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Commentary

The Case for the Euro--II

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The introduction of the euro will represent the most dramatic change in the international monetary system since President Nixon took the dollar off gold in 1971. When the dollar left gold, other countries left the dollar and the era of flexible exchange rates began.

In another sense, however, the introduction of the euro may be even more important than the dropping of the golden anchor. The advent of flexible exchange rates did not alter the power configuration of the international monetary system. Both before and after the breakdown, the dollar was the dominant currency in the system. But the introduction of the euro is likely to challenge the position of the dollar. In that sense, the introduction of the euro may be the most important event in the history of the international monetary system since the dollar took over from the pound the role of dominant currency in World War I.

The creation of the euro will set new precedents. For the first time in history, an important group of independent countries have voluntarily agreed to relinquish their national currencies, pool their monetary sovereignties, and create a supercurrency of continental dimensions. The euro will create an alternative to the dollar in its roles as unit of account, reserve currency and intervention currency. The transition to the new arrangements will involve a massive realignment of currency preferences in world banking, in international reserves and in capital markets, with permanent effects on the pattern of current accounts and trade balances.

Great Currencies

The introduction of the euro will be one of those epochal events that can only be understood in the context of long periods in history. Great international currencies have usually been associated with great powers in the period of their ascendancy. The pound was the dominant international currency of the 19th century both because Britain's monetary policy, tied to gold, had a history of stability, and because the British Empire, run from the financial center of London, had become the greatest empire of its time. The pound, however, suffered a jolt with World War I, at a time when another currency, the dollar, was waiting in the wings. After World War II, the Bank of England was nationalized, Britain's empire fell away, and monetary policy fell victim to that trade-off between inflation and unemployment called the Phillips Curve. Elizabeth I had a more stable monetary policy than Elizabeth II.



Both size and stability factors made the dollar dominant. Already by the 1870s, the U.S. had the largest economy, and by the outbreak of World War I, U.S. gross domestic product was more than thrice either of its nearest economic rivals, Britain and Germany. After World War II, the dollar achieved a position in world finance unrivaled since the days of the Roman denarius. Anchored to gold, it presided over an era of remarkably low unemployment, high growth and price stability, a great period that stands out in its performance characteristics far above its predecessor in the 1930s or its successor in the 1970s.

Nevertheless, fault signs began to appear even in the 1950s. Wartime price increases had made gold, the price of which had been set in the 1930s, undervalued. It was just a matter of time before the U.S. would no longer be able to convert dollars into gold at \$35 an ounce for foreign monetary authorities. By the early 1960s the U.S. had sold more than half of its gold reserves to European countries. Faced with requests for additional conversions of dollar balances in 1971, the U.S. put an end to convertibility of the dollar.

Advocates of flexible exchange rates had argued that under floating, countries would not need reserves, that balances of payments would automatically be brought into equilibrium, and that the threat of depreciation would be just as potent a bulwark against inflation as falling reserves. None of these predictions proved true. Freed from the link to gold, U.S. monetary policy became more inflationary; freed from the dollar, the other countries loosened their purse strings. Left untended, the Eurodollar market exploded. Gold and oil prices soared, huge oil deficits were financed through the Eurodollar market, and inflation, acting on progressive tax schedules, shifted taxpayers into higher brackets, increasing unemployment. A new word, stagflation, was coined to depict the phenomenon of rapid inflation and high unemployment. High inflation and the falling dollar in the late 1970s drove Europeans into the creation of the European Monetary System as a defense against the dollar.

International Seigniorage

A major objection against the use of the dollar as an international currency is that it gave the U.S. a power and an income that other countries did not have. Whereas other countries had to settle their deficits with owned reserves, the U.S. was enabled to settle its deficits by writing out its own IOU's, which, instead of being returned for payment, were added to reserves. The larger European countries vexed under what Charles de Gaulle called that "exorbitant privilege," by which the U.S. financed what de Gaulle's adviser Jacques Rueff called a "deficit without tears." The gain the U.S. acquired from the use of the dollar as an international currency was a form of seigniorage, or money tax.

