of Ten) and ratifying a new system of flexible

<sup>17</sup> Zanny M. Beddoes, 'From EMU to AMU? The case for regional currencies', *Foreign Affairs* 78: 4, July 1999, pp. 8–13.

<sup>18</sup> Cohen, *The future of money*.

exchange rates (mainly the product of a 1975 agreement between France and the United States). In this respect, the geopolitics of finance were no different from the geopolitics of other issues, where power has always played a pivotal role.

But that was before so many more states gained a degree of autonomy in monetary affairs. The more governments feel insulated from outside pressure, the less likely it is that they will meekly accept the diktat of an inner circle of self-appointed leaders. Bargains made at the top will not be treated with the same respect as in the past. Existing or proposed new rules will no longer enjoy the same degree of legitimacy among states further down the hierarchy, unless these states too are incorporated into the decision-making process.

A diffusion of monetary power is nothing new, of course. The 1960s and 1970s, when US hegemony seemed to be in decline, also saw the emergence of new powers in monetary affairs. Then too there was an increase of ambiguity in governance structures, especially after the breakdown of the Bretton Woods par value system in 1971–3. But even after those troubled decades the inner circle remained remarkably small, limited essentially to the United States and its partners in the G7—as evident, for example, in the celebrated Plaza and Louvre accords of the 1980s and the management of financial crises in Mexico and East Asia in the 1990s. What is distinctive about today, by contrast, is the sheer number of states that now feel entitled to seats at the high table.

That, of course, explains why recent years have seen a proliferation of new forums designed to widen participation in global discussions. A turning point came after the Asian crisis, when broad new interest was sparked in reform of what soon came to be called the ‘international financial architecture’. One result was the Group of Twenty finance ministers’ and central bank governors’ forum (G20), which was created in 1999 and now meets annually to discuss a range of economic and monetary issues. In addition to representatives of the G7 and European Union, the G20 brings to the table some dozen ‘systemically significant economies’: Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. A second initiative was the Financial Stability Forum (FSF), also dating from 1999, which is charged with improving the functioning of financial markets and bringing about a reduction of systemic risk. Convened twice a year, the FSF includes some 43 members representing 26 states and a variety of international financial institutions and supervisory bodies. Forums like the G20 and FSF are obviously intended to enhance the legitimacy of current reform efforts.

The same concerns also explain why so much attention is now being paid to the allocation of quotas at the IMF, which *inter alia* determine the distribution of voting power among the Fund’s members. Many advanced economies—including especially the members of the EU—appear to be overrepresented in the Fund’s voting system, while some of the larger emerging market economies are clearly underrepresented. Past quota adjustments, it is generally agreed, simply have not kept up with the transformation of the world economy. In 2006 IMF governors agreed that it was time to implement a new, ‘simpler and more transparent’ formula

to guide adjustments in the future, generating a plethora of competing proposals.<sup>19</sup> To date, consensus on any single approach has proved elusive—which is not at all surprising, given the zero-sum nature of the game. Any gain of voting shares for some countries must necessarily come at the expense of others. But some reallocation of quotas clearly does seem to be on the cards.

Wider participation, however, will not make rule-setting any easier. Quite the contrary, in fact. The efficiency of decision-making obviously suffers as more actors are given parts in the process. According to standard organization theory, the difficulties of negotiation actually increase exponentially, not just in proportion, with the number of parties involved. The more voices there are at the table, the greater is the temptation to smooth over unresolved differences with artful compromises and the deliberate obfuscations of classic diplomatic language. Clarity is sacrificed for the sake of avoiding the appearance of discord. Much room is left for creative interpretation.

Worse, even when some measure of agreement is achieved, little can be done about it. Apart from the IMF, none of the existing forums have any powers of direct enforcement. Bodies like the G7, G20 and FSF are essentially regularized procedures for consultation—little more than talking shops. Some advantage may be gained from the exchange of information and viewpoints that is facilitated. But wider participation, per se, does nothing to ensure that newly autonomous actors will feel obliged to compromise some part of their operational independence if it does not suit their interests. And even the enforcement powers of the IMF are limited today to just the poorest countries in the system, which remain the organization's only regular clients. The Fund's leverage rests largely on the conditions it may attach to its lending. But richer states, with their access to the global financial markets, no longer need the IMF for financing. Hence many are free to ignore Fund pronouncements, whatever the allocation of member quotas.

