3

The Euro and the Dollar: Toward a "Finance G-2"?

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In March 1997, my lead-off paper for the IMF's major conference on European monetary unification and the international monetary system began with the following paragraph:

> The creation of the euro will be the most important development in the evolution of the international monetary system since the widespread adoption of flexible exchange rates in the early 1970s. It will almost certainly be the most important development for the monetary (as opposed to adjustment) dimension of the system since the dollar succeeded sterling as the world's top currency during the interwar period. (Bergsten 1997b, 17)

Nobel Laureate Robert Mundell used very similar words a year later when he offered his own outlook for the pending new currency:

> The introduction of the euro will represent the most dramatic change in the international monetary system since President Nixon took the dollar off gold in 1971 [and since] the era of flexible exchange rates began . . . the euro is likely to challenge the position of the dollar [and hence] this may be the most important event in the history of the international monetary system since the dollar took over from the pound the role of dominant currency in World War I. (Robert Mundell, "The Case for the Euro—I and II," *Wall Street Journal,* March 24 and 25, 1998, A22)

The spectacular success of the euro during its first five years provides strong support for these predictions (which were of course virtually alone among those of American economists at the time). *The advent of a new glo-*

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bal currency based on a European economy as large as that of the United States clearly indicates that the international monetary system will look very different in the 21st century than it did in the dollar-dominated world of the 20th century or the sterling-dominated world of the 19th century. Euroland and the United States need to create a new "Group of Two" (G-2) mechanism to manage the dramatic change in their bilateral monetary relationship implied by this development and to exercise the cooperative leadership of the global monetary system for which they will now be jointly responsible.[1]

Current events underline the need for such new institutional arrangements. The euro has appreciated by more than 50 percent against the dollar from its lows of late 2000, and many observers believe that it will rise by at least another 10 to 20 percent. Anxieties are rising rapidly in many European quarters as a result, and the issue was at the top of the agenda of the meeting of Group of Seven (G-7) ministers of finance and governors of central banks in Boca Raton on February 7, 2004.

There is no agreement between Europe and the United States, however, on even the most fundamental elements needed to address the current situation in a constructive manner: the appropriate level or at least range within which the dollar-euro rate should settle, the mechanisms (sterilized intervention? changes in monetary policy? changes in fiscal policy? structural reforms?) for achieving and sustaining that rate or range, the implications thereof for economic and monetary policy in the two regions, and the impact on the rest of the world.

There are no institutional arrangements through which Euroland and the United States meet to address these issues together. As far as is known publicly, there have been no discussions on the need for such institutional arrangements, let alone on the substantive issues that would require agreement as a basis for fashioning cooperative policy responses to the problems identified here, either immediately with respect to the currencies' fluctuations or over the longer run with respect to the advent of a bipolar monetary system.

The Euro at Five

The first five years of the euro itself have been a spectacular success. Price stability has been maintained in previously low-inflation countries and remarkably achieved in member countries that were formerly prone to rapid price increases. The European Central Bank (ECB) has seamlessly succeeded the Bundesbank as the guardian of European stability. Nominal in-

1. The overall "G-2" concept is developed and described in Bergsten and Koch-Weser (2004). Short versions can be found in C. Fred Bergsten, "The Transatlantic Century," *Washington Post*, April 30, 2002; C. Fred Bergsten and Caio Koch-Weser, "Restoring the Transatlantic Alliance," *Financial Times*, October 6, 2003, 13.

terest rates are about 250 basis points below the weighted average of the predecessor currencies. The physical euro was introduced without a hitch. The euro became the leading currency for denomination of international bond issues in its very first year. The initial depreciation of the currency has now been replaced by appreciation to and beyond its initial starting point. The launch of the euro probably represents the most successful episode in the entire history of the European integration movement.

Countries throughout the world are expressing their admiration for the euro by seeking to join or emulate it. Virtually all the new members that will enter the European Union shortly wish to join the eurozone as well as soon as possible. Some of these countries, and a few others, have already "euroized" by adopting the euro as their domestic money or pegging to it. And being motivated at least partly by the success of the euro, many countries in Asia aspire to eventually create an "Asian currency unit" à la euro, and the South American countries have similarly considered a "Mercosur currency unit."