Dollar inflation only aggravated the money tax. When the U.S. inflation rate went up, dollar balances depreciated in real terms. In order to keep the same real value of reserves or the same proportion of reserves to imports, countries would have to increase their dollar holdings just to make up for inflation.

Not surprisingly, then, the impetus for Europe to find an alternative to the dollar has been strongest when the dollar is weak. Rising inflation and the weak dollar in the late 1960s led to the 1969 Hague Summit, which formally established the goal of monetary union; the weak dollar in the late 1970s provoked the Bremen Summit and the EMS; and the weak dollar in the late 1980s led to the Delors Report, the substance of which was implemented by the Maastricht Treaty. By contrast, not much was heard about monetary union when the dollar was comparatively strong in the middle 1960s, the middle 1970s and the early 1980s. If in recent years the Federal Reserve System has restored its credibility, it has done so too late to undermine this argument for European Monetary Union.

Forces similar to those at work undermining the dollar under the Bretton Woods arrangements act today to threaten the dollar in the future. In the postwar fixed exchange rate system, economic growth induced countries to accumulate dollars to add to their reserves. Flexible exchange rates reduced the importance of the balance of payments but increased the importance of the trade balance and current account. Not just governments and central banks but also institutional investors want to add dollars and dollar assets to their portfolios every year. Foreign money invested in the New York capital market finances U.S. spending over and above GDP, resulting in the huge current account deficits that have characterized the U.S. international accounts since the late 1970s. Associated with the capital inflow is the piling up of international indebtedness that has made the U.S. the biggest international debtor in world history.

It is true, of course, that the U.S. can take pride in recent economic achievements. With the exception of a nine-month recession in 1990-91, the 15 years between 1982 and 1998 have seen falling and low inflation rates and continuous expansion, producing no fewer than 38 million new jobs--more than the entire labor force of Germany! In addition, the U.S. is at the center of an electronic revolution that will change people's lives even more than the Industrial Revolution did.

Nevertheless, it would be a mistake to ignore the downside of this period. In the same 15 years current account deficits have exceeded \$1.5 trillion, turning the U.S. from the world's biggest creditor to its biggest debtor. In the 1940s, the U.S. accounted for more than a third of the world's output, was a large net capital exporter with a strong trade surplus, had an overwhelmingly strong reserve position with two-thirds of the world's gold stock, and was by far the world's largest creditor nation. A half century later, its share of world output has been reduced to 22%, it is the largest capital importer with a huge and chronic trade deficit, it has negative net

reserves, it has one of the lowest savings rates, and it is the world's largest international debtor nation. Although more favorable demographics in the U.S. than in Europe or Japan will provide a temporary respite in the next decade or so, the low-saving high-debt problems will one day come home to roost.

There will come a time when the pileup of international indebtedness makes reliance on the dollar as the world's only main currency untenable. It would be rash to predict instability of monetary policy in the U.S. under Alan Greenspan's watch. But the fact that the bulk of international reserves is held in dollars makes that currency a sitting duck in a currency crisis. It was no accident that the dollar fell to 79 yen in 1995 at the peak of the fallout from the Mexican crisis, wreaking havoc with Japan's already distressed economy.

A dollar-based system was inevitable in the early postwar years, when the rest of the world was wrecked by wars and wracked by instability. But with the soaring strength of Europe and (despite recent setbacks) Japan, sole reliance on the dollar as the main reserve, invoice and intervention currency presents risks that are no longer necessary. While the dollar will continue to be an important part of the international monetary system--and perhaps remain the most important currency for years to come--it is no longer necessary or even healthy for the U.S. or the rest of the world to rely solely upon the dollar.

