
A Challenging Anniversary

The Euro at Ten and the Financial Crisis

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I had planned to focus on the role of the euro in the world economy, but I cannot ignore the exceptional events we have witnessed recently. Nevertheless, even in these testing times, there are still good grounds to celebrate the euro. Despite our imperfect institutional framework, the Economic and Monetary Union (EMU) has sheltered European economies from turbulence over the last decade, and we can be assured that the current crisis would be having an even more severe impact were we without the single currency today. I would also argue that the euro has allowed Europe to play its part in setting out policy actions that will strengthen the global financial system in the future—something that will no doubt be a central concern in the months ahead.

The current events—far from pushing the euro to the background—have highlighted the advantages of a single currency and shown the value of deepening euro area coordination. The European Commission has prepared a major report, *EMU@10*, on the first 10 years of the EMU. When we analyzed the advantages and difficulties of the bold decision to create the euro, our assessment was, and is, very optimistic and positive. Over the 10 years of its existence, the euro has been an undisputed success. It has anchored macroeconomic stability in the euro area and brought historically low inflation and interest rates for much of the last decade. Despite the euro area's lower-than-expected growth rate—due largely to too few structural reforms—the macroeconomic stability combined with

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the boost to trade and investment brought by the euro has helped to create 16 million new jobs, more than in the United States in the same period. The euro's rapid rise to the status of a global currency in less than a decade is a reflection of its success.

Today the EMU is limiting the impact of the crisis in Europe and in the rest of the world as well. The single currency has provided stability in several ways. First, it has prevented the exchange rate and interest rate tensions among its members that used to be common during financial stress. Second, as we argue in our *EMU@10* report, our stability-oriented macroeconomic policy framework has reduced the level and volatility of inflation and interest rates, as well as output fluctuations, in the euro area. Third, since the start of the financial turmoil in 2007, the European Central Bank (ECB) has adopted a prudent monetary stance and has skillfully managed liquidity. This has helped to anchor inflation expectations and to ease conditions in the interbank market.

In short, the EMU has created a pole of relative stability in Europe that world economies have also benefited from, especially those that have strong trade and monetary links with the euro area. Its balanced current account position has also helped reduce the risks for the world economy associated with large global imbalances.

A Deepening Financial Crisis

Financial markets around the world have been going through an extraordinarily difficult period. The upheaval that began here in the United States has engulfed Europe and is now spreading rapidly across the international system.

The crisis intensified sharply as confidence in financial markets collapsed. As the flow of credit ground to a halt, central banks around the world stepped in to provide massive injections of liquidity.

The ECB was among the first to provide liquidity in euros and US dollars in coordination with the Federal Reserve and the Bank of England. This high level of coordination was evident again on October 8, 2008, when the ECB together with the Federal Reserve and five other central banks made an emergency interest rate cut of half a percentage point.

But the actions of central banks are not enough to restore confidence to markets. Risk aversion has now reached extreme levels. Deleveraging has accelerated as market participants are forced to sell off assets that are rapidly losing value.

Market sentiment has plummeted, brought down by deterioration in the banking sector. It is difficult to predict how far the crisis will go and when it will end. Following the spate of bank failures here in the United States, problems started spilling over to European banks.

Urgent Measures to Contain the Crisis

In the first year of the financial crisis, Europe saw the failure of a few national banks, mostly in the United Kingdom and Germany. Governments' swift actions were consistent with the need to rescue their own national banks, such as Northern Rock, IKB, and WestLB.

In September 2008, we saw for the first time the need to support financial institutions with cross-border presence. While providing such support was expected to be impossible, action by governments was fast and effective, as in the cases of Fortis and Dexia.

Confronted with the depth of the crisis and the acceleration of national responses, the European Union then quickly moved to establish close cooperation at the European level. Leaders of the four EU economies that are members of the G-8—Germany, the United Kingdom, France, and Italy—together with the three institutions of the euro area (the Eurogroup, the ECB, and the European Commission) met in Paris in early October 2008 and agreed on a series of measures to stabilize the EU financial system. Leaders pledged to protect individual savings and to take all necessary actions to guarantee the solvency and stability of the EU financial system.

Subsequently, the 27 finance ministers agreed to support the recapitalization of systemically important financial institutions. They agreed that in view of the different national situations there can be no uniform solution in the European Union but that national actions should follow eight commonly agreed principles. Countries now have the flexibility to act at a national level, while not compromising the common European interest and avoiding negative spillovers and a beggar-thy-neighbor race.

The Ecofin ministers also agreed on a series of measures concerning accounting standards and retail deposit protection. The Commission will now urgently bring forward a proposal to promote convergence of deposit guarantee schemes.

The European parliament has also pledged its support and readiness to act quickly and support necessary legislation. The heads of state and government of the European Union, who gathered on November 7, 2008, in Brussels, further supported these measures and stressed the need for coordination. These decisions are unique and consistent with our EU framework.

