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Remarks
The Euro: Global Implications and Relevance for Latin America
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I have been an observer of the "European Integration Project" for more than 40 years. I wrote my Ph.D. dissertation on trade creation and trade diversion in the European Common Market under Robert Triffin and Richard Cooper. I often have been struck by what I regard as an unhealthy preoccupation of Europeans to measure progress on their project relative to the economic significance of the United States and the U.S. dollar. As a result, they have often missed the larger picture with adverse effects on Latin America and the rest of the world.

From the beginning, the rest of the world has focused on whether the new Europe would be inward looking. I know of no definitive study that has reached an overall conclusion on this basic question. One reason, no doubt, is that the European Project is incomplete. Today it appears to be more undefined and controversial within Europe itself than it was twenty years ago.

If compelled to render a judgment, I would do so in the tradition of the two-handed economists. On the one hand, Europe has achieved a high degree of economic prosperity and stability. Unlike the period between the two World Wars and the first 25 years after World War II, Europe is no longer a source of global economic and financial instability. In this, Europe has set an excellent example for Latin America and other regions of the world.

On the other hand, at least in the area of international monetary institutions, Europe has become increasingly indifferent to the needs of the global financial system and insular in its outlook on international financial problems. In my experience, more often than not the official position of European leaders has favored the status quo, for example, in their prolonged preoccupation with fixed exchange rates starting in the early 1970s when a large majority of European leaders favored a return to greater exchange rate fixity and extending into the 1990s when Europeans blocked international discussion of alternative exchange rates regimes to the detriment of Latin American countries like Mexico and Brazil. Today, many European authorities appear to favor closing down the International Monetary Fund (IMF) as a meaningful international lending institution and most favor blocking meaningful reform of the Fund's governance structure. If they succeed it will be to the detriment of the international financial system and of regions such as Latin America that see a positive role for the Fund and seek an enhanced voice in the institution.

In these remarks, I discuss two aspects of these issues: (1) The international role of the Euro and the related international implications of Eurozone macroeconomic policies, and (2) The European threat to meaningful reform of IMF governance.

The Euro and European Economic Policy

The official position of European authorities is neither to encourage nor to discourage the development of the euro as an international currency. However, it is difficult to square this position with the frequent studies by the European Central Bank and the European Commission on the role of the euro in the global economy. For example, preoccupation with the euro's international role recently surfaced in the context of sovereign wealth funds. A document released by the Commission stated "Another contribution [from sovereign wealth funds] of potential relevance for the EU is the importance of their investments for the international role of the euro."[1]

I find this type of preoccupation remarkable and depressing 35 years after the de facto end of the Bretton Woods system in March 1973 and an end of any coordinated role for the official sector in financing the balance of payments of industrial countries. Despite these facts, European officials and academics continue to believe that the international role of the dollar provides special advantages to the United States. One would have thought that the term "exorbitant privilege" would have passed from the lexicon with the death of Charles de Gaulle in 1970. The size and strength of a nation's economy has international economic and financial implications, but the suggestion that those implications are predominantly the result of political power rather than market forces strikes me as a distorted perspective. I see the international role of the dollar on balance is a constraint on U.S. economic policy rather than an opportunity that yields net positive benefits or can be exploited to do so.

Nevertheless, some like to keep score on the euro and the dollar as international currencies. Perhaps, they think the winner should be awarded a World Cup filled with economic and financial benefits. Such scorekeeping is nonsense in particular as it pertains to the currency composition of countries' holdings of foreign exchange and the threat associated with an overhang of official holdings. Today, the public sector, as well

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[1] European Commission, "Sovereign Wealth Funds – Frequently Asked Questions," MEMO/08/126, February 27, 2008. It is possible that the Commission was expressing concern about the potential for sovereign wealth funds to make the euro too popular, but somehow I doubt it.

as the private sector, is unconstrained in the currency composition of their portfolios. Moreover, the evidence is that portfolio shares have been remarkably stable.

