EUROPEAN UNION AND THE EURO: A BIGGER GLOBAL ROLE BECKONS?

Russia's invasion of Ukraine has brought a muscular response from the United States, the European Union and the members of the North Atlantic Treaty Organisation in support of Ukraine. It has, for the first time in such a conflict, been accompanied the imposition of an unprecedented range of financial sanctions. This "weaponization" of currencies raises both challenges, and opportunities for the EU as the digitalization of finance accelerates globally, raising question marks over the dominant role of the U.S. dollar in international geo-politics.

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On 24 April a shaft of light penetrated the otherwise unremitting gloom which has swept over the European Union (EU) after Russian President Vladimir Putin launched his pitiless assault on Ukraine two months earlier. Emmanuel Macron was re-elected to be President of France for another five years.

If the French people had voted, instead, for Marine Le Pen, the right-wing nationalist and avowed euro-sceptic, this would have raised questions about France's role in the EU, and therefore Germany's.

Since the signing of the Treaty of Rome in 1957 the keystone locking the European integration project in place has been the Franco-German understanding that success, for each state and for the union, depended on their cooperation. This has never been truer than it is today.

But with the International Monetary Fund warning that the economic outlook is fast deteriorating in the EU and around the world[1], the vote in France still serves as a warning. The populist challenge has not been defeated, merely repulsed.

Worryingly, the United States, depending on the vagaries of its election cycles, has moved from being a supporter of European integration, to being, as it was under President Donald Trump, a potentially unreliable ally.

The United Kingdom, meanwhile, is no longer a supportive EU member state. Rather, it is now a large and, presently troublesome, neighbour.

Most ominously, of course, Russia's attack on Ukraine has triggered a full-scale war on the EU's eastern border.

But both the scale and style of the response to this aggression, and the speed at which it has been implemented by what is once again being referred to as "the West," has been as unprecedented as it was unexpected.

As the Financial Times notes[2], with some 330,000 troops now deployed on its eastern flank, "(the) North Atlantic Treaty Organisation (NATO) allies …...have collectively embarked on the most significant- and rapid- military deployment in the history of modern Europe," Eastern Europe is now more militarised than at any time since the cold-war, it adds.

[1] https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022

[2] https://on.ft.com/39uriMl

But this, coupled with warnings from Russian President Vladimir Putin that he could resort to the use of nuclear weapons, has stirred fears that the world could, by accident or design, even be on the brink of a global nuclear catastrophe.

As EU policymakers scan this landscape they can they look forward, assuming there is no nuclear confrontation, with more optimism than they might have imagined possible just a few weeks ago.

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Russia's attack on Ukraine has both re-energised the trans-Atlantic alliance and injected a new sense of purpose into the EU. Led by the United States, the twenty-seven EU member states have imposed on Moscow the most draconian financial sanctions ever deployed. For the EU this has involved overcoming what some feared would again be a serious barrier to cooperation, the treaty-based requirement demanding EU unanimity for such decisions.[3] This display of cohesion by the EU comes in the wake of a series of crises, ranging from the global financial disaster of 2007/8 to the covid pandemic,which have shaken the regionsince the turn of the century.

Looking forward, however, there are now signs that the European leaders are laying the foundations needed to make the EU stronger militarily and geo-politically, the latter by strengthening the global role of the single currency, the euro. They are, for example, examining whether they should follow in the footsteps of China and seize the opportunity presented by the remarkable impact digital technology is beginning to have on global finance to launch a central bank digital currency (CBDC).[4]

The Birth of the Single Currency: a Turning Point for the Continent.

There was widespread optimism about the EU's prospects on 1 January 1999 when, against a quite benign economic backdrop, it took a giant step forward in pursuit of deeper economic and political integration by launching the euro.

[3] https://on.ft.com/3snzy6M
[4] https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210714~d99198ea23.en.html

Many, in Germany in particular , watched anxiously however. They believed that political union should have preceded monetary union and they feared that the foundations of the single currency were deeply flawed. The troubled first decade of the single currency suggested that these fears could be justified.