More recently, as our banking sector faced systemic crisis, several EU national governments announced broad measures. The United Kingdom announced in October 2008 partial nationalization of its banking sector, and actions have been taken by Ireland, Denmark, Germany, Spain, and Italy. Others may follow. Such actions are broadly in line with the principles agreed by the Ecofin ministers, and all countries have pledged to comply with state aid and competition rules.

But the events in the financial markets point to the fact that systemic

problems are a global phenomenon and that the solvency of the global financial system is at stake. At the October 2008 meeting in Paris, EU leaders called for a summit with international partners to devise a coordinated approach to the crisis and to lay the foundations for the reform of the global financial system. I sincerely hope that further progress on coordination can be achieved here in Washington.

Reforms for a More Resilient EU Financial Sector

The crisis has raised deeper questions about the financial system and how it should be regulated. In this respect, the October 2007 Ecofin roadmap, which is in line with initiatives at the global level and in particular with the Financial Stability Forum recommendations, remains the basis for the EU policy response in the medium term.

EU leaders agreed in early October 2008 to further accelerate this roadmap. The Commission has already put forward changes to the capital requirement directive to limit risk exposure and to improve supervision of banks operating in more than one country by creating a college of supervisors. The Commission adopted a new legislative proposal for credit rating agencies in November 2008, providing for tighter rules. We are developing additional proposals covering market transparency, valuation standard of accounting of assets, prudential risk management and supervision, and further improvement of coordination.

Effects on the Real Economy

Restoring confidence and normal functioning to financial markets is especially urgent given the mounting evidence that the crisis is beginning to take its toll on the real economy. The risk that this will result in a vicious circle, with events in the financial markets and in the economy feeding off one another, is now a very real and worrying possibility.

Declining confidence, reduced availability of credit and its increased costs to households and businesses, together with oil and commodity price hikes earlier in 2008, are all affecting growth.

Recent indicators point to further weakening of the EU economy in 2008, with the revised growth forecast down to 1.4 percent and with growth weak and well below potential in 2009.

To support economic activity through additional financing, EU leaders have asked that the European Investment Bank increase its loan program to small and medium-sized businesses by 30 billion euros. And we shall ensure that our Lisbon Agenda of reforms is vigorously pursued to help accelerate the adjustments and increase growth and employment.

The crisis will clearly impact public finances, and public deficits will increase. The Stability and Growth Pact, when correctly applied, has suf-

efficient flexibility and allows the implementation of expansionary fiscal policies in the short term, while remaining prudent in the medium term. However, we must prevent deficits from spiralling out of control, and governments should strive to respect the 3 percent limit for budget deficits and 60 percent ceiling for government debts.

Stronger International Coordination

Current events provide a strong case for deepening coordination within the euro area, both to develop solid and decisive policy action in the face of crisis and to present a united front in international fora to better influence the global decision making process.

The euro area's recent actions have demonstrated that when it manages to swiftly agree on a coordinated position, it can be instrumental in finding agreement in the European Union as a whole and even internationally. It is vital we now build on this success, not least because beyond European coordination, there is now a serious need for global coordination.

The financial crisis has revealed how interlinked the world's economies and financial markets are. In addition, there are signs of major shifts in the geopolitical balance. Apart from the current turmoil in the banking sectors in Europe and the United States, let me point out the weakness of the dollar and the fact that advanced economies are slowing down while emerging markets are picking up the slack.

When this crisis is over, other challenges for the global economy will remain. Our future international system will have to absorb ongoing financial innovation, rapid shifts in capital flows, and the further unwinding of global imbalances. This is the main reason why we have no alternative; we need to pursue multilateral solutions.

I believe the European Union and the United States will lead this global movement together. We have long enjoyed a steady and cooperative relationship across the Atlantic. The situation in the 21st century demands that we build on our relationship and together reach out to our new partners.

We need to establish a global dialogue and a new framework that takes in the rising powers of the emerging world. International cooperation needs to rise to the new challenges as it seems that our multilateral institutions are finding it increasingly difficult to provide the answers we need. Our international institutions need to be made more inclusive and more effective.

Within a reformed governance system, there is scope for the International Monetary Fund (IMF) to play a more active role to steer international financial cooperation. The IMF may need to carry on its reforms if it is to exploit its full potential. Overall, I see value in continuing the IMF-led multilateral consultations and extending their scope to global financial

stability. And I call on the euro area to continue to be a committed and active partner in this process.

Conclusion

It is clear that the international financial system is in crisis and the stability of the world economy is at risk. What is less clear is how to overcome these challenges.

I believe that if we work together—at both European and global levels—we will find effective solutions. We need to strive for common answers that will safeguard the stability of our economies and financial markets for years to come.

I am convinced that a new global governance framework will emerge from this crisis. Within this new framework, Europe should speak with one voice and win a stronger political role for itself. I have already called for a consolidated representation for the European Union and the euro area in international bodies—which, incidentally, will free up room for emerging economies.

The EMU has made a positive contribution to world stability—and will continue to do so—and this implies new global responsibilities. Because the euro is now a global currency, the euro area should play an active role in international coordination.

