

# CURRENCY AND STATE POWER

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## Abstract

The purpose of this essay is to examine the effect of an international currency on state power. The discussion begins with a review of the aspects of state power that seem most relevant in the context of international monetary relations, thus setting the issue within a firm analytical framework. Emphasis is placed on disaggregating the concept of currency internationalization into the separate roles that an international money may play. Analysis then focuses on three specific questions: What is the effect on state power of each specific role, considered on its own? Are there interdependencies among the various roles? And are what are their relative or cumulative impacts? In the end, three roles appear to be of paramount importance: a money's role in financial markets, trade, and central-bank reserves. Other roles have little or no effect on the distribution of state power.

Though vast, the literature on international political economy has had remarkably little to say about the role of power in monetary relations. Well into the 1990s, the subject of international monetary power remained, in the words of Jonathan Kirshner (1995: 3), “a neglected area of study.” Only recently have scholars begun to explore the concept of monetary power in formal theoretical terms (Kirshner 1995; Lawton et al 2000; Andrews 2006a), including two previous efforts of my own (Cohen 2000, 2006). Many questions, though, still remain unanswered.

The purpose of this essay, building on my previous efforts, is to address one issue in particular: the effect of an international currency on state power. We all know that at any given time, a few national moneys play important international roles. It is also commonly assumed that currency internationalization directly impacts on the power position of issuing states. But what, precisely, are the connections between currency and power? In conceptual terms we really know very little about the specific causal pathways that run from cross-border use of a money to the capabilities of its home government. Indeed, at the most basic level, we are not even certain whether the net effect on state power is positive or negative. Room exists for a serious new examination of the subject.

The discussion begins with a review of the aspects of state power that seem most relevant in the context of international monetary relations, thus setting the issue within a firm analytical framework. Emphasis is placed on disaggregating the concept of currency internationalization into the separate roles that an international money may play. Analysis then focuses on three specific questions: What is the effect on state power of each specific role, considered on its own? Are there interdependencies among the various roles? And are what are their relative or cumulative impacts? In the end, three roles appear to be of paramount importance: a money’s role in financial markets, trade, and central-bank reserves. Other roles have little or no effect on the distribution of state power.

## FRAMING THE ISSUE

The concept of state power is not simple. Generations of specialists in international relations (IR) have explored every angle of the subject, yet consensus on many points remains elusive (Baldwin 2002). All we know for sure is that power is a complex and multifaceted phenomenon, almost chameleon-like in character, with implications and impacts that are highly dependent on context.

What aspects of state power are most relevant in the context of international monetary relations? Most discussions of monetary power tends to focus on overt manifestations of influence at a micro or macro level – the ability of a government to play an authoritative role in, say, crisis management or financial regulatory politics or the supply of payments financing. But to really understand monetary power, we have to go behind these manifestations to see where such abilities come from. That means highlighting two points in particular. One is the importance of autonomy as a *dimension* of monetary power. The other is the importance of interactions as a *source* of monetary power. These two considerations are fundamental. Together, they enable us to frame the central issue to be addressed in this essay: the relationship of currency to power.

### Autonomy

In much of the IR literature, including all the major work of Steve Krasner, state power is defined simply as the ability to influence the outcome of events. In operational terms, this naturally equates with a capacity to control the behavior of actors – “letting others have your way,” as diplomacy has jokingly been defined. A government, in this sense, is powerful to the extent that it can effectively pressure or coerce outsiders; in short, to the extent that it can exercise leverage or enforce compliance in pursuit of state objectives. Power is understood as another word for authority or leadership.

But influence is by no means the only meaning of power. As I have emphasized previously (Cohen 2000,

2006), there is also a vital second meaning, corresponding to the generic dictionary definition of power as a capacity for action. A state is also powerful to the extent that it is able to exercise effective independence in the formulation and implementation of policy – to act freely, insulated from outside pressure, to promote key national goals. In this sense, power does not mean influencing others; rather, it means not allowing others to influence you – others letting *you* have your way. This meaning of power is akin to Stephen Krasner's (1999) notion of "interdependence sovereignty," which he defines as the ability of a government to control activities within and across its borders. A useful synonym for this meaning of power is autonomy.

Influence and autonomy represent two distinct dimensions of power – respectively, power's external and internal dimensions. In the international security literature, drawing from the work of Thomas Schelling (1960), an analogous distinction is drawn between compellence and deterrence. The two dimensions are unavoidably interrelated. They are not, however, of equal importance. Logically and chronologically, power begins with autonomy, the internal dimension. Influence, the external dimension, is best thought of as functionally derivative – inconceivable in practical terms without first attaining and sustaining a relatively high degree of policy independence. As the saying goes in American football, the best offense starts with a good defense. It is possible to think of autonomy without influence; it is impossible to think of influence without at least some degree of autonomy.

This does not mean that autonomy must be enjoyed in *all* aspects of international affairs or in *all* corners of the world in order to be able to exercise influence in *any* aspect or relationship. Neither scope (range of issues affected) nor domain (geographic scale) need be universal for power to be effective. States can successfully apply leverage in selected issue areas or relationships even while themselves being subject to pressure or coercion in others. But it does mean that in a *given* issue area or geographic relationship, power begins at home. First and foremost, policymakers must be free to pursue national objectives in the specific issue area or relationship without significant outside constraint; to minimize compromises or sacrifices to accommodate the interests of others. Only then will a state be in a position, *in addition*, to enforce compliance elsewhere. Autonomy, the internal dimension, may not be *sufficient* to ensure a degree of foreign influence. But it is manifestly *necessary* – the essential foundation of power. The core importance of autonomy in this regard has not always been appreciated in the specialist literature.

The distinction between the two dimensions of power is especially relevant in the context of monetary relations. In the monetary domain, autonomy is an issue of much greater immediacy than influence. National economies are inescapably linked financially through the balance of payments – the flows of money in and out of a country generated by trade and investment. One country's surplus is another country's deficit. The risk of unsustainable disequilibrium thus represents a persistent threat to policy independence. Excessive imbalances generate mutual pressures to adjust, which can be costly in terms of both economic and political interests. Deficit economies may be forced to curtail 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 instead to see others make the necessary sacrifices. For most states, therefore, the foundation of monetary power is the capacity to avoid the burden of adjustment required by payments imbalance – autonomy.

