4

The Euro and Prospects for Policy Coordination

EDWIN M. TRUMAN

This chapter is divided into two sections. In the first, longer section, I evaluate the case for improved policy coordination with and by the euro area, which is the principal focus of the chapter. I review 10 topics and conclude that a prima facie case can be made for improvement. In the second section, I put forward 6 recommendations for how policy coordination with and by the euro area might be improved. Before moving on to substance, I cover some preliminaries.

What do I mean by policy coordination? In general, I prefer a broad concept including information exchange, dialogue and shared analysis, common objectives, joint action, and endorsement of current policies (Truman 2004a, 268). However, it is useful to try to distinguish which type of policy coordination one is talking about, which I have tried to do in the first section of the chapter.

What do I mean by policy coordination by and with the euro area? There is considerable policy coordination by and with the euro area today—with central institutions like the European Central Bank (ECB), with the European Commission in Brussels, and with officials in capitals of the various European countries. The issue considered here is whether more can and should be done. I am deliberately vague in the first section

Edwin M. Truman is a senior fellow at the Institute for International Economics. *He is grateful for the comments by Richard H. Clarida and Richard N. Cooper on an earlier version of this chapter. He is also grateful for comments from his colleagues William R. Cline, C. Randall Henning, and Catherine L. Mann and from Peter B. Kenen. He also thanks Fabrizio Iacobellis for excellent research assistance in preparing this chapter.*

of the chapter on the issue of the structure of the coordination process on the European side. However, in this context, policy coordination is intended to apply principally to the interaction of euro area officials with US officials but also encompasses the euro area's interaction in international forums such as Group of Seven (G-7) meetings, G-7 and Group of Eight (G-8) summits, Group of Twenty (G-20) meetings, and various meetings at or associated with the International Monetary Fund (e.g., its International Monetary and Financial Committee). It is a considerable complexity, at a minimum, that the euro area is not the same as the European Union, and I return to this issue in the second section of the chapter under the heading "Getting the Right Players on the Field."

The Case for Improved Policy Coordination with the Euro Area

The global economy has just emerged from an extended slowdown that followed a period of uneven global growth punctuated by a rash of external financial crises directly affecting countries in Latin America, Asia, and Europe (treating Russia as part of Europe for these purposes). For much of this period, the US dollar was strengthening or was very strong, ultimately casting a shadow over the early years of full European Monetary Union with the birth of the euro. That strength was associated with a dramatic rise in US productivity and economic growth, but also with the emergence of an oversized current account deficit and rapid further deterioration of the US net international investment position. It now may be that the US external deficit is in the early stage of correction or at least temporary stabilization.

This judgment provides the background for the first 6 of the 10 topics for policy coordination with and by the euro area that are examined below: external adjustment, rebalancing the global economy, global growth, fiscal policies, intervention strategy, and the IMF and global capital flows. I also consider four other topics: EU enlargement, euro-dollar peaceful coexistence, structural reform, and trade issues.

External Adjustment

The US current account deficit reached 4.2 percent of GDP in 2000, surpassing its previous maximum of 3.4 percent in 1987, and it has remained, or is projected to remain, at that level or above through at least 2005. The deficit narrowed a bit in 2001 under the influence of the US recession but widened to 4.6 percent in 2002 and 4.9 percent in 2003. Meanwhile, the weighted-average foreign exchange value of the dollar on the broad Federal Reserve index declined in real terms by about 13 percent from February 2002 through February 2004; the decline against the currencies of the major industrial countries more than accounted for the decline in the broad index.[1]

The explanations for the dollar's rise are as numerous as those of the dollar's decline. Debates about whether either its rise or its fall is good for the United States or the global economy, similarly, have failed to reach a consensus. It is very difficult to prove anything in this area in the absence of robust models of exchange rate determination. It is also very difficult to prove how large an adjustment of the US current account position may be under way. Estimates range from a couple of percentage points of GDP, from the current 5 to 3 percent, to more than 5 percent of GDP, enough to push the US balance on goods and services—which was 4.5 percent of GDP in 2003—into surplus and begin paying down the US net external debt.

Interestingly, both explanations can be supported by the productivity story about the behavior of the US economy during the past decade. Rosenberg (2003) justifies a smaller adjustment, down to 3–4 percent of GDP on the basis that the extraordinary surge in US productivity will continue and the global economy should and will continue to accumulate net claims on the United States. Erceg (2002), conversely, reminds us that in the face of a productivity shock that ultimately dies out, an economy has to repay the external debt that it accumulated while the productivity shock was under way, which means that the country must run trade surpluses.[2] In this connection, it is important to recall that if the United States is to stabilize its net international investment position relative to GDP, it might have to be running a surplus on trade in goods and services sufficient to cover its net income payments, currently approximately zero, but likely to move into negative territory once dollar interest rates return to neutral, plus net transfer payments, currently running about 0.5 percent

1. Over the two-year period, the real decline against the major currencies (Australia, Canada, euro area, Japan, Sweden, Switzerland, and the United Kingdom) was 23 percent on average while the dollar rose 2 percent on average against the currencies of 19 other important trading partners. Much of the increase is attributable to the dollar's nominal appreciation against the Mexican peso of 21 percent over the period, and its substantial appreciations against other Latin American currencies included in the index: the Argentine peso, the Brazilian real, and the Venezuelan bolivar.

2. The Erceg simulations, using an optimization model that takes account of intertemporal budget constraints, support the view that the dollar's appreciation was induced by the relative acceleration of US productivity in the second half of the 1990s. Hunt and Rebucci (2003) use a similar model and obtain a similar result for an asymmetric productivity shock to the United States; they also note that to explain fully the dollar's appreciation, their model requires a temporary but persistent decline in the perceived riskiness of US assets—in other words, a dash of irrational exuberance.

of GDP.[3] Stabilization of the US net international investment position as a share of GDP does not involve any paying down of US net indebtedness.[4]

However, Dooley, Folkerts-Landau, and Garber (2004) opine that a US current account deficit of less than 3 percent of GDP is "manageable." Mann (2003), looking at shares of the global portfolio of equities, has made an estimate that a deficit between 2.4 and 3.6 percent of GDP as of 2005 would be sustainable. Richard Cooper ("America is Saving Enough," *Financial Times*, February 20, 2004, 13) has argued that from the vantage point of the United States the case is weak for deliberately reducing US reliance on net savings from abroad in the form of large current account deficits. The United States is benefiting from the net inflow of foreign savings because it is adding to net investment, which importantly embodies technological advances, and enables the United States to absorb more goods and services than we produce, living beyond our means. From a global perspective, the issues are: How long will the rest of the world be content to send substantial amounts of their net saving annually to the United States? And how disruptive to global prosperity is an eventual US external adjustment process likely to be?

One does not have to rely on sophisticated macroeconomic models to conclude that US external adjustment may well be under way. Federal Reserve Board governor Donald Kohn (2004, 4) goes no further than the analysis of former Federal Reserve Board staff member Caroline Freund (2000) to conclude "when the deficit approached this magnitude [5 percent of GDP] in the past, markets had generally already begun to adjust to reduce it."

Federal Reserve Board chairman Alan Greenspan (2003, 3; 2004a, 4) is slightly more cautious:

> There is no simple measure by which to judge the sustainability of either a string of current account deficits or their consequence, a significant buildup in external claims that need to be serviced. Financing comes from receipts from exports, earnings on assets, and, if available, funds borrowed from foreigners. In the end, it will likely be the reluctance of foreign country residents to accumulate additional debt and equity claims against US residents that will serve as the restraint on the size of tolerable global imbalances in the global arena.

3. Assuming a normal nominal growth rate of US GDP of 6 percent, stabilizing the US net international investment position at the level of 25 percent of GDP that prevailed at the end of 2002 would be accomplished with a current account deficit of 1.5 percent of GDP. If US net income payments were 0.5 percent of GDP and net transfer payments were also 0.5 percent of GDP, the United States could have a small trade deficit of 0.5 percent of GDP, compared with its recent deficit of 4.5 percent of GDP. However, if, as would be likely, net income payments were to rise to 1 percent of GDP or higher, the United States would have to move into trade surplus.

4. Dollar depreciation does have a positive effect on US net international indebtedness as a share of GDP by increasing the dollar value of foreign-currency-denominated assets, which are more substantial than foreign-currency-denominated liabilities.

However, he too cites Freund as providing evidence that the point will arrive when this adjustment process will be fully under way. Neither Kohn nor Greenspan offers a view on the extent of possible adjustment in the US external accounts, when it will come, or if it is coming, but both are sanguine about the process.

Issing (2003, 5) is less sanguine than Kohn and Greenspan about the US external adjustment process. He is concerned about a disorderly adjustment process: "The current level of the US current account deficit is in the longer run unsustainable and an adjustment will eventually occur, whether actively supported by macroeconomic policies or not. The question is only whether it will happen in an orderly fashion." However, he does not define what he means by orderly. Presumably he means a process that is not disruptive to global economic growth and financial markets. He argues that the risk of a disorderly adjustment is increased the longer the flow imbalances exist and the larger they are because the required adjustment back to more reasonable levels would be larger. He also argues implicitly that the US current account deficit was the result of an inefficient allocation of world savings associated with euphoria over the US "new economy," which unreasonably boosted expected returns in the United States and resulted in "hot" portfolio flows partly induced by accounting irregularities at US companies.[5]

Issing does not express a view on the size of the needed adjustment in US external accounts, but he implicitly aligns himself with an IMF view that a US current account deficit of about 2 percent of GDP would be consistent with equilibrium in the saving-investment balance, which is his preferred analytical framework.[6] He suggests that there may need to be a

5. Issing seems to ignore the fact that the German DAX stock market index declined 68 percent from its recent (monthly average) peak in February 2000 to its trough in March 2003, and the UK *Financial Times* 100 (FT100) declined by 48 percent from its peak in December 1999 to its low in March 2003, while the US Standard & Poor's (S&P) 500 declined by 46 percent from its peak in August 2000 to its low in September 2002. Since their recent troughs through February 2004, the DAX has recovered 53 percent of its decline, the FT100 65 percent, and the S&P 500 75 percent. Moreover, the incidence of accounting and corporate governance scandals has been high in Europe as well as in the United States; witness the cases of Adecco, Ahold, Credit Lyonnais, Kirsch Media, Parmalat, Shell, and Vivendi. Irrational exuberance, artificially induced or not, was not confined to the United States. It may have continued longer or still be present in the United States because of excessively easy monetary policy, but that is another debate into which Issing did not enter. He did argue implicitly (*Wall Street Journal*, February 18, 2004) that the Bundesbank-ECB monetary policy framework with its emphasis on monetary and credit developments contributes "to limiting the emergence of unsustainable developments in asset prices" compared with other monetary policy frameworks. His argument is not supported by the data cited above.