But today these doubters have been proved wrong. The transformation of the geopolitical map of the world since 1999 suggests that the decision to push ahead with European Monetary Union has been proved to be prescient.

The sweeping financial sanctions being deployed against Russia signal the arrival of the "weaponization" of finance as an instrument of statecraft - in this case of war - on an unprecedented scale. This, too, is evidence that the euro arrived just in time. It demonstrates that, for a large, internationally engaged actor in the world economy such as the EU, a credible, globally used currency is now *one* of the foundations upon which not just its economic development but also its national/regional security *must* be based. This is particularly true for the EU which has never sought to develop a strong military capacity.

Indeed, this perception of the potential geo-political role of finance helps to explain why China, alongside its intense military build-up, is pursing the internationalization of its currency, the renminbi, with such determination. It also explains why there is so much, albeit misplaced, anxiety in Washington about what some see as the waning role of the still dominant dollar in the emerging geopolitical landscape (see below).

There are at least two further factors to cite in support of the argument that the euro was launched just in time. The first is rarely commented on.

In a lecture in Bologna on November 7th 1998 entitled "Lessons from the European Adventure," Professor Tommaso Padoa-Schioppa, one of the founding fathers of the Euro, addressed the vital role of a currency in a society.

"The importance of the single European currency transcends the economic and institutional sphere ….(a currency) profoundly affects interpersonal relations, identification of the society one belongs to, and individual and collective psychology," he said.

"To accept a piece of paper with no intrinsic value, from a stranger, in exchange for goods and services produced by the sweat of one's brow, is," he went on, "one of the most extraordinary manifestations of trust people can show towards the society to which they belong."

"That the monetary centre has become European is therefore a change of immense significance because *it means that trust is now founded on Europe,*".

Today, after only two decades, that trust is already deeply embedded. While the British cling reverentially to their illusory conception of national sovereignty, symbolised by a monarch's head on a "piece of paper," no such nostalgia for their now defunct currencies reverberates around the single currency's capitals, cities, towns or villages.

> *"In short, Russia could scarcely have done itself more harm to its relations with the EU than it has. It has strengthened its ancient enemy, Poland, and the defence posture of its most important European commercial partner, Germany."*

Seen from this perspective the success of the euro is just one vital component of an emerging pan-European Union identity which will exist alongside the national identities and languages bequeathed by a history.

The argument, deployed recently by political philosopher Francis Fukuyama, that there is a conflict here between national and regional identity is false: they can, and do, and must co-exist in the European Union.[5] There is, however, another reason to highlight the birth of the single currency as a turning point in Professor Padoa-Schioppa's "European adventure." It has survived a truly tempestuous childhood and adolescence far better than many imagined possible.

In doing so it has validated, once more, the wisdom of the oft-quoted judgement of Jean Monnet, one of the European Union's founding fathers, namely that "Europe will be forged in crises and will be the sum of the solutions adopted for those crises."

The Trials of the Single Currency.

Since the euro's launch in 1999 both the euro and the EU have been bombarded by a succession of crises. Indeed, the single currency was at the very heart of perhaps the most threatening of these crises, namely the euro debt crisis of December 2011.

[5] "A Country of Their Own: Liberalism Needs the Nation." Foreign Affairs. (May/June 2022). https://www.foreignaffairs.com/articles/ukraine/2022-04-01/francis-fukuyama-liberalism-country

As this financial firestorm raged question marks were raised over whether even Italy, one of the six original signatories of the Treaty of Rome, would still be an EU member when the turmoil had passed.

