EUI WORKING PAPERS

RSCAS No. 2005/09

Defining the Limits of Monetary Power within Currency Areas

Scott Cooper

EUROPEAN UNIVERSITY INSTITUTE
Robert Schuman Centre for Advanced Studies
Transatlantic Programme Series

EUROPEAN UNIVERSITY INSTITUTE, FLORENCE

ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

Defining the Limits of Monetary Power within Currency Areas

SCOTT COOPER

EUI Working Paper **RSCAS** No. 2005/09

BADIA FIESOLANA, SAN DOMENICO DI FIESOLE (FI)

All rights reserved.
No part of this publication may be reproduced, distributed or utilised
in any form or by any means, electronic, mechanical, or otherwise, without
the prior permission in writing from the Robert Schuman Centre for Advanced Studies.

Download and print of the electronic edition for teaching or research non commercial use is permitted on fair use grounds—one readable copy per machine and one printed copy per page. Each copy should include the notice of copyright.

Permission for quotation should be addressed directly to the author(s). See contact details at end of text.
Source should be acknowledged.

These papers were presented in a May 2004 workshop considering the political implications of competitive monetary systems.

ISSN 1028-3625

© 2005 Scott Cooper

Printed in Italy in March 2005
European University Institute
Badia Fiesolana
I – 50016 San Domenico di Fiesole (FI)
Italy

http://www.iue.it/RSCAS/Publications/

Robert Schuman Centre for Advanced Studies

The Robert Schuman Centre for Advanced Studies carries out disciplinary and interdisciplinary research in the areas of European integration and public policy in Europe. It hosts the annual European Forum. Details of this and the other research of the centre can be found on:
http://www.iue.it/RSCAS/Research/.

Research publications take the form of Working Papers, Policy Papers, Distinguished Lectures and books. Most of these are also available on the RSCAS website:
http://www.iue.it/RSCAS/Publications/.

The EUI and the RSCAS are not responsible for the opinion expressed by the author(s).

Transatlantic Programme

The Transatlantic Programme of the Robert Schuman Centre for Advanced Studies conducts policy-oriented and basic research on the subjects of transatlantic relations and transatlantic governance. Our activities aim at improving public and scholarly understanding of transatlantic partnership, and the role of the transatlantic partners in issues of global governance. The Transatlantic Programme was established in Autumn 2000, thanks to a generous grant from BP.

For further information:
Transatlantic Programme
Robert Schuman Centre for Advanced Studies
European University Institute
Via delle Fontanelle, 19
50016 San Domenico di Fiesole (FI), Italy

Fax: + 39 055 4685 770
E-mail: atlantic@iue.it
http://www.iue.it/RSCAS/Research/transatlantic/Index.shtml

Abstract

Leaders of currency areas, despite their power, face significant limits on the exercise thereof. As a result, the relationship between leaders and followers within these areas is better characterized as interdependence than dependence. Participation in a currency area shifts bargaining power between the leader and follower in two ways. First, the usefulness of a leader's threat to expel the follower—or the follower's threat to exit—depends on the relative costs of the follower's exit. The leader must weigh not only the loss of enforcement, extraction, and entrapment resources, but also the possibility that the follower's departure will destabilize or even capsize the boat. For both leaders and followers, a crucial consideration is how their economy would fare outside the currency area. On average, the follower has the weaker position because it needs the area more than the area needs it. But there is no *ex ante* reason to believe that the follower will always be weaker. Second, the rules of the area create basic parameters for bargaining. Formalized, symmetric rules tend to lock in a greater share of the benefits for followers and thus place limits on the leader's extraction, at least temporarily. Less formalized and/or more asymmetric systems give the leader greater scope for throwing its weight around and extracting resources.

Keywords

monetary relations, currency areas, policy leadership

Introduction[1]

Despite the abundant literature on individual currency areas such as the franc zone or the sterling bloc, there has been a dearth of *comparative political* analysis of how these areas work. One important exception is Jonathan Kirshner's analysis of how monetary power is exploited by leading powers within currency areas. He explains the mechanisms of dependence and analyzes the various ways a currency area's leader is able to gain power at the expense of follower states. He also uses detailed empirical examples to show how leaders have exploited the monetary dependence of followers.[2]

Although Kirshner's analysis and evidence are generally persuasive, it is striking how often modern currency areas seem to magnify the leader's weakness, rather than promote its strength. The sterling area may have been a source of British power in the 1930s and 1940s, but by the 1960s sterling was more of a problem than a solution. The Bretton Woods system went through a similar period of decline in the 1960s. The CFA franc zone has not declined in the same way, but has brought hardly any new resources to France, other than the intangible prestige of its existence.[3] The post-Soviet rouble zone was such a drain on Russia that the Russian government essentially abandoned the attempt within two years. U.S. reluctance to endorse a formal dollar area in Latin America seems also to be based on fears that formalization would be a burden more than a benefit.[4] Thus, while Kirshner fulfils his goal of demonstrating the existence and effectiveness of monetary power, a more complete picture of currency areas must flesh out the corresponding limits on that power.

The central theme of this essay is that, under some conditions, great power currency areas may constitute a greater liability than an asset. The basic economic idea is well understood: currency issue is an asset when others are buying but a liability when they start selling. Getting others to accept your IOU is a benefit that can become a burden if too many IOU's come due at the same time. But I argue that the political corollary is easily overlooked: currency issuers and currency users are in a reciprocal relationship in international money markets. The currency issuer gains real resources in return for its currency, but at the cost of increasing potential future claims against itself. Depending on institutional arrangements and on market conditions, currency areas may burden rather than benefit the issuers of even significant international currencies. No study of the opportunities for influence created by currency issue should forget the corresponding constraints. Benjamin Cohen makes this point in a discussion of monetary power:

> Latitude for the issuing government is apt to be greatest […] in the earliest stages of cross-border use, when its money is most popular […] Over time, however, policy will be increasingly constrained by the need to discourage sudden or substantial conversions into other currencies.

---

1 Thanks to David Andrews, Michael Artis, Jeff Chwieroth, Benjamin Cohen, Eric Helleiner, Randall Henning, Matthias Kaelberer, and Jonathan Kirshner for helpful comments, to Brooke Richards for research assistance, and to Brigham Young University and the European University Institute for research funding.

2 Jonathan Kirshner, *Currency and Coercion: The Political Economy of International Monetary Power* (Princeton: Princeton University Press, 1995). Benjamin Cohen's work in part reinforces Kirshner by emphasizing the importance of a dominant state as a key factor in sustaining a currency area, but also goes beyond Kirshner in pointing out that a dense network of institutional ties may sustain a currency area in the absence of a leading state. In effect, Cohen reminds us that some currency areas are symmetric; see Benjamin Cohen, 'Beyond EMU: The Problem of Sustainability', *Economics and Politics* 5 (1993): pp. 187-203; Benjamin Cohen, *The Geography of Money* (Ithaca: Cornell University Press, 1998), pp. 68-91; and Benjamin Cohen, *The Future of Money* (Princeton: Princeton University Press, 2004), pp. 51-61, 123-78. Other important comparative work on currency areas includes Andrew Walter, *World Power and World Money* (New York: St. Martin's Press, 1991); Carsten Hefeker, 'Interest Groups, Coalitions, and Monetary Integration in the XIXth Century', *Journal of European Economic History* 24 (1995): pp. 489-536; and Walter Mattli, *The Logic of Regional Integration: Europe and Beyond* (Cambridge, UK: Cambridge University Press, 1999).

3 Kirshner, *Currency and Coercion*, pp. 156.

4 Benjamin Cohen, 'U.S. Policy on Dollarization: A Political Analysis', *Geopolitics* 7 (2002), pp. 63-84. Postwar Germany and Japan were initially reluctant to allow international use of their currencies for similar reasons; Cohen, *Future of Money*, p. 38.

> Ultimately, effective political power may on balance be decreased rather than increased—precisely the reverse of the conventional wisdom regarding the political value of hegemony.[5]

Building on both Cohen and Kirshner, this study aims to elaborate the conditions under which leverage shifts from the currency issuer to currency users.

I argue that we must look at two characteristics of a currency area in order to understand the limits currency areas place on leaders. First, the power of the leader's threat to expel the follower—or of the follower's threat to exit—depends on the relative costs of the follower's exit. The leader must weigh not only the loss of enforcement, extraction, and entrapment resources, but also the possibility that the follower's departure will destabilize or even capsize the boat. Followers weigh the loss of membership perks and the domestic political ramifications of departure. For both, a crucial consideration is how their economy would fare outside the currency area. On average, the follower has the weaker position because it needs the area more than the area needs it. But there is no *ex ante* reason to believe that the follower will always be weaker—and plenty of examples to suggest the opposite.

