

Weak dollar, strong euro?

**The international
impact of EMU**

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ABOUT THE AUTHOR

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Contents

About the author

Acknowledgements

I. The new global currency	1
II. The benign neglect of the global impact of EMU	5
III. Key currency criteria and the euro	7
IV. The transition period	17
V. A note on the yen	25
VI. The pre-transition period	29
VII. The implications for policy co-operation	31

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Price Waterhouse is delighted to sponsor this CER paper on the international impact of EMU. For too long businesses have either underestimated or ignored EMU's impact beyond the technical details.

Fred Bergsten's paper challenges our myopia. He raises our eyes to the longer term, structural effects the euro may make to the international financial system and exchange rates. The euro could challenge the dollar as the world's major reserve currency (not an unalloyed blessing for the EU). The euro will also lead to a demand for a greater rebalancing of economic power in fora such as the IMF and OECD.

Above all, this paper alerts business leaders and governments to the management of the dollar:euro exchange rate. Businesses may find that exchange rate stability within Europe is achieved at the cost of increased instability outside it. It is therefore critical now that government and business prepare policies and strategies to ensure a smooth birth of the euro and a stable international trading environment.

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I. The new global currency

The creation of the euro will be the most important development in the evolution of the international monetary system since the widespread adoption of flexible exchange rates in the early 1970s. It will almost certainly be the most important development for the monetary dimension of the system since the dollar became the world's top currency.

1. SHARE OF WORLD OUTPUT AND TRADE % (1995)		
	<i>Output</i>	<i>Trade*</i>
United States	26.7	18.3
European Union	30.8	20.4
"Core" EU**	18.4	18.9
Germany	8.9	12.4
Japan	21.0	10.3

* Goods and services, excluding intra-EU trade
** excluding UK, Denmark, Sweden, Greece

SOURCE: UNCTAD, WORLD BANK, WTO

A successful euro based on a consolidated European capital market is virtually certain to become the first real competitor to the dollar since it surpassed sterling as the dominant currency about 65 years ago. At a minimum, the euro will become the world's second key currency with a role far greater than that of the DM. A bipolar currency regime, with Japan as an important but far less significant player, will replace the dollar-dominated system that has prevailed for over half a century.

The European Union, as a group, accounts for about 31 per cent of world output and 20 per cent of world trade (excluding intra-EU transactions). The United States provides about 27 per cent of global production and 18 per cent of world trade (see table). Yet the dollar maintains a share of global financial transactions (40 to 60 per cent,

depending on the category of transactions and whether intra-EU holdings are excluded, see Section III and Table 7) that is considerably larger than the combined total of the European national currencies (about 10 to 40 per cent) and three to four times that of the only European currency (the DM, less than 10 to 20 per cent) that is now used globally. Incumbency advantages and inertia are powerful forces in international finance, and sterling preserved a global role far in excess of the strength of the British economy for half a century. A sharp reduction, and perhaps eventual elimination, of this gap is nevertheless highly likely—perhaps to a position of about 40 per cent each for the dollar and the euro, with about 20 per cent remaining for the yen and a few minor currencies.

Even if EMU comprised only half a dozen “core countries”, for example Benelux, France, Germany and Austria, it would still constitute an economy about two-thirds the size of the United States and almost as large as Japan, with global trade exceeding that of the United States. Even a closure of only half the gap between the current market share of the dollar and the individual European currencies would produce a huge swing in global financial holdings and power relationships among the major countries. Now that EMU will also include the “Club Med” countries (Italy, Portugal and Spain), the likely effect will be to accelerate realisation of the effects cited in this paper.

The euro will have substantial implications for the functioning and management of the international monetary system. Without a new EU-US agreement to limit volatility, the dollar-euro exchange rate is likely to fluctuate considerably more than have the rates between the dollar and individual European currencies in recent years—replicating or even exceeding the sharp dollar-yen fluctuations that have marked the entire era of floating rates. There will probably be a huge portfolio diversification of \$500 billion to \$1 trillion into euros, mainly out of the dollar, that will have a significant impact on exchange rates throughout a longish transition period. The positioning of Europeans in the pre-transition period, to prepare for the subsequent appreciation of the euro without undermining their competitive positions, could produce a further substantial weakening of European currencies over the next year or so that will raise major problems for the United States and perhaps others. The creation of the euro will thus raise a series of key policy issues for the IMF, G-7 and other international financial bodies over both the short

and longer runs that will require intensive consultation and resolution.

On the institutional side, the new European Central Bank (ECB) should increasingly represent Europe in international monetary discussions and negotiations. This will pave the way for converting the G-7/G-10 into a G-3, initially in the Bank for International Settlements (BIS) and other central banking fora but, as fiscal and other policies become Europeanised, in the finance ministers' context as well. A similar consolidation should take place in European representation in the IMF and the other multilateral financial institutions.

This paper will attempt to analyse the implications of EMU for the world economy. Section II provides a brief discussion of the state of the international debate of these issues. Section III presents the criteria required for key currency status and applies the model to the euro in an effort to forecast its global role in the eventual system that will emerge. Section IV addresses the longish transition period to that "steady state". Section V draws a number of implications for the pre-transition period, ie, the remainder of 1998. After a short comment on the yen in section VI, Section VII lays out a series of questions for international policy cooperation that derive from the analysis, and suggests responses to them. This paper will divide the analysis into three distinct time periods: the long run *steady state*, when the euro is fully established as both the currency of Europe and a major international money; the *transition* period between the creation of the euro (assuming 1999) and its attainment of that steady state; and the *pre-transition period* between now and the euro's start-up. These distinctions are clear conceptually although they cannot be dated precisely in practice.

II. The benign neglect of the global impact of EMU

In sharp contrast to the extensive analyses of EMU itself, there has been surprisingly little official or even private discussion of its international implications. The initial blueprints, the reports of the Delors Committee (1989) and the Committee of European Central Banks (the Pöhl report), completely ignored the topic. In 1991 the European Commission belatedly produced a chapter on the subject in *One Market, One Money*¹ but there has been little subsequent discussion even within Europe itself except for a very general view that EMU will enhance Europe's global influence. The work programme of the European Monetary Institute on EMU, which is supposed to mobilise more than one hundred task forces, has reportedly been slow to take up its external dimension. Some outside observers have interpreted this European neglect of the topic as further evidence of Europe's inward-looking—and even “fortress Europe”—mentality.

¹ Emerson et al. *Oxford University Press*, 1991

Non-European governments have been equally casual about the issue. The United States, Japan and others outside Europe have apparently believed either that EMU will never happen (or will happen beyond the watch of current officials); or that it will be of little international consequence, so that discussing it is a waste of time; or that it is bound to be good for the world as well as for the Europeans so there is no need to worry about the results; or that it is a purely “internal” European matter and thus solely up to the Europeans themselves (or that they will reject any outside involvement anyway). This paper will argue that all these views are incorrect.

This international neglect of EMU continues the neglect of European developments that has characterised the G-7 and the IMF in recent years. Developments in the European Monetary System, ranging from German unification through the currency crises of 1992-93 and the conversion of the narrow-band system into a regime of very wide target zones in

response to the latter, have had major global consequences. The G-7's failure even to discuss them is one striking indicator of its sharp decline.

² Bergsten & Henning. *Global Economic Leadership and the G7. Institute for International Economics*, 1996.

