

2.2 THE EUROPEAN CONTRIBUTION TO INTERNATIONAL FINANCIAL STABILITY

by Richard Portes, Professor at the London Business School and Director of the Centre for Economic Policy Research (CEPR) at the occasion of the Inauguration of the Banque centrale du Luxembourg on 18 May 2001

I shall first set out the background or context in which I believe we must set any discussion of international financial stability today. This starts from globalisation itself, which has been the setting and perhaps the cause of recent serious international financial disturbances. These gave rise to the debate on the 'international financial architecture', which has included both financial stability issues and discussion of exchange-rate regimes. The debate has brought some important innovations but has in many respects been inconclusive. That is partly because today there are many voices that must be heard and accommodated – in contrast to the process that gave us the Bretton Woods agreement, where the dominance of the US in the postwar settlement was complete.

I then turn to the current threats to international financial stability. There have always been financial crises, and in a capitalist system there always will be (Portes, 1999). I shall briefly discuss their sources and the possible ramifications of instability.

We can then consider the role of the euro zone and EMU in this international environment. To paraphrase the blunt remark of the IMF's chief economist and extend its domain, 'Will Europe be part of the problem or part of the solution?'

2.2.1 The context: globalisation

The European Commission has recently asserted that 'EMU has intensified the forces for change in the EU financial system by fostering globalisation' (European Commission, 2001). One could just as well put the converse proposition: globalisation has had a profound impact on the financial systems of individual EU countries and the operation of the monetary union. But this holds for all countries.

Here we stress only one dimension of globalisation, the mobility of capital internationally. Capital flows and national net foreign asset positions have finally reached levels last seen in the previous era of globalisation, 1870-1913. The overall 'U-shape' of the evolution of capital mobility since 1870 is well documented (e.g., see Obstfeld and Taylor, 2001), and we now have fairly comprehensive data on stocks as well as flows for the past three decades (Lane and Milesi-Ferretti, 1999). The data show also that interest rates and equity market returns are increasingly closely linked across countries.

For major countries, nowhere are these links closer than among the members of EMU (e.g., see Danthine, *et al.*, 2000). Government bond spreads are small, reflecting the absence of currency risk, little variation in credit ratings, and some variation in market liquidity across countries. There is a single benchmark corporate bond yield curve. Analysts of equity markets are increasingly moving to a sectoral rather than a country perspective, as the country risk component in equity returns declines.

All this, and EMU itself, are the inevitable consequence of the decision made originally in the Single European Act to abolish all restrictions on capital movements in Europe. Member states were faced with the 'trilemma' or 'inconsistent trinity' of free capital mobility, fixed exchange rates, and independent monetary policies. Their initial decision to privilege capital mobility then led to the choice between exchange-rate stability and monetary autonomy, which was resolved at Maastricht in favour of the former. Moreover, at Maastricht too, the decision to enshrine price stability as the objective of monetary policy created a presumption (though not a formal bar) against any move to stabilize the exchange rate of the European single currency with respect to the dollar and yen. Proposals for any form of 'target zones' are not on the serious policy agenda.

The priority of free movement of capital is indeed reflected in the evolution of the international financial system since 1970. The pressures generated and transmitted by capital movements broke up the Bretton Woods exchange-rate system. The failure of the negotiations of the early 1970s to restore an institutional framework for exchange-rate stability showed clearly the choice of the major countries, especially the United States, when confronted by the trilemma. The Europeans then went their own way, and the exchange-rate mechanism of the EMS was supported by remaining restrictions on the free movement of capital – but not for very long.

The only significant reaction against this central element of globalisation came in the wake of the Asian financial crisis. Serious discussion of the costs as well as the benefits of capital mobility had begun after the Mexican crisis (e.g. Kenen, *et al.*, 1996), but it was paralleled by a movement to incorporate a commitment to capital account liberalization in the IMF

Articles of Agreement. This was abandoned in the autumn of 1997, as official circles discovered the virtues of appropriate sequencing of liberalization (and possibly even 'market-friendly' controls on inflows following the Chilean example).

The trilemma, however, is only the economic framework for policy choices made under the impact of the mainly exogenous drivers of change in the international financial system. In the light of recent developments, there is fierce controversy over whether the extraordinary progress of the last fifteen years in Information and communications technology has generated a permanent increase in productivity growth. There can be no doubt, however, that the ICT revolution has favoured globalisation, especially capital mobility, and there is strong evidence that information plays a major role in international capital flows (Portes and Rey, 1999, 2001).