Second, the rules of the area provide basic parameters for bargaining. Formalized, symmetric rules tend to guarantee a greater share of the benefits for followers and thus place limits on the leader's extraction. Rules that delegate some functions to third party monetary institutions also reduce the leader's power. Less formalized and/or more asymmetric systems give the leader greater scope for throwing its weight around and extracting resources. Of course, rules are a weak barrier to a determined leader: we expect the leader to modify or nullify rules that undermine the advantages of its leading power position. But both theory and history suggest that currency area rules may prove at least a temporary constraint on the leading state.

Kirshner provides historical examples of the effectiveness of exploitation by currency area leaders, but he understates the reciprocal threat *to leaders* from followers under some circumstances. Evidence from the sterling area is insightful: the sterling area did provide important resources to Britain, but large sterling holders also had a degree of leverage over Britain. For example, at Kuwait's independence in the early 1960s, the British Treasury instructed political officials to encourage Kuwait to keep its existing sterling reserves, but *not* to increase them in the future. Kuwait's pro-Nasser foreign policy tendencies made it an uncertain prop under the British balance-of-payments, and British officials were opposed to Kuwait increasing its leverage by means of increased sterling holdings.[6] Kirshner provides a similar example in his discussion of Zambia's attempts to use its sterling balances to coerce Britain during the Rhodesian independence crisis. He classifies this as an example of 'systemic disruption', but both examples demonstrate clearly the reciprocal nature of 'monetary dependence': leaders as well as followers have much at stake in a currency area.[7] Under certain conditions, leaders may find themselves ceding political leverage, rather than obtaining it.

Put differently, even asymmetric currency areas led by great powers create not so much monetary dependence as monetary *inter*dependence. Even though on average the relationship asymmetrically favours the leader, both leaders and followers are to some extent dependent on the currency area for insulation from the larger monetary world. That interdependence creates leverage on both sides. Notice that neither example suggests that followers are immune from monetary dependence: any Kuwaiti threat to sell its sterling reserves would have been limited by the fact that the attempt to sell would have lowered the value of its own sterling, as well as Britain's. The examples simply suggest that the relationship is reciprocal and that under some conditions followers may have more bargaining power than the leader. Overall, careful consideration of the limits of monetary power is necessary to fully appreciate the nature of monetary power.

---

5 Cohen, *Geography of Money*, pp. 129; see also Benjamin Cohen, *The Future of Sterling as an International Currency* (London: Macmillan, 1971), pp. 38-41.

6 UK Public Records Office, Treasury 317/24, A. Mackay, 16 March 1961.

7 Kirshner, *Currency and Coercion*, pp. 203-12.

 EUI-WP RSCAS No. 2005/09 © 2005 Scott Cooper

This remainder of this paper is divided into four parts. Section 1 discusses scope conditions for the study and reviews Kirshner's theory of the exploitation of monetary dependence as well as his discussion of the limits of exploitation. Sections 2 and 3 contain the theoretical framework for looking at how currency areas condition the power of leaders relative to followers. Section 2 examines the relative costs of the follower's exit or expulsion from the area. Section 3 looks at the currency area's rules. The conclusion suggests some implications for the broader study of international currencies.

Monetary Dependence and its Limits

Scope

Cohen differentiates 'currency areas' and 'currency regions': a currency area is a product of formal, state-to-state action linking currencies or exchange rates, while a currency region exists whenever a country's currency is widely used beyond the boundaries of the country.[8] Kirshner's study of monetary dependence includes both currency areas (e.g., the sterling area, the franc zone) and currency regions (e.g., Latin American dollarization). In this study, I follow Kirshner by including both types of arrangements, referring to the entire set of cases by the more common term 'currency areas'. One contribution of the present study, however, is the explicit recognition that (formalized) currency areas and (informal) currency regions may create different configurations of power. Varying levels of rule formalization will be an important part of the analysis in Section 3.

Currency areas range on a continuum between symmetric and asymmetric ideal types. Symmetry can be defined as the degree of shared control over decision-making within the currency region, on issues such as seigniorage, interest rates, money supply, etc. Today, the East Caribbean dollar and European Monetary Union are highly symmetric arrangements, while the Southern African rand zone and the dollar area exemplify asymmetric relations.[9] In this study, I include the entire continuum, although, not surprisingly, I also argue that more symmetric currency regions give the leader less power by design. At the extreme, in a perfectly symmetrical currency region, there would no longer even be a leader. Including the entire range of currency areas is helpful, however, in making comparisons among different types of arrangements. Since there is no natural cut-off point where a currency area shifts from being symmetric to being asymmetric, it makes more sense to treat the level of symmetry as a variable (see Section 3).

For convenience and to be consistent with the rest of this collection of working papers, I use the terms 'leader' and 'followers' to refer to the members of the currency area. This usage should not be taken to imply that the leader is always the most powerful in every specific circumstance. On the contrary, while the leading state has the greatest decision-making control over the currency area by

---

8 Benjamin Cohen, 'The Political Economy of Currency Regions', in Helen Milner and Edward Mansfield (eds.), *The Political Economy of Regionalism* (New York: Columbia University Press, 1997).

9 David Andrews, in the introduction to this collection, asserts that 'all [monetary coordination] schemes tend towards asymmetry, in fact if not in form' (David M. Andrews, forthcoming 2006. 'Introduction', in: David M. Andrews, (ed.), *International Monetary Power*. Ithaca NY: Cornell University Press. Revised versions of EUI-WP RSCAS Nos. 2005/07-2005/15 will be included in this book). I disagree. In addition to the examples in the text, other symmetrical currency areas include the late 19th century Scandinavian Monetary Union and the 1960s East African monetary union. While bilateral monetary coordination does tend strongly towards asymmetry, multilateral coordination varies more widely across the continuum. It is probably the case that no currency union is perfectly symmetrical, because even with a single currency and single central bank, each state has different underlying capacity to delay adjustment. Consistent with Cohen's argument in this collection, (Benjamin J. Cohen, 2005. *The Macrofoundation of Monetary Power*. EUI Working Papers RSCAS No. 2005/08), differing underlying openness and adaptability contribute to differing power even within institutions that are formally symmetric. Moreover, informal norms may reinforce such power asymmetries, as in informal deference to German leadership within EMU. However, the ideal of perfect symmetry is a strawman: EMU and the other mentioned examples are relatively symmetrical overall, even if not perfectly so. For supporting views of symmetry, see Cohen, 'Beyond EMU', pp. 197-200; and Cohen, *Future of Money*, pp. 153-78.

definition, the central argument of this essay is that followers rather than leaders may have greater bargaining power under certain conditions.

Kirshner's Monetary Dependence

In the most complete comparative study of power within currency areas, Kirshner defines monetary dependence in terms of asymmetric economic vulnerability. The leader of the currency area has influence over smaller followers because they fear expulsion from the currency area. Followers benefit asymmetrically from membership because it provides access to the accumulated credibility and prestige of the system, a degree of insulation from adverse trends in the international economy, and protection from currency manipulation by powerful states outside the area. Depending on the nature of the area, followers may also gain access to pooled reserves or balance-of-payments credit lines. Currency area membership is also typically linked to other benefits for followers, such as economic aid, military safeguards, and preferential access to the home state's capital and goods markets. For all these reasons, followers may depend heavily on continued membership in the currency area.[10]

According to Kirshner, leaders exploit followers' dependence in four ways. First, they can enforce the rules of the system to sanction followers. For example, the leader might interrupt the flow of currency to a follower in order to convince it to change specific policies. Second, leaders can use the threat of expulsion to get the follower to change its behaviour. Third, leaders may use their structural power within the area to extract concessions from followers. Finally, the leader of the currency area also has influence indirectly because followers' internal preferences are transformed by membership. For example, currency area membership strengthens domestic interest groups in the follower that are closely tied to the leader. In a process Kirshner labels 'entrapment', followers' interests are changed over time from the inside.[11]

Kirshner also points out some of the limits of monetary power in a currency area. Leaders are loath to extract so many resources from followers that followers opt out of the area. Leaders are similarly reluctant to wield the threat of expulsion since the follower might in fact choose to leave the area and deny the leader future benefits. Kirshner argues that the 'structural' power of extraction and entrapment is so valuable to the leader that it must carefully limit enforcement of the rules and threats of expulsion: 'The practice of enforcement and expulsion risks tempting states to abandon the system. This would cause the core state to lose the power it derives from the very existence of the system [...]'.[12]

In addition, Kirshner hypothesizes that the level of monetary dependence varies according to global economic conditions and the nature of the bilateral relationship between the leader and the follower. During periods of general international prosperity, the follower's costs of exit from the currency area are lower. But when economic conditions outside the area are poor, 'the greater the power of overt threats, and the more punishment will be tolerated without unilateral withdrawal from the system'. Similarly, the economic and political relationships between the leader and follower condition the vulnerability of the follower. For example, militarily strong states may be able to bully weaker followers. Thus, Kirshner explicitly recognizes that monetary power has its limits—although he never systematically discusses those limits.[13]

Even so, Kirshner explicitly rejects the idea of interdependence in a currency area.[14] Drawing on the logic of Albert Hirschman, Kirshner notes that because all members of a currency area pool

---

10 Kirshner, *Currency and Coercion*, pp. 12-17.

11 Ibid., pp. 116-19.

12 Ibid., pp. 117.

13 Ibid., pp. 119-21, 168. Kirshner also points out that large followers may gain the ability to disrupt the currency area, and that they could try to gain leverage from that ability. He acknowledges that systemic disruption is in some ways inversely related to the exploitation of monetary dependence, but argues that it is a weak tool for followers because it so difficult to implement successfully; ibid., pp. 275.