It is a telling example of the “non-aggression pact” that has emerged within the G-7, under which each participant largely eschews criticism of its peers in order to forestall criticism of its own policies—even when events emanating elsewhere have a substantial impact on the “silent partners” and the global system, for which the G-7 is supposed to provide leadership.²

The result of this neglect (with the exception of analyses by, for example, Alogoskoufis and Portes [*European Monetary Union & International Currencies in a Tripolar World* in Matthews B *et al*, *Establishing a Central Bank*, CUP, 1992], Cooper [*Will an EC Currency Harm Outsiders?* *Orbis* 36.4], Gros and Thygesen [*European Monetary Integration* St Martin's Press, 1992], Henning [*Europe's Monetary Union and the United States*, Foreign Policy 102] and Kenen [*Economic and Monetary Union in Europe: Moving Beyond Maastricht* CUP, 1995]) is that there has been relatively little consideration of (1) how EMU will affect the international monetary system, (2) the policy issues that will be raised as a result and (3) how the international community, particularly through the IMF and G-7, should respond.

III. Key currency criteria and the euro

The central systemic issue is the global role that the euro will play, most importantly in private global financial markets but also as an official reserve asset. There are nuanced differences between the criteria for the two (transactions currency and reserve currency) roles but I suggest five central considerations for both:

- ★ the size of the underlying economy and its global trade;
- ★ the economy's independence from external constraints;
- ★ avoidance of exchange controls;
- ★ the breadth, depth and liquidity of its capital markets;

2. ECONOMIC GROWTH IN THE EUROPEAN UNION AND UNITED STATES % (1986-1996)

	<i>EU 15</i>	<i>US</i>
1986	2.8	2.9
1987	2.9	3.1
1988	4.1	3.9
1989	3.5	2.5
1990	3.0	0.8
1991	1.6	-1.2
1992	1.0	3.3
1993	-0.8	2.4
1994	2.5	3.3
1995	2.3	2.0
1996	1.6	2.4

SOURCE: IMF, INTERNATIONAL FINANCIAL STATISTICS

★ the strength and stability of the economy and its external position.

The European Union is slightly superior to the United States on the first two structural criteria. The EU's gross domestic product (GDP) in 1996 was \$8.4 trillion, compared with \$7.2 trillion in the United States. The United States has been growing more rapidly for several years and may continue to do so in the period immediately ahead (see Table 2, previous page). In the long run, however, potential growth of output in the two

3. ECONOMIC OPENNESS* RATIOS: EU AND US, 1971-1995 % (1995)

	<i>EU</i>	<i>US</i>
1971	18.4	10.7
1972	17.9	11.2
1973	19.2	13.2
1974	24.8	16.8
1975	23.3	15.8
1976	24.5	16.5
1977	24.8	16.8
1978	23.5	17.3
1979	23.8	18.9
1980	25.9	20.8
1981	27.7	19.9
1982	26.7	18.2
1983	25.8	17.3
1984	27.4	18.3
1985	27.2	17.3
1986	21.9	17.8
1987	20.7	18.7
1988	20.6	19.9
1989	21.3	20.4
1990	20.5	20.9
1991	19.6	20.8
1992	18.9	20.4
1993	21.1	20.7
1994	22.3	21.6
1995	22.5	23.1

* "Economic Openness" is defined as exports plus imports of goods and services divided by GDP. The share of intra-EU trade in services is assumed to be the same as for goods.

SOURCE: IMF, INTERNATIONAL FINANCIAL STATISTICS. IMF, DIRECTION OF TRADE AND STATISTICS. OECD, NATIONAL ACCOUNTS.

regions is similar, so their rough parity in terms of economic weight is likely to continue.

The European Union also has a modestly larger volume of global trade flows. Excluding intra-EU trade, the volume of total EU trade (exports plus imports) totalled \$1.9 trillion in 1996. The comparable total for the United States was \$1.7 trillion.

In terms of openness, the share of exports plus imports of goods and services is now about 23 per cent of GDP in both the EU and the US (see Table 3, left). This ratio has doubled for the United States over the past 25 years while rising only modestly in Europe (discounting jumps in the ratio caused by the oil shocks). Both ratios are likely to continue growing slowly, as globalisation proceeds, but they too are likely to remain broadly similar. Both regions are thus fairly independent of external constraints and can manage their policies without being thrown off course by any but the most severe exogenous shocks.

It is virtually inconceivable that either the EU or the US would unilaterally resort to exchange or capital controls. The globalisation of capital markets has reached the point where all major financial centres, including Japan and many in the developing world, would have to act together to alter

4. CAPITAL MARKET INDICATORS: EU, US AND JAPAN, 1995 (\$ BILLION)

	<i>EU</i>	<i>US</i>	<i>Japan</i>
Total Equity Capitalization	2828	5136	3000
Domestic Debt Capitalization	5314*	10725	4958
Domestic Equity Issues	49**	73	5
Domestic Debt Issues	329	763	393
International Debt Outstanding	799	273	368
International Debt Issues	105	61	7
International Equity Placements	11	6	na

* Includes only France, Germany, Italy and UK

** Includes only France, Germany and UK

SOURCE: BIS, IFC, IMF AND OECD

international capital flows with any degree of effectiveness. The traditional option of using such controls to protect national reserve or balance-of-payments positions no longer exists for the money centres. Such actions are thus highly improbable in any context short of global military conflict, and perhaps not even then in light of the nature of modern warfare. In any event, they could only be sensibly pursued by the United States and European Union together. Hence the two regions will remain parallel on this key currency criterion as well.

It is less clear when, or even if, Europe will reach full parity with the United States in the breadth, depth and liquidity of its capital markets. The American market for domestic securities is about twice as large as the combined European markets (see Table 4, previous page). The European financial markets are highly decentralised at present—both across countries and, for Germany, within as well. There will be no central governmental borrower like the US Treasury to provide a fulcrum for the market. It may take some time to align the relevant standards and practices across the EU, especially if London is included—and the results will be much weaker if it is not. Germany may oppose wholesale liberalisation, as the Bundesbank has traditionally done within Germany, on the grounds that doing so would weaken the ability of the European Central Bank to conduct an effective monetary policy. More broadly, Germany may be no more enthusiastic about a global role for the euro than it has traditionally been for the DM. By contrast, leading Frenchmen have often spoken of wanting to use EMU to enhance Europe's global status.

On the other hand, Salomon Brothers estimate the total value of government bond markets in the EU to be 2.1 trillion ecu, compared with 1.6 trillion ecu in the United States. The issuance of international bonds and equities is already considerably higher in the current European markets, taken together, than in the United States (Table 4). Futures trading in German and French government bonds, taken together, already exceeded that in US notes and bonds in 1995. Expectations of the launch of EMU have already led to a substantial convergence in the yields of government bonds throughout Europe, including countries such as Italy and Spain. There are already clear signs of the development of an integrated European capital market for private bonds. So European parity on this key criterion is likely eventually, though it could take a while to come about.

