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Is the Present Crisis the Moment for the Euro's Global Emergence?

A Panel Discussion with Antonio de Lecea, Leszek Balcerowicz, C. Fred Bergsten, Erkki Liikanen, and Lawrence H. Summers

ANTONIO DE LECEA

I am somewhat uncomfortable with the title or the main question of this panel. It has two implicit assumptions that I find questionable. The first one concerns the reference to global emergence, which needs some explanation. The euro has already acquired an international currency status and therefore, in my opinion, it is inappropriate to refer to a possible future global emergence of the euro when it is already the second largest currency in the world.

The second issue is the link between the current crisis and the future of the euro-dollar balance because the underlying assumption seems to be that there can be only one dominant international currency. This assumption is based partly on history and partly on the concept of

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network externalities. Again, network externalities may play a role in some functions of international currency but not all of them. They may play a role for the currency as a unit of account and as a vehicle currency but not so much as a currency of investment (including foreign exchange reserves) because there are other considerations, as put forward by other speakers, particularly that of currency diversification.

If we look at one of the main determinants of the use of a currency as an international currency—size of capital markets—we find that capital markets in the European Union match the size of those in the United States. It is true that the composition differs. Equity capitalization is half that of the United States, but EU capital markets have been catching up in terms of efficiency, liquidity, and breadth. Therefore, rather than having a single dominant currency in the global monetary system, we can have two—I mean a bipolar system—and there may be room for more than two in the future.

This takes me back to the second issue: the relevance of the current crisis to bring about a bipolar monetary system. In a bipolar world, I do not think a single crisis will determine the shift or the tipping one way or another; change will probably be incremental. Crises are certainly destabilizing but are unlikely to shift from one currency to the other.

Having said that, what will be the impact of the current crisis on the role of the euro? Until now, the idea of crisis triggering a possible shift from one currency to another was based on a very different type of crisis, that resulting from disorderly unwinding of global current account imbalances. The argument went like this: The adjustment of current accounts would involve the depreciation of the dollar, which would expose the dilemma of countries holding a large amount of dollar-denominated reserves. By moving out of the dollar, they would stem their own evaluation losses. But eventually, they might lose confidence in the dollar and trigger its decline.

The current crisis started off as an adjustment to an imbalance but a different imbalance—reversal of the housing boom in the United States—and this is the only similarity. Since the crisis started, financial contagion, uncertainty about the allocation of the losses stemming from those bad assets, and the loss of trust have been the trigger.

And once contagion has spread, it does not matter whether the crisis originated on this side or the other side of the Atlantic. The original idea that the euro area financial sector might be immune to this crisis, unfortunately, did not prevail. Therefore, I would claim that the current crisis will not tilt the balance of power in one or the other direction. And even if the financial industry experiences profound transformations as a result of this crisis, the relative attractiveness of the financial markets in the United States and the euro will not dramatically change as a consequence of this crisis. The response of policymakers to this crisis and to other challenges will matter more.

Provided no massive policy mistakes are made on either side of the Atlantic, this crisis will not have a significant impact on the relative international status of the dollar or the euro.

LESZEK BALCEROWICZ

Before I address the relative role of the euro, let me comment on the present situation. I will skip the most difficult question of crisis resolution and mention what seems to be absent from today's discussion: the diagnosis and long-term lessons.

There is a tendency to discuss the reasons for the present crisis in terms of insufficient or wrong regulations and errors of specific institutions. These are very important reasons but probably only partial and approximate. The underlying reason is the excessive growth of credit in some countries, especially the United States. The faster credit grows, the more errors you accumulate, sooner or later leading to asset bubbles, which will eventually burst.

I belong to the group that thinks one should look at microeconomic policies, especially monetary policy in the United States. This brings us a lesson for the future. To what extent should future monetary policy of the Federal Reserve—because, to some extent, the Fed dictates monetary policy to the world—consider asset price developments? This issue is highly disputed, but we cannot avoid its discussion. In fact, the discussion has already started.

The argument that you cannot fine-tune asset price developments is not sufficient to reject the general case that monetary policy should, at a minimum, not contribute to asset bubbles. So this is the first point.