14 Ibid., pp. 40.

resources that all can draw on and because large states typically provide more resources than small states, the follower gains more from membership in the area than the leader. Using pooled reserves as an example of the broader sharing of resources, Kirshner explains:

> Given a two-state currency area, where country 1 provides $1 billion of reserves and imports $100 million a day; and country 2 provides $10 billion in reserves and imports $200 million worth per day, the magnitude of the asymmetry is actually twenty to one, not ten to one. If the area breaks up, country 1 loses a cushion of one hundred days, whereas country 2 loses a cushion of five days.[15]

Thus, the key to the leader's leverage is that the follower state is far more dependent on the currency area than the leader.

This argument is no doubt true *ceteris paribus*—i.e., small states do gain proportionately more from pooling with larger states—but may not be accurate in all circumstances because all other things are not always equal. For example, if the leader is involved in a balance-of-payments crisis at a time when the follower enjoys healthy surpluses and strong foreign exchange reserves, the leader may be unusually dependent on the follower state's reserves to help insulate the leader from global conditions. Under such circumstances, the costs to the follower of exiting the currency area would be low because it has the resources to establish its currency outside the area. But for the leader, the follower's departure could be very harmful. Moreover, because currency markets are subject to herd behaviour, the market reaction to the follower's departure could compound the problem far beyond the direct loss to the leader of the follower selling its currency reserves. Thus, particular circumstances may nullify or even reverse the asymmetry between the leader and followers, even if asymmetrical interdependence clearly favours the large state *on average*.

The task is to elucidate the conditions under which currency areas place limits on leaders, rather than just followers. What we are looking for is not a theory of monetary power in general (as in the Cohen, Andrews, and Helleiner contributions to this project),[16] but a theory of how currency areas reshape the relative power of leaders and followers. I argue that we can understand the limits on the leader by looking at two primary factors: the *costs of the follower's exit* and the *currency area rules*.

Exit Costs

The first key to understanding the relative power of the leader and follower is to look at the relative costs to the leader and follower if the follower exited the area. A twist on Kirshner's lifeboat analogy is helpful here. In discussing the form of monetary power he labels 'systemic disruption', Kirshner compares a monetary system to a lifeboat with one passenger rocking the boat in a way that risks capsizing it. The passenger's goal is not to capsize the boat, but to manipulate the risk of capsizing to increase his own bargaining power. I argue that systemic disruption is only one of the powers possessed by follower states, although, as Kirshner points out, that power is relatively limited: if the leader is weak enough and the passenger strong enough that boat rocking gets the leader's attention, the likelihood of capsizing is very high, which defeats the boat rocker's intention of gaining advantage *within* the system.[17]

For understanding relative power in currency areas, we should focus instead on the more significant threats of exit and expulsion. That is, who would lose more if the passenger jumped or was pushed overboard? The answer depends on the benefits accruing to the leader and the passenger inside the boat (e.g., is it a dinghy or a yacht? is the passenger good with the oars?), on how well the follower

---

15 Ibid., pp. 14-15; Albert Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California, 1969 [1945]).

16 Benjamin J. Cohen, 2005. *The Macrofoundation of Monetary Power*. EUI Working Papers RSCAS No. 2005/08; David M. Andrews, 2005. *Monetary Autonomy and Asymmetric Adaptation*. EUI Working Papers RSCAS No. 2005/07; Eric Helleiner, 2005. *Structural Power in International Monetary Relations*. EUI Working Papers RSCAS No. 2005/10.

17 Kirshner, *Currency and Coercion*, pp. 170-215.

can swim, and on how dangerous the water is. On average, the follower's exit is more costly to the follower than the leader. But in some circumstances the follower's exit threat may be more powerful than the leader's threat to expel. Three types of calculations shape this bargaining.[18]

Membership Benefits

The first factor is the flow of costs and benefits within the currency area. As Kirshner emphasizes, even when power flows generally to the leader, economic benefits may be flowing in the opposite direction.[19] A clear example is the benefits of membership in the West African franc zone, which entitles members to overdraft privileges at the French treasury, preferential access to French markets for capital and goods, military protection against external and internal enemies, and a variety of aid and technical expertise.[20] Members of the rouble zone gained access to Russian markets for their goods and also to subsidized energy resources—by one estimate, rouble zone members paid only 2% of the world market price for oil in early 1992 (and even then often defaulted on payments). Some rouble zone members also gained military security as a side benefit, such as the 25,000 Russian troops stationed in Tajikistan in the wake of the Tajik civil war.[21] Generous benefits to the follower make it less likely to leave the area, which is precisely why leaders offer such benefits. Leaders may, in effect, trade economic benefits for political leverage. The relative generosity or stinginess of those benefits should be a key consideration for followers.

The sterling area after the Basle reform of 1968 provides an extreme example of the lengths to which leaders sometimes go in order to keep members in the currency area. Sterling area members pledged to keep an agreed percentage of their currency reserves in sterling, in return for a British guarantee of the dollar value of those reserves. Britain had been repeatedly pressed in the past by sterling area members for such guarantees, but successfully resisted until 1968. Starting that year though, Britain pledged to maintain the dollar value of 90% of each country's official sterling reserves. The formal quid pro quo demonstrated the extent to which Britain was dependent on the sterling area's so-called followers.[22]

---

18 A fourth consideration is the transitional cost of the follower's departure; see Cohen, *The Macrofoundation of Monetary Power*, for the distinction between continuing and transitional costs. For the follower, this includes the costs of issuing a new currency, backing the currency with reserves, creating a new central bank, rewriting foreign exchange regulations, and so on. Although these are essentially one-off costs, some very poor states may have trouble paying them and therefore be deterred from exiting a currency area. On the other hand, based on the large number of small or even tiny countries with their own independent currencies, transitional costs should not be seen as an insurmountable barrier for any but the poorest countries. Moreover, depending on the nature of the currency area, there might be corresponding benefits that help balance these transitional costs. For example, if the follower begins to issue its own currency after sharing a leader's currency, the follower may gain new seigniorage revenues that eventually pay for the transitional costs. Politically, the follower might also gain a powerful national symbol that helps to create a stronger sense of national identity. For the leader, the transitional cost includes whatever it has to pay to alter institutional arrangements in the absence of the departing follower. These costs are likely to be very small.

19 The leader may actually be making 'economic sacrifices' in order to gain leverage over the follower and insulation from the global economy; ibid., pp. 13, 168. Cohen, 'Beyond EMU', also emphasizes the benefits provided by the leader as a key condition for the sustainability of currency areas.

20 James Boughton, 'The CFA Franc: Zone of Fragile Stability in Africa', *Finance & Development*. (1992), pp. 34-36; James Boughton, 'The CFA Franc Zone: Currency Union and Monetary Standard', *Greek Economic Review* 15 (1993), pp. 267-312; James Boughton, 'The Economics of the CFA Franc Zone', in Paul R. Mason and Mark P. Taylor (eds.), *Policy Issues in the Operation of Currency Unions* (Cambridge, UK: Cambridge University Press, 1993); Francis Terry McNamara, *France in Black Africa* (Washington, DC: National Defense University Press, 1989), pp. 110-27; Susan Strange, *Sterling and British Policy: A Political Study of an International Currency in Decline* (London: Oxford University Press, 1971), pp. 23-28. Kirshner also discusses this case in detail although he pays far more attention to Mali, which tried to escape but failed, than to Guinea, which managed to jump out and stay out; *Currency and Coercion*, pp. 148-56.

21 Daniel Sneider, 'Energy Price Hike Marks Further Russian Reform', *Christian Science Monitor*, 20 May 1992; Martin Wolf, 'Russia Rolls the Dice of Reform', *Financial Times*, 14 May 1992; Richard Pomfret, *The Economies of Central Asia* (Princeton: Princeton University Press, 1995), pp. 140-51; Richard Pomfret, *Asian Economies in Transition: Reforming Centrally Planned Economies* (Cheltenham, UK: Edward Elgar, 1996), pp. 118-28.