Two events indicate just how close the EU came to catastrophe. In December 2011, Wolfgang Schauble, then Germany's finance minister, could only respond guardedly when asked whether a euro member state could be forced out. "No such development can be seen at the moment," he said.[6] It was not until, after a further seven months of fraught, but essentially still fruitless negotiations that, on 26 July 2012, the decisive intervention was made to save the single currency, and arguably the EU itself. It is described in the ECB's Working Paper 2249 (March 2019) as "a watershed moment for the euro area."[7]

On that day, speaking (interestingly) in London, Mario Draghi, then President of the European Central Bank, finally began to calm still turbulent financial marketsby famously declaring: "Within our mandate, the ECB is ready to do *whatever it takes* (authors italics) to preserve the euro."[8] The euro now had, in the ECB, a lender-of-last-resort.

The euro crisis evolved out of the 2007/8 Global Financial Crisis (GFC), arguably, the worst financial/economic collapse since the Great Depression of the 1930s. This exposed the inadequacy of financial crisis prevention/crisis management tools in the both the U.S. and the EU. It also demonstrated, and not for the first time, firstly just how closely and potentially dangerously integrated trans-Atlantic financial markets had become, and secondly how vulnerable the euro was to a systemic financial crisis.

This, in turn, led to long overdue steps to start radically to reshape financial market regulatory and supervisory structures in the EU and more swiftly in the U.S.

The 2009 report by an EU expert group headed by former IMF Managing Director Jacques de Larosiere, highlighted many of the weaknesses in the EU's financial market oversight and suggested ways forward.9 But it was only after the Global Financial Crisis (GFC) had spread to the EU in 2011 that the union began to actually implement, in 2014, some of the steps required to strengthen its financial sectors' regulatory and supervisory frameworks.

Initial complacency, born partly out of ignorance, was to blame for this slow

[6] https://www.theguardian.com/business/2011/dec/30/euro-wolfgang-schauble-stabilise-handelsblatt?CMP=share_btn_link
[7] ecb.wp2249~543dd2fbd3.en.pdf
[8] https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html
[9] ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf

response. EU governments simply did not know, in sufficient detail, how enmeshed in U.S. finance their banks had become. So they did not expect the essentially U.S. based "sub-prime" crisis to engulf European financial institutions. Nor did the make the link between this vulnerability and their nation-state's dependence on finance intermediated by these weakened domestic banks – the so-called "doom loop."

Work by Professor Hyun Song Shin, then of Princeton University, shed light on this threat. He noted, in a lecture in 2011 given to the International Monetary Fund's Annual Research Conference: "U.S.-dollar assets of banks outside the United States are comparable in size *to the total assets of the U.S. commercial banking sector* (author's italics), peaking at over $10 trillion prior to the crisis…a substantial proportion … are the claims of European banks against U.S. counterparties,"10

Today, this financial crisis prevention/crisis management infrastructure,although strengthened is, worryingly, far from complete. But the euro has survived, demonstrating the depth of the EU's commitment to the single currency.

Crises Have Also Deepened EU Cohesion

Notwithstanding the inevitable tensions when, as with Ukraine today, so much is at stake, the crises of the past two decades have forged a higher level of cooperative intent between governments in EU member states and also officials in EU institutions. This was seen as member states and EU institutions came together to contain the euro debt crisis and, again, during the United Kingdom's EU exit negotiations. Determined British efforts to divide member states internally and so to undermine the EU negotiator, Michel Barnier, failed dismally and, as of today, damagingly for London.

Political cohesion, deepened by shared experiences of crises also helped to ensure that, after an at best faltering, arguably chaotic, start when she took office on 1 December 2019, Ursula von der Leyen, the new Commission President, is emerging as the most effective leader of this institution since Jacques Delors.

Wisely, von der Leyen, unlike Delors, has cast herself as a low-key practitioner of EU integration and has not sought to replicate the missionary zeal of her predecessor. Before she took office, the Commission in Brussels, notably its competition and economic and financial directorates, along with the European Central Bank in Frankfurt, had already worked closely in the EU's response to the euro debt crisis.

Since von der Leyen's arrival the Commission has successfully coordinated responses

[10] https://www.imf.org/external/np/res/seminars/2011/arc/pdf/hss.pdf

to the covid pandemic, including the launch of the potentially transformative Euro 800 billion covid recovery plan, the Next Generation EU (NGEU) programme.

