The Role of US and EU Financial Markets in the Global Economy

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It is a pleasure to participate in this conference on a hardy perennial topic: the Euro, the dollar, and the global economy and financial system. Characterization of the focus of this conference as a hardy perennial does not mean it is a weed. The topic is complex, but often contentious and controversial. My aim today is to be neither. I hope to be a bit provocative but also to offer some constructive suggestions. I first make a few contextual comments. I then turn to three interrelated topics, proceeding from the general to the specific: IMF reform; the euro, the dollar, and reserve diversification; and cooperation on anti-money laundering.

The United States and Europe have huge stakes and responsibilities in the stability of the international economy and financial system. How their authorities manage their economies and develop their financial systems are key. The challenge is to promote healthy, and to minimize unhealthy, competition between the euro and the dollar and their associated financial systems and economies.

We have heard a lot at this conference about the high degree of integration that already exists between our two economies. We have also heard ideas about how that integration should be strengthened and deepened. Others are more expert than I am about how to encourage further progress. What I know is that we have a shared interest in promoting financial integration between our economies. We also should have a shared concern about financial protectionism and nationalism. Successful resistance to those forces is crucial to the health of our increasingly open economies as well as the global system.

Touching briefly on the subject matter of the first session – macroeconomic developments – I am discouraged by the announcements in Washington over the weekend. True, the global economy appears to be poised to extend until 2008, if not beyond, its string of annual growth rates in excess of 4 percent, but we know that all good things come to an end. It is gratifying that the incidence of financial crises has been sharply reduced, but we know that financial crises have not been abolished. It also is true that the dollar has depreciated by 15 percent in real effective terms over five years, and the effects of that depreciation on the US external position are beginning to be recorded in the context of slower US growth and a cyclical improvement in our fiscal position.

However, the basis for self-congratulation is limited. The document released on Saturday at the conclusion of the IMF's multilateral consultation on global imbalances conveyed no urgency or sense of risk, perhaps because the official view now is that there is none. The document contained no new policy commitments, in particular from the United States on our national saving and fiscal position. It essentially ignored the role of exchange rates in the adjustment process; however, we know that if there is to be a substantial adjustment of global imbalances – not just the US deficit but also the oversized surpluses elsewhere – substantial real effective exchange rate changes for the Chinese yuan, the Japanese yen, and other currencies will be part of the process.

Contrary to the European position, European policies and postures are part of the problem of global imbalances. Europe will be and should be part of the solution in one way or another regardless of whether it adopts "growth enhancing reforms." In my view, Europe's parochialism on this issue is unfortunate.

These concerns are linked to my first topic: IMF reform. The IMF was the shared product of US-European cooperation more than 60 years ago. Europe and the United States labored continuously together to strengthen the Fund as the promoter of global growth and international financial stability until about a decade ago with the falling out over the Mexican program and other subsequent strategic disagreements.

Today, the IMF is faced with a crisis of legitimacy and relevance. To this informed, but now outside, observer, it would appear on balance that the United States does not care much about IMF reform, and Europe does not care at all. These are summary impressions of the views of the respective authorities. In the European case, those authorities and their views are widely dispersed, which is part of the challenge.

What needs to be done is clear. The United States and Europe should publicly renounce their sole claim to leadership of the Bretton Woods twins, which the European Union, to its credit, hinted at on Saturday. Representation on IMF executive board (and the World Bank's as well) needs to be reconfigured away from the traditional industrial countries toward the emerging market and other developing countries.

Finally, voting shares in the Fund, in particular, need to be substantially realigned to reflect the changing economic and financial weight of other countries in the global economy. The realignment should produce a significant reduction in the combined share of the so-called advanced countries; my test would be a shift of 10 percentage points. This task is not easy. Realignments among the industrial as well as the non-industrial members of the Fund are required, and the overall size of the Fund will have to increase by at least 50 percent.

Last September, Europe and the United States supported a first step in this direction and agreed to ad hoc increases in the quotas of four members. A second step was outlined to be completed by September 2008. However, without the second step, the entire exercise will be a meaningless Band-Aid. Statements at the recent IMFC meeting were not encouraging.

The issue of IMF legitimacy is closely linked to globalization and financial markets. On the one hand, we rely on the Fund to promote adherence to best practices in the interests of financial stability. On the other hand, IMF legitimacy is about China, India, Brazil, South Africa, Korea and many other countries playing responsible roles in management of the global economy and financial system, starting at home. In a globalized world, the robustness of financial systems in Europe and the United States are not immune to weaknesses elsewhere. Europe and the United States have a common interest in getting IMF governance reform right. I think this is agreed. What is lacking is strong political leadership on both sides of the Atlantic.

When it comes to my second topic, the international roles of the euro and the US dollar, there may be less agreement between Europe and the United States though I would submit that there should be substantial common ground. Differences in perspective are an understandable by-product of post-World War II economic and financial history. The US dollar was the n-th currency in the Bretton Woods world, and it still is today. As such, the United States has not had a choice about the international role of the dollar – come rain or come shine – aside from endeavoring to promote a vibrant, resilient and open economy and financial system.