6. Issing does not provide a source for the IMF view that he cites. It most likely is Isard et al. (2001), which estimates a saving-investment norm for the United States in 2003 of about 1.75 percent of GDP of net capital inflow. IMF (2002) can be read as supporting a view that a correction of 2 percent of GDP down to 3 percent of GDP is likely to be in the cards,

further adjustment in the US private saving-investment balance, but he is confident (Issing 2003, 8): "A considerably larger correction will be necessary for the public saving-investment balance, with the current [US] fiscal stance certainly not sustainable in the long run. Such a correction will in all likelihood imply lower growth for a long time." His basic message (2003, 5) is to get on with it, and the sooner the better: "By supporting an adjustment sooner rather than later policy-makers could, in principle, help to ensure such a gradual and orderly adjustment, while at the same time possibly contributing to a more efficient use of global savings and safeguarding the global trading system by limiting protectionist pressures."

It is not clear through what mechanism Issing thinks the narrowing of the US savings-investment balance will be translated into a narrowing of the US current account imbalance. Though slower US growth might play a role, and without denying that a significant ex post adjustment of savings and investment would be observed, one would think that substantial and rapid US external adjustment would be associated with substantial and rapid downward adjustment of the dollar. ECB president Jean-Claude Trichet has already decried the early-January 2004 movements of the dollar as "brutal" (*Financial Times*, January 13, 1).

US external adjustment may be under way. It could well involve a substantial further adjustment of exchange rates. The adjustment might be closer to 5 percent of GDP than 2 percent of GDP. A larger adjustment, which I think is more likely, can be based on the influence of the Erceg long-run equilibrium condition, a judgment that the cyclically adjusted US current account deficit is larger than the actual deficit,[7] and the observation that external adjustment processes generally overshoot.

My views, however, are not germane to the question at hand: Is there a case for the policy coordination with the euro area to try to understand and if necessary to adjust economic policies to help manage the inevitable adjustment process or to establish whether it is inevitable? As part of that policy coordination, the euro area and its partners might want to consider how large the adjustment is likely to be, through what channels it is likely to occur, and how the euro area and other policies should react. Thus, the policy coordination process by and with the euro area should include improved information exchange, dialogue and mutual education, and analysis. On the basis of that analysis, it is possible that policy coordination could progress to the establishment of common objectives and joint action

because that has been the historical pattern for industrial countries with large current account deficits. The same source can be read as implying a correction of closer to 4.5 percent of GDP down to 0.5 percent of GDP to stabilize the US international investment position as a ratio of GDP at its 1990–98 average.

7. This judgment is based on an assumption that the US output gap is likely to be closed, but that the probability that the output gaps in the euro area or Japan will be closed is substantially lower.

to achieve those objectives. The basic issues—size, channels, and policy adjustments—inform the next five topics.

Rebalancing the Global Economy

Even if the adjustment of the US external deficit during the next couple of years turns out to be unsubstantial—say, less than 2 percentage points of GDP—it will be the first step in an important rebalancing of the global economy, because the growth of the world economy cannot rely indefinitely on the further expansion of the US external deficit.[8] By assumption, even if the US external adjustment does no more than stabilize at 4 to 5 percent of GDP for the foreseeable future, the US deficit will no longer be providing a demand stimulus to the global economy.

If the US external adjustment is substantial, say, closer to 5 percentage points of GDP, the deflationary impact will have to fall on all regions of the world. To date most of the impact has been felt, at least directly, by other industrial countries: the euro area, other countries in Europe, Japan, Australia, Canada, and New Zealand.

The G-7 agreed in Dubai in September 2002 that this unbalanced process had continued far enough: "We emphasize that more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustment in the international financial system, based on market mechanisms." The language was convoluted, no doubt reflecting the contorted drafting by committee that was involved. However, the language broke fresh ground in embracing exchange rate flexibility, something that the Europeans and Japanese had resisted in the past, and in seeking to broaden the international adjustment process.

The G-7 communiqué issued in Boca Raton, Florida, on February 7, 2004, was substantially similar. It did offer a sop to the Europeans by including the tired phrasing "excess volatility and disorderly movements in exchange rates are undesirable for economic growth," terms that have been used and undefined in similar communications for three decades. The G-7 also clarified its call for exchange rate flexibility by confining it redundantly to those that lack such flexibility. The new G-7 statement changed nothing, certainly nothing fundamental with respect to economic and financial policies.

8. In general, it is inappropriate to look at bilateral trade balances. However, changes in those balances are indicative of the direct effects on the rest of the world of changes in a particular country's overall trade balance. In the recession year of 1991, the US deficit on goods and services was 0.5 percent of GDP, its lowest point since the mid-1970s. In that year, the US trade surplus with the EU was $17 billion, compared with a deficit of $86 billion at an annual rate in the first three quarters of 2003. The swing in the bilateral balance with the European Union accounts for more than a fifth of the $470 billion deterioration in the US deficit during the period.

It was a tactical mistake to link exchange rate adjustment to market mechanisms because that appeared to rule out a one-time upward adjustment of the Chinese renminbi. It was an even greater travesty or tragedy (take your pick) for the International Monetary Fund to abdicate its responsibility and not speak out on the question of the need for exchange rate adjustments and flexibility by emerging-market economies at the same time that it was expressing concern about the US current account deficit and the level of foreign exchange reserves in Asia (IMF 2002, 2003a).

This does appear to be an area where further policy coordination with the euro area could be fruitful. Again, in the first instance, improved policy coordination would involve information exchanges and dialogue backed by economic analysis. It could later mature into the development of common objectives and joint actions.

Global Growth

The adjustment of the US external accounts, when it occurs, will be accompanied by slower global growth; the only question is how much slower. US growth will be lower in the short run because US interest rates will have to rise to choke off the growth of consumption and investment demand and replace it with increased export demand, unless the US economy is not already at full employment, which it most likely will be by late 2005 when these adjustments are likely to begin to kick in. The lower investment will reduce US potential growth over the longer run because of the slower growth rate of the capital stock; the extent of the reduction will depend in large part on whether there is a concomitant narrowing of the US fiscal deficit.

At the same time, growth abroad will be adversely affected in the short run by the need to offset the removal of up to $500 billion (4.5 percent of US GDP) in net stimulus to the world economy, roughly 2 percent of non-US global GDP of $25 trillion, at current exchange rates. No doubt policies will respond, with a lag, and economies will adjust slowly on the supply side, but for a period of three to five years while the US external adjustment is under way, growth outside the United States will be lower than it otherwise would be.

These prospects raise issues about policy adjustments in the short and longer runs. With respect to European economic policy or at least the ECB's policy, if Issing's view is representative, the view appears to be that nothing needs to be done in the short run to facilitate global adjustment. Issing argues that there are no major imbalances in the euro area constraining growth; the real structural problem in Europe is that potential growth is too low; and Europe (and Japan) need to avoid being hoodwinked—as they were in the late 1980s, for example, in the Louvre Accord—into adopting misguided policies to expand domestic demand.

Issing also rejects the view that strong growth in domestic demand in the United States in the late 1990s had anything to do with saving the rest of the world, especially Europe, from stagnation and recession. He is right that strong US growth was largely spontaneous, with a supporting role played by a responsible fiscal policy and a neutral monetary policy in the United States. But the simple fact is that from 1998 to 2000 the growth of US domestic demand was more than three-quarters of a percentage point higher than the growth of real GDP. From 2000 to 2002, during the birth of the euro, the growth of US real GDP annually exceeded the growth of domestic demand by more than half a percentage point on average. The euro area was in stagnation from 2001 to 2003, and without the pull of its external sector, it most likely would have experienced a recession.

In 1999 (Truman 1999b), I argued that appropriate structural reforms in Europe should improve the investment climate and stimulate investment, thereby narrowing the savings-investment imbalance in Europe and boosting growth in the euro area, which would be in the US interest as well. Five years later, we can wish more had been done. The G-7 Agenda for Growth issued in Dubai in September 2003 emphasized supply-side policies but also made a tepid bow in the direction of the role of macroeconomic demand-side policies in the global adjustment process: "Higher economic growth through the G7 will redress global imbalances that arise inter alia from uneven growth within the G7." Such statements suggest that the policy coordination process with the euro area has a lot to address with respect both to future policies as well as learning the lessons of the past.

Turning to longer-run policies, as the chapter in this volume by Adam Posen and the work of Baily and Kirkegaard (2004) demonstrate, there is no neat separation between the short run and the longer run, nor between demand-side and supply-side policies and institutions. The G-7—in its Dubai Agenda for Growth, and reverting back to the G-7 in the late 1980s—links the two: "Working as a group we intend to do regular supply-side surveillance, benchmarking proposals and reviewing results. This will complement our ongoing demand-side surveillance and mutually encourage progress toward pro-growth policies."

One can ask whether the US commitment in Dubai to tort reform will have much of a supply-side impact, but both demand-side and supply-side issues at least are on the table. For the euro area, they include reform of the Stability and Growth Pact, reorientation of the monetary policy framework of the ECB in the direction of greater clarity and more emphasis on short-term growth, proemployment labor market reforms, and product market and competition reforms. For all the mature industrial economies, these policies are linked to the impending demographic overhang of elderly people as well as to immigration policies.

Thus, issues of global growth in the long run as well as the short run would appear to provide more than ample opportunity for improved policy coordination with and by the euro area. That policy coordination could take the form of the establishment of common objectives as well as agreements on joint action designed to support and sustain global growth.