On the second point, I have participated in many heated debates about global imbalances. And the question was how it was going to end, soft landing or hard landing? We are in a financial crisis that has no connection to the previous discussion about global policy imbalances. Perhaps we are witnessing an unhappy ending to the previous discussion on global imbalances. And perhaps we should bring some of those issues to the debates about the present financial crisis. Some very interesting issues have not been sufficiently discussed. What were the interconnections between the so-called global saving graph and excessive soft monetary policy? What were the dynamics of these two factors?

I agree with my predecessors that the most likely outcome of the present crisis, however it ends, would be neutral for the respective global roles of the euro and the dollar. One should not rush to the conclusion that the euro is going to benefit because the world is interconnected. Besides, the euro area's own economies are not as flexible as that of the United States. In the long run, certain factors prevent the euro from becoming a more important global currency, including faster rate of long-term growth and greater political cohesion in the United States than in the European Union.

C. FRED BERGSTEN

The dollar has been the world's dominant currency for about a century for a simple reason: It had no competition. No other economy was anywhere near the size of the American economy. No financial markets underlying any currency were anywhere near the size of the US financial markets. Through bad times and good for the US economy, the dollar was dominant.

This was true even in the late 1970s and early 1980s, when the United States ran three consecutive years of double-digit inflation; interest rates went to 20 percent plus; and we had the deepest recession since the 1930s. The dollar lost a little market share in that period but not much because there was no competition. The Deutsche mark was the closest competitor, and it never achieved a market share more than about one-quarter that of the dollar, mirroring the fact that the West German economy was about one-fourth the size of the US economy and, as Helmut Schmidt always reminded us, West Germany was "the size of Oregon, so don't expect us to play a global role."

All that changed with the advent of the euro because now we do have a currency based on an economy as large as or larger than the United States and financial markets that, while not equal in every respect even prior to the crisis, are certainly a competitor and are superior on some metrics. So the whole international competitive position for global currency status changed with the creation of the euro.

However, it is unlikely that the euro will seamlessly ascend to an equivalent role to the dollar for another simple reason that comes out of the study of the history of global currencies: inertia and incumbency advantages. We do not have very many observations to study this topic, but the history of the pound sterling suggests that incumbency advantages and inertia are very important. Sterling retained a major international role for more than 50 years beyond any conceivable notion that the United Kingdom was a major world economy, let alone the dominant world economy that it was when sterling first achieved its global dominance when it had no real competitor a century earlier.

So the crucial question is whether the inertia and incumbency advantages will be overcome by some significant event that would permit the newly eligible international currency, the euro, to move up alongside the dollar. In short, the United States has to make a mistake. The incumbent has to mess up badly when there is a competitor in place for the situation to change.

The United States did mess up considerably back in the late 1970s.

Later, productivity growth was very slow. But there was no competitor. Now there is a competitor, and so the immediate question, to link to the short term, is whether the current crisis originating in the United States is going to represent the mistake that would open the door for the competitor to ascend to a more or less equivalent position.

There are two responses to the question if one wants to conclude that this will not change it very much. One is that the United States could recoup rapidly. Yes, there is a crisis but the United States responds quickly and successfully. Recovering from the crisis in a sufficiently effective way not to lose global credibility, reputation, confidence, and the like has happened quickly, but we do not know yet if it has happened successfully.

The other possible savior from a dollar standpoint is that the Europeans do as badly as, or worse than, the United States in responding to the crisis. As Leszek Balcerowicz suggested, there would then be no net effect at all. I think the honest answer is we cannot know yet.

The interesting point is that the United States and Europe must cooperate to get the world out of the crisis. The issuers of the two key currencies have got to intensively cooperate to enable the world to come out of the problem. But at the same time, within that cooperation, there is inherently some competition because whichever one does better, whichever one resolves its own problems more successfully, whichever one comes out of the current difficulties more rapidly, will produce some important inferences about what the long-term market reaction is going to be to "euro versus dollar" and whether this situation will bring about the historic change required for a global currency relationship to change in the way it did in the past when the dollar replaced sterling, and now, when at least the potential exists for the euro not to replace the dollar but to move up alongside it into a true bipolar monetary system.

The other interesting question from the US standpoint is whether the ascendance of the euro to a more or less equivalent position would be a good or bad thing. Adam Posen earlier implied that it would be a bad thing. He noted that if Taiwan or Korea or some big dollar holder ever thought about moving off the dollar, the National Security Council guy would be out there to tell them to hold on. That might well be an accurate prediction, and we certainly saw it in the case of Saudi Arabia from time to time over the years. But the question is whether that is right and whether the United States should resist or welcome the advent of the euro as a more or less equivalent currency.