The capacity to avoid the burden of adjustment, like power itself, is also fundamentally dual in nature, subdividing into what I have characterized as the two "hands" of monetary power (Cohen 2006). These are the power to delay and the power to deflect, each corresponding to one of two different kinds 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.

Only once autonomy is established might a government then be able to turn its thoughts to the possibility of influencing others as well. In a real sense, of course, influence is inherent in autonomy. Because monetary relations are inescapably reciprocal, a potential for leverage is automatically created whenever operational independence is attained. By definition, a capacity to avoid adjustment costs implies that if payments equilibrium is to be restored, others must adjust instead. At least part of the burden will be diverted elsewhere. Hence a measure of influence is necessarily generated as an inescapable corollary of the process.

But what kind of influence? The influence that derives automatically from a capacity to avoid adjustment costs represents at best a contingent aspect of power, since it can be said to exist at all only because of the core dimension of autonomy. Moreover, the impacts involved are diffuse and undirected. This is very different from what is conventionally meant by the external dimension of power, which normally is understood to imply some degree of direct focus or deliberate intent. Autonomy translates into influence in the accepted sense of the term -- a dimension of power aiming to shape the actions of others -- only when the capacity for control is exploited, self-consciously applied to attain economic or political goals.

Essentially, the difference goes to the contrast between what Scott James and David Lake (1989), drawing on an earlier literature, label the first and second "faces" of hegemony (or power): the first face of direct government-to-government influence, exercised through various forms of positive or negative sanctions; and the second face of market leverage, which favorably alters incentive structures. The first face is intentional, deliberately seeking to exploit opportunities for advantage. The second face is more inadvertent, working instead through market processes to create dependencies and rearticulate interests. As James and Lake (1989: 8) write: "The invisible hand of market power... need not be exercised consciously." David Andrews (2006b: 16-17) makes a similar distinction between the "nonintentional exercise of power" and "purposeful acts," also referred to as statecraft. Stefano Guzzini (1993) calls the second face "non-intentional power." Kirshner (1995) calls it "entrapment." States may benefit from the second face whether they do anything about it or not. The first face requires explicit decision making.

Correspondingly, we may think in terms of two "modes" that are possible in the exercise of monetary influence: passive and active. The influence generated as a corollary of the adjustment process is exercised passively, even unpremeditatedly, and is best understood simply as the alter ego of autonomy. Alternatively, influence may be exercised actively, targeted at specific countries and applied with self-conscious purpose. Both modes of influence begin with autonomy as a basic and necessary condition, and in both cases other states may feel compelled to adjust. But whereas in the passive mode the pressures exerted on others are market-driven, operating through power's second face, in the active mode the pressures are exerted directly by government, power's first face.

The question, in short, is: Will the potential be actualized? *Can* it be actualized? 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, an aspect of power exerted without design and with impacts that tend to be dispersed and undirected. Only when conditions allow the potential for leverage to be 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 toward what end.

In a sense, passive influence in the adjustment process is relatively uncontroversial, broadly accepted as an unavoidable, if regrettable, consequence of inequality -- a veritable fact of life. Active influence attempts, by contrast, are apt to become far more politicized, since they are both elective and purposeful. The active mode seeks to *compel* others to behave in certain ways, taking us well beyond the notion of influence as simply an incidental by-product of autonomy. The active mode, in effect, aims to translate passive influence into practical control through the instrumental use of power. That is very big difference,

indeed.

### *Interactions*

Whether we are talking of autonomy or influence, it is evident that the key to analysis lies in the nature of interactions between states. In a monetary context the old-fashioned “elements of national power” approach (or “resources-as-power” approach) once dominant in the IR literature, identifying power with tangible resources of one kind or another, is clearly of secondary importance. The specific properties of states – their territory, population, armed forces, and the like – are not entirely irrelevant to monetary power. But for the most part they enter the monetary domain only faintly or indirectly. Far more salient as a source of power is the structure of transactional relationships among states, as emphasized in the so-called “relational power” approach (or “social-power” approach) that has emerged since the mid-twentieth century (Baldwin 2002). In this view, power arises directly from an actual or potential interaction between two or more actors – a relational property – rather than simply from the material possessions of any one of them. What matters is not endowments or resources but rather who depends on whom and for what.

In IPE, the first insight along these lines is generally credited to the economist Albert Hirschman ([1945] 1969) in his World War II-era *National Power and the Structure of Foreign Trade*, a book long neglected until it was rediscovered in the late 1960s. Looking at Nazi Germany’s trade relations with neighboring countries in East-Central Europe and the Balkans, Hirschman highlighted the hidden politics of international trade: how conditions of dominance and dependence among states may arise naturally from the asymmetries of foreign commerce, and how import and export policies may be used opportunistically to exert political pressure and leverage. In “State Power and the Structure of International Trade” (1976) – a title deliberately intended to evoke Hirschman’s earlier analysis -- Steve Krasner explicitly cited Hirschman as an inspiration for his own state-power theory of trading structures.

Subsequently, the relational-power approach was more fully developed by Bob Keohane and Joe Nye in their landmark work in the 1970s on the implications of growing interdependence in the postwar world economy (Keohane and Nye 1973, 1977). States, Keohane and Nye noted, were becoming increasingly intertwined -- hence each was becoming more and more dependent on others in all sorts of issue-areas, monetary as well as others. Mutual dependence, however, was rarely symmetrical. Opportunities thus were created for less dependent states to manipulate existing relationships to their own advantage. In the global system as a whole, Keohane and Nye concluded, it is possible “to regard power as deriving from patterns of asymmetrical interdependence between actors in the issue-areas in which they are involved with one another” (Keohane and Nye 1973: 122). The basic question, in simplest terms, was: Who needs whom more? Power, in general, could be understood to consist of a state’s control over that for which others are dependent on it.