Fiscal Policies

The lack of agreement within the euro area as well as within the United States on the role of fiscal policies in promoting growth and external adjustment is palpable. We have already noted the debate within the euro area about the Stability and Growth Pact. In the United States a similar debate rages, including about the external risks associated with profligate fiscal policies (see Rubin, Orszag, and Sinai 2004 for a recent example).

The current European view appears to be that the United States should act now to reduce its fiscal deficit and slow its growth in order to reduce its external deficits and slow the depreciation of the dollar. Japan's finance minister Sadakazu Tanigaki, as reported in the *Financial Times* of January 15, 2004, expressed a similar view; he called upon the United States to repair its trade and fiscal deficits because concern about them is driving the dollar lower on exchange markets.

It is worth remembering that macroeconomic relationships between changes in fiscal positions and exchange rates are not well understood. For example, during the second half of the 1990s, the US fiscal position swung into surplus, the dollar appreciated, and US external deficits widened. However, from 1993 to 1995, when the US fiscal position improved by 1.5 percentage points of GDP on a nominal and structural basis (OECD calculation, December 2002), the dollar depreciated by more than 5 percent on a real effective basis (Federal Reserve Board staff Broad Index) from the fourth quarter of 1993 to the second quarter of 1995, and the federal funds rate rose by 300 basis points in nominal terms and only slightly less in real terms.

Again, it appears that the euro area has the scope for constructive policy coordination on fiscal issues, which matter not just for the euro area but also for the rest of the world, especially against the background of the apparent incipient adjustment process for US external accounts. That policy coordination should start with extensive dialogue and shared analysis of the role of fiscal policy in the euro area as well as the United States and other industrial economies. On the basis of that shared analysis, joint and supportive action might be developed.

Foreign Exchange Market Intervention

Once a substantial adjustment of the US external position gets under way, it is likely to involve significant further adjustments in exchange rates. In that context, the question that will arise is whether foreign exchange market intervention should be one of the instruments used to attempt to manage the adjustment process. In my view (Truman 2003b, 262–63), exchange market intervention has definite limits as a policy instrument. Its effectiveness is uncertain and imprecise, and therefore it is at best a blunt or blunted instrument. It is more appropriately best used as a supplement to other more fundamental economic policies. As the Japanese have demonstrated by their actions during the past several years, exchange market intervention with respect to the major currencies is an easily discredited instrument that rapidly loses its effectiveness as the result of overuse unconnected with other policies. This is not to say that foreign exchange market intervention is an instrument never to be used. Moreover, I confidently predict that it will be used at some point by both the euro area and the United States during the period of adjustment of the US external balance that is likely to unfold over the next several years.

The challenge facing the euro area and the process of policy coordination by and with the euro area is to choose those moments wisely. Choosing them involves reaching a collective judgment about such matters as the likely extent of US external adjustment, how much has already occurred, and whether other more fundamental policies are likely to be supportive of that adjustment and exchange rate stability—for example, that ECB monetary policy is not tightening when there is a desire to depreciate the euro.[9]

The experience during the period 1985–88 is instructive in this regard. Foreign exchange market intervention had very little to do with the decline of the dollar starting in February or March 1985. The famous Plaza Accord, to the extent that it hurried the dollar along its descent, involved very little actual exchange market intervention, only oral intervention. The dollar's decline generally was regarded as orderly through 1986, but US and other authorities became nervous about its decline in early 1987.

This nervousness led to the Louvre Accord. The best efforts of the Federal Reserve Board staff failed to convince Federal Reserve Chairman Paul Volcker and the US Treasury that the dollar had a long way to go if it was to accomplish the scale of current account adjustment that we felt was under way. Thus, the G-7 minus Italy undertook in February 1987 to halt the dollar's decline with both oral and market intervention.

However, the dollar's decline continued right through the G-7's "Telephone Communiqué" of December 22, 1987, following the October stock market crash. The dollar did not reach its low on a real weighted-average basis until the second quarter of 1988, 10 percent below its level in the first quarter of 1987. It is also interesting to note that the Plaza and Louvre

9. This is a demanding condition. I have calculated (Truman 2003b, 258) that in half of the years from 1981 to 2002 the stance of US monetary policy was inconsistent with bringing the foreign exchange value of the dollar back to its average value for the entire period.

Accords contained US commitments, which were not kept, to reduce the US budget deficit, and the Telephone Communiqué was not agreed on until Congress had passed a two-year, $76 billion deficit reduction package as part of the budget summit that was held in the wake of the stock market crash.[10]

In the late 1980s, heavy intervention by Europe, the United States, and Japan conspired to give use of the policy instrument a bad reputation. It is possible that since 1995, the last period of substantial coordinated intervention, there has been too little use of the instrument. It is also possible that coordination with the euro area will again lead to premature and ineffectual foreign exchange market intervention by the United States and Europe. It is even possible that events will unfold—for example, another stock market crash—would justify such intervention on the basis of disorderly market considerations. However, let us hope that the underlying policy coordination is better informed than it was in the late 1980s and any intervention more effective. Certainly this is an appropriate topic for coordination by and with the euro area. The policy coordination would involve dialogue and shared analysis that could lead to joint action. I do not believe that it should involve the establishment of common exchange rate objectives.

Global Capital Flows and the International Monetary Fund

One of the major counterparts to the accelerated enlargement of the US current account deficit during the past decade has been the swing of the combined current account position of the developing countries and the newly industrialized Asian economies. They moved from a combined deficit of $72.8 billion in 1995–97 to a combined surplus of $124.9 billion in 2000–03, accounting for just over half of the $362.7 increase in the US current account deficit.[11] It has been unnatural for these countries to run current account surpluses, or at least surpluses that are so large for so long. They reasonably can be expected to be part of the solution to the global problem of the US current account adjustment, as was discussed above, moving from a position of net capital exporters back to a position of net capital importers.

In this context, the additional issue for consideration for policy coordination with and by the euro area is the associated adjustments in international capital flows and the consequent implications for the role of the

10. A similar package, which amounted to about 1.5 percent of GDP in 1987–88, today would be about $175 billion.

11. These data are from the September 2003 IMF *World Economic Outlook*. The corresponding enlargement of the total global discrepancy accounted for another 30 percent of the increase in the US deficit, which helps explain the attitude of the other advanced countries: "Why must all the [statistical] burden of adjustment be borne by us?"

IMF vis-à-vis emerging-market economies. Gross international capital flows are a magnified manifestation of net international capital flows. The Institute of International Finance (IIF) estimates that in 2003 its grouping of emerging-market economies ran a collective current account surplus of $91 billion, accompanied by $188 billion in net private capital inflows and $259 billion in reserve increases (IIF 2004). However, these numbers, even the net private capital flows, obscure much larger gross flows, especially given that the different categories of private capital flows are netted across those economies receiving net inflows and those economies producing net outflows.

It is notable that the IIF (2004, 1) commented that its modest further projected pickup in net private capital flows to emerging-market economies in 2004 to $196 billion came with "a risk that the pickup in flows into relatively risky assets has pushed valuations to levels that are not commensurate with underlying fundamentals." Regardless of the riskiness of the investments, larger gross flows in the context of smaller current account surpluses, or even deficits, which implies a change in the sign on net flows, will no doubt be accompanied by a resumption of financial difficulties in emerging-market economies after a period of relative quiescence without new problems.[12]

Moreover, as the IIF also notes in passing, one can reasonably expect that the narrowing of the US current account deficit will be accompanied by a substantial adjustment in US dollar short-term interest rates during the next two years of at least 250 basis points just to bring their level back to neutral.[13] The last time the world witnessed such an adjustment was in 1994, and some commentators (Roubini and Setser 2004) cite the Federal Reserve's removal of monetary stimulus as a factor contributing to the Mexican financial crisis of 1994–95.[14] Again, it is reasonable to expect new financial difficulties in emerging-market economies.

As a consequence, the IMF will be back in the center of international financial debates. It may or may not have adequate financial resources to deal effectively with the new problems. The US administration has decided to put its mouth where its money is not and has effectively vetoed an in-

12. Of course the problems of Argentina, Turkey, and Uruguay are still with us, but they date from financial flows of the late 1990s, not post-2000.

13. The federal funds rate is currently 1 percent and inflation is between 1 and 2 percent, depending on the measure used. A normal, neutral level of the real federal funds rate is around 2 percent, which suggests that the funds rate will have to rise by at least 250 basis points even if there is no increase in the US inflation rate.

14. In retrospect, the start of the Federal Reserve's monetary policy adjustment in 1994 was delayed too long. The increase in the nominal federal funds rate was 300 basis points and the increase in the real federal funds rate was 250 basis points, moving the stance of monetary policy from ease through neutral to restraint without a pause. In fact, the macroeconomic effects on the US economy of the Mexican crisis meant that the tightening was reinforced and did not have to be extended further during 1995.

crease in IMF quotas in connection with the Twelfth General Review of IMF quotas that was concluded in early 2003 (IMF 2003b). The US administration took this position to limit the resources that the IMF could devote to financial rescue operations at the same time the United States was voting for ever larger rescue operations (Roubini and Setser 2004, chapter 4).

The authorities in several European countries disagreed strongly with the way the IMF and the United States addressed the Mexican financial crisis in 1994–95, treating it as a liquidity crisis and providing a large financial package to meet the threat. That disagreement contributed to the much more cautious IMF response to the Asian financial crises of 1997–98. One consequence in the postcrisis period was the policies of many Asian countries to build up their foreign exchange reserves as a defensive reaction to the prospect of future crises on the understanding that financing from the IMF would not be available. In the process, those countries have contributed to the large US current account deficits of recent years and the substantial increase in US net international indebtedness. Today, the basic issues of the scale of IMF financial assistance, the balance of financing and adjustment, and the role of external private-sector financing in crisis management remain unresolved.

Thus, a case can be made for improved policy coordination by and with the euro area in the period ahead in connection with issues involving both the size and role of the International Monetary Fund against the background of the probable resumption of emerging-market financial crises. That policy coordination would involve a better dialogue on the underlying issues and the possible establishment of common objectives.