In my view, the best indicator of the behavior of official holdings of foreign exchange comes from reports of their holdings to the IMF by developing countries. This group of countries includes all except the traditional industrial countries.[2] These data indicate that by the end of the third quarter of 2007 the dollar's share had declined by 10.8 percentage points in value terms from the first quarter of 1999 when the euro was introduced. This measure incorporates the influence of changes in exchange rates on the value of existing holdings. Abstracting from the effects of such changes in exchange rates, the dollar's quantity share has declined by only 6.8 percentage points over eight and half years – less than eight tenths of a percentage point per year and hardly a rout.

Over the entire period, the euro's value share rose by 10.7 percentage points and its quantity share rose by 6.9 percentage points. However, what is instructive is that the bulk of the decline in the dollar's quantity share and the rise in the euro's quantity share – more than 60 percent of the total -- was in the first three years of the euro's existence, in other words, through the first quarter of 2002 when the U.S. peaked in real effective terms. During this period, the euro initially declined against the dollar and subsequently recovered to about the same level in nominal terms as when the euro was introduced. Moreover, the remainder of the rise in the euro's quantity share was completed by the end of the second quarter of 2004. Since then the euro's share was unchanged, while the dollar's share declined slightly, the yen's share declined significantly, and the share of

[2] The data now include a declining proportion, now about half, of total foreign exchange holdings of developing countries. However, China is a non-reporter and the share of the dollar in its foreign exchange holdings is widely believed to be more than the 60 percent for the average of all reporters. Moreover, many transition countries in central and eastern Europe are included, which introduces an upward bias to the euro's recorded share.

pound sterling and all other currencies as a group increased significantly. All this while the dollar has declined a further 15 percent against the euro.

The dollar's share in the foreign exchange holdings of developing countries is about twice that of the euro. The dollar's share in all foreign exchange transactions, as reported in the triennial turnover survey, is more than twice that of the euro. At the same time, some other measures of the private use of the euro suggest that its share is larger than that of the U.S. dollar. However, I know of no evidence that the euro is used with any frequency in transactions that do not involve at least one participant from a euro-area or European Union country as one of the parties or location for the transaction. To my knowledge, the euro is not used to invoice trade within Latin America. Euro-denominated bonds are not issued in New York. It is somewhat ironic that a non-Euro Area financial center, London, dominates trading in euro-denominated international securities.

The one case of the use of the euro without any connection to the European Union may be with respect illegal transactions, such as tax evasion, where the higher denomination of euro notes (five hundred and two hundred as compared with only one hundred for the dollar) gives the euro a technical comparative advantage. If Europeans take pride in this so-called supremacy, especially in light of recent revelations about banks in Liechtenstein, more power to them. However, I noted in the most recent (September 2006) poll of the attitudes of Euro Area residents toward their currency that less than a majority and only a narrow plurality of respondents thought that adoption of the euro had been advantageous.[3] Moreover, only 27 percent of those respondents, 13

[3] European Commission. 2006. "The Eurozone, 5 Years after the Introduction of the Common Currency." Flash Eurobarometer 193. http://ec.europa.eu/public_opinion/flash/fl193_en.pdf

percent of the total, felt that the introduction of the euro had reinforced the place of Europe in the world. One is forced to conclude that sensible citizens have reached the judgment that the policies and performance of the Euro Area economies are more relevant to their futures than the fact of their common currency.

Turning to Eurozone economic policies, I will limit myself to three observations.