The United States must obviously do everything it can to restore the strength and stability for the dollar in terms of its own economy and in terms of the world economy as well. But the key currency role is more ambiguous from a US standpoint. In the short term, it is great to finance those big imbalances and live beyond your means as long as you can. But, as Leszek just said, that set of imbalances and persistent overvaluation of the dollar in trade terms clearly contributed to the big capital inflow that kept interest rates low and enabled the United States to live beyond its means, which at least in significant part is an underlying cause of the current crisis.

I believe it would be healthy for the United States to move to a bipolar monetary system where there is competition. We all believe in competition in goods markets, financial markets, indeed practically all markets, so why not on the international currency front as well? History shows that you can run bipolar monetary systems (and Barry Eichengreen's recent work has reaffirmed that). There is no reason why the United States and Europe could not cooperate effectively to manage a bipolar monetary system. The competition it would promote might be a healthy element as we reflect on the causes of the current crisis and how to avoid them in the future. It might be a healthy element in reducing the prospect that we have to go through this dreary cycle again, having more bubbles that are bound to burst, and trying to keep the United States as well as others from living too far beyond their means.

ERKKI LIIKANEN

The European Central Bank (ECB) decided on October 8, 2008 to participate in a coordinated rate cut and later the same day decided to implement a new monetary policy. We should have announced the two simultaneously, but the rate cut decision was a coordinated one and the implementation decision only our own. Euro area banks will, henceforth, be able to get liquidity to the full amount of their bids at our policy rate. This is a major change in liquidity policy.

On the international role of the euro, Fred said that he sees the possibility of a bipolar world here. I am quite agnostic on this issue. I think we, as European central bankers, should not promote the euro and that the euro's international role should rather reflect the economic development of the euro area.

Although we are in the middle of the storm in the United States, after it is over, I expect the dollar to remain the safe haven or the last resort. I do not know whether Adam Posen's point is correct that this is a national security issue for the United States, because I am not in that business. Actually, my country is more known for peace and reconciliation. Martti Ahtisaari has got the 2008 Nobel Peace Prize, and I use this opportunity to pay tribute to him.

What are the critical issues for the international role of the euro? I think they are the size and dynamism of the European economy, financial-market development, and supervision of our evolving financial markets.

First, regarding the European economy, the critical issue is how we can promote growth, implement structural reforms, and increase competition in product and labor markets. If these reforms, known as the Lisbon objectives, are implemented, there will be more growth, more productivity, and more dynamism. And there will be more interest in investing in European equity markets, this return chasing element, which was mentioned earlier. So that is the first and most critical issue.

Second is financial-market development. The European financial markets have advanced quite a bit but are still not ready. We need deeper, more integrated, and more liquid financial markets. The ECB has contributed to that development by trying to create a uniform infrastructure for securities settlement in Europe. It sounds very technical, but the key issue in securities markets is that across-the-border transactions in Europe are expensive, about four to seven times more expensive than similar US securities transactions. To unblock that bottleneck we need to have common infrastructures and more competition. So when European financial markets become deeper and more liquid, and the assets made available to investors are also developed, I am sure the role of the euro will also become stronger internationally.

The third challenge is how to efficiently supervise these financial markets. André Sapir spoke about it at this conference. I think that these past months have taught us well that liquidity and solvency are twins. If you have trouble in liquidity, you may later have a problem with solvency. For that reason, I am a proponent of the position that supervision should be close to central banking but independent. And countries where they are in the same infrastructure, even though independent, have acted rather quickly.

Of course, we have a particular challenge because the European Union has 27 countries and the euro area has 15. The solution must be such that the basis is national supervision, which operates within national borders. But home- and host-country supervisors must cooperate if the bank being looked at is systemically important in more than one country. And for those truly European players—we may have 10 or 15 of these—we need to go even further in the future. They should have one supervisory counterparty at the European level. We cannot, in the long term, imagine that one of your major banks will have to operate with 25 different administrative practices in as many countries. Some of these issues are actually under consideration in the European Union because the European Commission has made proposals on how to move forward. We just need to use this opportunity to get it right.