More narrowly, developments in 'financial technology' have also been important. To be sure, derivatives and forward markets existed before 1914. But the remarkable sophistication of new financial instruments and today's financial markets has clearly favoured portfolio diversification at the international as well as the national level. The well-known 'home bias' of investors has not disappeared – information asymmetries play a role here – but it is declining.

Market participants themselves have been an independent force for globalisation. The major investment banks have been important carriers of the new financial technology, and the notable extension of their own global reach is an independent force promoting the globalisation of capital markets – in cross-border M&A, bank lending, and the financing of foreign direct investment. The growth of large multinational enterprises and the globalisation of their production and marketing strategies has underpinned the strong expansion of foreign direct investment we have observed since the early 1990s. The increasingly global perspective of the major investment institutions (mutual funds, pension funds, insurance companies) has contributed to bringing cross-border equity flows close to the level of cross-border transactions in bonds.

A new literature demonstrates the significance of the legal and institutional environment for capital markets (see e.g. La Porta, *et al.*, 1997). Despite the failings spotlighted by the Asian crisis, there have in fact been fairly continuous improvements in emerging market as

well as OECD countries in areas such as accounting standards, bankruptcy codes, and the like. These are fundamental in the institutional basis for globalisation.

Finally, the international institutions themselves have helped to develop the rules for capital markets. The IMF and the BIS have been particularly important in this respect. The Fund has also served more directly as a guarantor underpinning stability. For this purpose, it need not – and cannot, in my view – be the international lender of last resort. But both investors and governments are conscious of its presence and its capacity to intervene when problems arise. This undoubtedly creates moral hazard. That is a force for instability – but nevertheless a stimulus to capital flows and globalisation itself, whatever the consequences.

2.2.2 International financial stability

Governments and market participants must see great benefits in capital mobility, because the past three decades have brought many examples of its costs. The debt crisis of the 1980s and the Asian crisis of the 1990s are the two most prominent cases at the international level, but there have been a large number of national financial crises as well, in most of which volatile capital flows have been an important factor (Bordo, *et al.*, 2001). Especially for the emerging market countries, coping with international capital mobility has often been very difficult (Portes and Vines, 1997). So we have seen twin or even triple crises, involving exchange-market disturbances, threats to banking systems, and sometimes sovereign debt default (see Eichengreen and Portes, 1987, on the interconnections between these three crisis areas). These crises have been accompanied by some contagion and even apparent systemic threats, notably in 1982-83 when the major money market banks were heavily exposed to countries on the brink of default, and in autumn 1998, under the impact of the Russian default and the failure of LTCM.

The Mexican crisis of 1994-95 brought the G10 countries to study seriously possible changes in the international financial architecture, focusing on responses to sovereign liquidity crises. This first stage of the architecture debate was inconclusive, but efforts were relaunched and broadened after the Asian crisis erupted. The outcome, however, has in my view been very disappointing. It has been limited primarily to a move to implement 'standards' across a wide range of areas, from data dissemination to accounting regulations.

This will undoubtedly improve the framework for capital flows as well as domestic financial stability, and it may thereby help somewhat to limit the frequency and intensity of financial crises. But I have no doubt that crises will indeed recur. And the architecture debate has made little practical contribution to how they will be resolved. For example, it is hard to see any significant differences in IMF policies towards Argentina and Turkey since 1999 and how these cases would have been handled pre-1996 – neither in the approach to exchange-rate policies, nor in bailout packages, their conditionality, and private sector involvement.

Indeed, the focus on standards underscores the emphasis of policies on making the world safe for capital movements. It has been argued that major changes in international financial system come only when countries are convinced that they are necessary to safeguard *world trade* (Eichengreen and James, 2001). In that light, the discussions and policy responses of the last few years may suggest that policy-makers see no clear and present danger to trade from international financial instability. Capital market participants have opposed any major changes in crisis resolution (Portes, 2000), and governments have not wished to impose such changes. So practical measures have been confined to standards, with which market participants are generally more than happy.

National and international exchange-rate regimes also affect financial stability, and national policies have international consequences. There have been very wide exchange-rate swings among the major currencies in the period of floating rates, but countries have accepted this within the constraints of the trilemma. The Asian crisis has stimulated extensive debate on the viability of exchange-rate pegs – more broadly, of managed floats – and the desirability for emerging-market countries of going to one of the extremes of clean floating or dollarisation (e.g., Frankel 1999, Fischer 2001). The debate is still very open, especially in light of evidence that most countries exhibit a ‘fear of floating’ (Calvo and Reinhart, 2000).