All this has occurred despite a series of external shocks that could have easily derailed a more fragile monetary innovation. The global economy experienced its first recession in a decade. A bubble burst in financial markets around the world. The events of September 11, 2001, and two subsequent wars roiled the security environment. The exchange rate of the euro against the dollar dropped by more than 30 percent in less than two years and then appreciated by an even larger magnitude.

To be sure, there have been some glitches during this startup period. The ECB's communication of its policy actions and intentions has not always been as clear as desirable. The decision to create the new currency three years before its physical introduction was possible generated confusion and probably contributed at least partially to the unnecessary depreciation (Sinn and Westermann 2001). Three members of the European Union, most notably the United Kingdom, have so far declined to join the common currency. And monetary policy should have been eased much more rapidly to respond to the turndown in European growth in the period 2001–03 (Mussa 2003).

Most important, Europe has failed to follow up the creation of the euro with the complementary policy reforms that were widely expected and that are needed to ensure the success of the overall Economic and Monetary Union (EMU) and its members' economies. The creation of the common currency of course meant that the participating countries gave up two major national policy instruments: monetary policy and exchange rate policy. The adoption of the Stability and Growth Pact eliminated much of discretionary national fiscal policy as well. Moreover, currency unions (e.g., the United States) work effectively only if they possess the requisite internal adjustment devices, mainly via market mechanisms but assisted by governmental policies if necessary, notably regarding labor mobility and capital transfers from "surplus" to "deficit" regions.

Europe, at the national and/or regional levels, thus needed to implement a series of reforms to complement the creation of the euro and to capitalize on its potential for strengthening the region's growth and international competitiveness. Most of the needed changes are structural, relating to labor and capital markets but also to competition policies and the excessive intrusion of the state into numerous areas of the economy (Baily and Kirkegaard 2004, Posen forthcoming). Reform of the Stability and Growth Pact, which has proven far too rigid in the face of economic downturn or even prolonged stagnation, is also urgently required (as discussed in Adam Posen's chapter in this volume).

Even the most ardent supporters of the euro, both inside and outside Europe, have been severely disappointed by Euroland's failure to adopt the needed reforms. Much of the case for creating the common currency in fact hinged on the application in this case of Europe's traditional "bicycle theory," where one set of reforms led inexorably to follow-on reforms that would sustain the progress of the overall integration strategy. There has of course been some progress, and a number of countries are now pursuing at least initial steps in the needed direction. But much more is needed and, after five years, inadequate follow-on has been achieved.

Hence the Euroland economy is the most notable laggard in the entire world recovery. It has trailed even Japan in growth terms since the start of 2003. Its longer-run outlook remains cloudy. *The sustainability of the euro itself could even be at risk, due to the combination of sluggish economic performance and growing frustration with the constraints on national action imposed by monetary union, unless the requisite reforms are achieved before the currency's first decade is concluded*. This risk could even grow over time as the original rationale for the euro (and the entire European integration movement), the overarching security imperative of avoiding renewed conflict between France and Germany, recedes ever further into history and becomes at best a distant memory for current generations.

The overall verdict on the great European monetary experiment at age five is thus mixed. The common currency itself, as noted, has been a spectacular success. The surrounding policy environment, however, has not evolved nearly as rapidly as had been hoped nor nearly as fully as will be essential to successfully complete the process of Economic and Monetary Union. This uneven outcome clouds the outlook for the future international role of Euroland and thus its ability to develop, with the United States, an informal "G-2" steering committee to effectively manage both the bilateral dollar-euro relationship and the international monetary system more broadly.

The Euro in the World Economy

This mixed verdict on the EMU of course affects the international role of the euro. On the plus side, global acceptance of the new currency has al-

ready produced a bipolar international financial market (Draghi and Pozen 2004). The ECB's joint intervention with the Federal Reserve in the currency markets in September 2000 (and subsequent unilateral intervention) stopped the excessive depreciation of the euro and laid the foundation for its subsequent rebound. Again in cooperation with the Fed, the ECB injected substantial liquidity into financial markets in the wake of the terrorist attacks on September 11 and helped avoid any excessive spillover effect from those events. The international progress of the euro and ECB per se thus mirrors their impressive "domestic" record.