Finally, on financial crises, Kenneth Rogoff and others wrote a paper some time ago about the five big crises. That was the first time I heard that Finland, Sweden, and Norway are big countries because these three had crises in the late 1980s and early 1990s. All the current issues are well documented in our literature on the last crisis. In order to get out of the problem, we need solutions for bank recapitalization and equity, "bad banks" need more time to realize bad assets, and we need bank guarantees.

Some people ask why we are not dealing with the current problem at the European level. When I served at the European Commission with Sir Leon Brittan, I was the commissioner for the budget. The ceiling for the EU budget is 1.275 percent of the total GDP of EU countries. It is small but still extremely controversial. Margaret Thatcher became famous when she wanted "her money back" from that small budget. So, there are no financial resources to solve this with the EU budget.

Second, if you need to put in taxpayers' money to save a bank, it is difficult to justify to the electorate across national borders. The taxpayers must know that it is targeted at the territory for which they are liable. For that reason, I do not expect that the EU budget is the solution for injecting equity or granting guarantees.

But the question of harmonizing practices remains. The best way to do this would be to define basic criteria for action beforehand and have all countries follow the same rules. It has not happened quite this way, but we are not terribly far. The EU scheme has three elements: guarantees, recapitalization, and takeover provisions. We have all more or less signed on to the so-called British plan. But in the European Union, member states must submit all these measures to the European Commission for scrutiny because we have strict rules on state aid. Sir Leon Brittan was running that area. State aid rules allow the Commission to prohibit any state aid that distorts competition within the EU market. So there is no precise ex ante harmonization of rescue operations but ex post.

To conclude, I cannot imagine meeting this crisis with independent currencies in Europe. I was in Brussels in the 1990s when huge tensions broke out between the European currencies. People could not accept that 15 to 20 percent changes in exchange rate could take place overnight. Regardless of what people think about the European project, there is wide agreement today that the Economic and Monetary Union, the euro, has been a major pillar of stability in our economy.

LAWRENCE H. SUMMERS

Old habits die hard, so let me begin by remarking that a strong dollar is in the interest of the United States. My view is that the United States is best served by not conceptualizing itself as in competition with the euro. If the United States runs its economy and manages its currency well, life will work out okay, and in general, I do not favor a US strategy of seeking to assert with great force the primacy of the dollar. So in that sense, I agree with Fred.

Where I have difficulty with his argument is the notion that the United States should actively encourage currency competition so as to discipline itself, which reminds me of a particularly exotic doctrine in automobile safety: If daggers were placed in steering wheels, people would find it in their interest to drive much slower and there would be fewer automobile accidents.

This notion has a certain logic to it but is not usually accepted. In the same way, to seek to create a situation where we will do damage to ourselves by doing the wrong thing and, therefore, we will do the right thing seems to me to expose us more to ill consequences than to potential gain. Currencies, like languages, involve extremely important elements of coordination. That is the reason for the incumbency advantage a number of people have talked about at this conference. To have two currencies trying to be in complete equipoise risks substantial instability, as things rush from one direction to the other. None of this is to say that the United States should seek to thwart the euro.

The world will tend to maintain the strength of the dollar, the primal role of the dollar, unless we mess up quite badly, and that is a fine outcome. If we make a mistake, that will be unfortunate. We should certainly support the Economic and Monetary Union, but the notion that we actively profit from a kind of knife's edge to deter us from bad conduct doesn't strike me as being a healthy one. We will know much more 18 months from now about a question that seems to be central to thinking about many monetary and financial questions, not least the view of the euro.

One can have two views with respect to the current crisis. The first, which I call the made-in-America view, is that America rammed large deficits that created substantial imbalances, elected an administration that did not believe in regulation, fomented in retrospect a crazy set of mortgage practices, built up a phenomenal bubble, and created for itself a tremendous financial crisis that, being the world's focal economy, inevitably had spillovers because others purchased its assets substantially. And so America is the epicenter of this financial crisis. The financial crisis has an unfortunate fallout. The lessons to be learned concern various dysfunctional features of American financial practices and financial regulation. The event is a substantial boon to those who favor the view that the American model of capitalism, or more generally the Anglo-Saxon model of capitalism, is somehow inferior to alternative, more corporatist, and dirigiste models. This is one view with respect to the financial crisis.