22 Cohen, *Future of Sterling*, pp. 78-79; Strange, *Sterling and British Policy*, pp. 74-75.

Balancing these membership benefits are accompanying costs of membership, including whatever resources the leader is able to extract from members and diverted resources as a result of entrapment. For example, the benefits for followers in the franc zone must be weighed against the strings attached by the French government, including varying levels of French oversight on macroeconomic management, limits on trade outside the franc zone, potential interference in domestic politics by French troops, and so on. Sometimes of course, the net benefits to the follower will be negative rather than positive. For the Baltic states, cheap Russian oil and access to huge Russian markets in no way compensated for the ruinously inflationary rouble and—most important of all—the risk of being reintegrated into the Russian sphere of influence after a half century of involuntary association. Based on those terms, the rouble zone was a dinghy, not a yacht, and the three Baltic states' decisions to leave the rouble zone as soon as possible—even before permanent currencies were printed in Latvia and Lithuania—was a foregone conclusion.[23]

For the leader, the follower's exit or expulsion raises a similar calculation. In general, leaders prefer the follower remain inside the currency area because of the various benefits that accrue to the leader via extraction, enforcement, and entrapment. The magnitude of those benefits depends heavily on the rules of the system and also on the follower's size and economic development. For France, the departure of Ivory Coast or oil-rich Gabon from the franc zone would be much harder to swallow than the departure of Togo. However, even where the follower's membership in the currency area provides resources to the leader, those advantages must be weighed against whatever benefits the leader provides currency area members as a quid pro quo for membership.

Thus, for the leader as well as for the follower, the key issue is *net* benefits: does the follower pull its weight relative to the perks necessary to keep it in the area? Do the membership benefits to the follower outweigh the costs?

Need for Insulation

Second, both leaders and followers must weigh conditions outside the currency area. One purpose of a currency area is to provide insulation against the global economy, which is why currency areas were relatively popular in the 1930s and why Asian states increased their discussion of a yen bloc after the East Asian financial crisis of the late 1990s.[24] In times of global prosperity, jumping out of the lifeboat is less risky for followers. Outside conditions also include the supply of other leading currencies and whether those leaders are more inclined to offer help or to take advantage. For example, a number of countries that were closely associated with sterling in the post-World War II era joined the de facto dollar area in the 1960s and 1970s (e.g., the states of the East Caribbean and the Persian Gulf). Jumping out of the British lifeboat was facilitated by proximity of the American one. And when Estonia left the rouble zone, it immediately pegged its new currency to the Deutschmark. In short, is the ocean smooth or stormy? Are there nearby lifeboats, or just circling sharks?

Less obviously, leaders themselves must consider the degree of damage to the currency area that would be done by the follower's departure. Analytically, leaders benefit from the insulation the currency area provides against global economic conditions, even if (because they are larger) they need less insulation on average than followers. A currency area leader facing a balance-of-payments crisis, for example, may need the continued support of the currency area far more than does a smaller state with healthier finances. Worse still, the exit or expulsion of the follower may even undermine the stability of the entire area. Unlike

23 Grant Spencer and Adrienne Cheasty, 'The Ruble Area: A Breaking of Old Ties', *Finance & Development* 30 (1993), pp. 2-5; Peter Garber and Michael Spencer, *The Dissolution of the Austro-Hungarian Empire: Lessons for Currency Reform*, Essays in International Finance, no. 191 (Princeton: International Finance Section, Department of Economics, Princeton University, 1994).

24 See the Kirshner and Henning contributions to this project: Jonathan Kirshner, 2005. *Currency and Coercion in the Twenty-First Century*. EUI Working Papers RSCAS No. 2005/13; C. Randall Henning, 2005. *The Exchange Rate Weapon, Macroeconomic Conflict and Shifting Structure of the Global Economy*. EUI Working Papers RSCAS No. 2005/11.

Kirshner's systemic disruption where the follower rocks the boat to gain leverage but prefers to stay in the lifeboat, some followers actually prefer to exit and may, intentionally or unintentionally, destabilize the boat as they jump out. While Guinea's departure did not damage the franc zone appreciably, Ukraine's departure surely weakened the rouble zone, and Australia's would have devastated the sterling area in the 1960s. Large followers may provide resources to the area that are crucial for its continued vitality. Moreover, large followers may damage the currency area by the act of leaving.

For example, Susan Strange demonstrated the degree of Britain's dependence in the 1960s on six states with especially large sterling holdings—Australia, Malaysia, Kuwait, Libya, Hong Kong, and Ireland. A decision by any one of these states to convert its sterling balances to dollars would have substantially undermined the pound. Even worse, it would likely have touched off a market panic as others rushed to unload their sterling first. Officials at the Treasury and the Bank of England constantly reminded political officers of the important support provided by newly independent colonies to the British balance-of-payments, and British officials at all levels worked in the 1950s and 1960s to keep former colonies solidly inside the sterling area. Strange notes that the 'major interest in avoiding a break-up during [the 1960s] was Britain's' and quotes Prime Minister Wilson on the political importance Britain attached to the sterling area: 'To turn our backs on the sterling area would mean a body-blow to the Commonwealth and all it stands for'.[25]

In one particularly interesting case, the Wilson government tried in early 1966 to coerce Malaysia into negotiating a monetary union with Singapore but its coercive threat backfired when Malaysia responded with a threat to pull out of the sterling area. Finance Minister Tan Siew Sin noted pointedly that Malaysia was the largest net dollar earner in the commonwealth and that it had kept its reserves in sterling 'out of sheer loyalty […] though at some risk to ourselves'. The Malaysian government also stoked a harsh anti-British press campaign that hardened Malaysian public opinion and made it difficult for pro-British voices to be heard. Since Malaysia's sterling reserves amounted to US $1 billion (or 14% of Britain's net liabilities to sterling area countries), converting Malaysian sterling to dollars would have had disastrous consequences for Britain's balance of payments, which was already under stress. As Tan Siew Sin explained, 'If we had effected such a move, it could well have tipped the scales against sterling in view of its admittedly precarious position'. British decisionmakers quickly decided that their attempted coercion had been 'counterproductive', dropped their previous demands, and retreated to a position of neutrality in the Malaysia-Singapore negotiations. They even began to publicly assert that they had never attempted to coerce Malaysia in the first place (despite a substantial paper trail to the contrary). In effect, Britain recognized that, at that moment of British weakness, Malaysia would survive better without the sterling area than the sterling area would survive without Malaysia.[26]

More recently, Persian Gulf states have provided support to the U.S. dollar by holding reserves in dollars, holding financial assets abroad in dollar-denominated accounts, and by pricing oil in dollars. Over the years, members have occasionally discussed punishing the U.S. for its foreign policy or its depreciating currency by pricing oil in another currency unit. Such an action might not have catastrophic effects on the U.S. economy, but it would certainly have a large enough effect to make the threat noticed in Washington.[27]

A complicating factor is that the damage to the currency area might also be expected to damage the follower as it exited. Returning to the example of sterling in the 1960s, the six countries' sterling

---

25 Strange, *Sterling and British Policy*, pp. 74-128, quote at 89.

26 UK Public Records Office, Dominions Office [DO] 169/431/462, 23 Apr 66; DO 169/431/476, 17 May 66; DO 169/431/487, 20 May 66; DO 169/349/5, 27 Jun 66; DO 169/431/489A, 23 May 66. For context, see Scott Cooper, 'Third World Monetary Blocs: Small State Choice or Great Power Hegemony?' Paper Prepared for *International Studies Association Convention*, pp. 17-20 March 2004, Montreal. At the end of 1965, Britain's net sterling liabilities amounted to $7.3 billion with regard to sterling area countries, and $13.6 billion with regard to all countries and international organizations; Strange, *Sterling and British Policy*, pp. 81.

27 Moneyclips, 'Call to Delink Gulf Currencies from Dollar', 11 March 1995, Lexis/Nexis; Xinhua News Agency, 'Gulf States Consider to End Dollar Link', 26 February 1998, Lexis/Nexis.

holdings were so large as to be partially self-deterring: all were well aware that any attempt to sell their sterling reserves suddenly would have touched off a market panic that drastically lowered the value of the sterling they were trying to sell. Similarly, Persian Gulf states understood that weakening the dollar would also undermine the value of their own abundant dollar-denominated financial assets, and, even more importantly, weaken security ties to the U.S.[28]

Even so, decisionmakers in London and Washington could not take such threats lightly. Thomas Schelling's analysis of threats and crisis bargaining explains why. For one thing, followers might in some circumstances be angry enough to take actions that would be economically irrational. As Schelling puts it, in order to make a threat credible 'it does not always help to be, or to be believed to be, fully rational, cool-headed, and in control of oneself'. Similarly, threats sometimes succeed precisely because the target is afraid the risks will get out of hand: 'The fact of uncertainty—the sheer unpredictability of dangerous events—not only blurs things, it changes their character'.[29] In the case of Malaysia, regardless of whether the finance minister's threat made good economic sense, it was powerful because of the danger that the Malaysian government might, intentionally or accidentally, capsize the boat protecting sterling from global markets. The British were highly concerned about either possibility and chose to de-escalate the situation rather than risk a mutually disastrous outcome.