At the systemic level, and for all the complexities injected into the usual discussions of this topic, the fundamental issue surrounding the potential "struggle for dominance" between the dollar and the euro is quite simple.[2] The basic reason for the supremacy of the dollar during the past half century or more is that it had no competition. No other economy even came close to the size of the United States. Hence no currency could acquire the network externalities, economies of scale and scope, and public goods benefits necessary to rival the dollar at the global level. A largely similar situation for the United Kingdom explains the pound's dominance in the nineteenth century.

The clearest evidence for this conclusion is the fact that the dollar reigned supreme despite prolonged periods of very poor economic performance by the United States:

- The US economy grew very slowly for two full decades, from the early 1970s through the early 1990s, and its productivity growth was especially mediocre (running at 1 percent or less a year).
- It experienced high inflation for almost a decade, from 1973 through 1981, including three years of double-digit price increases.
- It has run large external deficits for most of the past 23 years, including two periods when those deficits were rising at clearly unsustainable rates (1982–87 and 1998–2003), and has become by far the world's largest debtor country (with a negative net international investment position of perhaps $3 trillion at the end of 2003).

The dollar did experience significant erosion of its global market share in the late 1970s and early 1980s. Moreover, its weakness and instability provided crucial impetus to the first effective efforts to create a European alternative, culminating in the European Monetary System in 1979. However, the dollar's share of global finance stabilized again in the 1990s and remained far above that of any other national money.

The overwhelming reason for the dollar's dominance is that the United States remained far larger, especially in terms of GDP but also in trade and

2. The following paragraphs are largely drawn from Bergsten (2002).

other size variables, than any other currency-issuing economy. Increasingly reinforced by incumbency advantages (see below), the dollar remained preponderant and attained a share of currency markets about four times as great as its share of world output and trade. The deutsche mark was the world's second key currency for most of the postwar period but never attained a market share greater than one-fourth that of the dollar; this was quite logical because the economy of the former West Germany was about one-fourth the size of the United States (and, as Chancellor Helmut Schmidt constantly reminded us, its geographical size was approximately equal to the state of Oregon). Japan, whose economy at one point grew to be more than half as large as America's, never realized anything like that portion of world finance because of the underdevelopment of its financial markets (as amply demonstrated during the decade-long crisis from which it may only now be emerging).

Econometric evidence verifies the central importance of size for international currency purposes. Eichengreen and Frankel (1996) concluded that a rise of 1 percentage point in a key currency country's share of world product (measured at purchasing power parity) is associated with a rise of 1.33 percentage points in that currency's share of central bank reserves. In a more sophisticated version of those estimates, which attempted to account for historical inertia (see below) as well as economic size, Eichengreen (1997) found consistent if modestly smaller effects: The rise of a currency's share in global reserves that derived from a rise of 1 percentage point in its country's share of global output (at purchasing power parity) is 0.9 percentage point, about two-thirds as much as in the prior calculation. The central importance of size was clearly validated.

The present Euroland is 20 to 30 percent smaller than the United States in total output and about 25 percent higher in its share of world trade. For all practical purposes, the two currency areas are close enough to be regarded as rough equivalents. The expansion of the eurozone to include all 15 members of the current European Union would take the numbers modestly (10–20 percent) above the United States in output. And the inclusion of the 10 new EU members would add at least another 10 percent or so to Euroland's output superiority (as well as bringing its population to about two-thirds greater than that of the United States).

In short, *it is clear that the euro provides the first real competition for the dollar since the latter's ascent to global currency dominance*. The most interesting questions relate to the time period and adjustment path over which that competition will play out and what its systemic consequences will be.

First, Euroland will need to further integrate its money and capital markets to realize the full international potential of its new currency (Portes and Rey 1998). The superiority of the American financial markets and those of the United Kingdom during the period of the pound's dominance were key elements in their global monetary leadership. The negative case

of Japan is also instructive; its failure to modernize its financial markets, despite repeated calls for such reform and even announcements of programs to do so (such as Prime Minister Ryutaro Hashimoto's "big bang" in 1996), undercut any possibility that the yen might have come to play a major international role.

The European financial markets, galvanized both directly and indirectly by the euro itself, have already made impressive strides (Danthine, Giavazzi, and von Thadden 2000). However, national rivalries have impeded cross-border mergers of both banks and equity markets. No single benchmark security, or yield curve, has developed to rival the US Treasury bill and other US government assets. The pace at which Euroland overcomes these shortcomings will be a major factor in the timing of the euro's rise in international asset allocation. Entry of the United Kingdom into Euroland would presumably accelerate the process.