EU Enlargement

Not all potential topics for policy coordination with and by the euro area concern the evolution of US external accounts and its implications for the global economy. One potential candidate topic involves EU enlargement—not whether it should have happened in May 2004, which might earlier have been a matter for political dialogue, but how it is happening. Of particular interest and concern are the applications of the various accession countries to join the euro area. What is the timetable? What are the associated economic and financial conditions and exchange rate arrangements?

Kenen and Meade (2003) have written on this important subject. They counsel that the exchange rate requirements should not be too rigid; for example, the requirement that the applicant members belong to the Exchange Rate Mechanism (ERM) II arrangement with narrow 2.25 percent bands is misguided. They also argue that the economic conditions should not be too strictly defined; for example, price stability should not be defined relative to the three euro area national jurisdictions with the lowest inflation rate when some of these jurisdictions are flirting with deflation. Finally, they advise that the larger accession countries should not rush the process of joining the euro area.

With respect to policy coordination with and by the euro area, the question is whether the euro area should consult with the rest of the world on the economic and financial conditions of euro area membership—for example, with the IMF and the G-7—or whether the euro area should treat the subject as an internal matter, as has been the case in the past. If history is any guide, the answer is that it is time to turn over a new leaf. The Europeans made a hash of such matters in 1992–93 with modest, but nontrivial, adverse implications for the international financial system; see Truman (2002). More controversially, but also more relevant, a strong case can be made that a major mistake was made on January 1, 1999, in not devaluing the deutsche mark as it entered the euro.

Given the IMF's abdication of responsibility recently with respect to exchange rate policies in Asia, one should not hold one's breath that the IMF will become involved in choices about transitional exchange rate arrangements in Europe; but that does not mean that the IMF's posture would be correct. Moreover, should the Europeans, including the euro applicant countries, once again make the wrong choices along the way, the risk would be a regional financial crisis that could have financial and economic implications extending beyond Europe.

Consider Hungary and Poland. Both are experiencing relatively slow growth, both have large budget and current deficits of close to or more than 5 percent of GDP, and both have government debt ratios of more than 50 percent of GDP and external debt ratios of more than 40 percent of GDP—and we can be confident that both ratios are understated. Both countries have moderate amounts of foreign exchange reserves equal to about twice their short-term external debts, but those reserves could be dissipated quickly in the solitary defense of a rigid exchange rate peg by each country if it is forced to join the ERM II with narrow 2.25 percent margins in order to qualify for joining the euro area. Hungary's short-term interest rate is close to double digits in nominal terms and quite high in real terms, with consumer price inflation in the 5 to 6 percent range. Poland has low inflation and moderate nominal interest rates, but its new monetary council is under pressure to cut interest rates further to stimulate the economy.

Can anyone be confident that either country will avoid an external financial crisis during the next five years or that a crisis in one country would not spread to other euro applicant countries? Are such risks the basis for international policy coordination by and with the euro area? I would say yes. Therefore, the case for improving policy coordination by and with the euro area on this topic would involve stepped-up exchanges of information, enhanced dialogue, and possible endorsement of the plan of action put forward by the Europeans.

Peaceful Coexistence Between the Euro and the Dollar

Some observers in the United States (e.g., Bergsten 1997) have projected that the euro is likely to emerge as a rival to the dollar as an international currency.[15] One has the impression that some in Europe, long envious of the reserve role of the dollar and more recently the international role of the dollar and the supposed benefits that the dollar's roles convey to the US economy, were expecting that in January 1999 each citizen of the euro area would receive a windfall gain from the birth of the euro.

Alan Greenspan recently has offered a more balanced view of the dollar's role. He acknowledges (2004a, 4) that "the United States has been rare in its ability to finance its external deficit in a reserve currency. This ability has presumably enlarged the capability of the United States relative to most of our trading partners to incur foreign debt." Noting that less than 10 percent of US foreign liabilities are currently denominated in nondollar currencies, he neglects to note that someone somewhere must be bearing the associated foreign exchange risk. He comments, "To have your currency chosen as a store of value is both a blessing and a curse." On the side of the blessing, he presumes, are somewhat lower interest rates, though one could question the quantitative significance of this effect if not the sign. On the side of the curse, he reminds us that during three decades following World War II the British economy was under severe pressure, in part, associated with the liquidation of pound sterling balances. Moreover, these were largely official balances. Therefore, their runoff was potentially easier to handle than a private-sector runoff of dollar-denominated assets would be for the United States.

As long as the United States keeps its economic house in order, including the flexibility and accessibility of its financial markets, I doubt the euro will rise to challenge the dollar as an international currency. This is assuming that the United States corrects its current fiscal excesses before they become serious. Fundamentally, I agree with Eichengreen (1997), who argues that the dollar's international role is a function of the economic vitality of the US economy and the avoidance of irresponsible policies, along with a heavy dose of inertia.[16]

I define (Truman 1999a) an international currency as one that is widely used as an international unit of account, a means of payment, and a store of value by nonresidents exclusively, for example, as issuers of securities

15. I am more skeptical; see Truman (1999a). The Conference Board (2004) finds that foreign direct investors report that the introduction of the euro has had less of an impact on global business than they might have expected.

16. Bergsten (1997) fully accepted the view that US macroeconomic policy errors might be necessary to accelerate the decline of the dollar's reserve role.

as well as investors and as sellers of goods and services as well as buyers.[17] Fundamentally, two international currencies would be inefficient and contrary to the rationale for having an international currency. It would be like giving international airline pilots who now universally communicate in English the option of communicating, or not communicating as the case might be, in their own languages.[18] The emergence of the euro as a significant international currency is not likely to happen. The euro's role in the immediate European environment may continue to expand, especially in connection with economic and financial activities involving on one side residents of the euro area, but this is not the same as becoming an international currency according to my definition.[19]

However, what if this judgment is mistaken? Would that not make the peaceful coexistence of the euro and the dollar an appropriate topic for policy coordination by and with the euro area?

Greenspan's recollection of the pressures on the British economy associated with the postwar decline in the role of the pound should remind us not only that they were painful for the British but also that they were painful for the rest of the international monetary system, first, by inhibiting the adjustment of the dollar's value and, later, some would argue by hastening it. The pound's role declined in the context of three international agreements with respect to managing the reduction in sterling balances. The third sterling balances agreement was associated in 1976 with one of the last IMF lending arrangements in support of an adjustment program by an industrial country. If the United States and the dollar were to get to that stage, the current hand-wringing and debates about the dol-

17. It is important to appreciate that the choice of an international currency today is made by the private sector via market forces, not by the public sector by government decisions or fiat. The dollar's private international role is much more important than its reserve role; at the end of 2002, foreign official assets in the United States were only 16 percent of total foreign holdings of portfolio claims on the United States. In their recent provocative paper on the revived Bretton Woods system, Dooley, Folkerts-Landau, and Garber (2003) draw an implicit connection between reserve currencies and international currencies. Whereas managing the former might prove to be difficult, managing the latter would be substantially more so. Moreover, the inertia of monetary authorities with respect to the currency denomination of their substantial reserve holdings (an inertia that is reinforced by self-interest when their holdings are large) is considerably larger than the inertia of the private sector. The reserve role of the dollar will be the last to go for the same reason that the US monetary authorities will be the last to reduce their official gold holdings substantially.

18. This is more clearly a sound argument with respect to the unit-of-account and means-of-payment roles for an international currency than the store-of-value role. In the last case, diversification arguments can be invoked in the name of the individual investor if not of the stability of the system as a whole.

19. The Conference Board (2004) reports that the US dollar is the currency most commonly used in business transactions, even for firms based outside the United States.

lar and the adjustment of the US external accounts would fade into relative insignificance.[20]

Given the political prominence of this issue and the focus upon it by commentators and the financial press, a strong case can be made for improved policy coordination with and by the euro area to address the matter. It should at least involve extensive dialogue and analysis. It could involve joint action. For example, Henning (2000) has suggested that US and European authorities should forswear official competition with respect to the international roles of their currencies, leaving decisions to private actors and monetary authorities in other areas without coercion or lobbying. Any competition would be limited to the liberalization of capital markets and to efforts, which could be jointly coordinated (see below), to make them more efficient.

Structural Reform

The G-7 in Dubai launched an initiative, as part of its Agenda for Growth, that is largely focused on the supply side of G-7 economies: "structural policies that increase flexibility and raise productivity growth and employment." Does this initiative suggest that structural policies are ripe for international policy coordination with the euro area? With all due respect to the good intentions of the G-7, there is not much mileage in policy coordination in this area. Moreover, the G-7's intentions may not have been so good; it may just have been interested in creating a diversion.

Notwithstanding the basic case for continuous structural change in modern market economies, a point eloquently stressed in Baily and Kirkegaard (2004), the case for cross-border policy coordination in this area is weak. The basic reasons are that there are limited spillovers across national boundaries from most structural reforms and that the immediate benefits are limited. Consider the range of issues identified as upcoming reform plans in the G-7 Progress Report on its Agenda for Growth issued in Boca Raton. The United States lists, along with tort reform, lifetime and retirement savings accounts, reducing the structural budget deficit (which some would classify as a demand-side measure), and affordable health care. The United Kingdom lists reductions in enterprise regulatory requirements, while Italy lists pension and corporate tax reform.[21]

20. See Bergsten (1997) and Henning (2000) for some of the issues involved, although they tend to focus on winding down the dollar's narrower reserve role rather than the dollar's broader role as an international currency.

21. None of these areas rises to the level of a structural reform that has substantial external spillovers. The leading example in this area is the US commitment at the Bonn Economic Summit in 1978 to decontrol its petroleum market, but the rarity of such examples suggests that it is the exception that proves the rule.

Experience has shown that policy coordination in practice is most likely useful when it is ad hoc, the benefits are relatively immediate, and they are generally available. Any cross-border payoffs from structural reforms are long term, such as, for example, a higher potential rate of growth for the national and the global economy. Policy coordination in the structural area qualifies principally as policy endorsement.