Finally, as Kirshner argues in this collection of working papers,[30] the globalization of financial markets only increases the appeal of regional blocs as providers of insulation. Accelerating capital mobility affects both leaders and followers, although smaller followers are at greater risk in the rougher waters of a globalized world. On the other hand, there are risks for large states as well, perhaps best evidenced by the European exchange rate crisis of 1992. As a result, leaders' and followers' relative need for insulation is likely to be an increasingly important factor in future power relations within currency areas.[31]

Domestic Politics

Third are the domestic political consequences of exit and expulsion. Of course, all of the considerations discussed so far must be filtered through some domestic political process as leaders and followers weigh costs and benefits: these cost-benefit calculations matter to the extent that they influence domestic decisionmakers and the constituencies they value. For example, membership benefits may flow to important interest groups with access to government leaders, and insulation may be a high priority for finance officials within the government. But treating domestic politics as a separate category reminds us that these issues cannot be handled as an abstract exercise in cost-benefit accounting.[32]

Domestic political considerations are especially important for followers because currency areas are designed to entrap them, reorienting them domestically towards the leader's economy. Some important domestic financial and commercial interests are likely to have developed over time a strong attachment

---

28 Scott Cooper, 'State-centric Balance-of-threat Theory: Explaining the Misunderstood Gulf Cooperation Council', *Security Studies* 13 (Forthcoming).

29 Thomas Schelling, *Arms and Influence* (New Haven: Yale University Press, 1966), pp. 37, 94. Kirshner's conception of 'systemic disruption' or boat-rocking explicitly builds on Schelling's discussion about 'manipulating the *shared* risk'; Kirshner, *Currency and Coercion*, pp. 172; Schelling, *Arms and Influence*, pp. 99; my italics .

30 Jonathan Kirshner, 2005. *Currency and Coercion in the Twenty-First Century*. EUI Working Papers RSCAS No. 2005/13.

31 Good analyses of the causes and consequences of increased capital mobility include John Goodman and Louis Pauly, 'The Obsolescence of Capital Controls?' *World Politics* 46 (1993), pp. 50-82; David Andrews, 'Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations', *International Studies Quarterly* 38 (1994), pp. 193-218; Eric Helleiner, *States and the Reemergence of Global Finance* (Ithaca: Cornell, 1995); and Susan Strange, *Mad Money: When Markets Outgrow Governments* (Ann Arbor: Michigan, 1998).

32 As Pauly and Walter remind us in this collection of working papers, political reactions will also be buffered by or filtered through domestic institutions: Louis W. Pauly, 2005. *Monetary Power and Political Autonomy: Exchange Rate Policymaking in Follower States*. EUI Working Papers RSCAS No. 2005/14; Andrew Walter, 2005. *Leadership Begins at Home: The Domestic Sources of International Monetary Power*. EUI Working Papers RSCAS No. 2005/15.

to the leading state's economy and will presumably resist any effort to jump ship. At the same time, we should not overstate this factor as, in some circumstances, domestic political interests might push the follower away from the currency area. Many a government has scored political points by targeting powerfully entrenched domestic financial and commercial interests, especially when controlled by unpopular minorities or expatriate communities. The crucial issue is not how large the leader-oriented domestic sector in the follower is, but how important it is to the follower government's political fortunes.

At the same time, there may also be political interests within the leader that are reluctant to see the follower leave the currency area. Because the leader is usually much larger than the follower, follower-oriented interest groups within the leader are likely to be less important than leader-oriented groups within the follower. But Stasavage's analysis of the franc zone demonstrates the possible impact of such groups. He shows that French commitment to subsidizing franc zone members over the past forty years has been crucially influenced by a small group of individuals within the French presidency and executive bureaucracy with a vested interest in maintaining the franc zone. Only as that group declined in importance in the early 1990s were the French willing to cut back on the expanding stream of subsidies to franc zone followers.[33] Thus, leaders as well as followers may have domestic political incentives to resist exit or expulsion.

In the end, calculations of exit costs cannot be easily operationalized. But they reinforce the following key components of bargaining power between leader and follower:

H1: Leaders have more leverage over followers when the currency area's net membership benefits for the followers are relatively high.

H2: The leader's leverage over the follower varies directly with the follower's need for insulation from the broader international economy, but varies inversely with the leader's own need for insulation.

H3: The leader's leverage varies directly with the political reliance of the follower's government on domestic interest groups that benefit from ties to the leader.

Currency Area Rules as a Limit

The second link between currency areas and the leader's power is the rules of the area. It may seem unusual to discuss rules as a source of power since the currency area's rules are in part a function of underlying power relationships between leaders and followers: we expect the leader to ensure that the rules of the area are written and interpreted to meet its own particular needs.

But rules may in practice have causal impact on power relationships for at least three reasons. First, even strong leaders may need to agree to rule-based limits on their own power as a condition for followers joining the institution. The leader may agree *ex ante* to certain constraints on future behaviour in exchange for followers' acceptance of more significant constraints. As a result of the shadow of the future, the leader may even comply with currency area rules that disadvantage it at a particular point in time, calculating that the long-term results will be more favourable.[34]

Second, because leaders are unlikely to anticipate all future contingencies that will affect their interests, it is possible that the same rules the leader initially approved will at a future date prove unwelcome to the leader. Thus, even if we assume that the rules will be written to favour the currency leader, problems of uncertainty and incomplete contracting make it likely that the rules will occasionally counter the leader's interests.

---

33 David Stasavage, *The Political Economy of a Common Currency: The CFA Franc Zone Since 1945* (Aldershot, UK: Ashgate, 2003).

34 G. John Ikenberry, *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order After Major War* (Princeton: Princeton University Press, 2001).

Third, the relative power of leaders and followers changes over timeBboth because of changes in costs of exit (as discussed in Section 2) and because of changes in underlying openness and adaptability (as discussed in Cohen's essay in this collection of working papers, EUI-WP RSCAS No. 2005/08). As initial power relationships fluctuate, the leader may find at a particular moment that its ability to bend the rules to its favour is lower than expected. Or, in a moment of weakness, the leader may find itself complying with rules initially intended to limit followers.

For these reasons, the rules of the currency area can be a potential constraint on leaders as well as followers. Of course, the rules are unlikely to constrain leaders indefinitely. As the costs of compliance rise, we expect the leader to use its underlying power to re-interpret or re-negotiate rules to fit its interests more closely. In the end, we expect the leader to abandon any rule-based system that proves overly constraining relative to its costs of exit. For these reasons, currency area rules are likely to be only a marginal or temporary constraint on the leader's power. But they are nonetheless a constraint.

Because the nature of the rules varies dramatically across currency areas, we can differentiate among three characteristics that affect the level of constraint on currency area leaders.

Formalization

The first distinction is whether the rules are primarily formal or informal. Sometimes the rules are highly formalized by multilateral or bilateral international treaties as in the Bretton Woods system or the franc zone, respectively. At other times, the rules are less formal and based on past practice, rather than specific agreements—e.g., the dollar area today or the rand area before 1974. Even the most formalized rules, however, rarely formalize all the broader aspects of the currency area relationship that matter to participants. For example, the former Soviet rouble zone gave the Central Bank of Russia a clearly defined monopoly on currency issue, but was ambiguous about the conditions for delivering currency notes to the other national central banks. This ambiguity gave Russia a significant lever for influence because it could—and did—link delivery of currency notes to other economic and political objectives. In addition, one key benefit of rouble zone membership was access to Russian energy at subsidized prices, but the exact nature and price of that access varied over time, at Russia's discretion.[35] Similarly, the post-war sterling area included precise rules about reserve pooling and especially exchange control, but the amount of development and military aid Britain would provide to members was determined on an ad hoc basis. Thus, even more formalized currency areas are marked by significant ambiguity and therefore require interpretation and negotiation. Because we expect the largest economy to benefit most from negotiation, less formalized rule systems place fewer limits on area leaders.

However, it should be emphasized that rules are only one component of power in a currency area. We should not expect the rules to completely constrain powerful states who have an interest in violating the rules. Powerful states may fail to comply with the rules or use their power to modify rules more to their liking. Even in these cases, however, formally specified rules raise the costs to powerful states of pursuing their narrow self-interest. As a result, formalized rules tilt the playing field more toward followers than would otherwise be the case. For example, the recent debate about whether Germany and France should be held to the formal rules of the EMU's Stability and Growth Pact provides evidence that rules may raise the costs of leaders' behaviour even if the leader is only weakly constrained. The very fact that members of the euro area are currently arguing publicly about whether Germany and France are pursuing allowable economic policies—but members of the dollar area are not debating U.S. behaviour in any parallel fashion—is evidence of the constraining role of rules.

35 Good descriptions of the rouble zone and its collapse, include Spencer and Cheasty, 'The Ruble Area'; Garber and Spencer, *Dissolution of the Austro-Hungarian Empire;* International Monetary Fund, *World Economic Outlook* (May 1993), Washington, DC: International Monetary Fund, pp. 65-68; Patrick Conway, *Currency Proliferation: The Monetary Legacy of the Soviet Union*, Essays in International Finance, no. 197 (Princeton: International Finance Section, Department of Economics, Princeton University, 1995); and Rawi Abdelal, *National Purpose in the World Economy* (Ithaca: Cornell University Press, 2001), pp. 45-75.