5. UNITED STATES CURRENT ACCOUNT BALANCE			
(\$ BILLION)			
1980	2.2	1990	-94.3
1981	4.8	1991	-9.3
1982	-11.6	1992	-61.4
1983	-44.2	1993	-99.7
1984	-99.0	1994	-147.8
1985	-124.5	1995	-148.2
1986	-150.5	1996	-185.0
1987	-166.5		
1988	-127.7		
1989	-104.3		

SOURCE: IMF, INTERNATIONAL FINANCIAL STATISTICS

The final criterion is the strength and stability of the European economy. There is obviously no risk of hyperinflation or any of the other extreme instabilities that could disqualify the euro from international status. On the contrary, the ECB seems likely to run an extremely responsible monetary policy and rapidly achieve a reputation for credibility (see Section IV). It is true that Europe, even when united on a common currency, may not carry out the structural reforms needed to restore dynamic economic growth on a continued basis. Markets prize stability more than growth, however, as indicated by the continued dominance of the dollar through extended periods of sluggish American economic performance. Hence the euro is sure to qualify on these grounds as well.

In addition, America's external economic position will continue to pose doubts about the future stability and value of the dollar. The United States has run current account deficits for the last fifteen years (table 5). It now has a net foreign debt of about \$1 trillion, by far the largest in the world and rising by 15 to 20 percent annually. That debt is still modest as a share of US GDP or exports and is not climbing at the explosive level of the mid-1980s, which prompted the sharp dollar depreciation of 1985-87. But America's external position will remain a source of doubt in the minds of both markets and officials. The EU, by contrast, has a roughly balanced international creditor position and

has run modest surpluses in its international accounts in recent years (table 6). On this important criterion, the EU position is decidedly superior to that of the United States.

6. CURRENT ACCOUNT POSITION OF THE EUROPEAN UNION (\$ BILLION)			
1990	-31.9	1994	21.2
1991	-81.9	1995	53.8
1992	-81.9	1996	92.2
1993	6.6	1997	114.9

SOURCE: IMF, INTERNATIONAL FINANCIAL STATISTICS, OECD

These five criteria qualify a currency for international status. If the specification is accepted, a prognosis for the relative shares of different currencies then depends on two variables: the relative position of the different currencies on the criteria, as already discussed, and the relative importance of the criteria.

Severe data limitations have precluded persuasive econometric tests of the latter. There is good reason, however, to believe that the relative size of the economies and trade flows of key currency countries is of central importance. A large economy has a naturally large base for its currency and thus possesses important scale and scope benefits. A large volume of trade gives a country's firms considerable leverage to finance in the country's own currency. Large economies are less vulnerable to external shocks than smaller ones and thus a "safe haven" for investors. They are more likely to have the large capital markets that are also required for key currency status.

There is a clear historical correlation between size and key currency status. Sterling and the dollar became dominant currencies during the periods when the UK and the US, respectively, were the world's dominant economies and, especially, traders. The only significant key currencies today are those of the world's three largest economies and traders: the United States, Japan, and Germany. Japan's economy is larger than Germany's (table 1) so the yen should have a larger role than the DM on that criterion, but Germany's trade (including with the rest of the EU) is

larger than Japan's and its exports have exceeded those of the United States in recent years.

Crude statistical analysis by Eichengreen and Frankel³ buttresses these conclusions and suggests that the size of the currencies' constituent economies may play a central role. They find that "one can explain much of the downward trend in the dollar's share of world reserves over the last 25 years, and the upward trend in the yen and DM shares, by the falling share of the US GDP in the world economy and the rising share of the Japanese and German GDPs." They estimate econometrically that every rise of 1 percentage point in a key currency country's share of world product is associated with a rise of 0.5-1.33 percentage point (depending on whether GDPs are calculated at market or PPP exchange rates) in its currency's share of central bank reserve holdings. Not even crude estimates are available for private markets so we will simply assume that the same relationships apply to them as for central bank holdings. We will apply the Eichengreen-Frankel ratios to countries' shares of world trade and world output.

³ Barry Eichengreen & Jeffrey A Frankel, *The SDR, Reserve Currencies, and the Future of the International Monetary System*. In Michael Mussa et al (eds), *The Future of the SDR*. IMF

The relevant comparison for present purposes is between the full (initially core) EU and the euro, on the one hand, and Germany and the DM, on the other. It would be improper to compare the euro, which will meet all of the key currency criteria, with the sum of all (or even a few) of the individual European currencies, most of which do not. To do so makes the common error of failing to recognise the systemic change that will occur with the creation of a new currency based on an economy that is four times as large.

Hence there will be a quantum jump in the size of the economy and trading unit in question: from Germany's 9 per cent of world output and 12 per cent of world trade to the EU's 31 and 20 per cent, respectively (or the core group's 18 and 19 per cent, see table 1). (Note a difference in terms here: for Germany 'share of world trade' includes its trade with the rest of the EU, but for the EU it excludes intra-EU trade. Empirically, this means that the difference between German and EU trade is considerably less than the difference between German and EU GDP.) According to Eichengreen-Frankel estimates, this jump of about 50-100

per cent in the early part of the transition period should produce a rise of about 25-133 per cent in the role of the euro compared with the DM, even with involvement of only a small core group. In the eventual steady state, a rise of 65-250 per cent in the size of the relevant economic base could be expected. That would expand the potential size of the currency's role by 30-335 per cent.

The DM, on most calculations, accounts for about 15 per cent of global financial assets in both private and official markets (table 7). Hence the postulated expansion of the economy underlying the key currency, from Germany to the EU, could produce a rise in the euro's role to 20-30 per cent even if EMU included only the core countries. The share could rise as high as 65 if the entire EU were eventually involved. The midpoint of these ranges, 25 and 42.5 per cent, may provide rough indicators of the

7. CURRENCY SHARES IN GLOBAL FINANCE, 1996
(%)

	<i>Dollar</i>	<i>DM</i>	<i>All EU*</i>	<i>Yen</i>
Official Foreign Exchange Reserves	64.1	15.9	21.2	7.5
(of which, Developing Countries)	(63.5)	(15.6)	(21.9)	(8.3)
Foreign Holdings of Bank Deposits	47.5	18.4	42.5	4.2
International Security Issues (1990-95)	38.8	na	40.6	20.6
Developing Countries ³ Debt	50.0	na	16.1	18.0
Denomination of World Exports (1992)	47.6	15.3	33.5	4.8
Foreign Exchange Market Turnover	42.0	19.0	28.0**	12.0
All International Private Assets [§]	37.9	15.5	32.0	12.4
(excluding intra-EU holdings)	(50.0)	n.a.	(10.0)	(18.0)

* Includes intra-EU holdings so considerably overstates consolidated EU position (and hence understates dollar and yen positions), except in final line.

** Includes only DM, sterling and French franc.

§ Includes international bonds, cross-border bank liabilities to non-banks, euro currency liabilities to domestic non-banks and euronotes.

SOURCE: BIS, IMF

likely future global role of the euro in the transition period and eventual steady states. Such shifts would, respectively, eliminate half and more than all of the present gap between the dollar and the DM.

As Eichengreen and Frankel themselves stress, their coefficients cannot be taken too seriously. The numbers do suggest, however, that the sharp increase in the size of the economy and trading unit underlying the European key currency could produce a quantum leap in the international role of that asset. Assuming that most of the increase in the euro's role came "at the expense" of the dollar, the euro could eventually achieve parity with the dollar.

It is worth reiterating that the GDPs and trade volumes of the United States and a united Europe will be quite similar. *Ceteris paribus*, one might therefore expect their currencies to play roughly similar roles in the world economy. *Ceteris* are of course not *paribus*, however, and it was suggested above that it may be some time before the pan-European capital market equals that of the United States. For the remainder of this paper, I will therefore postulate that the euro's role will eventually increase over the present role of the DM by between one half the current gap between the DM and dollar—which, as just indicated, could occur even when the euro rested only on the initial core group—and by enough to achieve full parity. This would leave their relative shares at about 30-50 or 40-40 per cent, respectively, with about 20 per cent remaining for the yen and a few minor currencies in either case.