In the fall of 1987, US Treasury secretary James Baker proposed the introduction of structural indicators into the multilateral surveillance process, and this new element was reflected in the communiqué from the Toronto Summit in 1988. The IMF struggled with how to implement this suggestion, but in the end decided it was too complex. The countries were too diverse to provide much hope that this type of device would promote Baker's laudable objective that focused at the time on the liberalization of labor markets. (See Boughton 2001, chapter 4, for an account of this episode.)

The OECD has labored in this vineyard with increasing intensity during the past 20 years. Its most recent impressive effort, OECD (2003), masterfully demonstrates the links between structural reforms and economic growth in member countries, drawing on an impressive array of both inhouse and external research. The idea, as in the G-7 Growth Agenda announced at Dubai, is to draw upon this research and develop a scorecard for use in multilateral surveillance exercises conducted at the OECD. However, as detailed in Baily and Kirkegaard (2004), because many of the labor market and product market reforms that are desirable today in Europe are very country specific in their content, there is little scope for policy coordination at the level of the euro area as a whole. It is not enough to call for or agree upon the need for structural reforms in these areas; broad agreement on diagnosis is one thing, but agreement on appropriate policy action is more problematic.

Policy coordination in this area offers some benefits: the exchange of information, the potential for solid analysis, and the articulation and endorsement of shared objectives and best practices (even if they are not always shared by domestic populations). However, that is pretty thin gruel.

One broad exception to this generalization is structural policies with respect to institutional harmonization, which do have spillovers across national borders. An example is capital standards for financial institutions that promote financial stability and a level playing field. Another example, cited by Fred Bergsten and Caio Koch-Weser in the *Financial Times* (October 6, 2003), is regulatory convergence in the area of accounting standards. The US-EU Financial Market Dialogue now covers many of these topics, including accounting standards, integration of equity markets, management of pension investments, and supervision of financial conglomerates. These examples are more about policy harmonization by and with the euro area, but they also potentially involve the establishment of common objectives and the coordination of policy actions, and they do have positive spillover effects. Another narrower exception might be the link between labor market reform in the European Union and restrictions or limits on migration that will be applied to new EU members, which would involve improved information exchange and dialogue.

Trade Policy

A final area where benefits might be reaped from policy coordination by and with the euro area is trade policy. The world knows that the European Union has a number of active policy disputes in the trade area, and with the United States in particular. Moreover, the European Union has a strong interest in promoting successful multilateral (Doha Round) negotiations. Cooperation is essential if progress is to be made in any of these areas.

However, there is no dearth of forums for cooperation by the European Union in the trade area with respect to information exchanges, dialogue, common objectives, or joint action. As pointed out by Bergsten and Koch-Weser in the *Financial Times* article cited above, a process of informal policy coordination has existed between the European Union and the United States in the trade area for many years with respect to bilateral, and also multilateral, trade issues. Problems remain, but not because of a lack of US or euro area attention to the underlying issues through a wide range of channels.

Improving Policy Coordination with and by the Euro Area

The preceding discussion made the positive case for improved policy coordination in its various dimensions with and by the euro area on at least 8 of the 10 topics considered. Six were linked in whole or in part to the prospect of substantial adjustment in the US external accounts, but 2 involve other matters. Eight topics make up a more than adequate agenda for policy coordination with and by the euro area, and others could be added.

The basic case having been made for increased policy coordination with and by the euro area, the question is how such policy coordination might be improved. I offer six suggestions.

Substance over Theater

The bias in most policy coordination processes is to prefer theater to substance. The objective is to make sure that you get a headline from a meeting, even if the topic has been inadequately prepared and there is little intention of following up. However, a second bias in policy coordination processes tends to militate against the first: a preference for long communiqués when it would be preferable to say only what is worth saying and is new, and if nothing is worth saying or new, to be quiet. This suggests the need for great care in expanding euro area policy coordination.

Former Federal Reserve governor Laurence Meyer tells a story (2004) about one of the first international meetings that he attended as part of a US delegation. He was surprised that at the delegation meeting before he left Washington, the staff produced a draft of the communiqué that was expected to come out of the meeting. In part, this phenomenon reflected conscientious staff work, but the problem was that the coverage of any real substance in the communiqué could only be drafted after some part of the meeting had occurred. If it all could have been drafted in advance, there would have been no reason to have the meeting, which is one reason the emphasis often shifts from substance to theater. This suggests a balance in policy coordination between substance, theater, and boredom.

The topics reviewed in the first section of this chapter are too important to be trivialized by an excess of theater or unnecessary verbiage involving platitudes with respect to common objectives or vapid endorsements of current policies. If policy coordination by and with the euro area is to be improved, it should focus as much as possible on issues of substance principally involving dialogue, shared analysis, and joint action. When a statement is issued that involves policy commitments, they should be explicit and verifiable.[22]

Mutual Education

Consistent with my first suggestion for improving policy coordination with and by the euro area, the policy coordination process—whatever the forum or the outcome—should place as much emphasis as possible on mutual education as a central aspect of dialogue and a necessary condition for establishing common objectives and agreeing on joint action.

Most of the topics outlined in the first section of this chapter involve issues about which there is genuine disagreement among authorities, in part, because of real disagreement about goals or the lack of a common analytical framework at the technical level. For example, how large a current account adjustment is necessary for the United States or the world? What is the best way to go about achieving it? What should be the respective roles of monetary, fiscal, and other policies in the process? What will be the likely implications for the global economy? What role can or should exchange market intervention play in managing the process? How best to achieve global balance in the context of a substantial adjustment of the US external accounts? What are the likely implications for capital flows to emerging-market economies as a consequence of US external adjustment? What should be the role of the IMF in any external financial crises that may follow? What is the link between growth policies and external adjustment? What is the best framework for thinking about fiscal

22. See Truman (2004a) for an elaboration of this argument.

policies, including countercyclical policies, automatic stabilizers, and medium-term fiscal objectives? What are the chances that the process of enlarging the euro area will have adverse implications for global financial and economic stability? What role should the IMF play in the euro area enlargement process? What are the implications of a world with two major international currencies? If we are headed for such a world, what is the best way of managing the transition process?

These are all important questions that can be, and in some cases have been, subjected to analytical treatment. To the extent that policymakers differ in their views of those analytical treatments or in their nonanalytical biases, an effort should be made to sort out those differences. This is likely to be a research-intensive process, but it is also likely to be the only way to achieve improved policy coordination. The euro area can take a lead in this mutual education process. It is an open question, which I touch on below, whether it is organized or equipped to do so.

Monetary Policy Framework

I have written about the contribution of the monetary policy frameworks of the three major economies (the euro area, the United States, and Japan) to international economic policy coordination. My conclusion (Truman 2003a) is that the adoption of inflation targeting as the framework for the conduct and evaluation of monetary policy by the ECB, the Federal Reserve, and the Bank of Japan would make a substantive contribution to improving Group of Three policy coordination.

First, the adoption of inflation targeting in the euro area and the United States would improve communication about policy intentions with markets. The empirical evidence suggests that this would improve economic performance, producing higher and less variable growth and lower and more stable inflation. Today, in the case of the ECB, the markets are thoroughly confused by the ECB's revised definition of price stability as inflation less than but close to 2 percent. The ECB has a long-run inflation goal of something between 1.75 and 2 percent, but the operational implications of that goal for current policy are opaque. In the case of the Federal Reserve, we learned during the period 2003–04 that it has developed a concern about deflation, but as to what level of increase in any particular measure of price inflation is too low or high, the market has been left to guess.

Second, the adoption of inflation targeting in the euro area and the United States would force the central bankers in their dialogues with each other and their dialogues with their finance ministry colleagues to be more frank about their policy objectives and how they intend to achieve them. This, in turn, would facilitate better analysis of their respective policies and the compatibility of those policies with the achievement of common objectives.

Third, I would hope that the adoption of inflation targeting by the ECB would improve policy performance, in particular average growth, because the ECB would choose a target closer to 2.5 percent, plus or minus 1 percent, rather than one of less than 2 percent. However, this has to do with the implementation of inflation targeting, not with the framework itself. Nevertheless, the framework, with its forward-looking emphasis, should also contribute to more proactive policymaking by the ECB. Moreover, the statistical analysis presented in Truman (2003a) suggests that economic performance (higher and less variable growth along with lower and less variable inflation) is likely to be enhanced by the adoption of inflation targeting regardless of the target chosen.[23]

I have proposed concrete steps by which the Federal Reserve and the ECB could adopt inflation targeting as a framework for their respective policies by themselves in a manner consistent with their current mandates and how they go about their business. The two central banks could use a bit of nudging to move to adopt inflation targeting and ex post blessing once they have done so. In the euro area, this might help to bury the hatchet between the monetary and the fiscal authorities.

In the United States, Alan Greenspan is regarded as a skeptic about inflation targeting. His recent speech on risk and uncertainty in monetary policy (2004b) has been similarly interpreted. Recently he has been more open to the framework than he had been previously. The softening of his position on this issue may reflect his exposure to my own analysis, but I suspect that the cumulative writings of Ben Bernanke (for example, Bernanke 2003) have been more influential. However, the evolution of Greenspan's position indirectly illustrates the basic point about the importance of mutual education in the success of the policy coordination process. An educational process has shaped US official thinking about inflation targeting. It follows that there is scope for mutual education by and with the euro area.

Getting the Right Players on the Field

Policy coordination with and by euro area is an overly complicated game because often the right players are not playing. To address this problem,

23. Clarida, in his comment on this chapter, notes that for inflation targeting to lead to exchange rate stability, formally a stationary exchange rate, the framework should target the price level rather than an inflation rate. Cooper, in his comment, suggests that exchange rate stability would be enhanced if the ECB and the Federal Reserve merely targeted a common price index. However, a common target, say 2 percent, is not the same as a common index; there are substantial differences between US and EU price indexes (Truman 2003a, 100). Moreover, one should expect only a limited contribution to exchange rate stability from the adoption of inflation targeting by the Group of Three economies, largely because during the past decade differences in inflation rates have not provided much guidance with respect to exchange rate movements; see Truman (2003a, 163).

several steps are necessary, mostly involving the euro area itself but also those seeking to coordinate with the euro area or with which the euro area is seeking to coordinate.