Relational asymmetries also underlay Susan Strange’s popular distinction between two forms of influence in the global economy – “relational” power and “structural” power. Dismissing what she called the “narrow (and old-fashioned) understanding of power” (Strange 1985: 11) defined by the resources-as-power approach, Strange emphasized the importance of interactions – mutual dependence. Power, she argued, could be understood to operate at two levels at once, structural as well as relational. Relational power, echoing more conventional treatments in the IR literature, was the familiar “power of A to get B to do something they would not otherwise do” (Strange [1988] 1994: 24) – a capacity to extract advantage within the established framework of activity. Structural power was “the power to shape and determine the structures of the global political economy... the power to decide how things will be done, the power to shape frameworks within which states relate to each other” (Strange [1988] 1994: 24-25) – a capacity to extract advantage by favorably modifying the existing framework of activity. In crudest terms, as I suggested in an earlier version of the same distinction (Cohen 1977), the first referred to the ability to gain under the prevailing rules of the game; the second, to the ability to gain by rewriting the rules of the game.

In the context of monetary affairs, relational asymmetries manifestly lie at the root of both hands of power, the power to delay and the power to deflect. And since autonomy, in turn, creates the potential for leverage, those same asymmetries therefore may be said to be the source of a state's influence as well, at both the relational and structural levels. The connections run from (1) mutual dependence to (2) a capacity to avoid the burden of adjustment to (3) one or both of the modes of monetary influence at either the relational or structural level.

Can the connections be formalized? Strange herself never offered a systematic analysis of the sources of either relational or structural power. By her own admission her aim was more to offer ideas, not build grand theory (Cohen 2008: 50-51). Nor do we find much help elsewhere in the scant literature on international monetary power. However, some formalization is possible if we look to a more recent innovation in IR scholarship – an emergent field of study known as “network analysis” (Hafner-Burton et al 2009; Kahler 2009).

In network analysis the main unit of analysis, as the name implies, is the “network,” defined as a special kind of social organization – “one that displays neither the hierarchical character of states and conventional international organizations nor the ephemeral bargaining relationships of markets” (Hafner-Burton et al 2009: 559-560). Networks are comprised jointly of diverse actors (termed nodes) and the patterns of relations among them (termed ties, connections, or links). Networks form structures that may either constrain or enable agents, thus influencing the distribution of power. As in the relational power approach to IR, influence within networks is related to position: to the nature of ties among nodes rather than to the attributes of individual actors. Power for any single actor is a function, above all, of the centrality (importance) of connections. Centrality corresponds to the number of shortest paths in the network that pass through a particular node, a form of asymmetry that indicates the dependence of the network on that node for maintaining connectedness. A node's network power increases when the actor gains exclusive ties to otherwise marginalized or weakly linked nodes or groups of nodes.

Suppose then that we think of monetary relations as a vast network, a structure of asymmetrical interdependencies, all operating within an established framework of norms, rules, and decision-making procedures. Centrality in the network may be assumed to enhance a state's capacity to delay or deflect the costs of payments adjustment and thus to create at least a potential for leverage, which may or may not be actualized at either the relational or structural level. Influence at the relational level may be understood to be a direct function of the degree of centrality in *specific* relationships. The more centrally placed a state is, relative to other states, the more relational power it will have. Influence at the structural level may be understood to be a direct function of the *cumulative total* of centralities. The greater the number of relationships in which a state is centrally placed, relative to other states, the more structural power it will have. The possibilities are obviously diverse. All, however, ultimately trace back to the same source – the characteristics of a state's position within the monetary network.

### ***The Monetary Power Agenda***

Overall, therefore, the aspects of state power that seem most relevant in the context of monetary relations seem clear. First is the foundation of autonomy – the capacity to avoid the burden of adjustment required by payments imbalance – which has two hands: the power to delay and the power to deflect. Autonomy, in turn, creates a potential for influence, which may remain passive or may be actualized, depending on circumstances. And influence may take the form of either relational power or structural power (or both). Underlying all is where a country stands – its centrality -- in the structure of the monetary network.

Framing the central issue is then relatively straightforward. Our interest is in the effect of an international currency on the power of its issuing state. A specific framework for analysis – call it the Monetary Power Agenda -- can be outlined in the form of a series of four interrelated sets of questions:

1. What is the effect of an international currency on the issuing state's position within the monetary network? In particular, is centrality of position enhanced or diminished?
2. What is the effect of an international currency on the state's monetary autonomy? On its power

- to delay? On its power to deflect?
3. What is the effect of an international currency on the state's capacity for influence? What is the likelihood that influence will be actualized?
  4. What is the effect of an international currency on the state's relational or structural power?

## MONEY AND POWER

Few knowledgeable observers doubt that an international currency can enhance the power of the state that issues it. As Strange (1971a: 222) put it long ago: "It is highly probable that any state economically strong enough to possess [an international money] will also exert substantial power and influence. The rich usually do." Likewise, in my own work, I have repeatedly stressed a gain of foreign influence as among the benefits of currency internationalization (Cohen 1998, 2004). If there is a conventional wisdom on the issue, that is it.

Remarkably, however, the conventional wisdom has never been put to a serious test. A broad causal relationship is assumed, linking currency to power, and much has been written about how the resulting capabilities might be used as an instrument of statecraft (Kirshner 1995; Andrews 2006a). But no one has ever tried to spell out the connections in detail, to see just how or why any one of the diverse cross-border uses of a national money might actually affect the autonomy or influence of its issuer. International currencies play many roles, and not all of those roles may have the same impact on state power. The framework provided by the Monetary Power Agenda permits us to take a closer look to see what specific characteristics of international money make the most difference.

### *The conventional wisdom*

The logic of the conventional wisdom is impeccable. The starting point is the pronounced hierarchy that has always existed among the world's diverse moneys, which I have previously characterized as the Currency Pyramid (Cohen 1998, 2004). From the days of the earliest coins in ancient Greece, competition among currencies has tended to throw up one or two market favorites that, for shorter or longer periods of time, predominate in cross-border use and set a standard for all other moneys. Notable examples included the silver drachma of Athens, the Byzantine gold solidus, the Muslim dinar, the florin of Florence, the ducat of Venice, the seventeenth-century Dutch guilder, the Spanish-Mexican silver dollar, Britain's pound sterling, and of course, in our own day, the U.S. dollar. Not insignificant is the fact that in every case the dominant currency's issuer – at least at the start – was also a major, if not dominant, economic and political power.