The second is that in a period of high global liquidity and globally lax supervision encouraged by the enormous complexity of financial instruments, a financial crisis developed with respect to imprudent practices of financial institutions everywhere and the first incarnation of the crisis happened to be American subprime lending. But that was largely coincidental; because America has more mark-to-market accounting, more institutions that operate on a hair-trigger because they are outside the system of large state-embraced banks, the crisis was felt first in America, was dimensioned first in America, was reflected first in America. But the magnitude of the financial system rot in Europe is not so much smaller as it is less discovered than the financial system rot in the United States.

Europe is behind because of slightly different exigencies of the real estate cycle and because of slower revelation of financial pain. But the crisis is fundamentally global or at least transatlantic and should be interpreted in transatlantic terms.

I do not know which of these views is right. I was always educated by Ted Truman when we worked together that my habit of posing things as dichotomies was wrong because the truth always lay somewhere in between. Perhaps the right way to frame the question is less as which of these views is right and more as where along the spectrum between "made in America" and "first discovered in America" should one see this crisis.

If you live in Europe, you tend very much to the first view: that it was more made in America. Many in the United States, particularly those associated with institutions that would be thought of more as part of the shadow banking system than of the official banking system, would tend more to the second view, that it was first discovered in the United States.

I am genuinely not sure where the truth lies. But the question will be enormously important because the more the reality is in the first category, the more these events threaten the dollar and the model for which it stands and the more likely they are to portend a change in currency arrangements. But if the reality is more in the second category, the less likely these events would point to the euro gaining share relative to the dollar.

It is certainly not the case that European stock markets have vastly outperformed American stock markets over the last nine months. Depending on how you choose your dates, they may have outperformed American stock markets or underperformed a little bit. But the same is much closer. Suppose one had said a year ago, "America's going to have a huge financial crisis. Bear Stearns is going to go down. Lehman is going to go down. AIG is going down. Merrill Lynch is going to be sold, and five Latin American countries are going to be able to borrow money cheaper than Goldman Sachs," and then asked, "How will the US stock market do relative to the European stock market?" The answer would seem obvious. But the fact that it is not does make one wonder how much of this is an export situation and how much of this is a global situation. Certainly, the dramatic movements in the dollar vis-à-vis the euro recently also point in the same direction. I will leave the question on where the truth lies between the two views for others more knowledgeable than me to answer. The answer to that question will bear on the future of the dollar and the euro and also on how different economic systems are assessed.

QUESTION AND ANSWER SESSION

C. Fred Bergsten: I was delighted, Larry, to tee things up for you to come back at with some vigor, as you always do. But I cannot resist then coming back to you by simply noting that when you said that the United States should not seek to subject itself to currency competition, it did sound a bit like a former and perhaps future secretary of the Treasury speaking.

But I was basically pleased because, I think, we agreed. You said the United States should not seek primacy for the dollar and should not seek to thwart an increased international role for the euro. We should, indeed, support the euro project. That is what I was saying. And, in a sense, let the best currency win.

I certainly did not say that we should do damage to ourselves in order to promote a bigger role for the euro, nor did I advocate for a complete equipoise, in your elegant term. But rather to say that within this framework of necessary cooperation, which we had for many years, will have for the indefinite future, and certainly have had to come out of this crisis, there will be an element of competition. And you said, in posing your dichotomy, it is really going to be a judgment matter that the markets and world opinion as a whole will develop over the next several years, as to how Europe and the United States do coming out of this and therefore, in part, in understanding how we got into it.

So, I think fundamentally we agree on it. We are both agnostic as to how it is going to come out. I guess the difference would be that I have greater equanimity about the prospect that, on this particular criterion of international currency roles, a bigger role for the euro might actually be a healthy thing, especially for future secretaries of the Treasury.

Erkki Liikanen: Just two comments. On the exchange rate, I feel uncomfortable when people explain everything with short-term changes in exchange rates. There have been changes recently, but let us look at them in the long term.

On the financial markets, Larry said that we have a problem in Europe that we know exists but has not yet been revealed. Europe is not isolated. But let us not take extremely strong positions before we know for certain. Of course, the banks that depend on wholesale funding have had a very tough time because markets are tight, the risk premia are high, and so forth.