First, the euro area will have to speak internationally with one voice on macroeconomic matters. For example, currently the ECB represents the European monetary authorities at portions of G-7 meetings of finance ministers and central bank governors. At the remainder of the meeting, the heads of the national central banks of France, Germany, and Italy join the meeting and the president of the ECB leaves. Moreover, there is no representative of the European fiscal authorities at these meetings because there is no euro area fiscal authority. The cure for this problem lies partly in Europe and partly elsewhere.

In Europe, it is desirable for the European project to get its act together and decide (1) who is in and who is out of the euro area and (2) what the euro area is. In this chapter, I have generally treated the euro area as if it were the same as the European Union. However, we know it is not. For many aspects of potential policy coordination, this lack of congruence may be a problem for both the euro area and its potential partners. For example, the role of exchange rates in the adjustment of US external accounts involves not only the euro-dollar relationship but also the euro-pound relationship.

The issue of who is in and who is out of the euro area principally involves the United Kingdom. The United Kingdom attends Ecofin meetings, is not a participant in the euro area, but is a full-fledged member of the G-7.

Once membership in the euro area is settled, or even if it is not, the basic issue is whether the European Union is an international organization or a supranational authority. Currently the Europeans want to have it both ways, and their interlocutors want to as well. For example, leaders of the European Commission sit down with leaders of the World Bank and IMF as international organizations to discuss financial assistance to the Balkans. At the same time, the European Commission is a member of the Financial Action Task Force on anti–money laundering along with most EU members. Is it there as an international organization or a supranational authority?

From the standpoint of interlocutors with the euro area, and of the United States in particular, they have a stake in how Europe evolves. In my view, US policy should push in the direction of encouraging the Europeans to get on with the construction of their own internal playing field.[24] Con-

24. In Truman (1997), I warned of the potential dangers of the EU project spending too long in a halfway house. My views on this subject appear to be similar to those of Henning (2000), who argues that the United States would be best served by streamlined EU decision making on economic issues accompanied by qualified majority voting (rather than consensus decision making) and substantially increased transparency.

versely, the United States recently, over the past decade or so, has preferred to preserve the option of divide and conquer with respect to its dealings with European authorities on some economic matters. That choice complicates meaningful policy coordination. For example, the Federal Reserve now deals principally with the ECB, but the US Treasury prefers to deal with the finance ministries of France, Germany, Italy, and the United Kingdom, which in turn complicates internal US policy coordination.

The United States has some leverage in this matter. For example, it could move to sunset the participation of the United Kingdom in G-7 meetings. As the UK economy shrinks in relative importance in the global economy, the rationale for including its representatives separately from the representatives of the euro area in international meetings also will shrink. The United States could also favor sunsetting participation of representatives of national euro area central banks in the G-7 process, along with the Bank of England.

The United States could also take steps to put the right players from its own team on the playing field when dealing with the euro area on economic matters. For historical reasons, including the fact that the European Union started out as an international organization motivated primarily by political considerations, US-EU summit meetings are handled primarily by the US Department of State. When it comes to economic matters, representatives of the State Department see their historical role as a way finally to get a seat at the economic policy table. The problem is that their presence, including their organization of such meetings, means that the right people, actual policymakers, are not at the meetings. Even if they are at the meetings, the meetings are underprepared and the potential for meaningful policy coordination is limited to a sideshow at best. They are detached from substance and have limited potential for mutual education.

Finally, coming back to the euro area itself, the role of the ECB needs to be clarified. The institution needs to be integrated better into the euro area policy process. The ECB has been endowed with the highest degree of goal independence of any central bank in modern history, enshrined in the Maastricht amendments to the Treaty of Rome. The treaty requires the ECB to support the general economic policies of the European Community, including "a harmonious and balanced development of economic activities, sustainable and noninflationary growth respecting the environment, a high degree of convergence in economic performance, a high level of employment and social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States." The treaty also leaves it to the ECB to decide how best to accomplish this, and the ECB has decided that achieving its definition of price stability is the only thing that it can do or publicly admit that it can do.

Presumably, the political authorities in the euro area have a bit of leverage over the ECB and its policy orientation when they make appointments to its governing board. They could require new appointees to take a different attitude toward the ECB's mandate. As was noted above, the adoption of inflation targeting as the ECB's monetary framework might aid in this process as well as make it more attractive for the United Kingdom and Sweden to join the euro area because they are comfortable using inflation targeting as their frameworks for the conduct and implementation of monetary policy.

Institutional Representation

As part of the process of institutional consolidation sketched above, the euro area should also take steps to rationalize its representation in international economic and financial bodies. Such steps have been considered within the European Union and euro area, but to date little progress has been made.[25]

EU representation on the IMF Executive Board is a prime example. Currently, EU members appoint or play a major role in electing 10 of the 24 members of the board. Nationals from these countries are 7 of the 24 executive directors and 8 of the 24 alternate executive directors. They not only directly control 32 percent of IMF votes, but they also potentially control an additional 12.5 percent of the votes of nonmembers of the European Union as of May 2004.[26] The decision-making process in the IMF Executive Board is primarily one of consensus, in which the number of bodies in the room is important because each of them speaks on important matters. Currently that process is distorted. European voices are heard much too often and tend to distort the consensus.

To remedy this situation, the EU countries should first agree to drop from their IMF Executive Board constituencies all countries that are not members of the European Union. This would reduce the number of EU first-row or second-row chairs below 10. Second, the EU countries should progressively consolidate their chairs into one appointed chair.[27] This consolidation would leave open the two other appointed chairs for China

25. Henning (1997) addressed this issue and concluded that the European Union should strike a bargain with the United States in which (1) the members of the European Union would establish common positions on IMF issues, (2) the EU quota in the IMF would be adjusted downward by eliminating intra-area trade and setting it equal to the US quota, (3) quotas of other IMF members would be increased commensurately, and (4) the IMF headquarters would remain in Washington. Kenen (2004) also addresses the issue of consolidation of EU representation in the IMF.

26. The 10 EU accession countries have 2.1 percent of the votes.

27. Representation of the ECB on the IMF Executive Board could be achieved by having the alternate executive director come from the ECB.

and Canada, on the basis of current quotas.[28] As a consequence, the size of the Executive Board could be shrunk back toward its original 20, and the door would be opened for representation of a broader set of countries on the board.

Again, this is an area where the United States has some leverage. As long as the IMF Executive Board is larger than the 20 seats mandated in the IMF Articles of Agreement, a vote is required every two years to maintain its size. That vote requires an 85 percent majority, which means US support is required to maintain the current 24 seats. Reducing the number of European seats on the IMF Executive Board and related bodies, allocating some of them to countries in other areas of the world, and reducing the total number of seats in the process would provide many political benefits as well as contribute to better policy coordination. It would also demonstrate euro area leadership.

Replace the G-7 with the G-20

Many of the topics for policy coordination by and with the euro area involve issues that extend beyond the purview of a US-EU Group of Two or the G-7 to the other major economic and financial players in the world, such as China, India, Mexico, Brazil, and South Africa.

If the euro area and the United States were to act jointly to disband the G-7/G-8 and move many of their policy coordination discussions at the level of finance ministers and central bank governors to the Group of Twenty,[29] this would be a major constructive step in rationalizing the institutions of international economic cooperation. It would reduce the number of international meetings. It would recognize the changing shape of the global economy. It would utilize a forum that was established in 1999 but has not yet taken on much responsibility. The G-20 involves central bankers in addition to representatives of finance ministries, which is

28. The five members of the IMF with the largest quotas appoint executive directors and their alternates. Currently those five are the United States, Japan, Germany, France, and the United Kingdom. If in the future the European Union were consolidated into one seat, and treating the euro area as the same as the EU, its collective quota would be reduced under most quota formulas by excluding intra-EU trade. A decline in the size of the EU quota would reduce the resources available to the IMF. Presumably, some of the Asian countries, which now consider themselves underrepresented in the IMF, would stand ready to compensate for the shortfall.

29. In addition to the G-7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), the G-20 includes Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, and the European Union, represented by the president of the ECB and the finance minister of the country holding the presidency of the EU if it is not a European G-7 country.

useful in an era of an increasing number of independent central banks, with respect to information exchange, dialogue, and mutual education as well as agreements on common objectives and joint actions.

My presumption is that economic summits eventually would be converted to G-20 affairs as well; that conversion is already under way with special invited guests at most recent summits.[30] With the G-20 as the new standard for summit meetings and meetings of finance ministers and central bank governors, this might facilitate other adjustments in institutional representation, including in due course collapsing the G-20 into the Group of Sixteen, concentrating EU representation in one pair, rather than the current five pairs, which would make room for adding other countries. In this manner, the development of the G-20 would follow the development of the Group of Ten in the 1960s as a grouping of the major countries responsible for the stability of the international economy and financial system and including both countries in deficit as well as countries in surplus, net debtors as well as net creditors. The IMF's International Monetary and Financial Committee includes as members many of the G-20 countries, but they are constrained to represent the views of their constituencies and as a result there is very limited scope for uninhibited interchange.

In the interests of mutual education, the G-20 should be strengthened through the use of ad hoc working groups to supplement the current structure that involves meetings at the level of ministers and governors and their deputies. This would help to increase the ratio of substance to theater. No doubt the United States and the euro area would continue to take the lead in guiding the work of the G-20, but the process would be more inclusive and more relevant. Enhancing the role of the G-20 would not preclude, and it probably would necessitate, an increase in informal policy coordination between the United States and the euro area, as an informal Group of Two.

Conclusion

This chapter has demonstrated the scope and need for increased policy coordination with and by the euro area, primarily with respect to topics linked to US external adjustment, but in other areas as well. I have outlined guidelines and concrete steps that could be taken by the euro area and its principal interlocutor, the United States, to facilitate improved policy coordination.

I am under no illusion that any of my suggestions will be implemented in the short term, but the need for improved policy coordination by and

30. The G-7 started as meetings of the Group of Five (G-5) in 1973 and generally included central bank governors after the first meeting. The G-5 did not meet at the level of heads of state or government until 1975.

with the euro area will remain and most likely increase over the years, especially if the euro and the European project prosper. Europe has long been a free rider with respect to the post–World War II institutions of international economic and financial cooperation. More often than not, the perspective of Europeans has been a short-run national perspective—what is in the immediate interests of their country, or occasionally region, rather than of the system as a whole. Alternatively, the European perspective has been to be against what the United States has proposed or advocated. It is time that Europe started pulling its full weight, especially if the euro is to emerge during the next 5 or 10 years as a major international currency.