The unravelling financial crisis only reinforces the need for Europe to move and speak as one on the world scene. We must rise to the challenge and promote a multilateral resolution of the global financial crisis.

The Internationalization of Currencies—A Central Banking Perspective

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It is an honor to be here to celebrate the tenth anniversary of the euro. It is a privilege to represent the institution—the European Central Bank (ECB)—that over the past 10 years has watched over the first steps of the euro and brought it up to be the second most important international currency in the world. The euro is now leaving behind its childhood and entering adolescence. As with many adolescents, it faces a common question: “What would you like to do when you grow up?”

The ECB, like any parent, might tend to be overoptimistic about its child’s future. This is why we have adopted a policy of neither encouraging nor discouraging the international use of the euro. It should be an entirely demand-driven process. Like modern parents, we recognize that the euro does not belong to us but should develop according to its own ambitions. We are here to ensure that it has a few key virtues, the first being stability.

Several people—including in the United States, where the euro’s birth was considered improbable a decade ago—predict a bright future for the euro, anticipating that it will surge to become the dominant international currency in the coming decades (Chinn and Frankel 2008). Others, however, think that the euro is unlikely to overtake the US dollar (Eichengreen and Flandreau 2008a).

I will not try to review what the euro has already achieved over the last decade. The ECB regularly publishes a report that can be easily consulted (ECB 2008a). I will instead assess the implications, in particular

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from a central banking point of view, of becoming an international currency. I will analyze both the advantages and the challenges. I will then try to assess whether the euro has the potential to further increase its role and examine the main obstacles to achieving such a status.

Implications of an International Currency

Even though the euro is currently not the dominant international currency, it has become an alternative to the US dollar as a reserve currency. Euro banknotes are a popular means of payment and store of value in the European Union's neighboring countries. What are the implications for the ECB and the euro area as a whole? I shall try to answer this question, drawing on the economic literature.

Countries can obtain two well-identified advantages from having an international currency. First, microeconomic gains stemming from lower transaction costs. Whether the currency is used for international trade, borrowing in the international markets, or simply tourism, the costs of conversion to a foreign currency and the exchange rate risk attached to these operations are eliminated. Second, the monetary authority issuing an international currency has larger seigniorage revenues to the extent that foreigners hold that currency in the form of non-interest-bearing liabilities, in particular as coins and banknotes. These gains are, however, relatively small and are estimated at less than 0.05 percent of GDP for the euro area, as only a small fraction of the total cash in circulation—10 to 15 percent—is held by non-euro area residents. International seigniorage gains are only slightly larger for the United States, at about 0.1 percent of GDP, as more than half of its stock of currency is estimated to circulate abroad (European Commission 2008, ECB 2007).

Other, broader implications of issuing an international currency are less well documented and not as easily quantifiable. Both the United Kingdom in the period before the First World War—from 1870 to 1913—and the United States in the period after the Second World War enjoyed a so-called exorbitant privilege from being at the center of the international monetary system (Meissner and Taylor 2006).

The privilege stemmed from the possibility to issue low-interest domestic currency-denominated liabilities to finance higher-yield investments abroad. Both the United Kingdom before 1913 and the United States until the end of the 1980s were net creditors toward the rest of the world, and this exorbitant privilege may be seen as their remuneration for being the “bankers of the world.” Over the past 20 years, the United States has shifted to a relatively large debtor position vis-à-vis the rest of the world, but its income balance has stayed positive thanks to a positive return differential between its external assets and its liabilities. For some economists, this is the result of the transformation of the United States from world

banker to “venture capitalist” with a “leveraged” position, where fixed-income domestic-currency liabilities finance riskier foreign assets taking the form of equity and direct investment (Gourinchas and Rey 2005).

The greater ability to issue domestic-currency liabilities has another important implication from a macrofinancial stability perspective. To the extent that external liabilities are mainly in domestic currency, whereas external assets are denominated in foreign currency—as in the case of equity and foreign direct investment and often also debt securities—issuers of international currencies tend to have a “long” position in foreign currency. As a result, fluctuations in exchange rates tend to produce countercyclical valuation effects on net external assets. When the exchange rate appreciates, foreign-currency assets shrink in domestic-currency terms and as a share of GDP. Conversely, following sharp devaluations—often associated with economic and financial stress—the foreign currency-denominated assets grow in domestic-currency terms and liabilities are unaffected, improving the overall investment position when it is more needed (Lane and Milesi-Ferretti 2005). As an example, after the currency crises in both 1949 and 1967, the pound sterling’s status as an international currency—with most of the large overseas liabilities still denominated in pounds—allowed the United Kingdom to cushion somewhat the impact of the devaluations (Cairncross and Eichengreen 2003).

The issuance of an international currency could potentially also have significant implications for the implementation of monetary policy. Let’s consider the experience of the euro over the past 10 years in that regard.