In Europe, before and since the advent of the euro, one senses ambivalence. The official position of the European Central Bank is not actively to seek to promote the euro's international role. At the same time research reports from the ECB are couched in the language of competition with the US dollar. European as well as US academics actively participate in conferences, often under official sponsorship, designed to keep score. This is like inviting two other people to fight! Officials know better, but they are not immune to cheer leading.

Europe and the United States have a shared responsibility here as elsewhere. At least 80 percent, and in some areas more than 90 percent, of international financial instruments are denominated in either the euro or the dollar: bonds, bank loans and deposits, foreign exchange reserves. In 2004, the two currencies were involved in 63 percent of all turnover on foreign exchange markets – spot, forward and swaps. These aggregate figures are more relevant to the future evolution of the international financial system than are their respective shares.

From the introduction of the euro in 1999 to the end of 2006, the value share of the dollar in all recorded foreign exchange holdings declined by 6.4 percentage points, while the quantity share declined 3.2 percentage points.[1] Over the same period, the dollar's shares in the recorded holdings of developing countries declined by 10.6 and 7.6 percentage points respectively. In all measures, the euro's shares increased by more than the dollar's shares declined. Is this evidence of competition or shared responsibility? In my view, the latter.

To the extent that international reserve diversification poses a potential threat to the stability of the international financial system, and arguments can be made on both sides of this issue, both European and US officials should be concerned. Rather than being cheerleaders for a rise in their currency's share, or bemoaning a decline, they should jointly promote greater transparency and accountability in the management of foreign exchange reserves.

[1] The underlying data are from International Monetary Fund, Currency Composition of Official Foreign Exchange Reserves (COFER). Changes in value shares reflect the effects of changes in exchange rates while changes in quantity shares are a better measure of actual reserve diversification. See Edwin M. Truman and Anna Wong (2006), *The Case for an International Reserve Diversification Standard*, Peterson Institute for International Economics Working Paper 06-2.

Today at least 26 holders of foreign exchange reserves disclose the currency composition of their holdings at least once a year. They include the United States, the ECB, four other countries in the euro area, and six other members of the European Union.[2]

My suggestion is that all EU members should follow the disclosure example of the 10 member countries and the ECB. With the United States, they should actively encourage other large holders to do the same. They should start with Japan the currency composition of whose reserves can be deduced roughly from information already available. China would be next!

Turning finally to cooperation on anti-money laundering and a micro aspect of the currency diversification issue, the euro and the US dollar circulate extensively as physical currencies outside the borders of the euro area and the United States. A minimum estimate for the dollar is 50 percent or almost $400 billion (as of the end of 2006), and a corresponding estimate for the euro is 20 percent or more than $150 billion.[3]

It is relevant that the maximum currency unit for the dollar is the $100 note, accounting for 72 percent of all US currency outstanding. The maximum unit for the euro is the €500 note, but there are also €200 as well as €100 notes. At the end of 2006, these three denominations accounted for 56 percent of all euro currency outstanding. It is widely agreed in law enforcement circles that the vast majority of large denomination bills are linked to tax evasion or other illicit purposes, domestic and internationally. Their continued circulation facilitates criminal activity.

You can see where I am going! I suggest that the United States and the euro area agree to stop producing currency in denominations above 50. As some may know, before the introduction of the euro, the United States protested the European decision to produce €500 euro notes on law-enforcement grounds though the suspicion was that the United States was concerned about a loss of seigniorage.

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[2] In addition to the ECB, the disclosers are Finland, Germany, Italy, Latvia, Lithuania, Romania, the Slovak Republic, Slovenia, Sweden, and the United Kindom.

[3] At the end of 2006, $830 billion in euro currency and $780 in US currency was outstanding. At 5 percent, the two economies earned an estimated $8 billion and $12 billion in seigniorage from the circulation of their currencies outside their borders.

What I am proposing is joint effort in law enforcement cooperation and against money laundering. At a seigniorage rate of 5 percent the United States would over time lose $28 billion to the extent that worn out bills were not replaced with smaller bills. The euro area would lose $23 billion. They both would make up some of the postulated loss from seigniorage on increased use of smaller bills and, one would hope, increased tax receipts to the extent that untaxed activity in the underground economy is reduced.

I understand that in Europe law-abiding citizens more often use large-denomination bills. They would face the modest inconvenience of fatter wallets. A similar objection could be voiced about the use of the dollar and euro to facilitate remittances, but those transactions are measured in the hundreds of dollars not in the hundred thousands of dollars. In my view, there are substantial net benefits from Europe and the United States working together in this area.

My basic message is the same on all three topics that I have discussed: Europe and the United States have a shared interest in active collaboration to strengthen the global financial system. I believe this emphasis on the benefits of cooperation between the euro and the dollar is consistent with the overall theme of this conference.

Thank you.