Second, Europe will need to get its act together institutionally. The European Union has been a fully equal partner to the United States in the management of the global trading system for many years. Cooperation between the members of this "trade G-2" was thus a necessary condition for the successful launch and completion of each of the major multilateral trade agreements of the postwar period (and again with the launch of the Doha Round in November 2001). Europe was able to successfully challenge the previous dominance of the United States in the trading system for two reasons. One, as with finance, was the rough equivalence of its trade volume (and, though less important here, of its total output) with the United States. The other, and of crucial importance, was Europe's early decision to centralize virtually all trade policy decisions and negotiations in a single entity (in this case, the European Commission in Brussels).

A somewhat parallel situation exists on the monetary and macroeconomic front. On most of the relevant objective criteria, Europe already equals the United States. But Europe still speaks with a multiplicity, even a cacophony, of voices on these issues. Hence it dissipates much of the potential for realizing a key international role for the euro.

Macroeconomic and monetary issues are qualitatively different from trade policy issues because markets dominate most outcomes on the former whereas intergovernmental activities by definition dominate the latter. Hence European institutional cohesiveness will not ensure a rapid rise in the international position of the euro. But organizational reforms that enable the countries making up Euroland to act together and speak with a single voice will probably be an essential prerequisite of full European equivalence with the United States à la trade (Henning 1997, 2000, 2003).

Third, the international role of the euro would obviously be strengthened if Europe were to improve its economic performance. Euroland has already achieved convincing price stability, but the achievement of dynamic growth may also be necessary for the euro to effectively challenge

the dollar (Kawai 1997). Whether or not that is true, international interest in the euro will surely rise. This will set in motion a self-reinforcing cycle of euro appreciation and increased portfolio diversification into euros by both private and official holders—but only if Euroland countries are able to both overcome their continuing structural impediments and find a way to employ more expansionary macroeconomic policies. For example, the eurozone members should recognize that the ECB ought to attach importance to output as well as stability goals and/or adopt more flexible guidelines for government budgets than those in the present Stability and Growth Pact.

Fourth, and perhaps most important, US economic policy may have to foul up for the euro to realize its potential to achieve rough parity with the dollar at the core of the international monetary system. Inertia is so strong in financial affairs that it may be impossible to dislodge an incumbent unless that incumbent essentially abdicates (Bergsten 1996). The pound maintained a central international role for at least a half-century after the United States had surpassed the United Kingdom's level of GDP. That role faded only due to the shock of World War I (during which the United Kingdom's trade and investment were disrupted and it had to sell off many of its foreign assets) and its own major economic mismanagement in the 1920s (a persistent macroeconomic slump, the pound's overvaluation, creeping protectionism, and a variety of capital controls) (Eichengreen 1997).

An interesting thought experiment is to ask what would have happened to the international role of the dollar in the late 1970s and early 1980s if the euro (or any other realistic competitor for the dollar) had existed at that time. That was a period when US inflation hit double digits, when US economic growth was mediocre, and when the United States started running huge external deficits and shifted from being the world's largest creditor country to its largest debtor. Even without such a competitor, the global market share of the dollar dropped substantially. European monetary integration was galvanized. Replication of such a period of poor US economic performance, which is certainly possible if not inevitable, might be a necessary condition for the euro to realize its underlying potential—whatever the Europeans do themselves to ensure, or even accelerate, the process.

Are there any foreseeable developments that could represent such a repetition of recent history? Here I would again join Robert Mundell and quote from his writings on the eve of euro creation in 1998:

> It would be a mistake to ignore [the fact that] in the last 15 years US current account deficits have turned the US from the world's biggest creditor to its biggest debtor. . . . The low-saving high-debt problems will one day come home to roost. . . . There will come a time when the pileup of international indebtedness makes reliance on the dollar as the world's only main currency untenable. . . . The fact that the bulk of international reserves is held in dollars makes the currency a sitting duck in a currency crisis. . . . Sole reliance on the dollar as the main reserve,

invoice and intervention currency presents risks that are no longer necessary. (Robert Mundell, "The Case for the Euro—I and II," *Wall Street Journal*, March 24 and 25, 1998, A22)

The United States' international debt and deficit problems have of course become much greater during the past six years since Mundell wrote those words. In 2003, the US current account deficit reached $550 billion, or about 5 percent of GDP. This took it well into the traditional "danger zone" in which the Organization for Economic Cooperation and Development's member countries, including the United States on three previous occasions in the postwar period, are forced to adjust (Mann 1999; Freund 2000). The net international investment position of the United States probably approached negative $3 trillion at the end of 2003 and could hit 40 to 50 percent of GDP within the next few years (Mann 1999, updated 2001).