It hardly seems implausible, therefore, to assume that there might be a connection between currency use and power. The very notion of hierarchy, after all, is inherently political, suggesting degrees of reciprocal influence – differential impacts on the ability of governments to achieve goals at home or abroad. So why not just connect the dots? The stronger the currency, the stronger the country. As Nobel laureate Robert Mundell (1993: 10) once wrote, "Great powers have great currencies."

In the extant literature, however, we find only the vaguest clues to how the dots might in fact be connected. Most commentators, including myself, have tended to limit themselves simply to enumerating the benefits that can accrue to the issuer of an international money. Standard analysis identifies four main gains – two economic and two political. These are:

1. **Seigniorage.** Technically defined as the excess of the nominal value of a currency over its cost of production, seigniorage at the international level is generated whenever foreigners acquire and hold significant amounts of domestic money, or financial claims denominated in the domestic money, in exchange for traded goods and services. Cross-border accumulations represent the equivalent of a subsidized or interest-free loan from abroad – an implicit economic transfer that

constitutes a real-resource gain for the economy at home. Included as well is the benefit of any reduction of overall interest rates generated by the extra demand for home-country assets.

2. Macroeconomic flexibility. Cross-border use can also relax the constraint of the balance of payments on domestic monetary and fiscal policy. The greater the ability to finance payments deficits with the country's own currency, the easier it is for policy makers to pursue public spending objectives, both internally and externally. Macroeconomic flexibility may be considered another way of expressing the autonomy dimension of monetary power.
3. Reputation. At the symbolic level, a position of prominence in the hierarchy of currencies can promote the issuing state's overall reputation in world affairs – a form of what political scientists today call soft power. Broad international circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations.
4. Leverage. Finally, in more tangible terms, prominence in the hierarchy of currencies may promote the issuing state's capacity to exercise leverage over others through its control of access to financial resources – a form of hard power. This benefit, obviously, corresponds to the influence dimension of monetary power.

But beyond enumerating these potential gains, little effort has gone into analyzing the specifics of causation. Currency internationalization, typically, is treated more or less holistically, with little regard for the distinctively separate roles that an international money may play. Apart from a few casual comments here or there, the possibility that these separate roles might have differential impacts on the power of issuing states has never been formally addressed.

### *The roles of money*

Impeccable as the logic of the conventional wisdom may be, therefore, it still leaves critical gaps in our understanding. We know that international currencies play many roles, to a greater or lesser extent. But we know little about how each of these roles separately may (or may not) connect to state power. Are all roles necessary to enhance the power of the issuer? Are they equally necessary? Is it possible that some are less important than others or perhaps not even needed at all? Is it possible that different roles are required to promote specific dimensions of power? To respond to these questions, we need to systematically disaggregate the concept of currency internationalization in order to isolate the impact of each individual role.

The standard taxonomy for characterizing the roles of international money, which I can take pride in originating (Cohen 1971), separates out the three familiar functions of money – medium of exchange, unit of account, store of value – at two levels of analysis: the private market and official policy, adding up to six roles in all. Specialists today generally speak of the separate roles of an international currency at the private level in foreign-exchange trading (medium of exchange), trade invoicing and settlement (medium of exchange and unit of account), and financial markets (store of value). At the official level, we speak of a money's roles as an exchange-rate anchor (unit of account), intervention currency (medium of exchange), or reserve currency (store of value). Each of the six roles is distinct in practical as well as analytical terms.

At any given moment, only one or two currencies are ever likely to be of significance for all of these diverse functions. These are what, with a nod to Strange (1971a, 1971b), I have called Top Currencies – moneys whose scope and domain are more or less universal. Top Currencies are what an economist would call full-bodied money, generally accepted for all purposes. Today the only true Top Currency is America's greenback, which for all its tribulations still dominates for most cross-border uses and in most regions (Cohen 2009). Not even the gale-force winds of the recent global financial crisis could topple the dollar from its perch at the peak of the Currency Pyramid, though debate about its future continues (Helleiner and Kirshner 2009).

Just below are what I call Patrician currencies – moneys whose use for various cross-border purposes, while substantial, is something less than dominant and whose popularity, while widespread, is something

less than global. Most prominent among these is of course the euro, the joint money of the European Union (EU), which is already second to the greenback in most categories of use. Though many observers have predicted that the euro is destined soon to achieve parity with or even surpass the greenback as international money (Chinn and Frankel 2008), the evidence suggests otherwise (Cohen 2009). In reality, after a fast start, cross-border use of the euro appears to have leveled off and is largely confined to the EU's immediate hinterland around the European periphery and in parts of the Mediterranean littoral and Africa. The only other Patrician Currency of note today, despite some recent loss of popularity, is the Japanese yen. Many expect the euro and yen to be joined eventually, though not any time soon, by China's yuan, otherwise known as the renminbi ("people's currency").

And below the Patrician Currencies come what I call Elite Currencies - moneys of sufficient attractiveness to qualify for some degree of cross-border use but with only limited scope or domain. These are the minor international currencies, a list that today would include inter alia Britain's pound sterling (sadly no longer a Top Currency or even a Patrician Currency), the Swiss franc, the Canadian and Australian dollars, and a handful of others.

The challenge is to look carefully at each of the principal roles of an international currency and, using the framework provided by the Monetary Power Agenda, ask: What is the effect on state power of each specific role, considered on its own? Are there interdependencies among the various roles? And are what are their relative or cumulative impacts? Only then can we begin to get a real handle on the specifics of causation in the currency-power relationship.

## THE PRIVATE LEVEL

In international markets, selected national currencies – whether Top, Patrician, or Elite – may play any of three roles: in foreign-exchange trading, trade invoicing and settlement, or financial markets. Examining each role on its own, it becomes evident that their respective implications for state power differ noticeably. All three may generate economic dividends, but only the financial-market role, where currencies serve as an investment medium, can prove advantageous in political terms as well. The big dividing line is between the medium-of-exchange and unit-of-account functions of money, on the one hand, and the store-of-value function on the other.