Researchers at the Brussels think-tank Bruegel maintain that this borrowing programme, which has already begun, will start to transform the role of the EU in international financial markets. It will make it one of the "major borrowers in Europe…putting it on a par with major sovereign issuers such as Germany, France and Italy."

As such, the programme can promote the development of a market for a Euro denominated "safe asset," akin to the market for U.S. Treasury securities. As the Bruegel researchers say this "could help resolve some of the long-standing issues with the European macro-economic and financial architecture."[11] Arguably, as important is the fact that such a "safe asset" would help to deepen the role of the euro internationally.[12]

The Revival of the Trans-Atlantic Alliance

The intense trans-Atlantic cooperation of 2007-12, without which the Global Financial Crisis (GFC) and its aftermath in Europe would not have been so effectively dealt with, has now re-emerged in the wake of Russia's invasion of Ukraine.

Much has been made of the way in which events so far have exposed Russia's unanticipated military ineptitude. As significant going forward, however, is the broader re-invigoration of the trans-Atlantic alliance.

The resolving of the sub-prime and euro debt crises depended on EU and U.S. finance ministers and central bankers working together cooperatively. This is something they have been primed to do during multiple such events stretching back decades, especially in the Group of 5/Group of 7 advanced economy settings, at the International Monetary Fund and at the Bank for International Settlements.

Since the annexation of Crimea in 2014, western defence establishments, with the wider threat to Ukraine threat in mind, have also been stepping up their cooperation, especially within NATO.[13] Prime ministers are fully engaged too. Together they are transforming the European geo-political environment.

[11] https://www.bruegel.org/2021/11/next-generation-eu-borrowing-a-first-assessment/

[12] https://www.cer.eu/publications/archive/policy-brief/2021/why-eus-recovery-fund; https://socialeurope.eu/eu-borrowing-time-to-think-of-the-generation-after-next

[13] https://on.ft.com/39uriMl

There is, for example, Finland, and perhaps Sweden, are applying to join NATO, strengthening the EU and, importantly, the former Baltic states of the Soviet Union. They are already NATO members.

Germany, partly in response to Russia's attack on Ukraine, has already made what must be seen as historic choices. Its plans to just wean itself off Russian gas and oil rather than pre-emptively to cut the supply lines now, have drawn fierce criticism. But the critics are wrong. They are underestimating both how much economic damage a protracted war in Ukraine is already doing to weakening trans-Atlantic economies, some of which are teetering on the brink of recession.

If they were tumble over the edge this could help to undermine the resolve underpinning their electorates' support for Ukraine. Hence U.S. Treasury Secretary's Janet Yellen's careful warning, on 19 April 2022, about the economic risks of moving precipitously to slash Russian fuel imports.[14]

But there are other dimensions to Germany's strategic stance. On 13 September 1944, President Franklin D Roosevelt's Treasury Secretary, Henry Morgenthau, argued that a post-World War II aim of the U.S. government should be "the de-industrialisation" of Germany, in effect its transformation into a nation of farmers or "pastoralization," through the permanent removal of its industry and any capacity to make instruments of war.[15] This policy was not adopted. But, ever since, fear of German re-militarisation has been a consistent thread running through political calculations on both sides of the North Atlantic. In Germany itself, especially on the political left, support for pacifism has been one of the themes of the nation's domestic political discourse.

And yet, on February 27, just days after Russia launched its first air-strikes against the Ukrainian capital, Kyiv, the new Chancellor of Germany, the centre-left Social Democrat Olaf Scholz, announced the creation of a special fund of Euro100 billion, to be spent on military procurement.

This was accompanied by a pledge to allocate, annually, 2 percent of Germany's gross domestic product to defence. As the Stockholm International Peace Research Institute argued, Chancellor Scholtz "did away with decades of political restraint and ushered in a new era of German foreign and security policy."[16]

[14] https://on.ft.com/3v2fh9e

[15] Robert Dallek, (Viking, 2017):p.