But if an exchange-rate peg does not provide a nominal anchor and basis for monetary stability, what is the alternative? Increasingly, countries have chosen to give more autonomy to national central banks in the framework of inflation targeting. Having thereby delegated responsibility for monetary stability, governments turn to fiscal consolidation, where some notable results have been achieved. EMU is of course a prime example

of this trend. And although ‘putting your own house in order’ is certainly not a guarantee of international financial stability, there can be no doubt that domestic stabilization has positive international spillover effects.

Finally, any consideration of the international financial environment must recognise the consequences of the growing number of serious ‘players’ in the system and in writing its rules. The United States still exhibits some of the hegemonic power it exerted with little hindrance in the period 1945-1970, no more so than in the policies of the IMF and international responses to recent financial crises. But the EU – in particular, the euro area and its members in the G-7 – as well as Japan do play major roles, and the major emerging market countries are unwilling to be ignored. This inevitably complicates the process of reaching agreement on any major initiatives.

2.2.3 Threats to international financial stability

Globalisation and free movement of capital provide the framework. International financial crises and the architecture debate, wide exchange-rate swings and prolonged misalignments are evidence that the framework is not always adequate. The trend towards monetary stability at the national level is encouraging, but multipolarity in the international system makes it harder to arrive at consensus. In this context, I turn to current threats to international financial stability.

Recent experience provides convincing examples of our inability to foresee at least some crises, and I have little confidence in any of the proposed systems of ‘early warning indicators’. But it does not take any sophisticated econometric modelling to see two significant sources of potential problems: further instability in Argentina, Turkey or both; and the unsustainable US international situation, which combines strongly negative current account and net foreign asset positions (exceptionally high by absolute and historical standards) with an overvalued currency.

We all hope that the latest IMF packages for Argentina and Turkey, together with determined and effective policy actions by those countries, will bring stability and growth. But we cannot ignore the risk that Argentina’s currency board will ultimately prove an unacceptable straitjacket or will bring deep domestic financial distress and a serious breakdown in the real economy, ending in sovereign default. Nor can we exclude the possibility that the Turkish political system will fail the test set for it by the IMF and the new

Turkish economy minister, in a country where hyperinflation has long seemed just around the corner. In either case, there could be significant contagion effects, and there are certainly other major emerging market countries with continuing or nascent economic and financial instability.

The risk of a 'hard landing' for the US internationally is not trivial, whatever the Fed may do to limit the danger of a deep recession. If the financial markets were to impose an abrupt correction of the current account deficit, this could require a dollar depreciation on the order of 40%; even a slower correction of the deficit would probably require depreciation in the range of 15-25% (Obstfeld and Rogoff, 2001). And we cannot be certain that monetary relaxation and tax cuts will forestall a serious US recession, with wide international ramifications; nor that the monetary relaxation will not rekindle inflation.

There is therefore no lack of potentially serious short-run dangers. I would add two longer-run phenomena that might merit concern. First, there is some evidence that the move to open capital markets has had different consequences in the current period than in 1870-1913. In the previous era of globalisation, the major capital exporting countries built up very large gross asset holdings in the emerging market countries of that time, with little offsetting international liabilities. Today, the net foreign asset positions of the major countries are much smaller than their gross assets and liabilities – that is, much of the lending appears to be more in the nature of portfolio diversification than development finance (Obstfeld and Taylor, 2001). One aspect of this has been the huge capital inflow during recent years into the capital-rich United States. Possibly because the capital-poor countries are unattractive to investors or unable to absorb major inflows productively. Capital mobility in the presence of domestic market imperfections in the capital-poor countries may lead to a significant misallocation of capital in the world economy. That is not an immediate danger to financial stability, but the long-run implications are worrying.

Second, the competition among potential recipients of capital flows can involve regulatory competition and a 'race to the bottom', which could indeed be destabilising. The Financial Stability Forum seeks to avoid this, and the wider push for standards is a countervailing force too. But there is evidently not a consensus on what is a 'tax haven' or what is 'undesirable tax com-

petition', nor on disclosure standards, on protection of minority shareholder rights, and many other dimensions of possible regulatory competition.

2.2.4 The role of the euro area and EMU

The good news is that EMU has brought internal stability: a stability-oriented monetary policy and substantial convergence on non-inflationary growth. We can have reasonable confidence that these conditions will be maintained even in the more difficult international circumstances of the current period.

There has also been substantial progress towards a single financial area, although the slow progress of the Financial Services Action Plan and resistance to the Lamfalussy Committee's proposals shows that there are still very significant obstacles. And their effects are evident in the lack of development of cross-border markets for insurance and pensions, the slow pace of rationalisation of clearing and settlement in securities markets, the frustrations of firms dealing with many regulators, and so forth. The EU has its own 'standards problems': in corporate governance (takeover codes, the protection of minority shareholder rights), lack of harmonisation of accounting and auditing standards, problems of insider information. Nevertheless, the explosive development of euro-denominated corporate securities markets and markets for asset-backed securities, as well as of private equity finance, are evidence of the effects of the single currency in deepening and broadening Europe's capital markets.