### *Foreign-exchange trading*

Nothing better illustrates the network-like quality of international monetary relations than the foreign-exchange market – that vast agglomeration of banks and other financial institutions around the world where national currencies are actively traded for one another. The underlying purpose of the market is to facilitate the transfer of purchasing power between monetary domains. Given the more than 150 distinct state currencies presently in existence, it is evident that the total of bilateral relationships numbers in the thousands, constituting a gigantic web of interactions. The metric for all of these relationships is of course the rate of exchange between each pair of currencies.

Not all relationships are of equal importance, however. In most cases, the direct connections between pairs of currencies are weak at best. How many people, after all, are likely to be seeking to trade the Mauritian rupee for the Polish zloty, or the Guatemalan quetzal for the Kazakhstani tenge? Markets between most currencies tend to be thin, meaning that the expense of direct purchases is likely to be high, if not prohibitive. Most wholesale trades therefore tend to go through a more widely used intermediary, a "vehicle" currency, in order to minimize transactions costs. The idea is to take advantage of scale economies or what economists call "network externalities." One peripheral currency is used to buy the vehicle currency; the vehicle currency is then used to buy another money. In the exchange market today, according to the most recent survey by the Bank for International Settlements (2007), the U.S. dollar is by far the most dominant vehicle currency, appearing on one side or the other of some 86 percent of all market transactions. (Percentages add up to 200 % because every transaction involves two currencies.)

Trailing far behind are the euro (37 %), yen (16.5 %), and a small handful of Elite Currencies.

Vehicle currencies clearly enjoy a position of centrality in the global currency network, since so many other paths pass through them. For issuing states, this almost certainly translates into economic benefit. Transactions costs are likely to be reduced for local enterprises; financial institutions may gain some competitive advantage from the volume of business done in their own home currency. Political benefits, on the other hand, seem slight, since the role appears to have little impact on monetary autonomy. Widespread use as an intermediary for currency trading in no way affects a state's ability to delay or deflect adjustment costs. No constraint on state action is removed or alleviated. The vehicle role is a purely mechanical one and can be easily replaced. Its power implications are minimal.

### *Trade invoicing and settlement*

Much the same can also be said of a currency's role in trade invoicing and settlement. Whenever goods or services are bought and sold internationally, the parties to the transaction must agree on the monetary unit to be used to denominate contracts and effectuate final payments. And here too scale economies dictate a dominant role for a small handful of currencies at the center of the global monetary network. Available data suggest that roughly half of all world exports today are invoiced and settled in U.S. dollars. Partly this is because of America's large market size and still predominant place as an importer and exporter, all providing a large transactional network that enhances scale economies. And partly it is because of the greenback's central role in the markets for virtually all reference-priced and organized exchange-traded commodities -- including, most notably, the global market for oil, the world's most widely traded product. Next in importance is the euro, which accounts for perhaps 15-20 percent of exports, mainly in and around the European region. Most other moneys play a marginal role at best.

The benefits of the trade role too appear to be largely economic rather than political. On the economic side, local enterprises need worry less about the issue of exchange risk; financial institutions may enjoy a competitive edge in providing commercial credit or other trade-related services in their own home currency. These are definite advantages. But on the political side gains again seem slight, and for much the same reason. The market's choice of a national currency for invoicing and settlement, on its own, adds nothing directly to the issuing government's ability to delay or deflect adjustment costs. Again, no constraint is removed or alleviated. Bills must still be paid on time, whatever the currency used. Here too direct power implications are minimal.

### *Financial markets*

Effects are quite different, however, in financial markets, where currencies play a role as an investment medium. One of the principal functions of financial markets is to facilitate the management of risk for net savers of all kinds, including large-scale institutional investors. Opportunities are created to promote portfolio diversification. At the domestic level this means widening the range of instruments available to serve as a store of value, from the simplest savings account through bonds and equities to the most complex sorts of options, derivatives, and so-called "structured" securities. At the international level this means, in addition, widening the range of currency choices that may be open to portfolio managers. To spread risk, global investors typically invest across a variety of currencies, including all the familiar moneys near the peak of the Currency Pyramid. Most popular here too is the U.S. dollar, though by a declining margin. Representative are the figures for the outstanding stock of international debt instruments (defined as securities issued in a currency other than that of the borrower's home country). At the end of 2007, according to the European Central Bank (2008), the greenback's share of the global bond market stood at 43 percent, down from about 50 percent in 1999. The euro's share, by contrast, was up noticeably, from just 19 percent in 1999 to roughly one-third in 2007. At least a half-dozen other moneys, including the yen and a number of Elite Currencies, account for the remainder.

Like the vehicle and trade roles, the financial role clearly yields economic benefits. Most significant is the seigniorage gain that automatically results from the willingness of market actors to hold a currency

that is not their own. In exchange for financial claims of one kind or another, the issuing economy acquires real goods and services that can be used for consumption or investment purposes. Additional benefits may also accrue to local banks or other financial institutions that generate, trade, or manage the claims owned by foreigners.

But unlike the vehicle and trade roles, the financial role also yields political benefits insofar as it relaxes traditional balance-of-payments constraints on domestic macroeconomic policy. Autonomy is enhanced when it becomes possible to finance external deficits with the state's own currency. Adjustment costs can more easily be delayed or deflected.

Is influence enhanced as well? We know that a *capacity* to exercise leverage emerges automatically as a corollary of enhanced autonomy in the adjustment process – the passive mode of influence. But can that potential be *actualized* – the active mode -- with specific targets and self-conscious intent? That depends greatly on two ancillary conditions: (1) the availability of alternatives to the state's currency as an investment medium; and (2) the magnitude of existing foreign holdings. The former variable is important because it determines the issuing state's ability to control the *supply* of investment opportunities; the latter, because it helps shape market sentiment regarding the attractiveness of those opportunities, thus affecting *demand*. At one extreme would be a situation like that enjoyed by the United States after World War II, when market actors had few alternatives to the U.S. dollar and greenback holdings were low. America had a virtual monopoly on quality outlets for savings, and few feared for the dollar's future value. As a result, Washington was in a position to make access to its financial markets an explicit instrument of foreign policy, welcoming friends or barring adversaries. At the other extreme would be a situation like the present, when alternatives to the greenback are more plentiful and the accumulated "overhang" of foreign claims on the United States has grown alarmingly. Any attempt today to actualize the potential for leverage might be met simply by a flight from the dollar, which almost certainly would be more disadvantageous than advantageous from America's point of view.