References

Baily, Martin Neil, and Jacob Funk Kirkegaard. 2004. *A Transformation of the European Economy*. Washington: Institute for International Economics.

Bergsten, C. Fred. 1997. The Impact of the Euro on Exchange Rates and International Policy Cooperation. In *EMU and the International Monetary System*, ed. Paul R. Masson, Thomas H. Krueger, and Bart G. Turtelboom. Washington: International Monetary Fund.

Bernanke, Ben S. 2003. A Perspective on Inflation Targeting. Remarks at the Annual Washington Conference of the National Association of Business Economists, March 25. Board of Governors of the Federal Reserve System. Photocopy.

Boughton, James M. 2001. *Silent Revolution: The International Monetary Fund 1979–1989*. Washington: International Monetary Fund.

Conference Board. 2004. *Global Exchange Rates: Do They Affect Investment?* New York: Conference Board.

Dooley, Michael P., David Folkerts-Landau, and Peter Garber. 2003. *An Essay on the Revived Bretton Woods System*. NBER Working Paper 9971. Cambridge, MA: National Bureau of Economic Research.

Dooley, Michael P., David Folkerts-Landau, and Peter Garber. 2004. *The Cosmic Risk: An Essay on Global Imbalances and Treasuries*. Frankfurt: Deutsche Bank Global Markets Research.

Eichengreen, Barry. 1997. Comment on Bergsten's "The Impact of the Euro on Exchange Rates and International Policy Cooperation." In *EMU and the International Monetary System*, ed. Paul R. Masson, Thomas H. Krueger, and Bart G. Turtelboom. Washington: International Monetary Fund.

Erceg, Christopher. 2002. The Effects of the US Productivity Acceleration on the External Sector. Division of International Finance, Board of Governors of the Federal Reserve System, Washington. Photocopy (November 18).

Freund, Caroline. 2000. *Current Account Adjustment in Industrial Countries*. International Finance Discussion Paper 692. Washington: Federal Reserve System.

Greenspan, Alan. 2003. Remarks on the Current Account at the Cato Institute. Federal Reserve System, Washington. Photocopy (November 20).

Greenspan, Alan. 2004a. Remarks on Globalization at the Bundesbank Lecture, Berlin. Federal Reserve System, Washington. Photocopy (January 13).

Greenspan, Alan. 2004b. Remarks on Risk and Uncertainty in Monetary Policy at the Meetings of the American Economic Association, San Diego. Federal Reserve System, Washington. Photocopy (January 5).

Henning, C. Randall. 1997. *Cooperating with Europe's Monetary Union*. Policy Analyses in International Economics 49. Washington: Institute for International Economics.

Henning, C. Randall. 2000. US-EU Relations After the Inception of the Monetary Union: Cooperation or Rivalry? In *Transatlantic Perspectives on the Euro*, ed. Randall Henning and Pier Carlo Padoan. Pittsburgh: European Community Studies Association, and Washington: Brookings Institution Press.

Hunt, Benjamin, and Alessandro Rebucci. 2003. *The US Dollar and the Trade Deficit: What Accounts for the Late 1990s?* IMF Working Paper WP/03/194. Washington: International Monetary Fund.

IIF (Institute of International Finance). 2004. *Capital Flows to Emerging Market Economies*. Washington: Institute of International Finance.

IMF (International Monetary Fund). 2002. How Worrisome Are External Imbalances? In *World Economic Outlook*, September. Washington: International Monetary Fund.

IMF (International Monetary Fund). 2003a. Are Foreign Exchange Reserves in Asia too High? In *World Economic Outlook*, September. Washington: International Monetary Fund.

IMF (International Monetary Fund). 2003b. *IMF Executive Board Recommends to Governors Conclusion of Quota Review*. Public Information Notice 03/02. Washington: International Monetary Fund.

Isard, Peter, Hamid Faruqee, G. Russel Kincaid, and Martin Fetherston. 2001. *Methodology for Current Account and Exchange Rate Assessments*. Occasional Paper 209. Washington: International Monetary Fund.

Issing, Otmar. 2003. Europe and the US: Partners and Competitors—New Paths for the Future. Remarks at German-British Forum, London. European Central Bank, Frankfurt. Photocopy (October 28).

Kenen, Peter B. 2004. Transatlantic Relations and the Global Economy. Princeton University. Photocopy (January).

Kenen, Peter B., and Ellen E. Meade. 2003. *EU Accession and the Euro: Close Together or Far Apart?* International Economics Policy Brief PB03-9. Washington: Institute for International Economics.

Kohn, Donald L. 2004. Remarks on the United States in the World Economy at the Federal Reserve Bank of Atlanta. Federal Reserve System, Washington. Photocopy (January 7).

Mann, Catherine L. 2003. How Long the Strong Dollar? In *Dollar Overvaluation and the World Economy*, ed. C. Fred Bergsten and John Williamson. Washington: Institute for International Economics.

Meyer, Laurence H. 2004. *A Term at the Fed: An Insider's View.* New York: Harper Business.

OECD (Organization for Economic Cooperation and Development). 2003. *The Policy Agenda for Growth: An Overview of the Sources of Economic Growth in OECD Countries*. Paris: OECD.

Rosenberg, Michael R. 2003. The Dollar's Equilibrium Exchange Rate: A Market View. In *Dollar Overvaluation and the World Economy*, ed. C. Fred Bergsten and John Williamson. Washington: Institute for International Economics.

Roubini, Nouriel, and Brad Setser. 2004. *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Markets*. Washington: Institute for International Economics.

Rubin, Robert E., Peter R. Orszag, and Allen Sinai. 2004. Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray. Paper presented at the American Economics Association–North American Economics and Finance Association Joint Session, San Diego, January 4.

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

Truman, Edwin M. 1999a. The Evolution of the International Financial System. Remarks at the Institute for International Monetary Affairs Eighth Symposium, Tokyo, December 6.

Truman, Edwin M. 1999b. The Single Currency and Europe's Role in the World Economy. Remarks to the World Affairs Council, US Treasury, Washington, April 6.

Truman, Edwin M. 2002. Economic Policy and Exchange Rate Regimes: What Have We Learned since Black Wednesday? Paper presented at European Monetary Symposium, London School of Economics, London, September 16.

Truman, Edwin M. 2004. A Critical Review of Coordination Efforts in the Past. In *Macroeconomic Policies in the World Economy*, ed. Horst Siebert. Berlin: Springer-Verlag.

Truman, Edwin M. 2003a. *Inflation Targeting in the World Economy*. Washington: Institute for International Economics.

Truman, Edwin M. 2003b. The Limits of Exchange Market Intervention. In *Dollar Overvaluation and the World Economy*, ed. C. Fred Bergsten and John Williamson. Washington: Institute for International Economics.

Comment

RICHARD H. CLARIDA

In his fine chapter, Edwin Truman raises 10 issues pertaining to the subject of policy coordination "with and by" the euro area. The chapter makes six policy recommendations and many provocative and thought-provoking observations in between. One senses a certain liberation of spirit and a desire on Truman's part not to quibble or qualify. After years of "speaking his mind" in offering private counsel at the highest levels of government, he now can "write his mind," and this makes the chapter a lot of fun to read.

The chapter offers a useful and timely organizing principle for discussing policy coordination and focuses on the issues of international imbalances and the process of international adjustment. I might have chosen a slightly different issue: Has insufficient policy coordination to date materially contributed to the global imbalances, which are the focus of much of the chapter's first section? Does insufficient policy coordination complicate the process of international adjustment that is already under way? I think the answer to these questions is probably "no."

On the real side, rebalancing the global economy has to do with global growth, fiscal policies, and structural reform. On the financial side, international adjustment has to do with foreign exchange intervention and with capital flows and the IMF.

Eliminating or even scaling back the US current account deficit will exert a material drag on global growth. Indeed, I have argued that the US current account deficit is a global general equilibrium outcome that reflects a deficit of growth and growth prospects in the rest of the world as

Richard H. Clarida is the C. Lowell Harriss Professor of Economics at Columbia University.

well as a postbubble excess supply of global saving relative to profitable investment opportunities. Given plentiful global supply (for goods if not commodities), global demand outside the United States must rise. I applaud the chapter's emphasis on structural reforms as contributing to both the present demand and future supply side. However, I share with the chapter a skepticism that "there is not much mileage in policy coordination" in the area of "structural policies that increase flexibility and raise productivity growth and employment."

Obviously, a major issue of policy coordination within Europe is the Stability and Growth Pact (SGP). In reality, I think that little can feasibly be achieved to coordinate US and European fiscal policies over the business cycle. In the medium term, fiscal consolidation is called for in the United States. However, it is hard for me to see how the pace or magnitude of this could be influenced by feasible paths for European fiscal policy—especially because the SGP puts pressure for fiscal consolidation in Europe as well.

With regard to foreign exchange market intervention, I share Truman's view that intervention "has definite limits" as a policy instrument. However, I also note that the evidence suggests that publicly coordinated interventions are most likely to succeed. Thus, although there is a possible benefit to coordination, it is only at the margins of a "limited" policy.

With regard to the issue of international capital flows, the main argument here is to improve coordination within the structures of an existing institution, the IMF. Global adjustment will require reduced net outflows from emerging-market countries and perhaps large net inflows to some (and certainly increased gross flows). As global interest rates inevitably rise, so do risks of emerging-market debt-service problems. I think it is at best an open question whether or not previous crises were exacerbated by insufficient policy coordination between the United States and the euro area. As I understand it, many in Europe wish to strictly limit IMF packages except under truly exceptional circumstances. It is not clear that a better coordinated process would produce "better" IMF packages, but it could well produce fewer smaller packages more promptly. Although a potentially better long-run equilibrium, it could in fact produce worse near-term outcomes if capital flows reflect the existing ad hoc regime.