Hence the dollar is now undergoing a substantial depreciation. Major dollar depreciations are nothing new; they have occurred about once a decade since the advent of generalized currency convertibility in the postwar period (in 1971–73, 1978–79, 1985–87, and 1994–95 to the dollar's all-time lows against the deutsche mark and yen). The current depreciation, however, is taking place in a very different world: one that includes the euro, the first potential competitor for global status that the dollar has faced throughout its period of currency hegemony.

This fall of the dollar could thus trigger important, indeed historic, systemic as well as market and macroeconomic effects, especially because the decline of the dollar is producing a proportionately much greater rise in the euro (because many of America's major trading partners, such as Mexico and China, are unable or unwilling to accept substantial appreciation of their currencies against the dollar). This substantial and prolonged strengthening of the euro could at some point begin to trigger the inevitable structural portfolio diversification into euros by both private and official holders, which I and others earlier estimated at between $500 billion and $1 trillion (Bergsten 1997b). That shift would mark the arrival of the euro as a major competitor for the dollar.

Such a scenario might indeed trigger the far-reaching systemic implications hypothesized at the outset of this chapter. Mundell in fact concluded that the euro "could present problems in the transition . . . magnified by the likelihood of a massive diversification into euro-denominated deposits. Both the EU and the US would need to take strong defensive action to ease the transition [but] it is unlikely that bilateral handling of the problem would be amicable" (Robert Mundell, "The Case for the Euro—I and II," *Wall Street Journal*, March 24 and 25, 1998, A22; see also Bergsten 2001). The next big problem facing the "international financial architecture" may thus center on the countries and currencies at its core, the United States and the European Union, rather than on the emerging market economies and their currencies as during the past decade.

A "Finance G-2" to the Rescue?

At the very minimum, the key finance and monetary authorities of Euroland and the United States need to create a new consultative arrangement to monitor the evolution of the dollar-euro exchange rate and to be prepared to recommend contingency plans to their governments if market movements become disorderly and/or overshoot. Part of the initial task of the group would of course be to define these key concepts ("disorderly," "overshoot") in the current context. It is simply inadequate for these officials, as at present, to get together sporadically around G-7 or other broader meetings—which are also complicated by the presence of other countries that are less relevant (e.g., Canada and even Japan) as well as by the absence of countries that *are* relevant (e.g., China and sometimes South Korea). A detailed agenda is suggested in Edwin Truman's chapter in this volume.

The more interesting and controversial question is whether such a consultative exercise should go further and develop a new "G-2 monetary regime." At some point, it will almost certainly be necessary for the G-2 members to decide on at least a very wide range within which they are prepared to see their currencies fluctuate. They in essence agreed to a floor for the euro in September 2000 and could at some early point approach a level at which they would seek to set a ceiling. The United States and Japanese authorities essentially reached agreement on such a range in the past decade when they intervened to check the yen's appreciation in 1995 and its depreciation in 1998. In retrospect, the three boundaries set under these implied ranges in the past permitted substantial overshooting in both directions and should presumably be significantly narrowed in the future.

A serious agreement on managing the floating exchange rate between the dollar and euro, even within very wide margins, would of course eventually require agreement on means for implementing that management. Sterilized intervention and even jawboning have now been demonstrated to represent additional policy instruments (Evans and Lyons 2003, Fratzscher 2004) and would represent initial lines of defense. The ECB and Fed could begin to collaborate more intensively on monetary policy. Meaningful cooperation on fiscal and broader economic policies will probably have to await substantially greater consolidation of the decision-making process within Euroland, however, perhaps as a result of the constitutional convention that is now in progress across the European Union.

A "finance G-2" would be wholly informal and would probably never even be publicly announced. Far from substituting for the G-7 or the IMF, one of its chief goals would be to make those bodies work better. As the group of players that is relevant to the effective management of the international monetary system increases, now to include China and a number

of other Asian countries, the need for a small informal steering committee à la G-2 of course increases.