On the one hand, it has been essential for the euro area to have its own monetary policy in order to face idiosyncratic shocks and focus on the maintenance of domestic price stability. This result would not have been possible without the introduction of the euro and the creation of a large internal economic and trade area free of exchange rate risk. On the other hand, the external demand for euro-denominated assets may affect domestic monetary aggregates, complicating their relationship with inflation over the long run. Recent ECB staff research shows that it is necessary to place money demand in the context of portfolio flows and international asset prices in order to explain euro area money supply dynamics and measure excess liquidity, which can pose risks to price stability (ECB 2008b).

In addition, successful international currencies are used as external anchors by a number of countries that prefer to fix the exchange rate and relinquish their monetary independence.

Such currency pegs eliminate one channel of adjustment of external imbalances for the anchor currency. As long as the pegging countries are smaller than the issuing country, this might not be a major problem. However, when the aggregate economic weight of all pegging countries becomes large, the margin for adjustment of the nominal effective exchange rate of the anchor currency becomes constrained. As a consequence, the adjustment of the nominal effective exchange rate might require a more

than proportional adjustment of the bilateral rates of the remaining floating currencies.

Moreover, fluctuations in the demand and supply of the euro among international investors, from both the private and public sectors, may have implications for the exchange rate. The increasing attractiveness of euro-denominated assets as a potential alternative to US dollar securities may generate sudden shifts in portfolio flows and unwelcome volatility in foreign exchange markets. Another potential indirect channel of disturbance in the dollar-euro exchange rate is the role of the US dollar in the invoicing of oil and other major commodities. Over the past few years, the surge in oil prices and other commodities—in US dollar terms—has been associated with a negative relationship with the exchange rate of the US dollar against the euro. In the case of oil prices, this could be the result of policies by oil-exporting countries to try to defend the purchasing power of a barrel of oil in terms of a basket of international currencies, including, in particular, the euro. It must be acknowledged that it is difficult to detect and isolate the direction of causality between the oil price and the US dollar.

Overall, for the ECB and the euro area, the international role of the euro offers positive opportunities and serious challenges. This explains the ECB's neutral stance aimed at neither directly promoting nor hindering the international use of the euro.

Determinants of the International Use of Currencies

What conditions cause currencies to dominate international markets? Do these conditions favor a growing role for the euro?

There is a large body of literature on the determinants of the international use of currencies. Most studies focus either on the store of value function of currencies and their role in foreign exchange reserves (see Chinn and Frankel 2008 for a recent review) or on the unit of account and means of payment functions, including the invoicing of international trade (see Kannan 2007). In the first case, users of an international currency are mainly concerned with its ability to maintain a stable purchasing power over time. In the second, users care about transaction costs and the economies of scale that are obtained from tapping into a large network.

In both cases, a number of economic, financial, political, and institutional factors contribute to increasing the popularity of an international currency. I will review these factors with particular reference to the euro.

Economic and Financial Conditions

Let me start with the economic and financial conditions supporting the international role of currencies. The size of the economy and its foreign

trade flows are crucial to promoting the international status of a currency. This is because there are scale economies and network externalities in using the currency that is also used by other agents in international transactions. The larger the economy and its trade flows, the more likely it is that smaller economies will adopt the currency of the larger trading partner. In this respect, the critical mass of the euro area, in economic terms, is large enough to exert gravitational attraction on the rest of the world. In 2007 the euro area accounted for about 16 percent of world GDP, measured at purchasing power parity, and its external trade was equal to more than 18 percent of world trade, at current exchange rates.

In the invoicing of international trade, however, network externalities tend to generate only one “winner.” For several decades, the US dollar has served as a medium of exchange and unit of account for homogeneous goods traded in organized exchanges, such as commodities and oil. In this case, inertia is very important, and it is very difficult to dislodge the incumbent currency, whose use is associated with low information and transaction costs. Yet even in this case, it would be possible to switch to a parallel invoicing system, including the euro, if agents expected others to start using the new currency and technological progress diminished transaction and information costs (Mileva and Siegfried 2007).

Transaction costs are important not only in international trade but also in the use of currencies as financing or investment instruments. For this reason, truly international currencies must be backed by large, deep, liquid, and efficient financial markets. In terms of size, credit quality, and liquidity, US dollar financial markets still have an edge over the euro markets, although this gap seems to have narrowed since the launch of the euro in 1999 (Galati and Wooldridge 2006). The US Treasury bond market remains the most liquid segment of the global bond market, whereas sovereign issuances are inevitably fragmented in the euro area. However, this structural problem has been mitigated by the removal of exchange rate risk since the introduction of the euro. Government bond yields have converged across euro area countries and are increasingly driven by common factors, although local factors continue to play a role (ECB 2008c). Indeed, the bid-ask spreads of sovereign bonds denominated in euros are not much higher than the spreads of those denominated in US dollars (Dunne et al. 2006). Interestingly, the euro area bond market for “corporate” issuance is quite well integrated (ECB 2008c), and effective bid-ask spreads are possibly even lower than in the United States (Biais et al. 2006).