The bad news is that the floating euro floated down on the foreign exchanges from the beginning, and we have seen a depreciation of more than 25% against the dollar. This is perhaps not as extreme a misalignment as in 1984-85, but the US current account deficit is even greater now than it was then, and its net foreign asset position has switched from positive to significantly negative. Exporters in the euro area are not unhappy. There is clearly disquiet in the general public, however, with scepticism about the new currency which may interact dangerously with the inevitable problems of the changeover to euro notes and coins.

Put your own house in order

With this background, how can Europe and in particular the euro area contribute to international financial stability? Although I have expressed some doubt about the adequacy of 'put your own house in order' as a guide to policy, it is certainly the right place to start.

This is right if only from self-interest, because the euro area is significantly vulnerable to the two major short-run threats, emerging-market crises and a hard landing for the dollar. Both could threaten internal financial stability in the euro area, which could then have major international spillover effects. It is important to develop safeguards before crises occur.

The banks of the major euro area countries are heavily exposed in Turkey and in Latin America.

Consolidated international claims of reporting banks on individual countries

(\$ bn, by nationality of reporting banks, end-December 2000, BIS data)

Claims on	France	Germany	Netherlands	Spain
Turkey	4.5	13.1	3.1	0.7
Latin America	19.8	36.0	15.2	51.5
Of which Argentina	3.1	8.4	3.3	19.0

It is clear why Germany did not hesitate in the case of Turkey to disregard its normal policy of opposition to large IMF bailout packages!

Turning to the dollar, Goldman Sachs are currently forecasting an exchange rate for the euro of \$1.22 one year from now – an appreciation of 40%. However desirable one might think an appreciation of the euro, a move of this magnitude could be highly destabilising. The recessionary forces and balance sheet movements it would generate could provoke financial distress as well.

The euro area financial system has not yet been tested by such events. There has been much discussion of its ability to deal with financial shocks (for example, Begg, *et al.*, 1998; Padoa Schioppa, 1999; Prati and Schinasi, 1999; Favero, *et al.*, 2000; European Commission, 2000). But it remains the case that EMU has created a single monetary authority with decentralized financial supervision and regulation; no clear locus of lender of last resort authority to deal with illiquidity; and no unified fiscal authority to underpin responses to insolvency. Nor is there any clear, unified locus of concern and policy-making in regard to exchange-rate policy and the issues of the international financial architecture. Although these difficulties need not be fatal, it is important to consider what further might be done to mitigate them.

Monetary union has most likely exacerbated the dangers of systemic risk-generalized financial distress.

Globalisation and deregulation have deepened the channels of contagion. It is true that cross-border M&A activity in euro-area banking is still limited, but it will probably take off after the wave of domestic consolidation has peaked. Meanwhile, the most extensive cross-border relationships are in the interbank market. These data are not entirely interbank, but they suggest the order of magnitude of the interbank exposures.

Consolidated claims of reporting euro-area banks on each other (aggregated)

(\$ bn, by nationality of reporting banks, end-December 2000, BIS data)

Claims by banks of	On banks in these 10 countries
Austria	37.1
Belgium	135.7
Finland	7.1
France	210.6
Germany	442.0
Ireland	10.8
Italy	80.0
Netherlands	121.4
Portugal	9.6
Spain	55.0

There are other sources of systemic risk that EMU has magnified (mostly foreseen by McCauley and White, 1997). Absent the tool of monetary policy at the national level, there is increased macroeconomic risk at that level. Competition in the banking sector and disintermediation, both of which have been stimulated by the development of the euro area financial markets, have put banks under pressure. This induces greater risk-taking, although the securitisation of bank assets at the same time gives them more liquidity (while increasing their exposure to market risk). And the mergers and consolidations within countries have created more institutions that are too big to fail. Finally, the movement towards conglomeration (integrating banking, securities and insurance activities in a single institution) complicates the tasks of supervision and regulation.

The ECB [2001] has recently argued forcefully for *'the preservation of a fundamental role for NCBs in prudential supervision in euro area countries'* italics in original. But many countries, from Luxembourg inside the euro area to the UK outside it, separate banking supervision from the central bank. So there is no strong presumption that financial supervision and regulation, if they were taken from the national level and centralized for the euro area, should be located in the ECB. Nor is

it clear that centralization of these activities would be desirable, as a part of the ECB or as its free-standing counterpart. There are extensive existing coordination structures for the exchange of information among national supervisors (European Commission, 2000): in particular, the Banking Supervision Committee and the Groupe de Contact, while dozens of Memoranda of Understanding have been set out in bilateral relationships. And in any case, centralization at the euro area level is politically not on, as the Lamfalussy Committee recognized when it ruled out an EU-wide analogue to the US Securities and Exchange Commission.