The structural features of a single currency European Union are thus likely to produce a euro that will ultimately challenge the dollar as the world's key currency. Alexandre Lamfalussy⁴ argues that the extent and timing of this challenge will depend largely on the ability of Europe to forge a single capital and financial market, and thus in part on whether the United Kingdom will integrate with the continent; on whether Europe can nurture and sustain a policy environment for steady and sustained economic growth; on the continuing advantages of incumbency and inertia that favour the dollar; and on whether the United States itself falters in ways that accelerate the decline of its currency. The timing questions are addressed in Section IV.

⁴ Newsweek, February 3, 1997.

From a systemic perspective, it is not very important whether the euro

comes to equal the dollar, to slightly exceed it or to slightly trail it. The achievement of rough parity, whatever the precise relationship, would convert an international monetary system that has been dominated by the dollar throughout the postwar period into a bipolar regime. Several very important policy consequences of that evolution are addressed in Section VII.

It is worth noting here, however, that such a transformation on the financial side would replicate developments on the trade side at a much earlier time. As noted above, the external trade of the combined EU roughly equals that of the United States. The EU has in fact always had a market position on trade comparable to that of the United States. In addition, the EU has had a common trade policy and spoken with a single voice on these issues from the very outset of the European integration process. Hence the policy regime in that area has already been bipolar for over three decades, as indicated by the necessity of agreement between Europe and the United States to bring all of the major multilateral rounds in the GATT (and recent sectoral agreements in the World Trade Organisation) to a successful conclusion. The prospective developments on the monetary side would repeat that evolution, giving Europe a comparable market position and generating institutional consolidation—the common currency and the ECB—to produce a similarly bipolar regime.

IV. The transition period

The evolution suggested above could produce a very large diversification of portfolios into euros, mainly out of dollars, as the new key currency increases its global role. The timing issues then become paramount. How rapidly will the shift occur? How long will the transition take? The following guesstimates are again intended solely to provide ballpark orders of magnitude for the transition period.

Global official holdings of foreign exchange total about \$1.4 trillion, divided roughly in half between industrial and developing countries (including Brazil, China, Taiwan and several of the other largest holders). The developing countries hold about 60 per cent of their reserves in dollars and 15-20 per cent in European currencies (table 7), the higher figure being relevant if EMU is larger than a core, notably if it includes sterling. Equalisation of these ratios would require a shift of \$100-150 billion. Cutting the difference roughly in half, with a resultant portfolio composition of 50-30 instead of the present 60-20, would produce a diversification of \$50-75 billion.

Shifts in industrial countries could be of like magnitude. Japan alone holds over \$200 billion, virtually all of it in dollars, and could shift at least \$50 billion into euros to position itself to intervene effectively in the euro market. Depending on the nature of any systemic arrangements that it might work out with Europe, the United States might want to build a reserve of euros that substantially exceeded its periodic holdings of DM (recently about \$20 billion worth) and other national currencies (including \$15 billion in yen).

The reshuffling of European portfolios will turn largely on the EMU arrangements themselves but could roughly net out. The "ins" will need fewer reserves in total and will of course no longer hold DM (as the DM will not exist). There have in fact been estimates that the monetary union, by the time it includes all EU countries, could have "excess reserves" of \$50-200 billion that it might want to dispose of. The entire EU held only

\$171.3 billion of reserves at the end of 1995, however, so any conversions would have to be toward the lower end of that range and it is doubtful that the Europeans would push up the euro by “dumping” dollars. Moreover, the “outs” will need a substantial reserve of euros if they aspire to eventual membership in EMU and thus need to pursue stable exchange-rate relationships with the “ins.” The reserve pooling envisioned for the ECB is too small to have any significant effect.

Official reserve shifts into euros, largely though not wholly out of dollars, could thus range between \$100-300 billion. Kenen (*op. cit.*) agrees that the euro “will be widely held as a reserve asset” but believes that holdings of it “will grow gradually via accumulation, not rapidly via asset switching”. Some of the shift could come from minor non-EU currencies, such as the Swiss franc and perhaps the yen (on the latter, see Section V). Sales of official dollars could be larger if the EMU members themselves decided to liquidate their “excess reserves”.

Private portfolio diversification could be much larger. Global holdings of international financial assets, including bank deposits and bonds, total about \$3.5 trillion (excluding intra-EU holdings). About 50 per cent are in dollars and only about 10 per cent in European currencies (table 8). A complete balancing of portfolios between dollars and euros would thus require a shift of about \$700 billion while a halfway move (to 40-20) would reallocate about \$350 billion. Combining the official and private guesstimates produces a potential diversification range of between \$500 billion and \$1 trillion.

**8. FOREIGN CURRENCY HOLDINGS OF US MONETARY AUTHORITIES
(\$ MILLION, DECEMBER 1996)**

	<i>DM</i>	<i>Yen</i>	<i>Pesos</i>	<i>Total</i>
Federal Reserve	13030.1	6152.7	-	19182.8
US Treasury Exchange Stabilization fund	6594.6	9023.6	3500.0	19118.3
TOTAL	19624.7	15176.3	3500.0	38301.0

SOURCE: NEW YORK FEDERAL RESERVE BANK, QUARTERLY REPORT

Such a shift, even spread over a number of years, could have substantial effects on exchange rates. Assuming no responses through interest rates, McCauley has estimated that a fall of 1 per cent in the exchange rate of the dollar against the euro would be required to achieve a portfolio shift of about \$15 billion from dollars into euros.⁵ A cumulative portfolio diversification of \$500-1,000 billion would thus require a currency adjustment of 35-70 per cent.

⁵ *Robert McCauley. The Euro and the Dollar. BIS Working Paper 1996.*

Again, none of the specific numbers should be taken seriously. For one thing, interest rates would undoubtedly respond to such large portfolio shifts and temper the impact on exchange rates. Moreover, official holders—at least in the major industrial countries—would surely recognise the need to avoid destabilising markets with their own diversifications and would presumably take collective actions to do so (see Section VII).

In addition, international borrowers as well as asset holders would increase their use of the euro and thus generate an increase in its supply that could partially (or even wholly) offset the increase in demand for it. The chief key currency countries (United States, Japan and Germany) have in fact traditionally run overall balance-of-payments deficits that added to world liquidity and frequently placed downward pressure on their currencies.

The actual magnitude of the net exchange rate impact of the rise of the euro could thus be considerably less than 35-70 per cent. However, it will probably still be quite substantial. In light of the anticipatory nature of most markets at most times, it could also occur much more quickly than is now anticipated. In light of the bandwagon effects that frequently characterise those markets, an overshoot that magnifies the impact for a time is also quite plausible. Gros and Thygesen, on the other hand, argue that portfolio shifts into the euro “should not have any disruptive effects on exchange rates or capital flows because they will be distributed over time and because financial markets have become so sophisticated”.⁶

⁶ *Daniel Gros & Niels Thygesen. European Monetary Integration. St. Martin's Press, 1992.*

The closest parallel in modern history was the international diversification of portfolios of large Japanese financial institutions, after Japan lifted its exchange controls at the end of 1980. Prior to that

time, the huge volume of Japanese investments generated by the country's rapid economic growth and high savings rate had been held almost wholly in yen assets. Attracted by the high real interest rates in the United States that accompanied the sharp increases in American budget deficits in the early 1980s, Japanese investors placed about \$230 billion in foreign (mainly dollar) assets from 1980 to 1985. The dollar appreciated by about 25 per cent against the yen (and 75 per cent against all G-10 currencies) during this period, due largely to this Japanese portfolio shift.