On balance, therefore, the power implications of the financial role are ambiguous. Autonomy is increased as a result of the greater degree of macroeconomic flexibility. But influence in the active mode may or may not be facilitated, depending as it does on ancillary conditions. In general, as I have previously suggested (Cohen 1998: 129), leverage is apt to be greatest at the earliest stages of cross-border use, when a currency is most popular. Later on, advantages are likely to be eroded by the accumulation of balances abroad. Overall, the role can be regarded as a two-edged sword, potentially useful as a means to shape the behavior of others but, in time, possibly also dangerous to its user.

## THE OFFICIAL LEVEL

At the official level, involving relations between governments, national currencies may also play any of three roles, as an exchange-rate anchor, intervention currency, or reserve currency. Here too each role, considered separately, has its own implications for state power. Likewise, here too the biggest difference is between the medium-of-exchange and unit-of-account functions, on the one hand, and the store-of-value function on the other.

### *Exchange-rate anchor*

Since the breakdown of the Bretton Woods pegged-rate system in the early 1970s, governments have been free to choose whatever exchange-rate regime they desire, from various versions of a "hard" or "soft" peg to managed flexibility or an independent ("clean") float. States that prefer to retain some form of peg have a wide range of units of account to choose from. Moneys may be anchored to a single currency, a "basket" (weighted average) of currencies, or even the International Monetary Fund's reserve unit known as the Special Drawing Right (SDR), which is itself based on a basket of four major currencies. In practice, only a few currencies figure prominently as exchange-rate anchors, either for single-currency pegs or as a prominent part of basket pegs. Most dominant, once again, are the U.S. dollar and euro.

About sixty states presently align their exchange-rate policy, wholly or in part, with the greenback, ranging in size from tiny islands in the Pacific to China. Some forty countries, including four European mini-states (Andorra, Monaco, San Marino, and the Vatican), seven present members of the European Union (EU), and several more candidates for EU membership, rely solely or mainly on the euro.

As with trade invoicing at the private level, the anchor role at the official level appears to produce gains that are largely economic rather than political. The relative stability of a peg is likely to reduce the cost of doing business with aligned countries, as compared with economies with more flexible or freely floating rates. Power implications, by contrast, appear to be as ambiguous as with the financial role. An anchor role certainly enhances the centrality of a currency, putting it at the core of a formal or informal monetary bloc. That may help promote the issuing state's soft power, by adding to the country's global prestige and reputation. But hard power benefits little, since on its own the pegging function, understood simply as a currency *numéraire*, does nothing to augment monetary autonomy. Indeed the net impact on the issuing state's power position could even turn out to be negative, to the extent that use as an anchor constrains the government's ability to resort to exchange-rate shifts as part of the adjustment process. Its power to delay or deflect might actually be eroded. This role too may be a two-edged sword.

### ***Intervention currency***

Except for an absolutely clean float – rare in practice -- all exchange-rate regimes involve some degree of government intervention in the exchange market, whether modest or substantial. But what foreign currency should be bought or sold in order to manage an exchange rate? Here too, as in foreign-exchange trading, scale economies matter. Efficiency criteria dictate choosing a currency that is as widely traded as possible, to ensure that the effects of intervention will be generalized quickly. That means relying on one of the most popular international moneys such as the U.S. dollar, euro, or yen. Use for intervention purposes generally tends to mirror a money's prominence as a vehicle currency.

Effects of the intervention role, for the issuing state, appear to parallel those of the anchor role. On the one hand, there is likely to be some economic benefit, insofar as widespread use of the currency advantages home financial institutions. On the other hand, power implications are ambiguous. There is nothing in the intervention role, considered separately, that augments monetary autonomy. There is, however, a risk of loss of influence over the exchange rate in the adjustment process to the extent that bilateral rates are controlled by the intervention practices of others. Once again, we find a two-edged sword.

### ***Reserve currency***

Finally, we come to the role of reserve currency – the function that most readily comes to mind when we think about international currencies. Central banks, by tradition, maintain a reserve of internationally acceptable assets, partly as formal backing for their national money but mainly to help, if needed, to finance balance-of-payments deficits. Reserve assets serve as a store of value that can be used directly for intervention purposes or else can be more or less quickly converted into a usable intervention medium. For historical reasons gold is still included in the reserve stockpiles of many countries, despite the fact that it is no longer directly employable as a means of exchange. So too are SDRs, which like gold must be exchanged for a more utilizable instrument when the need for financing arises. But the great bulk of reserves is held in the form of highly liquid assets denominated in one of the small handful of moneys at the peak of the Currency Pyramid. Once again the U.S. dollar predominates, accounting at end-2008 for some 64 percent of global reserves according to the IMF's public database on the Currency Composition of Official Foreign Exchange Reserves (COFER). This was down from 71.5 percent in 1999 but well up from a low of around 45 percent in 1990. And once again the euro is second, with a share of 26 percent at end-2008, up from 18 percent in 1999.

Effects of the reserve-currency role most closely resemble those of the financial role. On the one hand there are clear economic benefits, including a gain of seigniorage for the economy as a whole as well as

heightened profit opportunities for local financial institutions that are in a position to assist foreign central banks in the trading and management of their reserves. On the other hand power implications are ambiguous and highly dependent on ancillary conditions.

Here too autonomy is increased as a result of a greater degree of macroeconomic flexibility. The more foreign central banks are willing to add to their reserve holdings, in effect extending credit to the issuing state, the easier it is for the issuer to delay or deflect adjustment costs. A capacity to exercise leverage emerges. But whether that potential can be actualized is another matter entirely. Much depends on the same ancillary economic considerations that make the financial role so contingent: the availability of alternatives and the magnitude of existing holdings. Because here we are speaking of official state institutions, and not just private market actors, much also depends on political considerations, including especially the nature of the issuing state's diplomatic and security relations with reserve holders. Does the issuer enjoy strong foreign-policy ties with its creditors – perhaps a traditional patron-client linkage or a formal military alliance? Or are relations more adversarial? Depending on how these considerations fall out, possibilities vary enormously along a continuum of state power, from a condition of potentially great strength to a position of decided weakness.