A stronger example is the United States' leading role in the Bretton Woods monetary system from its creation in 1944 until its de facto collapse in 1971. Despite the fact that the U.S. was, along with Britain, a key architect of the system, the dollar-exchange standard became increasingly uncomfortable for the United States as confidence in the dollar declined in the 1960s. Because the U.S. was unwilling to tighten its belt domestically and because it could not devalue its currency within the system (without acquiescence from partners that was not forthcoming), the fixed exchange rate system left the dollar overvalued and placed a high burden on U.S. exports. On the one hand, that the U.S. tolerated these burdens for so long—throughout much of the 1960s up until August 1971—is evidence that formalized rules can reshape the behaviour of even powerful states. Rather than ignoring the rules, the U.S. attempted to interpret the rules to its own advantage and to attain support for modifying the rules. On the other hand, that the U.S. in the end solved its dilemma unilaterally by breaking out of the system is evidence that formalized rules are an imperfect barrier to a determined leader.[36] I hypothesize that formalization places more effective limits on leaders than informal rules, not that it makes those limits perfectly effective.

Decision-making Symmetry

Second, currency area rules can also be differentiated according to how symmetrically they distribute decision-making control over questions of money supply, seigniorage, external exchange rates, capital controls, and so on. As discussed in Section 1, we can think of a continuum between asymmetrical and symmetrical endpoints, and it is perhaps easiest to compare arrangements within a region over time. For example, the South African rand zone was most asymmetrical before 1974: South Africa completely controlled the issue of currency in all four members (i.e., South Africa, Botswana, Lesotho, and Swaziland). But as the zone was formalized starting in 1974, it also became less asymmetrical. South Africa ceded greater control to the other states by allowing them the option of circulating their own parallel currencies and agreed to share seigniorage revenues with the smaller currency area members according to their share of currency circulation. It did not, however, grant followers direct influence over the rand itself, which was issued solely by the South African central bank.[37] The East Caribbean dollar and European Monetary Union are the most symmetrical modern currency areas; unlike the rand zone, both involve shared control of the currency-issuing central bank.[38] Other highly symmetrical currency areas have involved separate central banks issuing

---

36 Even Gilpin, a well-known proponent of power-centered explanations, acknowledges Bretton Woods as a (temporary) constraint on the U.S.; Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987), pp. 131-42.

37 On the several variants of the rand area, see John Stuart, *The Economics of the Common Monetary Area in Southern Africa* (Durban, South Africa: Economic Research Unit, University of Natal, 1992), pp. 60-81; Mats Lundahl and Lennart Petersson, *The Dependent Economy: Lesotho and the Southern African Customs Union* (Boulder: Westview Press, 1991), pp. 271-317; and Colin McCarthy, 'SACU and the Rand Zone', in *Regionalisation in Africa: Integration and Disintegration*, ed. Daniel C. Bach (Oxford: James Currey, 1999). Note that sharing seigniorage does not require symmetrical control. South Africa could have given its followers a share of currency profits without also giving them some control over their domestic money supply.

38 On the East Caribbean, see Cohen, 'Beyond EMU'; E. Eustace Liburd, 'Aspects of Multinational Central Banking in the OECS', in Ramesh F. Ramsaran (ed.), *The Experience of Central Banking with Special Reference to the Caribbean* (N.p.: Regional Programme of Monetary Studies, 1995); and Novelette Davis-Panton, 'Issues Relating to the Central Bank's Autonomy in Jamaica', in Ramesh F. Ramsaran (ed.), *The Experience of Central Banking with Special Reference to the Caribbean* (N.p.: Regional Programme of Monetary Studies, 1995), pp. 68-69. The many good descriptions of EMU include Horst Ungerer, *A Concise History of European Monetary Integration: From EPU to EMU* (Westport, Conn.: Quorum Books, 1997), pp. 199-255, 273-92; Emmanuel Apel, *European Monetary Integration: 1958-2002* (London: Routledge, 1998), pp. 94-156; and Kenneth Dyson, *Elusive Union: The Process of Economic and Monetary Union in Europe* (London: Longman, 1994), pp. 112-73.

interchangeable currencies, as in the East African monetary union of the late 1960s and the Scandinavian Monetary Union of the late 19th century.[39]

Note that symmetry is defined in terms of decision-making control, not economic or political outcomes. As Kirshner emphasizes, even in an asymmetric system, economic resources may actually be flowing from the leader to the follower. And a goal of this essay is to show that control over currency area decision-making does not give the leader political power in all circumstances. In other words, I treat symmetry as an independent variable and political power as the dependent variable.

At the same time, there is a straightforward causal link between decision-making symmetry and power. The leader is often able to decide the issues over which it has the predominant voice—e.g., money supply, interest rate policy, exchange rate policy—in a way that transfers burdens of adjustment onto followers rather than itself. How this works out varies according to the nature of the currency system, but examples are plentiful. During World War II, the British used their control over the sterling bloc's pooled reserves to slow the transfer of reserves outside the currency area until more than a decade after the war. The power to freeze sterling balances was not part of its *ex ante* portfolio of decision-making but a mechanism Britain seized upon as a result of its established control over pooled reserves. Britain's blocking of balances had the effect of limiting followers' trade outside the sterling area, thereby tying followers more closely to the leader than they were before.[40] France in the 1980s and early 1990s used its decision-making control over the reserves of the West African franc zone in a somewhat different manner. Despite franc zone limits on lending to member states, France chose to funnel extra funds to client states in West Africa which were suffering serious balance-of-payments problems. Because the French Treasury managed franc zone accounts, France was able to unilaterally bypass franc zone rules (albeit with the hearty approval of impoverished African governments) to infuse liquidity into the system. However, when France unilaterally decided to reverse course in 1994, franc zone governments were forced to accept a substantial currency devaluation.[41] In both cases, asymmetric control over currency area decision-making translated into broader power over monetary and political outcomes.

By way of contrast, more symmetrical currency areas have reduced the leader's power over those same outcomes, at least temporarily. For example, the initial design of the rouble zone—while far from the symmetrical ideal—nevertheless distributed decisions about credit creation fairly symmetrically across the fifteen national central banks. The various central banks quite predictably engaged in massive credit creation that undermined Russia's control of its rouble money supply. As a result, Russia eventually used its other powers to rewrite the currency area's rules unilaterally, demanding greater control over credit creation from followers that wanted to stay inside the rouble zone.[42] Similarly, the Scandinavian Monetary Union was highly symmetrical in allowing each of the three national central banks control over issue of gold coins and gold-backed currency notes. As the union broke down during World War I, the symmetry of the union worked to the disadvantage of Sweden which continued to honour its previous agreements by exchanging devalued Danish and Norwegian notes and gold coins at parity. Despite its status as 'first among equals', Sweden's lack of asymmetrical control over currency issue within the union effectively limited its control over its

---

39 On East Africa, see Scott Cooper and Clark Asay, 'Regional Currencies in Africa: The Domestic Politics of Institutional Survival or Dissolution', *Perspectives on Global Development and Technology* 2 (2003), pp. 131-60. On Scandinavian Monetary Union, see Michael Bergman, Stefan Gerlach, and Lars Jonung, 'The Rise and Fall of the Scandinavian Currency Union 1873-1920', *European Economic Review* 37 (1993), pp. 507-17; Lars Jonung, 'Swedish Experience Under the Classical Gold Standard', in Michael Bordo and Anna Schwartz (eds.), *A Retrospective on the Classical Gold Standard, 1821-1931* (Chicago: University of Chicago, 1984), pp. 361-404; Cohen, 'Beyond EMU'.

40 Kirshner, *Currency and Coercion*, pp. 143-46. It also had the effect of driving some followers, like Egypt, completely out of the area.

41 Stasavage, *Political Economy of a Common Currency*, pp. 39-44.

42 Garber and Spencer, *Dissolution of the Austro-Hungarian Empire*; Spencer and Cheasty, 'Ruble Area'; Abdelal, *National Purpose*, pp. 45-59, 68-70.

domestic money supply. Not surprisingly, however, Sweden's patience with such conditions was short-lived, and Sweden eventually forced the disintegration of the union.[43]

In sum, symmetrical decision-making control, while hardly a perfect constraint, does reduce the leader's ability to derive benefits from the currency area, and may even cause the leader to shoulder unexpected costs. The Russian and Swedish examples also re-emphasize the limits of formally symmetric rules as a constraint on leading states: in the end, both leaders chose to force the disintegration of the union, much as the United States dismantled the dollar-exchange standard. Thus, symmetry appears to provide a temporary constraint, tolerated by strong leaders for a time, but ultimately abandoned if the constraint grows too severe.