The timing, extent and even direction of the shift between dollars and euros in the transition period will be critically affected by the conduct of the ECB's monetary policy. Many Europeans believe that the euro will be relatively weak at the outset, at least until the ECB has time to develop a credible reputation. (Some also hope that the euro will be weak, in order to improve Europe's trade competitiveness and thus help rescue it from its continuing economic doldrums. See Section VI.) Uncertainty alone is viewed as likely to push the euro downward. And even if the euro rapidly attains credibility, borrowing in euros and other "supply side" effects as noted above could equal or even outweigh the demand for euro assets and thus push its exchange rate down rather than up.

Part of the answer of course depends on the relationship between the dollar and the European national currencies at the creation of the euro, and thus the initial exchange rate between the two. If the European currencies had appreciated substantially in the pre-transition period, and moved well above their "fundamental equilibrium exchange rates" (FEERs), the euro would be likely to depreciate. It will be argued in Section V, however, that the opposite is much more likely: that the European currencies will lodge at levels below, perhaps considerably below, their individual fundamental equilibrium exchange rates between now and 1999. Hence the more likely direction of change for the euro, based solely on its starting point, will be upward. The initial exchange rate is thus an important topic for international consideration; see Section VII.

Even without the "advantage" of an undervalued initial rate, my own judgment is that the euro will be quite strong from its inception. The Maastricht Treaty gives the ECB a mandate to emphasise price stability. The management of the new ECB will clearly make every effort to establish its credibility as promptly as possible. There will be no

government to pressure the ECB to pursue an easier course—though France undoubtedly hopes that the “Euro-X committee”, consisting of the finance ministers of the countries in EMU, will co-ordinate macro-economic policy. The ECB will be especially chary of any depreciation of the exchange rate of the euro. To the contrary, it is likely to view euro appreciation as an early sign of success. Moreover, Germany will simply not let EMU happen unless it is assured of a strong euro. The effective Bundesbank veto over the entire arrangement is another reason to believe that the euro will be strong from the outset.

Comparisons with the Bundesbank are both inevitable and instructive. The ECB charter is much more single-minded. The ECB will be the first central bank in history without a government looking over its shoulder and possessing at least some powers over it. Because it lacks the 50-year history and secure reputation of the Bundesbank, the ECB will have to be especially tough in pursuing a responsible monetary policy. This is especially true now that the initial membership will certainly include Italy, Spain and Portugal.

Fiscal policy developments are likely to reinforce this outcome. The Maastricht fiscal criteria are being fudged to a modest extent to enable EMU to start on time. The “growth and stability pact” seems likely to have substantial loopholes. Since unemployment will remain high and pervasive at the startup point, national governments are likely to deploy their only remaining macro-economic tool—fiscal policy—in an expansionary direction, in turn intensifying pressure on the ECB to pursue a restrictive monetary policy. This highlights the contradiction between the theory of optimal currency areas—which stresses the need for budgetary flexibility in constituent states—and the Treaty’s arbitrary limits on budget deficits and public debt positions.

The result could be a (hopefully mild) European version of the Reaganomics of two decades earlier. Many Europeans seem to believe that expansionary fiscal policies after 1999 would produce a weak euro. To the contrary, combining such fiscal policies with a resolute ECB will strengthen the euro further. The proper analogies are with the Federal Reserve in the early 1980s, in the face of rapidly growing US budget deficits, and the Bundesbank response to growing German budget deficits brought on by unification in the early 1990s; both situations produced

very strong currencies. There are legitimate reasons for concern about this policy mix, but a weakening of the euro is not a likely outcome.

If this set of assessments is correct, even without the additional impetus of expansionary national fiscal policies, it sharply enhances the possibility that the euro will quickly become the world's second key currency. The addition of a credible monetary policy to the structural attributes listed above would accelerate the postulated portfolio diversification.

This effect could be intensified by contemporary events in the United States. The budgetary accord between the Administration and Congress has produced a fairly credible agreement to eliminate the remaining deficit in the American federal budget by 2002. Every dollar decline in the budget deficit is associated with a decline of one third to one half of that amount in the current account deficit. That correction is achieved through a depreciation of the real exchange rate of the dollar, prompted by the decline in interest rates fostered by the reduced credit demand of the federal government.

Exchange-market developments of the late 1990s and early 21st century could thus represent a reversal of their evolution in the first half of the 1980s. During 1980-85, US budget deficits soared. The elimination of Japanese exchange controls triggered large investments in the dollar. Fiscal tightening in Europe and Japan further enhanced the dollar's appreciation. In the period ahead, to the contrary, further reduction of the American budget deficit could coincide with European fiscal expansion and a large diversification out of the dollar triggered by creation of the euro. Substantial dollar depreciation could thus occur in the transition to EMU.

This discussion highlights the importance of the policy mix, especially in Europe but also in the United States, in determining the exchange-rate impact of the euro. A tough and effective "stability pact" in Europe, contrary to my expectations as noted above, would enable the ECB to pursue a less restrictive monetary policy and thus reduce the speed at which it is likely to assume a prominent global role. A reversion to growing budget deficits in the United States could push American interest rates upward and "defend" the dollar against the loss of its international role in the short run (while eroding it in the longer run by promoting

further increases in America's current account deficits). The structural characteristics outlined in Section III would inevitably propel the euro into international prominence but such circumstances would slow, and perhaps for some time limit the extent of, that evolution.

It must be emphasised that an "effective" stability pact could produce much more severe international risks than a more permissive variety as postulated here. If the EU truly abandoned all flexibility in the conduct of fiscal as well as monetary policy, the resulting absence of macroeconomic instruments could portend the use of other, far less desirable, tools to counter the region's severe unemployment and growth problems. One would be competitive depreciation—but, as noted, this would run counter to the desire for a strong euro. Another would be trade protection, for which there are already substantial pressures in Europe, which would be devastating to the global trading system in light of its bipolar structure as noted above. The possibility of such outcomes underlies the imperative of discussing EMU and its potential global effects in the G-7 and other multilateral fora, as proposed in Section VII.

Many analysts share the view that the euro will eventually rival the dollar as the world's key currency, eg, Kenen (*op. cit.*). The conventional wisdom, however, is that such a shift will take considerable time to happen (an exception is Alogoskoufis and Portes, *op. cit.*). None of the authors has hazarded a specific guess but they imply that the transition will be measured in decades rather than years.

Such an analysis implicitly assumes that the redistribution of private and official international portfolios is a linear function that occurs incrementally over time. There is evidence from the history of key currencies, however, that major shocks can produce rapid changes in portfolio composition. The devaluation of sterling in 1931, for example, dramatically reduced the international role of that currency and propelled the dollar unambiguously into the dominant spot that it has held ever since. The onset of double digit inflation in the United States in the late 1970s produced a sharp drop in the reserve currency share of the dollar in only a few years.