It would be difficult for other countries to criticize the G-2 for providing such a steering committee. The dollar and euro stand leagues above all other currencies in the international monetary system. Their underlying economies are by far the largest in the world. China may need to be added to the group in a decade or so, if its economy continues to expand rapidly and its currency attains the global status that has always eluded the yen, but a finance G-2 would appear politically legitimate as well as economically essential for at least the foreseeable future.

The European Union and the United States both have major interests in constructing and implementing a finance G-2. Euroland was quite anxious about the decline of its currency in 2000 and is already extremely anxious about the present appreciation. It surely recognizes that the process could go much further—simply as a result of continued dollar decline, especially if the Asians continue to resist increases in the value of their own currencies; additionally if the inevitable portfolio diversification into euros gets under way in earnest; and even more so if their productivity and economic growth accelerate appreciably and enhance the appeal of their asset markets. A decision by China or Japan to shift a substantial portion of its official reserves from dollars to euros would in and of itself trigger sympathetic moves of private portfolios and dramatically intensify the currency problem from a European perspective.

American reactions have been similar. The dollar's overvaluation and a soaring trade deficit were widely tolerated when the economy was booming in the late 1990s but became a major source of concern and criticism with the slowdown after 2000 (Baily 2002). Nor would the United States now welcome a free fall of the dollar any more than it did in 1987, when it attempted to call a halt to the Plaza-induced depreciation with the Louvre stabilization effort. More fundamentally, as noted above, the existence of the euro as a credible alternative to the dollar means that the United States may be unable to finance its future external deficits—and hence its budget deficits as well—nearly as painlessly as in the past.

A finance G-2 would of course contribute substantially to a broader evolution of systematic economic cooperation between the European Union and the United States. Such a structure would in turn help both regions overcome their most fundamental foreign policy problems: the tendency of the United States to pursue unilateral strategies and the tendency of Europe to ignore its external responsibilities because of its intensive internal agenda. A *finance G-2* (whether or not part of a broader G-2) would constantly remind the United States that unilateralism is not an option for it in the economic domain, even in the financial component thereof, where dollar supremacy has prevailed for so long. It would constantly remind Europe that its external affairs need to be managed carefully. It *will inevitably become a necessary feature of the international monetary*

policy of both and thus a central element of the global monetary system of the 21st century.

Moreover, the creation of an effective G-2 across a number of economic issues (including but ranging well beyond finance, per Bergsten and Koch-Weser 2004) could play a central role in restoring harmony to overall transatlantic relations. Relations between the United States and much of Europe remain tense, in the wake of the sharp disagreements that preceded the Iraq war, and their security dimension seems unlikely to produce reconciliation any time soon. New economic initiatives are thus the most likely route to patching up the overall relationship and could bring major foreign policy as well as economic benefits (Bergsten 2004).

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Comment

RANDAL QUARLES

Having been asked to discuss the stimulating chapter by Fred Bergsten on the past and future of the euro, my reaction was that too much attention is being focused on exchange rate policy coordination mechanisms and attempts to define appropriate exchange rates and too little on what seems to me of far greater importance: namely, the more effective functioning of economies in the interests of sustained stronger growth and higher employment.[1]

Bergsten himself gets into this when he notes the disappointments connected with the European Union's efforts to achieve the admirable goals of the Lisbon Agenda, including in particular the limited progress in adopting structural reforms to provide greater incentives for investment and for both job creation and willingness to take jobs. As the chapter notes, "Europe has failed to follow up the creation of the euro with the complementary policy reforms that were widely expected and that are needed to ensure the success of the overall Economic and Monetary Union." Even accounting for the recent economic slump, the trend in the euro area has been toward declining long-term growth rates. Consensus forecasts for average growth in the euro area for the next 10 years have declined from 2.8 to 2.2 percent during the past three years. Though the explanation includes the slower growth of the working-age population, that is only part of the story.

European leadership has recognized the long-term problems it must confront, and the European Union itself put forward the goal at Lisbon of

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1. I should say at the outset that I do not plan to comment on currencies.

becoming the most competitive and dynamic economy in the world by 2010. This is a challenge that the United States relishes, and its policymakers no doubt would be happy to see Europe—and other areas—grow faster, create more jobs, achieve the higher productivity growth that will expand real incomes, and in general provide a more dynamic contribution to the world economy.