I have argued so far that investors take into account liquidity and transaction costs when dealing with international currencies. Once these structural and cost differentials converge across currencies, traders and investors can discriminate among various alternatives on the basis of the return on their investment. In brief, international currencies must be able to preserve their external value, avoiding inflation and sharp nominal devaluations. It is well known that the erosion of the status of the pound

sterling as leading international currency was caused by a series of large shocks accelerating a declining trend. The First and Second World Wars accelerated the fading of the United Kingdom as a major political and imperial power. The economic decline was highlighted by at least three devaluations in 1931, 1949, and 1967, which progressively undermined the confidence of international investors in the ability of the pound sterling to preserve its external value. Recent evidence suggests that the pound sterling lost its dominance already in the mid-1920s but then regained the lead in the second half of the 1930s (Eichengreen and Flandreau 2008b). The jury is still out on this case, but it is evident that inertia in the international use of currencies is much stronger in the case of the invoicing of trade, where network effects favor the use of only one currency. Inertia is somewhat less powerful when investors decide how to allocate their portfolio, leaving greater room for currency competition.

Obviously, inflation and devaluations accompanying the demise of world currencies are not natural accidents but the result of wrong macroeconomic policies and structural weaknesses. These often take a long time to emerge in the form of an erosion of external competitiveness and a rise in external imbalances, fiscal profligacy and internal imbalances, low productivity, and, eventually, sluggish growth and high unemployment. Conversely, strong and balanced economic performances foster the international status of currencies.

Where does the euro stand in terms of policies and performance? The euro area fares relatively well compared with major economic partners, although a greater effort has to be made to raise productivity and lift the potential growth rate of the economy. The external position is fairly balanced. The Stability and Growth Pact guards against the emergence of public deficits and debt. Over the past 10 years, inflation has been kept relatively low in spite of large supply-side shocks. The institutional setting of the ECB, with its independence from political pressure and its mandate to preserve price stability, helped to rein in inflationary pressures and indirectly fostered the confidence of domestic and foreign residents in the capacity of the euro to preserve its value.

Political and Institutional Conditions

Let me turn to the political and institutional conditions for currencies to steadily take on an international role. This is clearly a more complicated issue.

Historically, countries with stable political systems and the capacity to enforce the rule of law, both inside and outside their borders, had currencies that were widely traded and accepted internationally. Certainty with regard to property rights, which may be undermined by political instability, and the ability of the issuer of the international currency to rule and to raise revenues to repay its financial obligations are crucial in this case.

The existence of “hard power” certainly contributes to the ability to enforce property rights, domestically and internationally, and thus helps in developing an international role for the currency. From this point of view, Europe cannot compete at present with other providers of hard power. On the other hand, the success of the Economic and Monetary Union provides Europe with a form of “soft power.” This power is translated in different ways, such as the anchoring of several currencies to the euro, the adoption of the independent central bank model in the Maastricht Treaty, technical assistance on issues related to monetary policy, payment systems, supervision, banknote issuance, and the like.

Good economic governance is also a fundamental ingredient of successful international currencies. The Dutch guilder in the 17th and 18th centuries, the pound sterling in the 19th and early 20th centuries, the US dollar in the late 20th century, all were (or are) international currencies backed by strong empires and states but also supported by the economic power and success of their issuers.

Some academics regard political and economic governance as the “Achilles’ heel” of the euro (e.g., Cohen 2007). They claim that the delegation of monetary and economic responsibilities across member states and EU institutions is unclear, and they lament the lack of a single unitary governance structure, the so-called commander in chief, behind the euro. Over the past year, the financial turbulence has posed a serious test for monetary authorities throughout the world. The reaction of the ECB has shown that the central bank can act rapidly and effectively to address liquidity issues.

As the crisis has evolved from a liquidity to a solvency problem, the challenge has moved increasingly to supervisory authorities and finance ministers. The ability to provide a coordinated European response is being tested. On specific occasions, such as the bailout of the banks Fortis and Dexia, the framework has functioned properly.

On the more general response to the crisis of confidence in the financial system, it is paradoxical that the relatively healthier European banking system might have to suffer more because of the uncoordinated and piecemeal reaction of national authorities. There is also a risk of a renationalization of the single market for financial services, as a result of different solutions being implemented in different countries.

The fear of many academics and observers has long been that, without a specific framework for crisis resolution, the European banking system would be unable to address major shocks. The problem might turn out to be a different one. The absence of a crisis resolution framework does not prevent effective solutions from being found and implemented. But since these solutions are different from country to country, they may lead to problems of discrimination and difference of treatment, undermining the functioning of the single market. This certainly would not contribute to the international role of the euro. And this is confirmed by the recent weakening of the exchange rate.

Another important institutional condition for the international success of currencies—closely linked to good economic governance—is trade and financial liberalization. By definition, only currencies that can be freely converted for trade or investment purposes have the potential to achieve the status of international currencies. According to Barry Eichengreen, the US dollar owes part of its success in maintaining its position as main reserve currency to the absence of truly convertible competitors since the Second World War. In his view, the international use of potential reserve currencies—such as the French franc, the Japanese yen, or the Deutsche mark—was directly or indirectly discouraged by the respective governments (Eichengreen 2005).