Nevertheless, it is questionable whether there are appropriate *incentives* and *structures*, as well as *ex ante* agreed *procedures*, to govern intervention in *crisis* circumstances. One cannot easily call a meeting in the middle of a business day of a committee covering several countries and expect it to resolve the issue by the opening of the markets on the next day, unless the members need not actually convene because they have already worked out how to respond to various contingencies. We have no reason to believe that the authorities have reached this point.

This is the first area in which action is needed. This does not mean, however, that the authorities should spell out (say) the precise conditions under which they would expect to extend lender of last resort facilities to a troubled institution. It does mean that they should decide in advance how that decision would be made and implemented, as well as how its costs would be shared. One cannot help but think that a 'small' crisis – the failure of a medium-size bank with substantial cross-border activities – could have a salutary effect in concentrating minds on the particular problems of crisis response in real time, without resulting in serious systemic consequences. But no one will wish to engineer even a 'small' crisis, nor is it clear precisely what is the optimal size! I have to confess to concern that the authorities are not ready for the challenge of even a medium-size event of this nature. History shows that they do and will occur, often in unexpected forms, and neither history nor the body politic is kind to those who mismanage them.

There is an alternative, and complementary, mode of action which should meet fewer political obstacles than trying to centralize supervision and regulation. That is to improve the information and incentives to act in a *decentralized* mode (see Favero, *et al.*, 2000). This is congenial to a more flexible regulatory environment

as well as consistent with the broad move towards financial standards (the Financial Stability Forum, etc.). Prescribing more *disclosure* may seem interventionist, but in fact it is merely giving market participants the means with which to 'self-supervise'. For example, much attention has been devoted in the United States to proposals that banks be required to issue a minimum amount of subordinated debt, whose market price would be a sensitive indicator of the health of the institution (Calomiris). The European authorities should examine how this might be applied here.

The ECB has powers to *take* push the process of improving information and incentives substantially further on its own initiative. It could, for example, require disclosure of balance sheet information and exposure in the interbank market. In a more prescriptive fashion, it could take measures to reduce the size of uncollateralised interbank exposures. And it could propose uniform procedures for 'prompt corrective action' and (ultimately) orderly closure when the capitalisation of a bank weakens. Often regulatory forbearance (perhaps arising from regulatory capture) inhibits such moves and induces the sort of 'gambling for resurrection' that was so disastrous in the US savings and loan institutions debacle.

There are other aspects of putting the house in order that would contribute to international financial stability. There is a wide range of advances that could be made in applying better standards across the euro area, indeed for the EU as a whole, and many of these figure in the Financial Services Action Plan. In many of these instances, harmonisation is preferable to the least common denominator of mutual recognition and avoids any temptation to join the race to the bottom. Often private-sector firms and market participants prefer that too – for example, European firms choosing to cross-list their shares tend to go to exchanges that apply tougher standards for accounting and disclosure, because that will be a good signal to investors (Pagano, *et al.*, 2001). A quite different but equally important policy area that affects financial stability is pensions. The political difficulties are obvious, but fiscal consolidation requires ambitious reforms.

EU enlargement and international financial stability

Looking outside the current borders of the European Union, we see first our neighbours to the East. Here there are two areas where policy could significantly improve the prospects for international financial stabil-

ity. First, enlargement of the EU will ultimately result in further countries coming into EMU. When they do, the Council of the European Central Bank will grow further beyond its already unwieldy size. It is essential to reform the governance of the ECB so as to permit effective decision-making. Otherwise, euro area monetary policy-making will suffer. Moreover, neither market participants nor other countries will be able to interpret ECB decisions, whatever improvements are made to its communications policies. This was recognised at the Nice European Council, and a discussion has begun; a detailed analysis of the problem and alternative solutions is given by Baldwin, *et al.* (2001).

Second, exchange-rate policy for the accession countries raises important unresolved issues. Under current rules, new entrants will have to go into the Exchange Rate Mechanism for two years prior to entry into EMU. The difficulties of applying an exchange-rate band regime for countries undergoing rapid structural change and productivity growth are widely recognised (Begg, *et al.*, 1999). It would hardly contribute to international financial stability if a new entrant were forced to exit from the ERM! Policy-makers should focus more closely on this problem.