First, it is striking how preoccupied European policymakers are with the euro's exchange rate with the U.S. dollar. Moreover, to the shame of economists, policymakers and the general public appear be fixated on that exchange rate rather than the economically more relevant real effective exchange rate for the euro. It is true that through the end of January 2008 the euro had appreciated 72 percent against the U.S. dollar in nominal terms since the dollar's overall peak in February 2002, but the appreciation had been only 25 percent since the introduction of the euro in January 1999. Moreover, the real effective appreciation of the euro was only 25 percent since the dollar's peak and 5 percent since the euro's introduction.[4]

From the perspective of the implications of the euro for the international economy, what is relevant is not how much the euro appreciates or depreciates or even the effects of that appreciation or depreciation on the Euro Area economy. What is relevant is that Euro Area policymakers and the general public are too preoccupied with this topic. If the euro is to become a truly international currency, then the citizens of the Euro Area will have to get used to the fact that movements in their currency's exchange rates are beyond the direct influence of Euro Area policies. Moreover, more likely than not they will have to live with a somewhat "overvalued" currency and consequent trade

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[4] The data on the euro's broad real effective exchange rates are from the Bank for International Settlements http://www.bis.org/statistics/eer/index.htm

and current account deficits for the Eurozone as a whole. This is the central lesson from the history of the dollar over the entire post-World War II period and in particular since the final demise of the Bretton Woods exchange rate system in 1973.[5]

Second, if the euro is to become a truly international currency, then Euro Area policymakers will have to take the implications of their policies for the health of the global economy much more seriously than is the case today. It is fine for the European Central Bank to focus narrowly on price stability in the Euro Area and to examine the implications of their policy choices trough that lens. However, as they do so, others can reasonably call into question whether those choices are the best ones for the global economy. Dating back to the days of the Bundesbank, the persistent European pattern has been to lag behind the United States and the rest of the world in adopting counter-cyclical economic policies. The result has been that first Germany, and now the Euro Area, subsequently benefits from export-led recoveries, in effect free riding on the macroeconomic policies of the rest of the world. This may have been optimal for those economies, but it has been less than optimal for the world as a whole.

Third, one major economic policy challenge facing Euro Area policymakers today is that, as noted earlier, the European Project is incomplete. Aside from monetary policy, it remains difficult to characterize Euro Area macroeconomic policy because there is no policy. Thus, the challenge for the euro as an international currency is whether such a currency can successfully and positively be sustained in today's world, where the gold standard as a source of price stability has long since been abandoned, without an

[5] See Edwin M. Truman. 2006. What Can Exchange Rates Tell Us? In *C. Fred Bergsten and the World Economy*, ed. Michael Mussa. Washington: Peterson Institute for International Economics.

accompanying full set of coherent economic policies. I remain as skeptical as I was before the introduction of the Euro in 1999.[6]

The European Threat to IMF Reform

The incomplete European Project also has potential adverse consequences for the reform of international financial institutions, in particular the International Monetary Fund. There is no mechanism within Europe to force a progressive, outward looking vision of the role of the Fund in the global economy and international financial system. The result is that most of the leaders of the sovereign nations of Europe pursue narrow national interests having more to do with their own status and with preserving the status quo than with the general good. Within the non-official community, and more rarely within the official sector in Europe, are some exceptions to this generalization.

IMF Managing Director Dominique Strauss-Kahn recognizes that the Fund faces twin crises of relevance and legitimacy, but I have seen scant evidence of any supporting sense of urgency on the part of most European leaders. I am no longer privy to views expressed in closed deliberations, such as the meeting of the G-20 deputies that has just been held here in São Paulo, and I hope I am mistaken in my observations as an outsider. However, my overwhelming impression is that the European objective is to embrace a minimalist outcome from the IMF reform discussions that have been ongoing for more than three years and are supposed to reach a conclusion next month in Washington, or at the latest by the time of the annual meetings in mid-October.