Convertibility is not an issue in Europe, but protectionism, especially against foreign capital, might be. We are currently observing attempts in different countries to limit the inflow of capital from foreign countries, in particular in so-called strategic sectors. However, the definition of “strategic” remains vague and can give rise to quite imaginative interpretations.

Concluding Remarks

To sum up, currencies emerge as international players thanks to a combination of a number of conditions. These include geopolitical influence, political stability, and the enforcement of the rule of law, as well as good political and economic governance. Only large economies generating meaningful network externalities possess international currencies. They must also be economies with deep, efficient, and open financial markets where it is possible to invest without the risk of incurring large transaction costs or capital losses. Eventually, once all these factors have been accounted for, the quality of economic governance and economic institutions and the ability to devise policies that support confidence in the external value of the currency can make the difference. Obviously, inertia in the international use of currencies is strong, and sudden changes in their relative position are unlikely, barring very large shocks.

Since its introduction 10 years ago, the euro has emerged as the second most important currency in the world. The euro area offers the opportunity of a large, deep, and increasingly integrated financial market for foreign operators willing to hold euro-denominated assets. The monetary policy conducted by the ECB has certainly contributed to supporting confidence in the euro. We now face a different type of challenge, related to the integrity and sustainability of the single market in the face of a major financial crisis.

Given the dimension of the current turmoil, it is not surprising that market participants view the ongoing developments with some concern. After all, the birth of the euro was followed by a substantial depreciation of the euro against all other currencies. The young currency and the young

central bank needed to be tested in good and in bad times. The premature death of the euro was preannounced several times. But the skeptics had to concede.

In light of Europe's past experience, one element has to be taken into account in analyzing the current situation. Either a strong response is provided to the challenges posed by the current turmoil to the single financial market within the existing institutional framework or the framework itself is changed in favor of a more centralized system of supervision and crisis resolution. After all, this is how the euro was born, as it became clear, in particular after the 1992–93 foreign exchange crisis, that it was not sustainable to run different monetary policies within a single market. The same logic could apply in the case of financial regulation and supervision. And national authorities know it.

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The Euro and the International Monetary System

DOMINIQUE STRAUSS-KAHN

We are facing a very serious situation in the financial markets and the global economy. We have to make some hard choices, and we must start making them very soon. I will therefore spend most of my time today on what needs to be done to contain the crisis and on its implications for the global economy.

I apologize in advance if it seems like I have spoiled a birthday party for the euro by talking too much of the storm outside. But I want to take advantage of this gathering, as well as the broader gathering of the fall 2008 World Bank/International Monetary Fund (IMF) meetings, to discuss what we need to do. We can solve the problems in the financial markets and the global economy so long as we act quickly, forcefully, and cooperatively.

In October 2008, the IMF gave its assessments of what is happening in the financial markets and the global economy. Let me talk first about the outlook for financial markets and the actions we must take there because, as we all know, the heart of the problem is in financial markets.

An Action Plan for the Financial Markets

First, the numbers. In the IMF's October 2008 *Global Financial Stability Report*, we estimated that financial-sector losses could be about \$1.4 trillion, almost 50 percent higher than our estimates in the spring, which others

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thought to be pessimistic. About half of these losses have been realized, but there are still significant losses in the system.

But the problems in the financial markets now go beyond the cash losses. We are facing a crisis of confidence. The private sector cannot restore confidence on its own. Macroeconomic policy measures by governments will not restore confidence on their own. Piecemeal measures on financial markets will not restore confidence on their own. What will restore confidence is government intervention that is clear, comprehensive, and cooperative between countries. A few simple principles should govern action:

- **Principle 1:** Government action needs to have a clear objective so that effective oversight of how public money is used is possible.
- **Principle 2:** National plans need to be comprehensive. They must contain guarantees to depositors and assurances to creditors that are sufficient to ensure that markets function. They must deal with distressed assets and provide liquidity, and, most importantly, they must include bank recapitalization.
- **Principle 3:** Action should be coordinated, at the global level and at the regional level when appropriate, for example, in the European Union.
- **Principle 4:** Action should be fair, in that taxpayers, who are taking on the downside risks, should be able to share upside gains once the crisis passes.

How might this be applied in practice? I would highlight four sets of actions. First, as many governments have now concluded, the fragility of public confidence has reached a point where some explicit public guarantee of financial-system liabilities is unavoidable. This means not only retail bank deposits but probably also interbank and money market deposits, so that activity may restart in these key markets. Of course, such a step should be temporary and include safeguards such as heightened supervision and limits on deposit rates offered.

Second, the government needs to take out troubled assets and force the recognition of losses. Asset purchases should be done at fair value. Why fair value? Because transparent bank recapitalization and restructuring of balance sheets is essential to the process. If capital is to be attracted to banks, it is better to pay a lower price now, recognize losses, and give banks an upside if the implied loss turns out to be smaller than expected.