So far, though, identifying and agreeing on a goal has not been enough to ensure progress. The European Union still faces a number of challenges on the path to meeting its Lisbon objectives, and the European Commission has warned that the European Union may fail to reach them. Early in 2004, Commission president Romano Prodi said that member states were in danger of missing midterm targets, and productivity and employment growth were still contributing too little to European growth. The Commission has put its finger on the major problems: low employment ratios (especially among men 55 to 64 years of age), inadequate use of information and communication technologies, and lagging investment in research and development.

The European Commission's own findings show a clear path to higher productivity: lowering regulation, increasing expenditures on research and development, completing the integration of markets and promoting competition, and reforming financial services so that capital markets can respond to these policies by directing finance to dynamic, employment-producing enterprises.

The recent announcement in Berlin by Prime Minister Tony Blair, Chancellor Gerhard Schröder, and President Jacques Chirac calling for decreased regulation and support for more state-led investment, sincere as it is, seems to indicate part of the problem as well as part of the solution. So long as the underlying assumption that state activity is the solution to every economic problem governs European thinking about growth, it will be hard to achieve the freedom for individual economic action and competition that will promote innovation, adoption of technological improvements, and higher investment.

Using a database from the Organization for Economic Cooperation and Development, Alesina et al. (2003) have reaffirmed the relationship between investment levels and the extent of deregulation. They found that the greatest effect on investment can be had from deregulation in areas such as financial services and retail and wholesale trade, where progress has been made but more can be done. This accords with the European Commission's own work showing that productivity differences in service sectors such as those that use information and communication technologies account for much of the gap between US and EU productivity growth in the past 10 years.

In my view, the vigorous pursuit of growth-oriented policies is critical, and the Group of Seven (G-7) has made an Agenda for Growth the key theme for its 2004 process. By specifying individual reform goals and

using a process of mutual surveillance and support, the G-7 hopes to lay the groundwork for stronger growth in all seven economies, including the United States.

Coming back to the issue of policy coordination, I am not sure quite what Bergsten has in mind or what deficiencies he sees more generally. Whether it is a matter of discussion of exchange rates, monetary and fiscal policy, or anything else, the G-7 has very extensive and mostly informal processes of discussion. The G-7 ministers and central bank governors meet at least three times a year. The G-7 deputies meet many times more than that. That remarkable Washington invention—the telephone—is used frequently for consultations. Officials travel a lot. And there are many other forums: the Bank for International Settlements meetings, the Financial Stability Forum, the Group of Twenty, United States–EU summits, and so on.

In today's world, no country can set global economic policies all by itself or only with one or two others. A continual process of informal discussion and contact provides the best means for understanding the interaction of national policies around the globe and greater sensitivity to each country's concerns. I have a particular concern that a formal "Group of Two" could fail to take appropriate account of financial developments in other important economic areas—not only the other G-7 members, but also some of the large and fast-growing economies that are acquiring real weight in the international financial system.

In the end, I think our current informal processes are working as well as they can in a world of diverse perspectives. The most important contribution any country can make is to improve its own economy's performance—to raise growth, employment, and standards of living for all its residents. The better an economy functions individually, the more positive a contribution it can make to the global economy.

Reference

Alesina, Alberto, Silvia Ardagna, Giuseppe Nicoletti, and Fabio Schiantarelli. 2003. Regulation and Investment. NBER Working Paper 9560. Cambridge, MA: National Bureau of Economic Research.

Comment

HERVÉ CARRÉ

Fred Bergsten's chapter includes both a careful assessment and thought-provoking propositions. The first part of his chapter, "The Euro at Five," is a particularly well-balanced assessment of what has been achieved with the new currency. I cannot but agree with the statement that "the first five years of the euro have been a spectacular success" and that "even the most ardent supporters of the euro, both inside and outside Europe, have been severely disappointed by Euroland's failure to adopt the needed reforms." Being one of these supporters, I have nothing to add. I thought that the adoption of the euro would act as a catalyst for structural reforms—and I am disappointed.

So I direct my remarks to the second part of the chapter, which focuses on the euro and the world economy. It rightly states that the euro provides the first real competition for the dollar, and it raises four issues, which I will address in turn.