These examples reveal, however, that the major non-linear shocks have derived more from poor performance and policy on the part of the

incumbent than from the improved position of a new rival. Continued good performance by the United States could thus delay, or even limit permanently, the rise of the euro. The euro's achievement of the criteria for key currency status, as outlined here, is a necessary condition for its moving up alongside the dollar but its actually doing so may have to await a serious policy relapse by the United States—or enough erosion of America's external debt and deficit position to again raise severe concerns around the world, even if its internal economy is in relatively good shape, as in the middle 1980s.

The issue is thus whether the combination of (1) the creation of a new economic and trading unit roughly equal in size to the United States and (2) the rapid establishment of the credibility of its currency could overcome (3) the incumbency advantages and inertia that favour the dollar. I believe there is a significant possibility that it might do so, and that any serious consideration of the international policy implications of the euro must take that possibility into account.

V. A note on the yen

This analysis has so far largely ignored the yen. The reason is that we do not now have, nor are we likely under foreseeable developments ever to have, a tripolar monetary system in any meaningful sense of the term.

Japan's economy is about twice the size of Germany's and its trade is only slightly smaller, and it has an even better record of price stability over the past 15 years. Its currency plays a much smaller role than the DM (see table 7), however, suggesting a significant deficiency in its meeting the other key currency criteria—notably the capabilities of its financial markets. Indeed, the role of the yen in denominating Japan's own export contracts has recently dropped to a seven-year low, from its peak of 43 per cent in March 1993 to 35 per cent in September 1996. The latest report on this topic from Japan's Ministry of Trade and Industry concludes that “the yen is nowhere near achieving the status of a truly international currency.”

In a world of two economic superpowers, the EU and the United States, Japan's weight relative to the other two will decline. Japan's continued failure to deregulate and modernise its capital and financial markets, despite the recent proposals of the Hashimoto government, is likely to remain a major barrier to such a role for the yen. Indeed, the continued fragility of Japan's financial sector, and its links to the troubled economies of South East Asia, is more likely to repel than attract international interest.

Japan is also still engulfed in a prolonged period of stagnation. Despite living in the world's fastest growing region, and despite a series of fiscal stimulus programmes totalling \$500 billion and near-zero interest rates, it has experienced very little growth for five years. Deep structural problems, focused on but going well beyond the financial system, are clearly involved.

Indeed, Japan may have missed the moment when it—and its currency—

could play a substantial international role. Its leadership even within Asia is being challenged, most notably by China. Hong Kong and Singapore threaten to bypass it as a financial centre. Serious deregulation and a revitalisation of the Japanese economy cannot be ruled out but, on present readings, there is little reason to believe that the yen will play in the same league with the dollar and the euro.

Analogies with trade policy are again instructive. Many analysts, particularly in the 1980s and early 1990s but some still today, have hypothesised the emergence of a tripolar world economy with a triad of north-south regional groupings centered around Europe, Japan, and the United States. The logic has been much more compelling regarding trade than finance because Japan's status as a premier exporter and large surplus country has been far more extensive than its prowess on monetary matters.

It has turned out at least so far, however, that major trade groupings have developed around Europe (the EU itself and its association agreements with East European and Mediterranean countries) and the

⁷ Fred Bergsten, *The World Economy After the Cold War. Foreign Affairs*, 69.3, 1990; Paul Krugman, *The Move Toward Free Trade Zones. Paper presented at symposium sponsored by the Federal Reserve bank of Kansas City 1991*

United States (NAFTA and the planned Free Trade Area of the Americas) but not around Japan. The only regional trading arrangements within Asia are the minor Australia-New Zealand and ASEAN free trade areas. The big regional arrangement in the area is the Asia Pacific Economic Cooperation Forum (APEC), which links Japan (and China, Korea and the rest of East Asia) across the Pacific with North America. A two-bloc world, within the global context of the WTO, may in fact be evolving in the trade area along the lines projected in this paper for the monetary arena—an outcome far more desirable than a three-bloc world.⁷

At the same time, the yen obviously cannot be ignored. It will probably continue to play a minor key currency role, perhaps maintaining (or even modestly increasing) its 10-15 percent market share. Japan may yield to China as the world's third largest economy (behind the European Union and United States) within the next decade or so but China will still be a poor nation without many of the other attributes of a key currency country. Moreover, Japan is likely to continue to be extremely competitive in world trade and to bolster its position as the world's largest creditor country. Japan will

thus remain a junior partner in the management of the international monetary system, and it will need to be included in any new EU-US arrangements.

The novel argument has been made that the euro is more likely to rival the dollar if the yen also asserts a larger role, on the grounds that the dollar would then be more likely to lose its scale and inertia advantages.⁸ The opposite is much more likely to be true: continued stagnation of the yen's international role will enable the euro to compete across a wider range of the globe, notably in the rapidly growing markets of Asia, than if the yen were effectively involved as well.

⁸ *Fabienne Ilzkovitz, Prospects for the Internationalisation of the Euro. European Commission 1996.*

VI. The pre-transition period

The pre-transition is the period between now and the start-up of the euro, at the outset of 1999. Plans and expectations for the euro will increasingly affect the exchange markets, as they already have to an extent for some time. I will not discuss the implications for exchange rates among the potential members, nor between the “ins” and “outs” nor *vis-à-vis* non-EU European countries (such as Norway and Switzerland), but rather concentrate on the likely implications for the dollar and the global system.

The chief consideration is the desire of the putative EMU membership to avoid a dilemma. On the one hand, most of them—certainly Germany—want a strong euro. On the other hand, at least some of them—including France—have argued that their currencies are overvalued against the dollar (a view which is extremely hard to square with the fact that the United States is running an external deficit of almost \$200 billion and is by far the world’s largest debtor country; although it is more defensible with respect to the yen—see Section VII). Some members of the latter group may even want a weak euro, as noted above. At a minimum, they would not want it to appreciate to any significant extent.

The only way to avoid the dilemma is to achieve a competitive depreciation of the European national currencies in the pre-transition period. This enables the EU, if permitted by the United States (see Section VII), to engineer an initial exchange rate below—perhaps well below—the fundamental equilibrium exchange rates for the euro. (It would also provide some immediate support for the continental European economies, all of which are struggling with high unemployment and sluggish growth, especially as they tighten fiscal policy in pursuit of the Maastricht criteria). The euro can then appreciate in its early years without undermining the long-run competitive position of the European economy. (Here I assume that the initial external exchange rate of the euro will reflect a weighted average of the market exchange rates of the national currencies that participate at the outset).

The continued impressive growth of the American economy and the continued sluggishness of the European continent have provided persuasive, market-based reasons for dollar strength in the recent past. So has uncertainty about the start-up of the euro itself, with every new doubt about the fiscal rectitude and membership of EMU suggesting unfavorable comparisons with the DM. The Europeans' desire for a depreciation of their currencies could be explained simply by a wish to help extricate themselves from their current economic woes by improved trade performance. And the Europeans could have driven their currencies down further by more aggressive relaxation of monetary policy, which could have easily been justified in purely domestic terms.

Nevertheless, there is considerable evidence that pre-positioning to avoid the euro dilemma has already been affecting the posture of European officials toward the exchange markets. The Bundesbank, despite its traditional support for a strong DM, has periodically joined the call for a "stronger dollar" despite any evidence (or even argument) that the dollar is undervalued. This jawboning helped propel the dollar in early 1997 to its highest levels against the DM and other European currencies since 1994. And then between February 1997 and April 1998 the DM fell from DM 1.69 to DM 1.82 to the dollar.