George Soros: The current crisis has revealed a fundamental flaw in the design of the euro. In such a crisis, the central bank can do certain things, and the treasury has to do certain things. In the case of the euro, you have a common central bank but no common treasury. This issue has come to the forefront now when there is a need to effectively underwrite or rescue banks. France and Germany prefer to do it on a national basis. Smaller countries that are weaker would like to do it on a European basis. How this issue is going to be resolved will have a major influence on whether the euro is qualified to be an international reserve currency.

This factor has played into the fluctuation in the value of the euro because it is very hard to know exactly why currencies move the way they do. Certainly, the more pressing issue is the shortage of dollars. The euro, in fact, was overbought in the early stages of the recession, which started in the United States. In fact, the economic slowdown was transmitted to Europe via the declining dollar. And now that the financial crisis has become more severe, there is a pressing shortage of dollars among European banks. They have to pay tremendous premiums for it. That is the other factor that has accounted for the move to the euro.

Leon Brittan: On George Soros' point that the European side of the crisis cannot be dealt with exclusively by the European Central Bank but has to be dealt with by treasuries, this may not be an acceptable pragmatic British approach, but as far as I see it, it does not matter whether it is done by European institutions, so long as it is done by Europe. By this I mean that if, for historical institutional reasons, it is impossible for Europe to agree on a big plan to be implemented, it does not matter so long as the European finance ministers agree on the principles that should be applied by individual countries, which have a degree of flexibility as to how they apply them but at the same time are dealing with the same problems with the same broad objectives.

Not everyone on this panel entirely shares the theme about the euro replacing the dollar or not. But the framework of discussion implies that it is a good thing. Your side wins, as it were.

Larry said he was in favor of a strong dollar, in a slightly mantra-like fashion at the beginning of his remarks. I was going to agree with Fred, but then he said in his concluding remarks, "Let the best currency win," implying that this is a contest and that winning is a good thing. Erkki, with whom I agree, said that it is not a European objective to make the European currency, the euro, an international reserve currency.

I want to bring to bear a little bit of the experience of the United Kingdom. I remember the time when Britain was struggling to retain the international role for sterling. It became very clear to the younger among us that having this international role as a reserve currency was not only not a big prize but also a major handicap to dealing with the British economy.

One thing is clear, if the cap fits, wear it. If you are a major country where economic fundamentals are pushing your currency away from its central role in the world, there is nothing more disastrous than to try and follow policies that are designed to cling on to that role because those policies are going to be seriously disadvantageous.

Erkki Liikanen: On the role of subsidiaries, there is a difference between a subsidiary of a bank and a branch of a bank. The subsidiary is legally independent. So in these crisis resolutions that we have had, countries were able to take action in the case of subsidiaries because the national supervisor of the subsidiary supervised the bank. They knew the situation and had the ability to act nationally. A branch, however, is outside the full national supervision of the host country. So if it is a question of a branch, it will be more difficult. In the subsidiary case, it has worked.

To George Soros, one comment on the European treasury issue. The last two or three years have been rather positive in that area even though we do not have a big European budget. But certain good, sound, basic principles have been applied due to the Stability and Growth Pact, which aims at cutting excessive deficits and which has been working. The pact has been respected in Germany and also in France; we have given a greater role to automatic stabilizers. Everybody has to accept that excessive deficits are harmful to economic development.

C. Fred Bergsten: Just to clarify Sir Leon Brittan's last point. When I said let the best currency win, I meant in a market sense. Let the market determine whose policies are better, whose performance is better. That will, as Larry and I both said, probably determine which currencies will play which relative roles in the future.

I distinguish market choice from national interest or certainly any driven by national policy to promote either currency as the dominant one. I thought I was clear in my remarks that I had a preference, which Larry did not care for. But my preference for that kind of competitive international currency role is based in part on its disciplinary grounds. And I hope I will, therefore, retain your support for my view in this debate.

Leszek Balcerowicz: On banking supervision in Europe, whatever arrangement that emerges should be country-specific because countries differ. For example, some small European banks are of systemic importance in some new EU members. And second, it would not be advisable to have complete harmonization of supervision. And I give you one example from my own experience as a former central bank governor: The rate of growth of housing credit denominated in Swiss francs has been excessive, specifically in Poland and some other new EU members. We introduced special regulations that have slowed this growth. One can call it a reverse of subprime because it makes it more expensive and more difficult for poor people to get housing credit. I think it was working in the sense that it slowed the rate of previously excessive growth of credit. Such solutions cannot be European; they have to be country-specific.