[16] https://www.sipri.org/commentary/blog/2022/explainer-proposed-hike-german-military-spending

Significantly, Germany's eastern neighbour Poland has also responded forcefully. Only months ago Poland was seen as one of the "black sheep" of the European family. Poland's confrontation with Brussels over its allegedly undemocratic interference with the EU principles under-pinning the rule of law and judicial independence led the Financial Times to ask,"Can Poland step back from the brink?."[17] Russia's war in Ukraine has transformed the situation. Poland, with a population of 38 million, is the largest of the former satellite states of the Soviet Union to join the EU. It has been one of the better performing economies in the EU27. It already has one of the EU's bigger armies. Nevertheless, it has announced plans to more than double, to 300,000, its military personnel and increase its annual military budget to 3 percent of gross domestic product, strengthening its military role in NATO, and, by extension the EU.[18] Poland's stature as a potential powerhouse in the EU and, eventually, in the euro area, has also been enhanced by the way it has responded to the war on its eastern border by offering sanctuary to over 3 million Ukrainian refugees.[19] This humanitarian choice is one of the most vital contributions to the NATO response to President Vladimir Putin's war.

In short, Russia could scarcely have done itself more harm to its relations with the EU than it has. It has strengthened its ancient enemy, Poland, and the defence posture of its most important European commercial partner, Germany. Simultaneously, it is eroding its strategically valuable and economically vital commercial partnership with Germany, the energy supply deals which date back to over fifty years.

America's unmatched military strength and, given the centrality of financial sanctions to the NATO response, the global dominance of the U.S. dollar, have both been key elements in the West's muscular response to the Ukraine crisis.

Key, too, has been the little remarked upon "collegial" tone which President Joe Biden's administration adopted in its approach to alliance management, a point highlighted by an analysis by the Financial Times in early April.[20] This contrasts with the near contempt which President Donald Trump was prone to display towards his EU counterparts or, as revealed by Fiona Hill, then the senior Russia adviser in the National Intelligence Council, the bullying approach adopted by some senior policymakers around President George W Bush.[21]

The importance of the personal role of President Joe Biden in this should not be

[17] https://on.ft.com/3JDCpiQ

[18] https://www.reuters.com/world/europe/poland-ramp-up-defence-spending-army-ukraine-war-rages-2022-03-03/

[19] https://data2.unhcr.org/en/situations/ukraine/location?secret=unhcrrestricted

[20] "Weaponisation of finance: how the west unleashed 'shock and awe on Russia." https://on.ft.com/3DLnLob

[21] https://www.nytimes.com/2022/04/11/magazine/trump-putin-ukraine-fiona-hill.html?smid=em-share

underestimated. As I learnt in early June 1987, when I spent a day interviewing the then Senator Biden for the Financial Times, he is both a committed trans-Atlanticist and a person who seeks to build a consensus in pursuit of his objectives. ("A man who moves to America's new beat" Financial Times: 10 June 1989).

Donald Trump's presidency, the support he still enjoys and the influence he still wields across the Republican Party and in the country at large, tells the EU that in trans-Atlantic relations it should not now to take too much on trust. Presidents are permitted only two four-year terms of office and Europe must now question the long- term reliability of the United States as an ally.

With this in mind, Germany's move to strengthen its military capacity is also welcome because it has also been taken with a glance at the U.S. in the rear-view mirror. It is paying attention to the fact that the EU must, out of self-interest, be ready to cope again with a unilateralist U.S. President and that it must play a strong role in helping the EU in pursuit of what it terms "strategic autonomy."

Of course, it would be best for "the West" if the U.S. cast off its post-WWII self-image as the unchallenged global hegemon. It should recognize that the "collegial" approach to alliance management now being adopted by the Biden Administration better fits a fast-changing and a more complex geopolitical landscape, notably as a result of the rise of China. Such a shift is self-evidently in Washington's own long-term interests. But, as a United Kingdom still lost in dreams of past imperial grandeur has discovered, this is not easy to do.