One approach to this problem would be euroisation. Although it might be appropriate for only a few countries, it should not be ruled out *a priori*, as the Ecofin suggested in November 2000. Using a stable currency issued by a monetary authority outside the country, whose domestic supply is limited to that earned through balance-of-payments surpluses, has potential advantages relative to a currency board or a pegged exchange-rate regime. Speculative attacks are no longer possible, so there is no currency risk, and domestic interest rates no longer incorporate that premium. There are typically lower transaction costs and greater transparency in policy. Using a stable foreign currency may itself implant a 'stability culture' in monetary affairs. There are clear costs as well: the loss of seignior age revenues that may be important to governments with limited tax-raising capacities; the absence of a lender of last resort; and the definitive renunciation of an 'escape clause' (an exit option), short of political cataclysm.

These benefits and costs must be weighed by the domestic political authorities. The Council (Ecofin) opinion of 7 November 2000 asserts that 'before finally adopting the euro', the candidate countries must fulfill the Maastricht criteria: 'any unilateral adoption of the

single currency by means of "euroisation" would run counter to the underlying economic reasoning of EMU in the Treaty... [it] would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro.' The DG ECFIN paper for Ecofin on 'Exchange Rate Strategies for EU Candidate Countries' (22 August 2000) was even more extreme. It claims that the 'sequencing entrenched in the Treaty for the adoption of the euro' would be altered, the 'principle of equal treatment between present and future as among future member states will be violated', that 'negotiating' euroisation would alter the *acquis communautaire*, etc.

It is true that once a country enters the EU, its exchange-rate policies become legally a matter of common concern. But not before. And using the euro in no way prejudices or impinges on the accession process or the subsequent process of entering into Monetary Union. It cannot run counter to any legal provision of the Treaties. Using the euro is *not* equivalent to participating in EMU, nor 'unfairly' getting a 'head start', nor does it implicate the ECB in any significant way. Unilateral euroisation cannot affect the credibility of the euro, since the euroising country cannot participate in the economic institutions of EMU, and it would certainly be made totally clear at the outset that the ECB would not respond to any 'bailout' request.

Unilateral euroisation is not entry into the single currency (EMU). Suppose the CFA countries were to propose euroisation – on what grounds would we wish to forbid that, supposing that we could? Should we have stopped DM-isation in Kosovo? If Turkey wished to deal with its long inflationary history and current financial crisis by euroising, why should we seek to impede that? What negative implications have Panama's long-standing use of the dollar or the recent dollarisation in Ecuador and El Salvador had for the US? In general, it is clear from the international debate on exchange-rate regimes that euroisation may be an appropriate option not just for some of the accession countries, but elsewhere too. That could promote international financial stability. Ecofin should reconsider their position on this issue, and possibly a reflective analysis by the ECB could show the way.

Europe and the euro in the international financial system

We now come to the broad international domain. Here there are three important issues: exchange-rate policy, the international financial architecture, and the international role of the euro. At a slight risk of oversimpli-

fication, I think it fair to characterise the positions of the EU and the euro area in all three areas as nonexistent. This is more than unfortunate. It is unwise.

I am not recommending target zones. Desirable or not, there is no appetite for formal target zones now or in the politically foreseeable future, either in the euro area (not just the ECB), or in the United States. France and Japan like to talk about it, and that can do no harm, especially if it softens attitudes toward foreign exchange market intervention, which is a separate issue.

In appropriate circumstances, intervention can help to maintain international financial stability. One need not have a formal target zone in mind to recognise that the current euro/dollar rate is a massive misalignment. The longer it persists, the more distortions it will generate in resource allocation – and, perhaps, the more violent will be the inevitable ‘correction’.

The euro will appreciate. Policy-makers should seek to manage that process to limit the instability it might cause. But there is widespread belief that sterilised intervention – that is, purchasing euros in the markets without a corresponding tightening of monetary policy – would be ineffective. New research challenges this consensus and suggests that the impact could be substantial and sustained.

This new work focuses on the portfolio effects of intervention. To the extent that central bank orders mimic private trades, the portfolio effects of such trades can tell us something about how intervention would work. Martin Evans and Richard Lyons (2000) find that private buy orders in major foreign exchange markets have an immediate effect on exchange rates of about 1 percent per \$2 bn. The analysis applies directly to unilateral, sterilized central bank intervention. If intervention strategy were timed appropriately, Evans and Lyons find that buy orders would have a *persistent* effect of about 1 percent per \$3 bn. These results suggest that if the authorities want a sustained 10-percent appreciation of the euro, that would require selling about \$30 bn of their foreign exchange reserves. This is small in relation to ESCB reserves, even to those under the direct control of the ECB. It has been argued that at least \$75 bn of ESCB reserves are indeed ‘excessive’. Using somewhat over half the ‘excess’ in a sustained policy of sterilised intervention to bring the euro back to dollar parity and reverse market psychology could be a good investment.