Lawrence Summers: The issue of European crisis governance is profoundly important. We will know better how well the system works a year from now than we do today. I'm inclined to agree with Leon Brittan, that whatever defenses can be offered for it are more in the pragmatic domain than in the theoretical domain. We will know just how pragmatically effective and successful it is.

At a WP3 meeting 10 years ago, I had inquired, "Could you just help me understand, suppose the third largest bank in Spain is about to fail, who are the players and who is responsible for what. What is up to the Spanish Treasury? What is up to the Spanish central bank, which no longer has a currency? What is up to the ECB? What is up to Brussels? Just tell me what the protocol is."

And again, this was 10 years ago. At that point, half a dozen European hands were raised. It was like any group of economists: Half a dozen answers were offered to the question by half a dozen Europeans. I assume that matters have been rationalized since then, but I do think it is an important issue, particularly when you have to move rapidly.

Erkki Liikanen: Larry asked 10 years ago about a Spanish bank. But I would like to take a more complicated question, that of Fortis, a Belgian bank that got into trouble. Its balance sheet is 225 percent of the Belgian GDP. How was the crisis handled?

As far as emergency lending is concerned, the rules are clear. The central bank has the responsibility after authorization of the ECB Governing Council.

As far as equity is concerned, Fortis has headquarters in Belgium and subsidiaries in two other countries. The treasuries got together on that particular Sunday and decided how they would inject equity. All the decisions were announced at the same time, 10 o'clock on Sunday. The Spanish case is simpler because there are fewer participants in the discussion.

Alexander Swoboda: In the mid-1960s there were already discussions in the United States on whether it was worth keeping the link to gold and the international role of the dollar and so on. And there was the case of Britain, which Sir Leon Brittan mentioned. It is not a question of actively promoting the international role of one's currency for the sake of actively promoting the role of the currency and winning a competition on international markets. It is a matter of the costs and benefits of having a currency that is an international currency.

A number of small countries—Germany was mentioned and Switzerland, my own country—actively discouraged the international use of their currencies because it had many disadvantages. So, I think, you decide you want a strong currency or you want a good, deep, resilient market for assets denominated in your currency, which encourages use of your currency in markets. And that contributes quite naturally to your currency being more used as an international currency. But it is not a political decision: "I want my currency to be the dominant one." If Britain was trying to retain its currency's dominance, it was partly because it was afraid of what would happen to the British economy if the Commonwealth dumped British reserves. It was not because it wanted to maintain the empire.

Edwin (Ted) Truman: I have a slightly broader question that goes beyond the European discussion, and it was raised in part by the discussion about bank subsidiaries in Eastern Europe. I'm not quite sure it makes a difference whether an entity is a subsidiary or branch. I mean it makes a legal difference, but as we have learned from this crisis, there are reputational risks. And once your reputation is at risk, it does not matter why.

My broader issue is: A country has a national supervisor, and the national treasury is responsible for solvency support. But some countries have financial institutions that are large relative to the country's GDP, for example, Iceland, Malta, Belgium, and Switzerland. It is a tragedy for Iceland, but if the country were the size of Germany and had comparable institutions as a multiple of GDP, it would be a problem for everybody. So if we are going to insist on principally national supervision and principally national treasuries to do the solvency operation, or if they cannot do it, then there are implications for everybody else. You have a question for the global system and whether others in the system will say, "Your bank cannot get that large." That would be one answer. I am not sure what the right answer is, but this crisis has raised this question.

Peter B. Kenen: What is important to a country is not that its currency is the reserve currency. What is important to a country—and this implies that two or three currencies can play international roles at the same time and not compete for dominance—is that its nationals, for example, enjoy the advantages of its currency being used widely abroad (invoicing of trade, private-sector uses, and so on) and not the fact that the Chinese, for example, may be holding X billion US dollars in their reserves.

Too much attention is being given to the role of the currency in the official sector or in the monetary system narrowly defined. We should be looking at the role of currencies in the international business sector. And there it is obvious that more than one country or entity, such as the monetary union, can promote the international use of its currency or assist its nationals in doing so without necessarily competing with some other government.