Geopolitics and the Euro

The European Union has long been unwilling either to develop or to project globally a military capability. Indeed, it could not even defend itself without U.S. support. What military power it has today has been woefully fragmented. This may now have begun to change.

But the quite sudden and comprehensive deployment of financeas a weapon for putting pressure on Russia presents the European Union with a both new challenge and an opportunity.

After finally displacing the British pound during WWII, the U.S. remains today the dominant global currency. This dollar dominance is underpinned by the U.S. rule of law, by the dollar's ready convertibility into other currencies, by America's strong and credible financial institutions and deep financial markets, and by the extra-territorial reach that comes from the dollar payments system. This is why any deployment of wide-ranging and effective financial sanctions by the EU is currently inconceivable without U.S. engagement.

The euro, however, already shares with the dollar some of the same characteristics of a global currency. In the EU, for example, unlike in China, the rule of law is sacrosanct, a pillar of its democracy and a foundation for foreigners' confidence in their longer-term EU investments.

But the euro's financial markets are no match for America's. There are still important regulatory, institutional and market gaps which need to be plugged in order to strengthen the euro domestically and internationally.

A looming question here is whether, as some maintain, the dollar's international role is waning? If so,should the EU launch a central bank digital currency (CBDC) with the objective of strengthening the euro's global position?

A lengthy working paper by the IMF, "The Stealth Erosion of Dollar Dominance." discusses the evidence for the alleged decline in the dollar's global role in some detail.[22] Gita Gopinath, First Deputy Managing Director of the International Monetary Fund has argued that the example of the Russia-Ukraine war could spur the faster adoption of digital finance. Cryptocurrencies, stablecoins and central bank digital currencies are already seen as ways possibly to evade financial sanctions.[23] A recent report by Stanford University's Hoover Institution,"Digital Currencies: the U.S., China and the World at a Crossroad," highlights the way in which China was quick to recognize the geopolitical significance of the impact fast-changing digital technology can have on financial markets and national currencies.[24]

The EU has already recognised that a central bank digital euro may be needed. Last year the ECB launched a two-year investigation phase to assess its practicality.[25] The evidence from around the world suggests that it is a question of when, not whether, more central bank digital currencies will be launched.

According to Marcus Brunnermeier and Jean-Pierre Landau, digitalization of finance "has the potential to reshape the international monetary system as cross border payments become easier." China's decision to launch a CBDC is often seen

[22] https://www.imf.org/en/Publications/WP/Issues/2022/03/24/The-Stealth-Erosion-of-Dollar-Dominance-Active-Diversifiers-and-the-Rise-of-Nontraditional-515150

[23] https://on.ft.com/3qPT3oy

[24] www.hoover.org/research/digital-currencies-us-china-and-world-crossroads

[25] https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210714~d99198ea23.en.html

"as the first act in a new and fierce international currency competition," they add.26 If this is what transpires, collegially coordinated trans-Atlantic cooperation in the deployment, regulation and supervision of fast evolving digital financial markets and cooperation in the oversight of "the West's" central bank digital currencies, becomes a vital shared interest.

Returning, finally, to Jean Monnet's dictum that Europe "will be forged in crises," the war in Ukraine is already emerging as a crisis which is re-shaping the EU militarily. Partly because of the expanding role of financial sanctions in geopolitics, but also because of intensifying currency competition, it will also help to reshape the future of EU financial markets and the euro.

Mario Draghi, is currently Italy's prime minister but, previously, as ECB President, was widely acknowledged to be the figure who played the decisive role in saving the euro in the 2011-12 debt crisis.

On 3 May he called for the EU to both deepen economic integration and abandon the requirement for unanimity on foreign policy decisions - a clear sign that the debate about what changes are needed now to buttress the EU and its single currency is already well underway.[27]

[26] https://www.europarl.europa.eu/thinktank/en/document/IPOL_STU(2022)703337
[27] https://on.ft.com/3LHtyhF