A case in point is provided by the Fund's recent effort to tighten up its rules for the management of exchange rates by member governments—the first revision since 1977 of the principles for what is called bilateral surveillance of currency practices.<sup>20</sup> Central to the revision is a new injunction urging states to avoid practices that cause 'external instability'. But there is little that the Fund can do if nations choose to resist. Some countries, like China (the obvious target of the new injunction), continue to maintain formal pegs that generate large trade imbalances. Others that have ostensibly abandoned pegging in favour of inflation targeting nonetheless intervene massively to manage their exchange rates, whatever the external consequences—a pattern of behaviour known as 'dirty' floating. The high reserve holdings generated by today's global imbalances make dirty floating feasible for many. Only governments that lack the requisite liquidity are susceptible to IMF blandishments.

<sup>19</sup> Richard N. Cooper and Edwin M. Truman, 'The IMF quota formula: linchpin of fund reform', policy brief in international economics no. PB07-1 (Washington DC: Peterson Institute for International Economics, 2007).

<sup>20</sup> International Monetary Fund, 'IMF surveillance: the 2007 decision on bilateral surveillance', fact sheet, June 2007.

Overall, therefore, the prospect is for growing ambiguity in the system's governance structures. Whether they are part of the bargaining process or not, newly autonomous states now have more leeway to follow their own instincts. Some will undoubtedly continue to play the confidence game, at whatever cost in terms of 'external stability'. Others may well prefer to pool or surrender their monetary sovereignty in some degree. In effect, many governments have been freed to make up their own rules as they go along through practice and the gradual accumulation of experience.

In time, of course, patterns of behaviour that originate in self-interest may lead to shared expectations (intersubjective understandings) and can eventually even become infused with normative significance. Often, what starts from a logic of consequences (a concern with material impacts) comes ultimately to rest on a logic of appropriateness (a concern with what is 'right'). That kind of evolutionary process, relying on the development of informal norms rather than formal rules, is a hallmark of English common law. Increasingly, it is becoming central to international monetary governance as well.

## Conclusion

The dynamics of power and governance in global finance today are indeed changing. A leaderless diffusion of power is generating greater uncertainty about the underlying rules of the game. At the state level, governments increasingly question the need for a strictly national currency. At the systemic level, governance now relies more on custom and usage, rather than intergovernmental negotiation, to define standards of behaviour.

Greater ambiguity is not necessarily a bad thing, especially if it allows states and societal actors to get along without undue friction. But it does also have distinct disadvantages that cannot be ignored. Governance plainly is less tidy when effectuated through social conventions rather than formal agreements. *Lex non scripta* is inherently more opaque than *lex scripta*. Hence a wider latitude is afforded actors for strategic manoeuvres that may be made at the expense of others. Outcomes may be neither as stable nor as equitable as we might wish. Crises could become more frequent or difficult to manage if more governments feel free to do their own thing, discounting disruptive externalities. Burdens of adjustment could fall disproportionately on the weakest members of the system, which have benefited least from the leaderless diffusion of power.

Can anything be done to lessen such risks? Since states remain the basic units of world politics, responsibility continues to reside with governments, which still have little choice but to try to resolve their differences through negotiation. What is needed, however, is a change of bargaining strategy to conform more comfortably to the new distribution of power. With autonomy spread more widely among actors, it is becoming increasingly fruitless to aim for specific prescriptions for behaviour—what in biblical language might be called 'thou shalt' types of rule. More governments are now in a position simply to ignore detailed injunctions

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when they wish. But it is not impractical to aim for the reverse—general ‘thou shalt not’ types of rule that set outer limits to what might be considered acceptable. Even the most insular governments are apt to recognize that there is a common interest in keeping potential externalities within bounds. If prevailing governance structures are to retain any practical influence at all, that is the direction in which the dynamics of rule-setting must now move.