At issue is much the same calculus that Strange (1971a, 1971b) had in mind, decades ago, when she distinguished between “top” currencies and “negotiated” currencies. In Strange's typology, a top currency was one whose international standing derived directly from its inherent market appeal, based on such attributes as stability of value, liquidity, and a broad transactional network. The logic was essentially similar to what James and Lake (1989) later called the second face of hegemony. Negotiated currencies, by contrast, required implicit understandings or explicit political deals to preserve or promote their elite status, much more like James and Lake's first face of hegemony. The more a money retains its appeal on economic considerations alone – Strange's top currency – the greater is the issuing country's capacity for influence. State strength is enhanced. But the more the issuer must instead rely on positive or negative sanctions to persuade others to hold its money – Strange's negotiated currency – the less can the issuer effectively actualize its influence. The state's position is weaker. A negotiated currency may be a money in decline, as sterling was in the early decades after World War II; it might also be a money on the rise but not yet ready for prime time, as China's yuan is today. London back in the 1960s had to cajole or coerce other countries to remain members of the sterling area. Beijing, in our own time, must still bargain for bilateral agreements with foreign governments in order to promote a role for the renminbi. A priori, it is not always easy to see where an issuing state is likely to fall along this continuum of possibilities.

## INTERDEPENDENCIES

Overall, a distinctive pattern emerges. All six roles generate economic benefits of some magnitude. Political effects, however, tend to be more ambiguous. Only the two store-of-value roles – the financial role at the private level and the reserve role at the official level – seem to add directly to the issuing state’s monetary autonomy, creating a potential for effective leverage. In this respect, there is a clear dividing line between the store-of-value function and the other two functions of international money (medium of exchange, unit of account). But whether, in practice, that potential can be actualized is unclear without a closer examination of ancillary conditions, both economic and political. Influence may be enhanced – but, also, may not.

Does this mean, then, the two store-of-value roles are the only ones that matter for state power? That appears to be the view of Herman Schwartz, one of the few scholars to have even considered the question. In a brief aside in a recent book (Schwartz 2009: 5), Schwartz describes the medium-of-exchange and unit-of-account functions of an international money as “largely secondary” because they “do not imply public or private willingness to offer finance on the scale needed to escape the usual tradeoffs.” In other words, macroeconomic flexibility (escaping “the usual tradeoffs”) is the key, and only the store-of-value function (“finance”) provides it. But such a view is misleading since it assumes greater insularity among money’s functions than in fact is warranted. Analysis cannot stop with a consideration of each role on its own. The possibility of interdependencies among the various roles must be considered, too.

For example, we know that the intervention role of an international money is closely tied to its importance as a vehicle currency. As indicated, scale economies matter in exchange-rate management. The more widely traded a money is, the more quickly will effects of purchases or sales be spread throughout the exchange market. It clearly makes more sense to make use of a peak currency like the U.S. dollar or euro for intervention purposes rather than the loti of Lesotho or the Paraguayan guarani. In this sense, the intervention role is directly dependent on the vehicle role.

Likewise, it is evident that a close link exists between the invoicing role of a currency in international trade (a unit-of-account function) and its settlement role (a medium-of-exchange function). It is no accident that typically these are spoken of, as I have done here, in tandem: the trade role. Examples do exist of contracts denominated in one monetary unit and settled in another, but they are relatively rare. Most parties to international trade find it more convenient to use the same currency for both purposes.

The real question, however, concerns the two store-of-value roles and the dividing line between them, on the one hand, and the other two functions of international money on the other. Is either the financial-market role or the reserve role in any way dependent on a currency’s use as a medium of exchange or unit of account at either the private or official level?

At the private level, the answer is clear: No. For most portfolio managers, seeking diversification to manage risk, use of any given currency as an investment medium is most closely tied to the critical qualities of “exchange convenience” and “capital certainty” -- a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a set of well developed financial markets for claims denominated in the issuing country’s currency, sufficiently open to ensure full access by investors of all kinds. Markets must not be encumbered by high transactions costs or formal or informal barriers to entry. They must also be broad, with a large assortment of instruments available for investment purposes. And they must be deep and resilient, with fully operating secondary markets for most if not all financial assets. Neither exchange convenience nor capital certainty appear to depend in any way on how much a money may or may not be used as a vehicle in currency markets or for trade invoicing and settlement. In currency markets the vehicle is not held as a store of value at all. In trade, a species of investment instrument is created in the form of commercial paper, but the claims involved are very short-term and effectively self-liquidating.

At the official level, the answer is trickier. In principle central banks are no less free than market investors to diversify the currency composition of their holdings, so long as the assets they hold can be quickly converted when needed into a medium useful for financing purposes. To that extent, the qualities they seek are the same as those valued by private actors: exchange convenience and capital certainty. There is no reason to think that store-of-value choices should be directly linked to the degree of a money's use in the foreign-exchange market or global commerce. In practice, however, reserve preferences in most countries tend to be distinctly skewed, favoring one currency in particular. In Latin America, the Middle East, and much of Asia, the U.S. dollar typically predominates, while around Europe and in parts of Africa the euro is more popular. Why is that?

Superficially, it might appear to have something to do with the anchor and intervention roles. If a country's money is formally or informally aligned with one anchor currency in particular, it makes sense to intervene in that currency as well; and that in turn would logically encourage concentrated holdings of the currency, to facilitate easy entry or exit in the exchange market. But that fails to explain why we also see the same kind of skewed preferences in states with floating exchange rates, which may not actively manage their moneys on a regular basis. Nor, for states that do intervene frequently, does it account for the choice of anchor to start with. Such decisions are not made arbitrarily.

Looking deeper, it seems evident that the really crucial link lies elsewhere – in the trade role. Politics aside, reserve preferences are most likely to reflect the pattern of currency choice in a country's foreign commercial relationships. The popularity of the U.S. dollar in Latin America, the Middle East, and Asia is a direct reflection of either or both of two considerations: the importance of the United States as a market or supplier; or the importance of reference-priced and organized exchange-traded commodities in each country's exports. Since the greenback is the main monetary unit used for invoicing and settlement in both bilateral trade with the United States and global commodity trade, it is hardly surprising to find it dominant in the reserves of these countries as well. Conversely, the euro naturally dominates in the European region, where trade relations are focused more toward members of the EU.