Third, private money is scarce in today's environment. Therefore, support from the government is needed. One strategy that has worked in past crises is to match new private capital subscriptions with government capital, which imposes a market test for the use of public funds.

Fourth, a high degree of international cooperation has become urgent. The collapse in confidence in the markets has been almost matched by a

collapse in confidence between countries. We saw a very bad trend toward unilateral measures taken with national interests in mind, with unintended beggar-thy-neighbor consequences for others.

We are beginning to see a turnaround in this. At the Ecofin meeting in early October 2008 some principles were agreed to, and on October 8 we saw coordinated moves by major central banks. We need more coordination. Financial institutions now span many countries, and credible rescue plans must be consistent across many jurisdictions. I urge European countries especially to work together.

There is no domestic solution to a crisis like this one. I know, having myself served as a minister of finance of my country, how difficult it is in the European Union to reach consensus and make decisions. I do not underestimate the problems. Nevertheless, cooperation and coordination in actions is the price of success at both the European and global levels. The weekend's meetings will be an opportunity for finance ministers to talk about how to bring about the needed cooperation. All kinds of cooperation have to be commended. All unilateral actions have to be avoided, if not condemned.

How Is the Financial-Sector Turmoil Affecting the Global Economy?

One of the reasons action is so important is that the turmoil in the financial markets is having serious effects on the global economy. Even if strong and coordinated action along the lines I have been talking about is taken, we think the world is going to experience a serious slowdown.

We foresaw this in spring 2008. At that time, we were criticized for being too pessimistic. Now I am afraid that it seems we were too optimistic. Our best forecast now is that world growth will be around 3 percent in 2009, which may not sound so bad. But the projection for advanced countries is worse: very close to zero until at least mid-2009, with a slow recovery during the rest of that year. World growth will be driven increasingly by growth in emerging and developing countries. And they will grow at a lower rate than they have in the recent past: 7 percent in 2008 and 6 percent in 2009. The financial-market crisis is also going to have longer-term effects.

The United States

In the United States, a new generation of households, businesses, and banks will now have fresh and vivid memories of a financial crisis. They will be more cautious and take fewer risks. This is not a bad thing. In fact it is part of a long-term correction that is due. Before the crisis, people—and especially banks—took too many risks. Now changed attitudes to

risk will reshape patterns of consumption and investment. We are already beginning to see this.

How should macroeconomic policymakers in the United States respond to this? My answer is that they should not try to fight the long-term change but that if both private investment and private consumption fall sharply in the short term—as private saving rises—then there may be a need for the government to support the economy. The options for fiscal policy will be constrained by the large addition to the federal debt caused by the recently passed rescue package. But fiscal stimulus measures may still be justified in the near term so long as they are balanced by longer-term measures that promise to contain deficits and debt, especially reform of entitlement programs.

Europe

In terms of economic impact, Western Europe has been hit at least as hard as the United States in 2008. This is partly because of the appreciation of the euro.

But let me make one point, which is very relevant to the subject of this conference. We have not yet seen a foreign exchange crisis. Sure, we have seen a couple of days when the euro-dollar rate has moved by a couple of percent, and we have seen some equally sharp movements of the pound sterling and other currencies. But none of this approaches a crisis, and we have certainly not seen the kind of abrupt and disruptive movements of exchange rates that characterized the Asian crisis.

Why is this? One reason is obviously the success of the euro. For example, consider what 2007 might have been like if Europe had not had the euro. If the past is any guide, the appreciation pressure on the euro would have gone disproportionately into the Deutsche mark, which may have appreciated much more than the euro now has. In other countries, political and business forces would have lined up in favor of decoupling or devaluing against the mark.

Anticipating the possibility of exchange rate realignments, market participants would have withdrawn capital from countries at risk of realignment, driving up interest rates and risk spreads and potentially causing current account financing problems. Higher interest rates would have undermined housing markets and choked growth.

As in the past, exchange rate realignments would likely have been needed to restore order, and these exchange rate realignments in turn would have caused inflationary pressures in countries that devalued. So there is no question that the euro has contributed to the stability of its member countries during this crisis. And for its members it has become an essential element of the global monetary system.

However, European countries still face major challenges in dealing with the current crisis, and policy options are constrained. Many Euro-

pean countries have limited scope for fiscal stimulus because of already high debt and aging populations. There is more leeway in monetary policy. Indeed, the European Central Bank took appropriate action in early October 2008.

Emerging Economies

In 2009 almost all global growth will come from the emerging economies. But the effects of the turbulence are also beginning to mount in their financial markets and economies.

Emerging economies are generally in a much better position than in the past. They have large reserve buffers, solid current account positions, and healthier banks. However, there is still a large group of countries that are very exposed to global financial conditions due to high external financing needs and in some cases banking system fragilities.