The central issue facing Europe and the other traditional industrial countries is how rapidly they are willing to share leadership and responsibility for global growth and

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[6] See Edwin M. Truman. 1997. Remarks at Roundtable on Lessons of European Monetary Integration for the International Monetary System. In *EMU and the International Monetary System*, ed. Paul R. Masson, Thomas H. Krueger, and Bart G. Turtleboom. Washington: International Monetary Fund.

financial stability with other members of the IMF. How long will they seek to perpetuate the status quo of European dominance over the IMF? In my view, in the absence of definitive evidence within the next few months that Europe has adopted a change of course, the IMF will go into eclipse as an institution of global economic and financial governance. Many in Europe may respond to such a prospect with an expression of good riddance to the IMF. They think Europe does not need the Fund. They not approve of the job that the IMF has been doing over the past fifteen years. Europe is all that matters. Those Europeans who hold these views are mistaken. An IMF that is much reduced in authority and its capacity to meet the challenges of global economic and financial integration will adversely effect all countries.

As most informed observers know, the IMF faces three immediate governance issues: (1) Will the Fund adopt a new quota formula that points decisively in the direction of redistributing voting power away from Europe and other industrial countries and toward emerging market countries and other developing countries? (2) Once adopted, will that formula be used immediately, along with a meaningful boost in basic votes, to implement a substantial redistribution in voting power within the Fund? (3) Will Europeans give up their stranglehold on representation in the IMF executive board? My perceptions of European views on each of these issues follow.

First, with respect to the quota formula, Europeans have accepted giving a higher weight than at present to GDP, but they have resisted giving much weight to GDP measured on a purchasing power basis rather than at market prices and exchange rates. They have insisted upon inclusion of international trade in the formula with a significant weight despite the fact that the economic case for including such a variable is nugatory and the result of doing so would be biased transparently in favor of smaller industrialized economies, in particular within Europe.[7] For the same reason, they have opposed the exclusion of intra-Euro Area trade from measures of this highly questionable variable. Finally, Europeans have embraced the introduction into the formula of devices such as compression factors that reduce the quotas for a few large countries.[8]

The net result of these tactics so far has been to produce a formula that if directly applied would result in a distribution of IMF quotas that is more advantageous to Europe and other industrial countries than the current actual distribution of IMF quotas. Some argue that a revised, transparent quota formula that points in the direction of significantly redistributing IMF quotas and voting power away from the industrial countries can not be devised. That is not true. Among others, my friend and former colleague, Ralph Bryant, and I separately have advanced several alternative ways to accomplish meaningful reform of the quota formula.[9]

With respect to the second issue, implementation of the new quota formula, even Europeans understand that they cannot support the use of the new formula as currently proposed. Thus, they reportedly favor setting aside the new formula, completely undermining that portion of the reform agenda, and instead prefer to embrace gimmicks

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[7] See Richard N. Cooper and Edwin M. Truman. 2007. The IMF Quota Formula: Linchpin of Fund Reform. *Policy Briefs in International Economics* 07-01. Washington: Peterson Institute for Internaional Economics.

[8] The European Central Bank has published a paper on the new quota formula that exquisitely illustrates European sophistry by limiting the discussion to a narrow range of issues while completely dismissing other points of view. The paper reasons backward from the European position of no substantial change in the status quo. Martin Skala, Christian Thimann, and Regine Wolfinger. 2007. The Search for Columbus's Egg: Finding a New Formula to Determine Quotas at the IMF. *European Central Bank Occasional Paper Series* No. 70 (August). Frankfurt: European Central Bank.

[9] See Ralph C. Bryant, "Reform of Quota and Voting Shares in the International Monetary Fund; 'Nothing" Is Temporarily Preferable to an Inadequate 'Something." Washington: Brookings Institution (January 2008). For two of my own proposals, see Cooper and Truman cited above and Edwin M.Truman. 2006. Rearranging Chairs and Shares: the Sine Qua Non of IMF Reform. In Edwin M. Truman ed. *Reforming the IMF for the 21st Century*. Special Report 19. Washington: Peterson Institute for International Economics.

to bring about a very limited further adjustment in the quotas of a small group of countries.