Truman's recent book (Truman 2003) has made a persuasive case for explicit Group of Three inflation targeting. He argues that this would offer better communication with markets, more honest dialogue with finance ministries, and faster average eurozone growth.

However, coordination is not commitment. In my research with Mark Gertler and Jordi Gali (2002), we work out the theory of inflation targeting in a two-country Nash noncooperative game, showing that inflation targeting is optimal and can be implemented with a forward-looking Taylor rule. This requires the exchange rate to be flexible and not anchored. Under this policy, the exchange rate is nonstationary. In general, there are gains to cooperation, and inflation targeting in the form of a modified Taylor rule with weight on home and foreign inflation is optimal. This rule requires a flexible and nonanchored exchange rate, and it implies a nonstationary exchange rate. Under commitment, even without cooperation, an anchored and stationary exchange rate can be achieved. This is because commitment will require price-level targeting, not just inflation targeting.

References

Clarida, R., M. Gertler, and J. Gali. 2002. A Simple Framework for International Monetary Policy Analysis. *Journal of Monetary Economics* 49: 879–904.

Truman, Edwin. 2003. *Inflation Targeting in the World Economy.* Washington: Institute for International Economics.

Comment

RICHARD N. COOPER

Edwin Truman discusses the possible desirability of policy coordination between the European Union and the United States under 10 headings, and he supports 8; he also makes 6 proposals for improving the structure and process of international economic cooperation. I cannot comment on all of them, and I agree with many of his suggestions, so I will be selective and emphasize areas of disagreement, or at least doubts.

For a start, I find it helpful to distinguish clearly among the possible modes of economic cooperation, which range from the simple exchange of accurate information (data and policy), through analysis of current circumstances, advance notice on upcoming changes in policy (with explanations), occasional coordinated changes in policy or joint action, to routinized joint action and harmonization of policy. Many of these different forms of cooperation can be found in Truman's chapter, but he is not entirely clear about what should actually be done under each of his headings.

Several of Truman's suggestions for policy coordination arise from his clearly stated assumption of the need to reduce sharply—by 2 to 5 percent of GDP—the large current account deficit of the United States. My guess, in contrast, is that on the 10th anniversary of the euro, 5 years from now, we will still have a large US current account deficit—perhaps not 5 percent of GDP, but running several hundred billion dollars and still a dominant feature of the world economy, as it is today. With the special exception of 1991, the United States has run a current account deficit since 1982, and it has generally exceeded $100 billion since 1984. For complex reasons

Richard N. Cooper is Maurits C. Boas Professor of Economics at Harvard University and chairman of the Advisory Committee of the Institute for International Economics.

involving demography, habits formed at low income levels followed by rapid growth, risky political and legal environments, and imperfect national capital markets, the rest of the world has savings in excess of acceptable investment opportunities, and the United States (along with Britain and Australia) and the world's poorest countries alone show a willingness to absorb these savings on an ongoing basis, the latter because of foreign aid grants. I do not believe this condition will change soon or quickly, so to try to reduce greatly the US deficit would put tremendous and unnecessary contractionary pressure on the world economy.

Active and socially useful cooperation on policies requires that the cooperating parties have a similar (and approximately accurate) view of how the world economy works and a shared view of objectives. The first condition is not met in the domain of macroeconomic policy, and the second is met only at a high level of generality: Everyone favors growth with low inflation and low unemployment. For example, my impression is that the consensus view among American economists is that fiscal stimulus (a reduction in taxes or an increase in expenditures) will increase GDP in normal circumstances. My impression is that the consensus among German economists is that a fiscal stimulus will not increase GDP and indeed may reduce it. It is difficult to coordinate fiscal policies when such radically different views prevail. It is logically possible that both consensuses are correct, domestically; but to coordinate policy usefully and effectively we would need shared views on that point.

Europeans, I believe, have gotten themselves into a serious bind, both substantively and procedurally, with respect to macroeconomic management. In the Economic and Monetary Union (EMU), "price stability" is the primary and so far the sole objective of European Central Bank (ECB) policy. Under the Stability and Growth Pact, budget deficits cannot exceed, except in exceptional circumstances, 3 percent of GDP. These are highly constraining conditions. Indeed, the usual instruments of macroeconomic policy—monetary, fiscal, and exchange rate policy—are in practice denied or severely limited to EU member states, and can be used for the EMU as a whole only to pursue price stability, ignoring entirely the other influences that monetary and exchange rate policy can have on an economy. There is little under these constraints that can be coordinated with the United States—or any other country or group.

Procedurally, the ECB alone decides on monetary policy and exchange rate intervention; it can neither solicit nor accept advice from member governments. How can it "coordinate" anything—unless the prohibition on advice does not apply to foreign governments! It is unclear who is in charge of exchange rate policy, as opposed to intervention; the practical result is that no one is in charge.

Truman points out that there is some US ambivalence toward a unifying Europe, and he suggests that the US government sometimes exploits the capacity to "divide and rule." Though not denying that claim with respect to some individual officials, I suggest that the US practice of going to national European capitals rather than to Brussels in many instances is driven by a desire to get something done, sometimes urgently, rather than to "divide and rule," because only in national capitals has it been possible to get decisions. Thirty years ago, Henry Kissinger famously asked what "European" number he should call in the event of a foreign policy crisis. Europe provided a response, 28 years later, in the form of Xavier Solana—although even today he has almost no authority to make decisions. Yet in the area of macroeconomics there is still no Xavier Solana, one person who can speak authoritatively (even if noncommittally) for Europe.

Europe has been integrating for half a century. Much progress has been made, slowly, but much remains to be done. Europeans cannot agree on what is the unfinished business because they cannot agree on a desired destination. At the present pace, another 50 years may be required to "complete" Europe, whatever that may mean. In the meantime, how can Europe coordinate macroeconomic policy with the United States? Perhaps only a crisis will speed up the process. I favor government by foresight, rather than government by crisis. But too few governments show great foresight. The Maastricht Treaty of 1992 is directed to the problem of the 1980s, inflation, not to the problems of the early 21st century. It may be that a strong further appreciation of the euro could provide the jolt necessary to provoke the necessary substantive and procedural changes in European macroeconomic policy.

Truman urges the ECB, and on the Federal Reserve, to set explicit inflation targets. I am not enthusiastic about inflation targeting for these two large economies, unless the target is a *common* price index, which I would also urge on Japan, as a stepping stone to much tighter management of exchange rates—ultimately a single currency. As Richard Clarida points out in his comment on Truman's chapter, independent inflation targeting leads to a random walk in exchange rates. An exception is when the same target is used and is achieved.

The US approach to "anchoring" monetary policy is to empower a committee of people with diverse but sensible views to argue about how best to achieve the many objectives they have been given and make a practical decision every six weeks, subject to close public and especially congressional scrutiny. The Federal Reserve, it should be noted, is independent of the president, in that he or his executive branch leaders cannot instruct it on monetary policy, but it is not independent of the political process, having been chartered by simple legislation, which could be changed through the normal legislative process. The Federal Reserve thus must continually earn its independence, like the Bundesbank (whose primary objective was, artfully, "stability of the currency," not "price stability") but unlike the ECB.

Given the primary objective of price stability, it would be difficult, I believe, for the ECB to target inflation at a rate other than zero, which would be undesirable. The ECB's official formulation, "less than two percent," I assume was a fudge to reconcile its statutory charge with practical considerations. The ECB is apparently satisfied that an inflation rate close to 2 percent is "low and stable" and satisfies the requirement to achieve price stability, even though after a decade a 2 percent inflation rate would leave the measured price level 22 percent higher than it was initially. But could the ECB legally set a target of 2.5 percent (up 28 percent in a decade), as Truman suggests, or 3.0 percent, which could arguably still be called "low and stable"?

Truman makes several suggestions to improve the structure and procedures for international economic cooperation. One of them involves consolidating European seats on the board of the International Monetary Fund, which now number 8 out of 24, not counting Russia. This could surely be done within the current IMF Articles of Agreement; but the ECB could not be seated formally on the Executive Board without an amendment to the Articles, because only states can join (unlike the World Trade Organization, which also allows entities other than states as members).

Truman urges substituting the Group of Twenty (G-20), at the ministerial level, for the current Group of Seven and Group of Eight (G-7/G-8) meetings. The G-20 first convened in 1999, following the Asian financial crises. No doubt considerable thought was given to the selection of countries, but I am not aware that there was a formal rule beyond an emphasis on emerging markets and some attempt at geographical dispersion. Its legitimacy is open to question. Apart from India and, arguably, Indonesia, it does not include any of the world's poorest countries.

At the time it was formed, the G-7 encompassed the seven largest countries of the world, in terms of both GNP and foreign trade; and all were democracies, with the leaders able to appreciate the problems for sensible policy sometimes posed by electoral politics. A Group of Five summit was created initially, at French initiative, to coordinate action to overcome the world recession of 1975. These were the countries with enough economic weight to make a difference if they coordinated their policies; and except for President Gerald Ford, all the heads of government had been ministers of finance. Ford evidently liked the meeting, because he convened a second one the following year, at which Canada and Italy were added.

Thus a precedent was set that has endured for nearly 30 years. The G-7 is outdated in terms of GNP and trade, now that China exceeds Canada and Italy in both. But the criteria for expanding the G-7 are unclear. One could create a club of countries whose GDP exceeds $500 billion; in 2004, that would add China, Spain, Mexico, Brazil, India, and South Korea, in that order. All but China are democracies. If on political grounds it was thought necessary to add an Arab country and a sub-Saharan African country, they should probably be Egypt and Nigeria, the most populous representatives of which Nigeria formally is democratic. With the G-7, that would bring the total to 15, and to 12 if the 4 Euroland countries could designate a single representative.

As the number grows, it is more difficult for the participants to have a serious conversation, as opposed to making preset statements. The G-20 almost certainly exceeds this limit of viability. But if the committee is to become that large, it might as well be the International Monetary and Financial Committee, which includes 24 principals, all ministers, representing most of the countries of the world following the constituencies of the IMF's Executive Board—which, according to Truman, could and should be cut back to its statutory size of 20. I believe that would command much greater legitimacy than the G-20.