Policy responses will need to be tailored to the circumstances of individual countries. For those with high reserve levels, there could be room to draw them down to finance a temporary and sudden shortfall in capital flows—not to defend a particular exchange rate but to mitigate adverse effects on banks or corporations associated with depreciation. Other countries, though, will need to raise policy interest rates in line with rising risk premia to stem outflows and bolster confidence in their currencies.

Finally, some emerging economies may need help and possibly substantial help. For our part, the Fund is supporting member countries with advice, and if needed we are ready to support them with financing. We have activated emergency procedures to respond quickly to urgent requests, with high-access financial programs based on streamlined conditionality that focuses on crisis response priorities. We have plenty of liquidity to support our members if they need financing.

Before concluding, let me talk about two other issues.

Food and Fuel Crisis

The first issue is the other crisis in the world economy, which is affecting many developing countries. High food and fuel prices continue to put enormous pressure on developing countries. Prices have eased in recent months but remain well above their levels at the onset of the recent price surges.

About 50 countries are really hurting, with uncomfortably weak reserve positions. National budgets are also under pressure, and inflation is on the rise. In low-income countries the average inflation rate is expected to exceed 13 percent by the end of 2008. Inflation hurts the poor most because they are least able to protect themselves, and it leads to greater inequality and sometimes to unrest.

Developing countries can help themselves, for example, by shifting budget support toward subsidies for goods particularly consumed by the poor, or, when feasible, better-targeted social safety net programs that protect the poor in a cost-effective manner.

But developing countries also need help from others. The Fund is doing its part—together with the World Bank—with advice and technical assistance. The Fund has also increased financial support to 15 countries, and we have changed our Exogenous Shocks Facility so that we can provide assistance more quickly, in larger amounts, more flexibly, and with more focused conditionality. Donors must also help. One complication is that the budgets of advanced countries will be under more strain because of the financial crisis. It is very important that they not respond to the crisis by cutting aid, which goes to the poorest and most vulnerable people in the world.

Looking Beyond the Crisis

The second issue is that even though we are still in the midst of the financial crisis, we need to draw some lessons from it.

Lessons in Regulation and Supervision of the Financial Sector

For the financial sector we have a good start in the recommendations and technical work of the Financial Stability Forum (FSF), much of which was done in collaboration with the IMF. But of course, strong as they were, the FSF recommendations have not been adopted in time to prevent the crisis from unfolding. In fact, the crisis is the result of three failures: regulatory and supervisory failure in advanced economies, failure in risk management in the private financial institutions, and failure in market discipline mechanisms. Now we need to go further. Let me emphasize a few points.

We need to have more flexibility and less procyclicality of some of the Basel II norms, including on the question of “fair value.” The rating agencies have to adapt to the new complexity of the financial sector, limit conflicts of interest, and accept supervision. We need to close loopholes and fill information gaps in financial regulation and supervision. This includes looking again at regulation for covering securitization, private equity companies, and mechanisms that increase leverage. We also need to give more thought to regulating hedge funds, either directly or indirectly, by regulating their counterparties.

How should we tackle this work? Let me be blunt. I think the IMF can help in coordinating this effort, drawing on the expertise of others. Why? Two reasons: First, the Fund—with its universal membership and demonstrated financial diplomacy (for example, its work on sovereign wealth funds)—can bring together the different actors in a global forum

that discusses risks to global stability and policy responses, and second, the Fund has the machinery for follow-up through bilateral surveillance and Financial Sector Assessment Programs (FSAPs).

Improving the Financial Architecture

Like a forest fire that leads to renewal of the soil, every crisis gives birth to new ideas, and especially new ideas to improve the international financial architecture. Earlier in October 2008, Robert Zoellick made an inspiring call for a “new multilateralism.”

Let me add a few ideas to the debate. One can trace most of the problems in the architecture to either lack of legitimacy or lack of effectiveness. Legitimacy must be conferred by reliance on broader groups. One very simple change that could be made is to extend the G-8 to at least China, India, and Brazil, and perhaps others.

But this needs to be accompanied by greater reliance on multilateral institutions with near universal membership, so that no country that wants to participate in the international system is left out. Of course, the institutions themselves have to be representative as well as universal, and especially we need to see an increasing role for and responsiveness to emerging markets. Both the reform of Fund quotas and the broader governance reform that we are undertaking are very important for this.

As to effectiveness, I would like to see greater simplicity and more follow-up. To achieve more simplicity we need better coordination between international organizations. It sometimes seems that you need a scorecard to keep track of the players in development: development banks, the UN Development Program, the World Food Program, and national administrations. The roles of the different multilateral institutions need to be better defined so that there are fewer overlaps between them.

We also need better follow-up of agreements and communiqués. There is a certain poignancy in reading past communiqués. They remind me of a discarded children’s board game. They once inspired great passion but are quickly forgotten. (This has not changed since I was finance minister in the 1990s.) One way to better follow up the work for the “Gs” would be to have a kind of secretariat.

The current crisis is, if nothing else, a wake-up call. Put simply, we have to manage the system better than we have so far. And I believe that we can do better. This is a time of serious challenges, but it is also a time when we can think imaginatively and act boldly.