An additional problem is that if the cumulative size of the increase in quotas is limited to less than 12-1/2 percent, as favored by Europeans, even if it is combined with a tripling or more of basic votes, the result will not produce a "significant further realignment of members' quotas" in line with their "relative positions in the world economy" as called for in the Singapore resolution. The reason is that a substantial proportion of the total increase would and should go to under-represented industrial countries and to sustain the relative positions of other industrial countries. To achieve the type of realignment in voting power called for in the Singapore resolution will require increase in total quotas of at least 25 percent using a credible formula, and more likely 50 percent. To this Europeans reply, the IMF has plenty of liquidity and there is no need to increase the size of the Fund substantially at this time especially if doing so would accelerate the decline in Europe's voting share in the Fund.

In my view, each member of the Fund should receive some increase in its quota at this time. It is true that the Fund's liquidity is at an all time high, but that is not the only consideration. It is unwise and unfair to base the amounts that countries inevitably will need to borrow from the Fund over the next five years on the size of their quotas that were set a full decade ago. If a general increase in IMF quotas were postponed for another five years, to the end of the current review period, it would be longest such stretch in the history of the Fund and would help to harden further the resolve of the anti-globalization forces within all countries.

Turning to the third issue – representation on the IMF executive board – the European position has been that this issue is not on the reform agenda. Presently, representatives from the 27 traditional advanced countries, not counting Russia, occupy at least half the seats. At a minimum, representatives from members of the European Union occupy 7 seats. Everyone knows what needs to be done to break this logjam: dramatic consolidation of European representation. I commend U.S. Treasury Under Secretary David McCormick for recently putting the issue of representation on the executive board squarely back on the table along with a call for reducing the bloated financial cost of IMF governance.[10] It may well be that the executive board is too large, but its size cannot be reduced without dramatic changes in representation.

What explains the lack of constructive European leadership on these three aspects of IMF governance? In my view there are two basic explanations. First, the larger countries in Europe, which want to preserve their relative positions in the IMF pecking order, are in an unholy alliance with the smaller countries in Europe, which want to preserve the careers of their nationals on the executive board. Second, and more serious, is a lack of appreciation of the urgency of the issue. The urgency of the issue derives from the fact that without a credible agreement on IMF quotas implementing the 2006 Singapore Resolution the financial structure of the Fund cannot be successfully addressed because the latter subject is bound into one overall political package. If there are further significant delays in addressing the Fund's financial structure, the institution, including the morale of its dedicated staff, will be weakened. As a result when Europeans next

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[10] David McCormick, "IMF Reform: Meeting the Challenges of Today's Global Economy,." Remarks at the Peterson Institute for International Economics, March 25, 2007.

decide a global solution is needed to address a global issue, the capacity of the Fund to play its appropriate role will have been reduced.

A current example is provided by international discussions about the development of a code of conduct for sovereign wealth funds. The European Commission recently lent its strong support to the IMF-sponsored dialogue aimed at developing such a code of conduct.[11] Unfortunately, prospects for the IMF management and staff successfully to reach a consensus on such a code with the sponsoring authorities are undercut by European intransigence on IMF governance issues. The growth of sovereign wealth funds reflects a dramatic redistribution of international wealth from traditional industrial countries like the United States and countries in Europe to countries that historically have not been major players in international finance and have had little or no role in shaping the practices, norms, and conventions governing the international financial system. Countries with sovereign wealth funds do not want to continue to be second-class guests in a European-dominated club.

The lack of progress on IMF governance reform is not the fault of the euro. However, it may be the fault of European leaders who have become fixated on touting the increased role of their currency in the international financial system and consequently have ignored more important issues that are likely to have a profound influence on the stability of that system. As a consequence, the implications to date of European Monetary Union for Latin America and the rest of the world have been decidedly negative.

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[11] European Commission, "Commission Puts Forward Proposals to the European Council on Sovereign Wealth Funds and Financial Stability," IP/08/313, February 27, 2008.