More generally, the euro area should behave more like a single monetary area in the international domain. It should indeed become Europe’s *interlocuteur valable* on exchange-rate issues, in discussion with the US and Japan, and on the international financial architecture. That requires a much more cohesive policy from the Euro Group; more joint policy-making between it and the ECB; and unified, coherent external representation in the international institutions, particularly the IMF and G-7. It is past time to admit that the current messy compromises are inadequate.

Europe’s limited influence on the architecture debate, which has clearly been dominated by the United States, is partly due to the inability to arrive at agreed European positions and to represent them effectively (Coeuré and Pisani-Ferry, 2000). For example, the Europeans have broadly favoured a more rule-based, less discretionary approach to private sector involvement in crisis resolution. The American preference for a case-by-case flexibility has so far prevailed – and even some German policy-makers may regret that their hands were not tied more tightly when it came to dealing with Turkey.

Looking to the future, the Europeans are noticeably cooler to the Meltzer Commission’s proposed sweeping restrictions on the IMF than are many American members of Congress and officials in the Bush administration. If Europe cannot speak clearly on these issues, it may find serious difficulties ahead. The four top jobs in the IMF under the Managing Director must now be filled. Will Europe have a more cohesive approach to this important problem than it did when the MD post was under discussion? Taking responsibility for international financial stability covers a wide domain.

Indeed, that responsibility goes beyond the realm of statistics and economic analysis, beyond formal institutions, even beyond the law. I refer to the black economy, to the various international mafias, to drug barons and the like. What do they all have in common? They use the dollar – specifically, \$100 bills. In general, I see no harm whatsoever in healthy competition between Europe and the United States. But I do object strongly to Europe competing for American business with these objectionable characters by printing 500 euro notes! We can do without that particular source of seigniorage, and I hope those notes will be issued very sparingly.

I conclude with the role of the euro in the international financial system. I have argued that the euro could attain

a status like that of the dollar as an international currency, within a horizon of 5-10 years, assuming that the UK were to enter and that further financial market integration were successfully implemented (Portes and Rey, 1998).

The United States Treasury's publicly expressed view on any possible challenge to the dollar's international status is lack of concern, if not lack of interest. But was the quick move to block an Asian Monetary Fund really only a reaction to a perceived threat to the IMF? Or might it have reflected some concern to maintain dollar dominance? Dollarisation for emerging markets is popular in the US Congress, and the Treasury's scepticism seems milder and more ambivalent than in pre-euro days. There is evidence of some perception of competition here.

What is the response of the European policy authorities on these issues? The Euro Group has been totally silent on the international role of the euro. The European Central Bank, however, appears to have accepted our analysis of the synergies between the integration of euro-area capital markets, falling transaction costs, and international currency use of the euro. Indeed, it calls this a 'virtuous circle' (ECB 1999, p. 39). Among the virtues are considerable benefits for euro area governments and firms. Yet virtue is not rewarded – nor even encouraged:

'In conclusion, the international role of the euro is mainly determined by the decisions of market participants in a context of increasing integration and liberalisation of product and capital markets worldwide. The Eurosystem therefore adopts a neutral stance, neither hindering nor fostering the international use of its currency.' (ECB 1999, p. 45)

Indeed, the markets will determine the relative status and roles of international currencies. But when there are multiple equilibria, the markets can be guided towards one or another. Why be 'neutral'? Why not go for the 'good equilibrium'? The 'therefore' in the ECB's statement simply does not follow. Perhaps, like many inconsistent statements and policies, it reflects a compromise – in this case, between German and French views.

Competition between the euro and the dollar for the key currency role could be dangerous. Although there are no conclusive arguments that a world of multiple reserve currencies is unstable, the precedent of rivalry between the dollar and sterling in the interwar period is not encouraging. So this may require careful, co-operative management.

The tasks are considerable. The stakes are high. International financial stability is a precious public good. Europe and the euro-area authorities can take concrete actions to support it – EMU and the euro can contribute to international financial stability. But this will require much more focus on these issues than we have seen hitherto.