First, *for the euro to realize its potential, there is a need to further integrate money and capital markets*. I fully agree, but it is useful to point out that the pace of financial integration has accelerated with the adoption of the euro. Deeper integration is reflected in more homogeneous markets, a wave of consolidation among intermediaries and exchanges, and the emergence of new products and techniques. Market operators have adopted more pan-European strategies and policymakers have responded by assigning a high political priority to the completion of the internal market for finan-

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cial services. They are committed to implementing the Financial Services Action Plan (FSAP)—a package of policy initiatives aimed at improving the functioning of the EU financial system—by 2005. As a matter of fact, the money and derivatives markets are already highly integrated, and the bond markets are deeper and more homogeneous, with higher issuance volumes and a sharp rise in corporate bond issuance. But, despite a growing internationalization of equity issuance, more mergers and acquisitions across borders, and consolidation of formal stock exchanges, equity markets are still fragmented. Posttrading infrastructure is slowly being transformed—still offering limited scope for cross-border trading.

Finally, while consolidation among financial intermediaries has taken place mainly within national boundaries, cross-border mergers show an increasing trend. The objective of a single financial market remains to be achieved, but significant progress has been made, and the deadline for the implementation of FSAP by 2005 is expected to be met.

The second issue raised by Bergsten's chapter is *the need for the European Union to get its act together institutionally*. It is clear that the Economic and Monetary Union (EMU) project is still in the making as regards the external side. The European Community Treaty sets out procedures to deal with the international aspects of the EMU, and since 1999 practical arrangements have been devised for the internal coordination of external positions. The Eurogroup and the Ecofin have devoted much work to establishing common positions and common understandings on a wide range of issues. Although this allows the euro area to start playing a role commensurate with its financial and economic weight, it needs to be complemented by further progress on external representation. A single European voice is long overdue, as Bergsten points out.

The third issue is *the need for the European Union to improve its economic performance.* This is much needed, and I can only agree, but I would introduce a nuance into Bergsten's assessment. The slow growth in the euro area is mainly due to the lack of structural reform or, to be more accurate, to the slow adoption of the much-needed structural reforms in implementing the Lisbon Agenda. I really think that the macroeconomic policy of the past five years has been broadly appropriate.

I have stronger reservations about the fourth issue—that *for the euro to realize its potential to achieve rough parity with the dollar at the core of the international monetary system, the United States may have to foul up.* Although a crisis scenario cannot be excluded, it is not likely. Increased portfolio diversification into euros by both private and official holders will certainly take place over time, but this will be a long-term development. It will also be a market-driven development, which can occur only when the euro-denominated financial markets are as wide, deep, and resilient as the dollar-denominated markets. Furthermore, there is a practical obstacle to such a crisis scenario: US Treasury notes, the preferred asset of official holders, have no equivalent in the euro-denominated markets. Govern-

ment bonds in the euro area will still be issued by 12 agencies with different borrowing requirements, issuance strategies, and instruments.

However, over time, the euro will become an alternative to the dollar, and this has systemic implications for international monetary relations. With no past experience in the management of a multipolar monetary system, the proposal to set up a "finance Group of Two" (G-2) made in Bergsten's chapter is particularly relevant. There is a strong economic case to set up an informal finance G-2 along the lines sketched out in the chapter. Such an arrangement is already working informally in many areas. The chapter mentions the trade area, obviously, and the cooperation between the European Central Bank and the US Federal Reserve. I would also add financial markets, where an informal ongoing dialogue has already proved quite successful, and more recently a structural policy dialogue.

The question is how to develop this method to cover exchange rate development and, more generally, fiscal and macroeconomic policies. Obviously the difficulty comes from the EU side, from the present inability of the euro area to get its act together. Unfortunately, under existing circumstances, there is no short-term answer to this governance problem in the euro area. Even the draft Constitutional Treaty that is now being discussed does not provide a solution to the problem.

To conclude, I would like to stress how stimulating Bergsten's chapter was. As he reported, Europe is facing two major challenges:

- completing the Lisbon Agenda in time, and
- getting its act together on the external aspects.

I agree with most of the chapter, and I particularly welcome the suggestion to construct and implement a finance G-2, building on existing informal arrangements. Let us hope that this proposition will be as successful as the ideas Fred Bergsten developed in March 1997!