Third Party Agents

Third, the rules of some currency areas delegate some functions to institutions that may be difficult for the leader to control. Some currency areas include a third party monetary institution like a supranational central bank or currency board that is not wholly under any state's control.[44] *Ceteris paribus*, we would expect any created institutions to respond more to the currency leader than to followers, but there are good reasons to doubt that the leader will retain full control over the institution. Barnett and Finnemore, drawing from sociological theory, stress the organizational interests of the institution in furthering its own purposes and strengthening its own autonomy.[45] Alternately, rational choice theory stresses that delegation to an agent invariably involves some slippage between the principal's goals and the agent's actions. Nielson and Tierney point out that agent slippage is made even more likely by the collective nature of the principal behind many international organizations: when the leader shares control over the agent, the ability of the principal to monitor and sanction negligent agents decreases significantly.[46] For both sets of reasons, currency areas that empower a third party monetary institution place limits on the ability of the leader to exercise its monetary power. Much recent criticism of the European Central Bank for overly tight monetary policies exemplifies this possibility.[47] Another example is the East African Currency Board (EACB) after the independence of Kenya, Uganda, and Tanzania in the early 1960s. Because the leadership of the EACB had been recruited and trained by former colonial power Britain, the EACB was only partially under the control of its nominal masters in East Africa. In an extreme case, one of the key EACB decisionmakers, J.B. Loynes, had been seconded from the Bank of England and seems to have routinely provided confidential EACB information to British officials in the region, undercutting the EACB's negotiations with Britain.[48]

Other interesting examples can be found if we relax our state-centric focus. Both the sterling area and the rouble zone empowered partially autonomous monetary institutions *within* the leading state: the Bank of England and the Central Bank of Russia, respectively. In each case, political leaders lacked some degree of control over monetary decisionmakers within the state, complicating governments' ability to gain desired benefits from the currency area. For example, in July 1993 the Central Bank of Russia (CBR) unilaterally hastened the collapse of the rouble zone by largely breaking the link between old roubles in circulation outside Russia and the new roubles in circulation in Russia itself. To minimize interference by the Russian government, the CBR timed its announcement to coincide with a Yeltsin vacation away from

---

43 Bergman, Gerlach, and Jonung, 'Rise and Fall', pp. 513-16; Cohen, 'Beyond EMU', pp. 199.

44 Third party institutions seem more likely in formalized currency areas like EMU, but one can also imagine a less formalized agreement to delegate monetary control to a trusted external institution.

45 Michael Barnett and Martha Finnemore, 'The Politics, Power, and Pathologies of International Organizations', *International Organization* 53 (1999), pp. 699-732.

46 Daniel Nielson and Michael Tierney, 'Delegation to International Organizations', *International Organization* 57 (2003), pp. 241-76.

47 For example, Paul De Grauwe, 'Challenges for Monetary Policy in Euroland', *Journal of Common Market Studies* 40 (2002), pp. 693-718.

48 UK Public Records Office, Treasury, 317/579 and 317/757.

Moscow. CBR Chairman Geraschenko's explicitly stated goal—'to determine who will stay in the rouble zone and who must leave'—clearly demonstrates the ability of implementing institutions to usurp decision-making from political leaders. The bank's *fait accompli* had profound consequences for Russian foreign policy in its 'near abroad', but Yeltsin, after hurriedly returning to Moscow, eventually acquiesced to the CBR's action.[49] In short, by changing our unit of analysis from leading states to the governments of leading states, we expect that third party monetary institutions even within the leading state may use their autonomy to complicate the leader's control of bargaining with followers.

Taken together, the rules of the currency area help set the parameters of leader-follower bargaining. Relatively formalized systems with symmetric control place limits on the leader's ability to use its size within the currency area to extract resources from followers. When those systems also contain a third party implementing institution, the leader's power is further diminished. The leader may still gain many of the available resources, but it is constrained by the system's rules from taking as much as it might like in a particular circumstance—at least until those constraints become so substantial as to encourage the leader to break out of the system entirely. But when rules are less formalized and not subject to a third party institution, there is more scope for bargaining and we can expect the leader's economic size relative to followers to increase its advantages. Similarly, in less symmetric systems, leaders are able to use their larger share of control for their own advantage. *Ceteris paribus*, leaders face the fewest constraints in informal, asymmetric currency areas with no external monetary institution. For example, dollarized economies like Ecuador and El Salvador share none of the dollar's seigniorage revenues and have no influence over the Federal Reserve Bank—this informal, asymmetric relationship imposes few constraints on the United States and allows it to dispose of economic resources as it sees fit. On the other hand, even informal asymmetric currency areas place some constraints on the leader, such as marginal difficulty in regulating the money supply and the risk of political backlash.[50]

In sum, I suggest three characteristics of the currency area's rules may place limits on leaders. These can be stated in the form of the following probabilistic hypotheses:

H4: More formalized rule systems limit opportunities for bilateral leader-follower bargaining and therefore place greater limits on the leader's power.

H5: Currency area rules that distribute decision-making symmetrically reduce the set of issues on which the leader can act unilaterally and therefore constrain the leader's power, at least temporarily.

H6: Currency areas that empower a third party monetary institution reduce the leader's control and therefore its ability to benefit from its power.

Conclusion

I have tried to show that leaders of currency areas, despite their power, may also face significant limits on that power. As a result, the relationship between leaders and followers can best be characterized as interdependence, rather than dependence. Of course, monetary bargaining power is also derived from factors beyond the currency area—see especially the Cohen, Kaelberer, and Walter contributions to this project[51]—but the currency area itself has an important independent impact. I argue that we can understand that bargaining by looking at currency area rules and at the relative costs of the follower's exit from the area. For both leaders and followers, a crucial consideration is how their economy would fare

---

49 Anne McElvoy, 'Rouble Reform Leaves Little Change in Consumers' Pockets', *(London) Times*, 27 July 1993, Lexis-Nexis; Oliver Wates, 'Yeltsin Softens Rouble Reform', *Financial Post (Toronto)*, 27 July 1993, Lexis-Nexis; Anatol Lieven and Anne McElvoy, 'Rouble Panic is Storm Before Calm', *(London) Times*, 28 July 1993, Lexis-Nexis.

50 Cohen, *Future of Money*, pp. 74-81. In the example, U.S. government control over the dollar area is of course limited by a highly independent third party monetary agent, the Fed.

51 Cohen, *The Macrofoundation of Monetary Power*; Matthias Kaelberer, 2005. *Money, Markets and Power: Explaining Patterns of Pegged Exchange Rate Regimes*. EUI Working Papers RSCAS No. 2005/12; Walter, *Leadership Begins at Home: The Domestic Sources of International Monetary Power*.

outside the currency area. On average, the follower has the weaker position because it needs the area more than the area needs it. But there is no *ex ante* reason to believe that the follower will always be weaker.

Although examples have tended to focus on monetary dependence within formalized currency areas, the same logic applies to informal currency areas. That is, it should apply to any type of currency internationalization, whether formal or informal. As I have suggested, informal currency areas place relatively fewer constraints on currency leaders and allow them greater scope to use their bilateral bargaining advantage vis-à-vis followers, especially when those areas are also asymmetrical. Today's dollar area is a good example, but this should apply to the euro and yen as well. Notice that the euro area is really two areas: the formal, relatively symmetrical arrangements of the twelve countries at the core, plus informal, asymmetrical relations between the twelve and other countries linked to the euro—including the non-euro EU members, a number of smaller European states and protectorates, and former colonies outside Europe.

The next step would obviously be more systematic testing of these hypotheses. I have tried to provide examples of currency areas that illustrate all the different analytical categories, but careful analysis of the bargaining power of leaders and followers in these various arrangements is beyond the scope of this study.

Finally, although this essay has emphasized the limits of monetary power, it should not be forgotten that currency areas can provide tremendous benefits to powerful states. We should not take the last decades of the sterling area, for example, as representative of its entire history. Cohen and Kirshner emphasize the increased insulation, seigniorage, status, and political leverage that leaders may accrue within a currency area. In effect, leaders accept constraints because followers are typically constrained more. Politicians in states that lead currency areas have certainly stressed these benefits as reasons for the maintenance of a leadership role. At the same time, there does not appear to be any literature systematically testing whether those benefits outweigh the accompanying costs. For example, typical analyses of the sterling area, franc zone, or rouble zone suggest that the leader subsidizes followers economically in return for the prestige of having them in its monetary area and the possibility of occasional tribute. Kirshner carefully separates economic and political costs and benefits for the leader and acknowledges that in many cases economic resources will flow away from the leader. But he also asserts that the leader gains more from entrapment and extraction than it gives up in economic subsidies. One implication of this essay is that Kirshner's proposition may need qualifying: future research should examine the conditions under which that proposition is valid.[52]

Scott Cooper
Department of Political Science
Brigham Young University
Provo, UT 84602
U.S.A.

scott_cooper@byu.edu

52 Cohen, *Future of Money*, pp. 78-81; Kirshner, *Currency and Coercion*, pp. 13, 116-19, 168.

 © 2005 Scott Cooper

References

ABDELAL, Rawi, 2001. *National Purpose in the World Economy*. Ithaca: Cornell University Press.