References

- Baldwin, R., *et al.*, 2001, *Nice Try: Should the Treaty of Nice be Ratified?*, Monitoring European Integration **11**, CEPR.
- Begg, D., *et al.*, 1998, *The ECB: Safe at Any Speed?*, Monitoring the European Central Bank **1**, CEPR.
- Begg, D., *et al.*, 1999, *Monetary and Exchange Rate Policies, EMU and Central and Eastern Europe*, Forum Report of the Economic Policy Initiative, CEPR.
- Bordo, M., *et al.*, 2001, 'Is the crisis problem growing more severe?', *Economic Policy* **32**.
- Calomiris, C,
- Calvo, G., and C. Reinhart, 2000,
- Coeuré, B., and J. Pisani-Ferry, 2000, Events, ideas and actions: an intellectual and institutional retrospective on the reform of the international financial architecture, Conseil d'Analyse Economique, Paris.
- Danthine, J.-P., *et al.*, 2000, *EMU and Portfolio Adjustment*, CEPR Policy Paper no. 5.
- Eichengreen, B., and H. James, 2001, 'Monetary and financial reform in two eras of globalisation (and in between)', paper for NBER conference on Globalization in Historical Perspective, Santa Barbara, May.
- Eichengreen, B., and R. Portes, 1987, 'The anatomy of financial crises', in R. Portes and A. Swoboda, eds, *Threats to International Financial Stability*, Cambridge University Press.
- European Central Bank, 1999, 'The international role of the euro', pp. 31-53 of *Monthly Bulletin*, August, Frankfurt.
- European Central Bank, 2001, The role of central banks in prudential supervision.
- European Commission, 2000, Report on financial stability, Economic Papers no. 143, Directorate-General for Economic and Financial Affairs.

- European Commission, Directorate-General for Economic and Financial Affairs, 2000, 'Exchange rate strategies for EU candidate countries', 22 August (ECFIN/521/2000).
- European Commission, 2001, 'EMU: the first two years', Euro Papers no. 42, April.
- Evans, M., and R. Lyons, 2000, 'The Price Impact of Currency Trades: Implications for Intervention'.
- Favero, C., *et al.*, 2000, *One money, many countries, Monitoring the European Central Bank 2*, Centre for Economic Policy Research.
- Frankel, J., 1999, 'No single currency regime is right for all countries or at all times', Princeton Essay in International Finance no. 215.
- Fischer, S., 2001, 'Exchange Rate Regimes: Is the Bipolar View Correct?', address to American Economic Association, January.
- Kenen, P., *et al.*, 1996, 'From Halifax to Lyons: What Has Been Done about Crisis Management?', Essay in International Finance no. 200.
- Lane, P., and G.-M. Milesi-Ferretti, 1999, 'The external wealth of nations: measures of foreign assets and liabilities for industrial and developing countries', CEPR Discussion Paper no. 2231.
- La Porta, R., *et al.*, 1997,
- McCauley, R., and W. White, 1997, 'The euro and European financial markets', Bank for International Settlements Working Paper No. 41, May.
- Obstfeld, M., and K. Rogoff, 2001, 'Perspectives on OECD Economic Integration: Implications for U.S. Current Account Adjustment', in *Global Economic Integration: Opportunities and Challenges*, Federal Reserve Bank of Kansas City.
- Obstfeld, M., and A. Taylor, 2001, 'Globalization and capital markets', paper for NBER conference on Globalization in Historical Perspective, Santa Barbara, May.
- Padoa Schioppa, T., 1999, 'EMU and banking supervision'.
- Pagano, M., *et al.*, 2001,
- Portes, R., 1999, 'An Analysis of Financial Crisis: Lessons for the International Financial System', pp. 471-478 of W. C. Hunter, *et al.*, eds., *The Asian Financial Crisis: Origins, Implications, and Solutions*, 1999, Kluwer Academic Publishers
- Portes, R., 2000, 'The Role of Institutions for Collective Action', pp. 47-73 of C. Adams, R. Litan and M. Pomerleano, eds., *Managing Financial and Corporate Distress: Lessons from Asia*, Brookings Institution, Washington DC.
- Portes, R., 2001, 'Global Financial Markets and Financial Stability: Europe's Role', pp. 195-213 of *Governance, Equity and Global Markets, proceedings of World Bank ABCDE-E Conference*, La Documentation Française, 2000.
- Portes, R., and H. Rey, 1998, 'The emergence of the euro as an international currency', *Economic Policy* **26**, pp. 305-343.
- Portes, R., and H. Rey, 1999, 'The determinants of cross-border equity flows', CEPR Discussion Paper no. 2225, NBER Working Paper no. 7336.
- Portes, R., and H. Rey, 2001, 'Information and capital flows', *European Economic Review*.
- Portes, R., and D. Vines, 1997, *Coping with international capital flows*, Economic Paper no. 30, Commonwealth Secretariat.
- Prati, A., and G. Schinasi, 1999, *Financial stability in European Economic and Monetary Union*, Princeton Studies in International Finance no. 86.