In the months remaining before the startup of the euro, numerous changes in the economies and policy on both sides of the Atlantic will of course affect the exchange markets. The new budget agreement in the United States could place significant downward pressure on the dollar (although it must be noted that the largest part of the actual budget correction is likely to be programmed toward the end of the adjustment period, around 2001-2002). A slowdown (or especially recession) in the American economy could also lead to reduced US interest rates and intensify that effect. A pick-up in European growth is occurring and could produce upward pressure on its currencies before the initial exchange rate is established. The probability of some or all of these developments has intensified the desire of the European authorities to take advantage of the current environment, which has been bullish for the dollar and bearish for almost all their currencies, to promote a depreciation that will be sufficient to permit the euro to commence at an undervalued level even if some reversal occurs before its startup.

VII. The implications for policy co-operation

This analysis suggests four major policy issues that should be addressed at the international level, in the G-7 and/or the IMF:

- ★ the initial exchange rate between the euro and outside currencies, especially the dollar;
- ★ the portfolio diversification into euros that could have major exchange-rate consequences during the (possibly longish) transition period;
- ★ management of exchange rates between the euro and the dollar (and the yen) in the eventual steady state, when fluctuations could be considerably greater than in the past due to the altered economic structure of Europe;
- ★ the international representation of Europe following the centralisation of its monetary policy in the ECB.

The initial exchange rate

I have just argued that Europe has already been seeking, and will probably continue to seek, sufficient depreciation of its national currencies to justify a substantially undervalued start-up rate for the euro (relative to its fundamental equilibrium exchange rates).

The United States and the rest of the world should reject this strategy. It represents a blatant effort to achieve competitive depreciation, both to help rescue Europe from its high unemployment and to enable the euro to become a “strong currency” without any substantial costs to the competitive position of the European countries.

France is running sizable trade and current account surpluses, even

adjusting for its high level of unemployment. Germany is running the world's second largest trade surplus and is the world's second largest creditor country. The EU as a group has been in surplus for the past few years. By contrast, the United States is the world's largest debtor nation with a net foreign debt in excess of \$1 trillion that is rising annually by 15-20 per cent. Its trade and current account deficits were each roughly \$185 billion in 1996 and soared well above \$200 billion in 1997. On these long-term fundamentals, it would be extremely difficult to make a case that the European currencies are overvalued and the dollar is undervalued.

Hence the G-7 should, at a minimum, actively resist further dollar appreciation. The difficulty of course is that the short-run fundamentals strongly favour the dollar, and it would be highly undesirable to pursue the proposed currency strategy through higher interest rates in Europe or lower interest rates in the United States at this time. But the G-7 should "put its money where its mouth is," if and when tested by the markets, to demonstrate its intention to avoid further deviation from the long-run fundamentals and thus major problems over the longer term.

The transition period

The postulated portfolio diversification from (mainly) the dollar into the euro could have substantial effects on the exchange rate between the two. I have made ballpark guesstimates on the magnitude and timing of that impact but there is simply no way to predict either with any degree of confidence.

Moreover, other events during the (presumably longish—five to ten years?) transition period may substantially affect the outcome. For example, enthusiasts for EMU believe that the forging of the monetary union will itself induce—perhaps force—European governments to seriously address their structural rigidities and thus enable them to restore more rapid and sustainable growth rates. By contrast, strict adherence to the Maastricht fiscal criteria and a tough application of the growth and stability pact could prolong Europe's current economic malaise.

Hence it would be impossible to calculate the fundamental equilibrium exchange rates for the euro, and perforce the other major currencies, that would emerge at the outset of the new steady state. It would therefore

be a mistake to deploy target zones or any other predetermined mechanisms to attempt to limit dollar-euro fluctuations during the transition period, extensive and volatile though those fluctuations may be. There would simply be no sound basis on which to base such ranges.

On the other hand, markets could become extremely unstable because of the uncertainties surrounding the transition. It will thus be important for the IMF and the G-7 to monitor events closely, to attempt to form judgments as to the likely outcome as the process evolves, and to intervene to limit unnecessary volatility. In light of the uncertain level of rates in the eventual steady state, however, such intervention would have to be mainly of the traditional smoothing variety, rather than aimed at correcting disequilibria as under target zones or other more defined regimes.

It could also become desirable at some point, presumably during the transition period though perhaps even later, to negotiate off-market transactions, perhaps through a Substitution Account, to limit the market impact of central bank conversions of dollars, if such conversions appeared likely to be large enough to destabilise markets. If world reserves were to fall sharply as a result of rapid dollar depreciation, triggered by switches into euros, a new issuance of SDRs might be needed to fill the gap. Such devices should be considered if the events hypothesised were to come about.

The steady state

The more difficult, and ultimately much more important, question is whether a more structured exchange-rate regime should be envisaged to manage the steady-state relationship that will eventually emerge between the dollar and the euro (and the yen). There is obviously no need to answer the question now. Nevertheless, it is instructive to begin thinking about it as the implied bipolar regime will suggest to many observers—including businesses planning their long-term investment strategies—that a sea-change may occur in international monetary and thus economic relationships.

Theoretically, the availability of a more attractive alternative to the dollar could reduce the ability of the United States to finance its large external deficits and thereby force it either to adopt more internationally consistent policies or to accept greater dollar depreciation. The huge level of

America's gross external liabilities (more than \$4 trillion) and the array of alternative assets available to international investors is already sufficient today, however, to place considerable limits on the policy autonomy of the United States. Indeed, such constraints were already felt in Washington in the late 1970s—when the US was still the world's largest creditor country—when a free fall of the dollar signalled the need to tighten monetary policy sharply and triggered the \$30 billion “dollar support package” of October 1978. Similar pressures emerged in 1987 when the dollar began to fall too rapidly after the Plaza adjustment effort, forcing the United States to call a halt to its depreciation strategy and negotiate the Louvre Accord in an effort to stabilise rates. The international adjustment process may not be too different for the United States in the new bipolar world than it is today.

The change is likely to be greater in the European case. The individual European countries already pay relatively little attention, at least in terms of policy reaction, to fluctuations in their currencies *vis-à-vis* the dollar and yen. But external events will play a much smaller role in the unified European economy. Hence even larger and more frequent exchange-rate changes can be accepted with equanimity. The EU is indeed likely to place greater reliance on them to achieve external adjustment. One result will be larger fluctuations and probably greater volatility between the two lead currencies. From the European standpoint, the key implication is its enhanced ability—for better or worse—to resist external pressures to change internal economic policies and thus a reduced interest in international policy co-operation.

One of Europe's few motivations to take an interest in external monetary developments has been the problem caused for intra-European currency relationships by a weakening dollar: dollar depreciation strains the EMS by pushing the DM up against the weaker European currencies as well as itself. This effect will of course disappear when the euro comes to encompass all EU currencies. Hence the creation of the euro will eliminate one of the EU's chief interests in international cooperation for managing exchange rates.