ANDREWS, David 1994. 'Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations', *International Studies Quarterly*, 38 (June), pp. 193-218.

ANDREWS, David, 2005. *Monetary Autonomy and Asymmetric Adaptation*. EUI Working Papers RSCAS No. 2005/07.

ANDREWS, David, forthcoming 2006. 'Introduction', in: David M. Andrews, (ed.), *International Monetary Power*. Ithaca NY: Cornell University Press.

APEL, Emmanuel, 1998. *European Monetary Integration: 1958-2002*. London: Routledge.

BARNETT, Michael, and Martha Finnemore, 1999. 'The Politics, Power, and Pathologies of International Organizations', *International Organization*, 53 (Fall), pp. 699-732.

BERGMAN, Michael, Stefan Gerlach, and Lars Jonung, 1993. 'The Rise and Fall of the Scandinavian Currency Union 1873-1920', *European Economic Review*, 37 (April), pp. 507-17.

BOUGHTON, James, 1992. 'The CFA Franc: Zone of Fragile Stability in Africa', *Finance & Development*, (December), pp. 34-36.

BOUGHTON, James, 1993. 'The CFA Franc Zone: Currency Union and Monetary Standard', *Greek Economic Review*, 15 (Autumn), pp. 267-312.

BOUGHTON, James, 1993. 'The Economics of the CFA Franc Zone', in: Paul R. Masson and Mark P. Taylor, (eds.), *Policy Issues in the Operation of Currency Unions*. Cambridge: Cambridge University Press, pp. 96-107.

COHEN, Benjamin, 1971. *The Future of Sterling as an International Currency*. London: Macmillan.

COHEN, Benjamin, 1993. 'Beyond EMU: The Problem of Sustainability', *Economics and Politics*, 5 (July), pp. 187-203.

COHEN, Benjamin, 1997. 'The Political Economy of Currency Regions', in: Helen Milner and Edward Mansfield, (eds.), *The Political Economy of Regionalism*. New York: Columbia University Press, pp. 50-76.

COHEN, Benjamin, 1998. *The Geography of Money*. Ithaca: Cornell University Press.

COHEN, Benjamin, 2002. 'U.S. Policy on Dollarization: A Political Analysis', *Geopolitics*, 7 (Summer), pp. 63-84.

COHEN, Benjamin, 2004. *The Future of Money*. Princeton: Princeton University Press.

COHEN, Benjamin, 2005. *The Macrofoundation of Monetary Power*. EUI Working Papers RSCAS No. 2005/08.

CONWAY, Patrick, 1995. *Currency Proliferation: The Monetary Legacy of the Soviet Union*. Essays in International Finance, no. 197. Princeton: International Finance Section, Department of Economics, Princeton University.

COOPER, Scott, 2004. 'Third World Monetary Blocs: Small State Choice or Great Power Hegemony?'. Paper prepared for *International Studies Association Convention*, 17-20 March, Montreal.

COOPER, Scott, (Forthcoming). 'State-centric Balance-of-threat Theory: Explaining the Misunderstood Gulf Cooperation Council', *Security Studies*, 13.

COOPER, Scott, and Clark Asay, 2003. 'Regional Currencies in Africa: The Domestic Politics of Institutional Survival or Dissolution', *Perspectives on Global Development and Technology*, 2 (June), pp. 131-60.

DAVIS-PANTON, Novelette, 1995. 'Issues Relating to the Central Bank's Autonomy in Jamaica', in: Ramesh F. Ramsaran, (ed.), *The Experience of Central Banking with Special Reference to the Caribbean*. N.p.: Regional Programme of Monetary Studies, pp. 58-86.

DE GRAUWE, Paul, 2002. 'Challenges for Monetary Policy in Euroland', *Journal of Common Market Studies*, 40 (November), pp. 693-718.

DYSON, Kenneth, 1994. *Elusive Union: The Process of Economic and Monetary Union in Europe*. London: Longman.

GARBER, Peter, and Michael Spencer, 1994. *The Dissolution of the Austro-Hungarian Empire: Lessons for Currency Reform*. Essays in International Finance, no. 191. Princeton: International Finance Section, Department of Economics, Princeton University.

GILPIN, Robert, 1987. *The Political Economy of International Relations*. Princeton: Princeton University Press.

GOODMAN, John, and Louis Pauly, 1993. 'The Obsolescence of Capital Controls?', *World Politics*, 46 (October), pp. 50-82.

HEFEKER, Carsten, 1995. 'Interest Groups, Coalitions, and Monetary Integration in the XIXth Century', *Journal of European Economic History*, 24 (Winter), pp. 489-536.

HELLEINER, Eric, 1995. *States and the Reemergence of Global Finance.* Ithaca: Cornell.

HELLEINER, Eric, 2005. *Structural Power in International Monetary Relations*. EUI Working Papers RSCAS No. 2005/10.

HENNING, C. Randall, 2005. *The Exchange Rate Weapon, Macroeconomic Conflict and Shifting Structure of the Global Economy*. EUI Working Papers RSCAS No. 2005/11.

HIRSCHMAN, Albert, 1969 [1945]. *National Power and the Structure of Foreign Trade*. Berkeley: University of California.

IKENBERRY, G. John, 2001. *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order After Major War*. Princeton: Princeton University Press.

INTERNATIONAL MONETARY FUND. 1993. *World Economic Outlook* (May). Washington, DC: International Monetary Fund.

JONUNG, Lars, 1984. 'Swedish Experience Under the Classical Gold Standard', in: Michael Bordo and Anna Schwartz, (eds.), *A Retrospective on the Classical Gold Standard, 1821-1931*. Chicago: University of Chicago, pp. 361-404.

KAELBERER, Matthias, 2005. *Money, Markets and Power: Explaining Patterns of Pegged Exchange Rate Regimes*. EUI Working Papers RSCAS No. 2005/12.

KIRSHNER, Jonathan, 1995. *Currency and Coercion: The Political Economy of International Monetary Power*. Princeton: Princeton University Press.

KIRSHNER, Jonathan. 2005. *Currency and Coercion in the Twenty-First Century*. EUI Working Papers RSCAS No. 2005/13.

LIBURD, E. Eustace, 1995. 'Aspects of Multinational Central Banking in the OECS', in: Ramesh F. Ramsaran, (ed.), *The Experience of Central Banking with Special Reference to the Caribbean*. N.p.: Regional Programme of Monetary Studies, pp. 47-57.

LUNDAHL, Mats and Lennart Petersson, 1991. *The Dependent Economy: Lesotho and the Southern African Customs Union*. Boulder: Westview Press.

MATTLI, Walter, 1999. *The Logic of Regional Integration: Europe and Beyond*. Cambridge: Cambridge University Press.

MCCARTHY, Colin, 1999. 'SACU and the Rand Zone', in: Daniel C. Bach, (ed.), *Regionalisation in Africa: Integration and Disintegration*. Oxford: James Currey, pp. 159-68.

MCNAMARA, Francis Terry, 1989. *France in Black Africa*. Washington, DC: National Defense University Press.

NIELSON, Daniel, and Michael Tierney, 2003. 'Delegation to International Organizations', *International Organization*, 57 (Spring), pp. 241-76.

PAULY, Louis W., 2005. *Monetary Power and Political Autonomy: Exchange Rate Policymaking in Follower States*. EUI Working Papers RSCAS No. 2005/14.

POMFRET, Richard, 1995. *The Economies of Central Asia*. Princeton: Princeton University Press.

POMFRET, Richard, 1996. *Asian Economies in Transition: Reforming Centrally Planned Economies*. Cheltenham, UK: Edward Elgar.

SCHELLING, Thomas, 1966. *Arms and Influence*. New Haven: Yale University Press.

SPENCER, Grant, and Adrienne Cheasty, 1993. 'The Ruble Area: A Breaking of Old Ties', *Finance & Development*, 30 (June), pp. 2-5.

STASAVAGE, David, 2003. *The Political Economy of a Common Currency: The CFA Franc Zone Since 1945*. Aldershot, UK: Ashgate.

STRANGE, Susan, 1971. *Sterling and British Policy: A Political Study of an International Currency in Decline*. London: Oxford University Press.

STRANGE, Susan, 1998. *Mad Money: When Markets Outgrow Governments*. Ann Arbor: Michigan.

STUART, John, 1992. *The Economics of the Common Monetary Area in Southern Africa*. Durban, South Africa: Economic Research Unit, University of Natal.

UNGERER, Horst, 1997. *A Concise History of European Monetary Integration: From EPU to EMU*. Westport, Conn.: Quorum Books.

WALTER, Andrew, 1991. *World Power and World Money*. New York: St. Martin's Press.

WALTER, Andrew, 2005. *Leadership Begins at Home: The Domestic Sources of International Monetary Power*. EUI Working Papers RSCAS No. 2005/15.