Nowhere is the importance of the trade role better illustrated than in the Middle East, where the dollar has long reigned supreme as a reserve asset, particularly for Saudi Arabia and most other oil-producing Gulf states. Partly, of course, the greenback's predominance can be accounted for by non-economic considerations – not least, long-standing security understandings between Washington and governments in the region, which reportedly include certain guarantees for the dollar. In this sense, the greenback has taken on some of the attributes of a “negotiated” currency. But can there be any doubt that much of the explanation lies, as well, in the dollar's central role in the global oil market? Since revenues come in the form of greenbacks, it is most convenient simply to hold them or invest them in dollar-denominated assets. U.S. policy makers are acutely aware of the extent to which the dollar's reserve role in the Middle East follows directly from its trade role. One of their worst nightmares is that because of recurrent bouts of dollar weakness, oil producers might one day shift to an alternative currency, or basket of currencies, for the invoicing and settlement of energy trade. Almost certainly that would result in a shift of reserve preferences as well, severely eroding the monetary leverage that Washington currently enjoys.

Plainly, therefore, it is misleading to dismiss the trade role, along with the other medium-of-exchange and unit-of-account functions, as “secondary.” In terms of direct implications for state power, the dividing line between the two store-of-value roles, on the one hand, and money's other two functions (medium of exchange and unit of account), on the other hand, remains essential. But indirectly, the role of a currency in private trade can be seen to play a vital part, too, insofar as it helps to shape government reserve preferences. Overall, three of an international money's six possible roles – specifically, the trade, financial, and reserve-currency roles -- matter critically for state power, not just the two store-of-value roles.

## RELATIVE AND CUMULATIVE IMPACTS

What are the relative or cumulative impacts of these three roles? It seems reasonable to

conclude that of the three, the financial role contributes least to state power. On the other hand, adding the other two roles to the financial role is likely to move the issuer from limited relational power to something closer to structural power.

There are three reasons for discounting the relative impact of the financial role, considered on its own. First, as compared with the reserve-currency role, it is clearly more difficult to actualize any potential for influence. We know that both store-of-value roles enhance autonomy, by relaxing traditional balance-of-payments constraints on domestic macroeconomic policy. A capacity for leverage is the automatic corollary of any increase in the power to delay or deflect adjustment costs. But when the enhanced autonomy results from decentralized investment decisions in the open marketplace rather than from centralized government choices, impacts are bound to be more dispersed and diffuse, making it harder to target specific actors with self-conscious intent. When a currency is held just by private investors, pressures can be brought to bear on other states only indirectly. When the same currency is held by public agencies, pressures on foreign governments can be applied directly, to much better effect.

Second, the financial role also offers a lower degree of control over supply, again as compared with the reserve-currency role. That is evident from the differing degrees of diversification in private markets and official reserves. At the private level, as indicated, as many as 8-10 currencies figure prominently in global finance. It is not like the immediate aftermath of World War II when just one country, the United States, could enjoy anything like a monopoly over available alternatives. Given this level of competition, few issuing states are in a position even to try to exercise deliberate leverage through the role of their currency as an investment medium. Assets denominated in the monetary units of countries like Australia, Canada, and Switzerland are all actively traded in global markets, but no one would claim that this translates into any kind of power for their issuing governments. At the official level, by contrast, where just two currencies dominate, an effective duopoly prevails. More room, accordingly, is offered for actualizing influence.

Third, it seems clear that while a given currency can play a financial role even if never used as a reserve currency, the reverse is unlikely ever to happen in a market-based monetary system. Monetary history suggests that the financial-market role comes first and then is followed by a reserve role *in addition*. Certainly that was the pattern followed by the pound sterling in the nineteenth century, which first found an international role as a consequence of London's pre-eminence as a financial center, and only later began to be held by central banks as well. Likewise, it was true of the U.S. dollar, which first rode the rise of New York as a rival to London for foreign lending well before it surpassed sterling as a reserve asset. It is necessary to think in terms of cumulative effects. A state whose currency is used alone as a store of value in private markets gains only the influence created by that role. But a state whose currency is used as a store of value by central banks too gains the cumulative effect of both roles – a greater capacity to move from the passive to the active mode.

The link, of course, is the trade role, which plays a critical part in determining which among several investment currencies will emerge as a favored reserve asset as well. The issuer of an international money that is used only as investment medium can aspire at best to just some modicum of relational power. The money may rise to the status of an Elite Currency, but not beyond. But add widespread use for trade invoicing and settlement leading to a reserve-currency role, and soon the issuing state becomes much more centrally placed in the global monetary network, moving closer to some degree of structural power. Combined dominance in all three – financial markets, trade, and reserves – produces the “exorbitant privilege,” as Charles De Gaulle put it, of a true Top Currency.

## CONCLUSION

The conclusion may be briefly summarized. Currency internationalization does indeed impact directly on the power position of issuing states. The effect derives from three roles in particular: a money's role in financial markets, trade, and central-bank reserves. The financial and reserve roles – the two store-of-

value roles – enhance the issuing state’s monetary autonomy, making it easier to delay or deflect adjustment costs. Autonomy in turn creates a capacity for influence, though whether that capacity can be actualized will depend on ancillary conditions that may vary considerably over time. The link between the two store-of-value roles is a currency’s role in trade invoicing and settlement, which impacts directly on central-bank reserve preferences. The more a currency dominates in each of these three roles, the more it moves from limited relational power to some degree of structural power.

The practical lesson, therefore, is clear. Several states around the world today are thought to harbor ambitions to amplify their monetary power – including, most prominently, the four BRIC countries (Brazil, Russia, India, and above all China). One way to do this is to promote internationalization of their currency. How can that be done? The analysis suggests two critical imperatives. One is a commitment to broad financial-market development, building up the exchange convenience and capital certainty of their currency, in order to attract the interest of private investors and portfolio managers. The other is a commitment to wider use of their currency in trade invoicing and settlement, reshaping commercial relationships, in order to attract the interest of foreign central banks. Neither path is easy, of course, and success is by no means guaranteed. But the consequences could be significant, even profound.

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