Nevertheless, there will be strong systemic reasons for the installation of new currency management arrangements between the European Union and the United States (and Japan), once the euro has moved up alongside

the dollar. The euro and the dollar will dominate world finance, and the likelihood of sharply increased volatility between them—and the omnipresent possibility of prolonged misalignments if the outcome is left solely to market forces—could be extremely destabilising for other countries and the world economy as a whole. Prolonged misalignment would also be costly for the European Union and the United States themselves, as the United States found out in the 1980s when much of its manufacturing and agricultural sectors were severely victimised by acute dollar overvaluation; though they are less open to external events than most other economies, the share of international transactions in each is sufficiently large to provoke major distortions if sizable currency disequilibria are permitted to persist.

Such misalignments would also inevitably generate strong trade protectionism, as in the United States in the early 1980s when the “free trade” Reagan Administration was forced to impose import quotas on automobiles, machine tools, steel and other sectors because of the dollar overvaluation generated by its macro-economic policies and its “benign neglect” of the currency. Given the pivotal responsibility of the EU and US for global trade policy, as noted above, any such relapses would be extremely harmful to the world economy. The case for a new currency stabilisation arrangement will be very strong.

As noted above, we cannot now calculate a credible fundamental equilibrium exchange rate for the euro when it reaches its eventual steady state. There is good reason to believe, however, that we will be able to do so when that time arrives. Given the likely volatility that will otherwise ensue, and the prolonged misalignments that can result, there will be a strong case for negotiating and installing a target zone system at that time among the G-3: the European Union, Japan and the United States.

The history of the yen-dollar exchange rate since the onset of floating in the early 1970s is instructive in this context. The United States and Japan have been the two largest economies and two of the three largest trading countries throughout this period, just as the United States and the European Union will be the two largest economies and traders once European monetary union is completed. There are of course important structural differences between US-Japan and US-Europe trade and economic relations, such as the absence of huge imbalances and the much

greater role of American direct investment in Europe, that will probably persist in the future. There are also obvious political, security and cultural differences between the two relationships.

It is nevertheless important to recall that the Japan-US economic relationship has been plagued by large and volatile currency swings that have produced sustained misalignments. We are now in the fifth such cycle since the late 1960s. During each cycle, the dollar becomes substantially overvalued and the yen substantially undervalued. Large increases in both countries' external imbalances result. Protectionist pressures emerge in the United States (and in some other countries) that undermine the relationships between the countries and threaten the global trading system. The yen then appreciates precipitously, generating international financial instability and substantial adverse effects on the Japanese economy itself (as most recently in 1993 and 1995). Such results from these cycles occurred in 1971-73, 1978-79, 1985-87, and 1993-95. The current depreciation of the yen to a level (130:1 in April 1998) far below its fundamental equilibrium exchange rate indicates that another such cycle is well underway.

It would have been highly desirable for the United States and Japan to have limited the extent of these problems by installing a target zone for their currencies, as they in fact did in late 1986 (as the precursor to the Louvre Accord that subsequently extended the arrangement to Europe). These particular initiatives were short-lived because they were undertaken before the dollar had completed its necessary depreciation after the massive overvaluation of the early and middle 1980s. However, such a regime may commend itself to the two economic superpowers of the future as a means of avoiding prolonged misalignments that could otherwise disrupt their trade, monetary and overall economic relations—with extremely adverse effects on world trade and finance as well.

Many Europeans believe that international policy co-operation and even co-ordination will be facilitated by EMU. Europe will then speak with a single voice, enabling it to interact more confidently with the United States and perhaps forcing the United States to adopt a more consistently co-operative stance. Some Europeans indeed view this outcome as an important goal of EMU.

The analogy with trade policy cited at the outset provides some support for this concept. The “multilateral trading system” has been essentially bipolar since the creation of the original Common Market, which has always spoken with a single voice on most trade matters. Most observers believe that this negotiating structure, despite producing prolonged stalemates, played an instrumental role in facilitating the eventual success of the three large postwar liberalisation negotiations (the Kennedy Round in the 1960s, the Tokyo Round in the 1970s and the Uruguay Round in the late 1980s-early 1990s). It has been on display again recently in forging the two most important liberalising steps since the end of the Uruguay Round, the agreement on trade in telecommunications services and the Information Technology Agreement on trade in high-technology goods.

The contrary view is that the most successful periods of international monetary history have been those of “hegemonic stability” dominated by a single power—the United Kingdom in the late 19th century and the United States in the first postwar generation. We have never experienced a successful monetary regime managed by a committee of (even two) relatively equal powers. Most historical efforts to achieve such co-operative leadership have in fact failed.

Several scenarios can be envisaged. The United States could react defensively to its loss of monetary dominance, seeking to create a formalised dollar area—perhaps based on the APEC and Free Trade Area of the Americas (FTAA) that it has been promoting in the trade arena—as the United Kingdom created the sterling area in the 1930s. The EU could adopt a strategy of “benign neglect”, arguing that the United States has done so repeatedly in the past and that its turn had now come. Conflict between the two poles could easily arise.

As with the economics, there is no a priori answer. It will be a major task of policy in both regions, however, to realise the promise of potential co-operation rather than falling into new patterns of conflict. The underlying strength and history of the North Atlantic relationship should bode well for a successful outcome, but achieving it will clearly be a major policy challenge in the early twenty-first century.

Institutional implications

The final question concerns the institutional implications of EMU and the ECB. Some are obvious but others are more complex. It seems axiomatic that the ECB will replace the individual European central banks in all fora where the latter are now represented. The G-10 in the BIS (which is really a G-11), for example, will become a G-5 (EU, US, Japan, Canada and Switzerland) if it continues to exist. The Governor of the ECB will be the counterpart of the Chairman of the Federal Reserve and of the Governor of the Bank of Japan in the meetings of G-7 finance ministers and central bank governors.

The more complex issues relate to those fora where the representatives of Europe must discuss, and even negotiate, issues that range beyond monetary policy. These include the G-7, where finance ministers represent their governments, and the IMF, where Executive Directors are appointed by governments (and come from central banks in only a few cases).

The answer is presumably that the national European governments will continue to play their current roles until fiscal and other economic policies are consolidated *à la* monetary policy with the ECB. National and ECB representatives will thus participate together in fora that link monetary and broader economic policy, like the G-7. There is an analogy with the current G-7 summits, where the President of the European Commission attends, along with the heads of state of four EU member governments, because of the Commission's competence for EU trade policy and some other issues. The arrangement is untidy but workable.

Conclusion

Whatever one thinks of the specific proposals made here, the major message is that all of the issues cited need to be thoroughly and consistently addressed by the leadership of the international economic and financial community, as well as by the EU itself. The evolution of all these developments will have a major impact on the United States, Japan and the rest of the world. The "benign neglect" of the topics described in Section II is anomalous and needs to be promptly rectified.

When Valéry Giscard d'Estaing and Helmut Schmidt decided to create the European Monetary System in 1978, one of their goals was to avoid the instabilities being generated at that time by the United States and the

dollar—and thereby to foster a more effective international monetary system. The evolution of the EMS into EMU could bring that vision closer to reality, above all because Europe has already demonstrated the feasibility and benefits of intensive international policy co-ordination.

In the absence of effective co-operation between the European Union and the United States, however, the creation of the euro could create greater international instability. This would be a deeply ironic outcome in light of the goals of the original Giscard-Schmidt initiative and its contemporary successor. It is up to the governments of the two regions to achieve a smooth transition from the sterling and dollar-dominated monetary regimes of the nineteenth and twentieth centuries to a stable bipolar system in the early twenty-first century, thereby strengthening rather than jeopardising the foundations for global economic co-operation.