Of course, exchange rate movements are of some proposition. You do want a modicum of exchange rate stability. But that speaks to the kind of monetary policies you follow, not policies designed to encourage reserve accumulation by foreigners but rather policies to assure domestic financials and price stability. This debate is cast too narrowly in terms of competition between currencies as reserve currencies and insufficiently in terms of a role for your currency that is commensurate with your role in the world economy and that promotes or assists this role rather than trying to displace another currency in the system.

Lawrence Summers: I will comment on a couple of issues. First, how good is it in terms of lowering borrowing costs to have your currency be a favored reserve currency? Second, how good is it to be a transaction currency, which is Peter's issue. And there is a third issue, which is awkward to talk about but I suspect may be quantitatively more important: How attractive is your paper money as an asset for hoarders outside the law to hold? And what does that mean for seigniorage? I suspect the numbers from extra seigniorage loom fairly large relative to some of the other numbers you calculate in this area. It is obviously not the most consequential issue in the world, but we in the Treasury in the 1990s were of the view that it was a modestly internationally uncivil act for the Europeans to introduce the €500 note when we had made a very conscious decision to resist issuing the $500 note so as to make our currency less attractive for drug dealers and black marketers. If you calculate the seigniorage gain that results from the European act—it is essentially an interest-free loan forever of that amount of money—$50 billion to $100 billion can plausibly be attributed to it. Let me leave it at that.

Erkki Liikanen: I just want to comment on Ted Truman's two critical questions. He asked about the size of the country and size of the balance sheet of the bank. I think it is a serious issue. We have been very closely following Iceland. Icelandic banks have branches and subsidiaries in Finland also.

The balance sheet of Icelandic banks was 10 times bigger than the GDP of that country. So we should always remember—and everybody is learning it—that the central bank should be strong enough with its balance sheet so that it is able to do its job as the lender of last resort. That is the first point. The second is that the treasury of each country must be able to assess its capacity to act in case of a problem with solvency. And that is where the Fortis case is interesting because it was relatively big. Belgium was able to act, together with the Netherlands and Luxembourg.

The difference between a subsidiary and a branch is not only theoretical. I am in the middle of a problem at home (Finland) because three Icelandic banks are now in receivership. Two of them have subsidiaries and one has a branch in my country. I have been following Norway and Sweden. They have considered it possible to give liquidity assistance—emergency lending—to a subsidiary because that is independently supervised by the host country. But to give emergency lending to a branch is a different case. So there are concrete differences between those two structures in a crisis.

C. Fred Bergsten: Let me close with two empirical and hopefully not very provocative points. Peter rightly noted the distinction between the private or vehicle use of a currency and its reserve currency use. Historically, there has been a pretty high correlation between those two uses. I do not think there is a strong theoretical reason for that, although some logic links the two. But they have always been parallel. So whereas I think you are conceptually right, I do not think it leads to a big difference in terms of one's judgment on the impact of the international role of your currency—if you get one, you get the other, and you have to look at them as a package.

The other is on Larry's point about the gains from seigniorage. If you are right, Larry, that the gains are as much as $50 billion to $100 billion for the European Union by issuing those mafia-friendly notes, it still does not necessarily swamp the other effects of the international role of your currency. It depends on the answer to the question Leszek and I posed earlier, the extent to which the international role of your currency has an important measurable impact on your domestic economic outcomes.

And again, that comes back to the provocative point. If the international role of the dollar was an important factor in promoting the imbalances, promoting the huge capital inflow, promoting the low interest rates, excessively easy monetary policy, and promoting the mispricing of risk, then the quantitative implications could swamp any seigniorage gain or loss. Now that is an if, because we have a lot of controversy over that analytical linkage. But those kinds of comparisons would have to be made because there is no definitive answer. It would have to be part of the equation as to whether you thought it was a good thing or not such a good thing for your currency to play a big global role.

Adam S. Posen: Five years ago, we held a conference at the Institute and I edited the volume on the euro at five, then also with the support of the European Commission. Euro skepticism in the United States remained a significant factor at the time, and we had to sell the idea that the euro was succeeding. Five years later, that is no longer the issue.

Let us hope that this conference and everyone's participation draws a line on the Europhobe nonsense that existed for too long in the United States, even though we can continue to debate about what it means going forward.