An Alternative to the Dollar

What should other countries do in the world of a potentially unstable dollar? National floating is a possibility, but most nations that have tried this option have lapsed into monetary instability. Floating deprives small countries of a readily definable and transparent target for monetary policy, it balkanizes the nondollar world, and it serves to amplify and exaggerate the power and importance of the dollar. Contrary to the predictions of its advocates, more rather than fewer reserves are needed under a regime of floating exchange rates. It is no accident that the four Asian economies that escaped the crisis in that continent--China, Singapore, Taiwan and Hong Kong--had immense currency reserves, a stable monetary regime or both. In the future, high monetary reserves will be looked upon as a ticket to independence.

The creation of a genuine multilateral world currency is a theoretically interesting option--a great opportunity missed at the 1944 Bretton Woods meetings. But historically, international monetary reform in the direction of a world currency has always been blocked by the presiding superpower--Britain in the 19th century and the U.S. in the 20th century. Today, there is no prospect at all for a world currency and any proposal for one up until now would have been blocked by the U.S. Once the euro is established, Europe will probably see its interest in joining the U.S. in opposing any change that would limit the international scope of the euro.

Fixed exchange rates to the dollar--the Bretton Woods solution--would theoretically be a step toward stability if it were accompanied by an adjustment mechanism such as that which operated automatically under the old gold standard or which operates when a country uses the currency board mechanism. But without some kind of commitment to dollar convertibility, it would not generate much interest as a world-wide system. Nor would it have the multilateral patina that the Bretton Woods arrangements provided in the early postwar decades. It would be possible of course for the U.S. to develop institutions for internationalizing a dollar area. For many countries, however, and certainly for Europe, joining a dollar area would be totally unacceptable.

A Dollar-Euro World

Fortunately, unlike many other countries, Europe has an alternative. With the road to economic integration already paved, Europe needs only to put the finishing touches on its common market with a European currency. With 11 countries set to join, the stage is set for a single-currency area that can be a worthy alternative to the dollar. This attractive new option would be of enormous advantage to other countries in the event that the dollar again leans toward instability, and especially for countries where political difficulties make a dollar fix unworkable.

The introduction of the euro would at once make it the reserve currency of choice for a large number of countries connected in trade and finance with Europe. Diversification from the dollar to the euro would begin once confidence in the policies of the new European central bank were established. China has already indicated that it will keep part of its reserves in euros, and other countries will follow. What would such an international monetary system be like?

At first glance, it appears to be dominated by the three main currencies, the dollar, the euro and the yen, with the dollar-euro rate the most important price in the world.

The U.S. and the EU together account for between 50% and 60% of world output; counting Japan, the three areas account for close to 70% of world GDP. It is probable that monetary union in Europe will provoke steps toward an Asian monetary bloc, spearheaded by Japan, China or the members of the Association of Southeast Asian Nations.

While the dollar, the euro and the yen will be the most important currencies in the world for some time to come, it would be a mistake to ignore the role of gold. Gold is currently the second most important reserve asset. Total above-ground gold stocks amount to about 110,000 tons, worth \$1.1 trillion at \$10 million a ton. Financial authorities hold about a third of this--more exactly, 1.1 billion ounces--worth \$330 billion at \$300 an ounce. EU countries hold 458 million ounces, counting gold held by the European Monetary Institute on their behalf. By comparison, the U.S. holds 262 million ounces. Europe will thus have a strong voice in determining the role played by gold in the future of the international monetary system.

It would be a mistake to think that Europe's interest would lie in dumping large stocks of gold in any big sell-off. None of the big holders have any interest in depressing the price of an important reserve asset. But Europe may find that its gold holdings have a hitherto unnoticed use in building confidence in the euro. When the euro is compared to the great international currencies of the past, its two great strengths become immediately apparent: the large size of its transactions area, and the culture of stability that will surround the European system of central banks.

It is also necessary to note, however, that the euro will have two unique weaknesses compared to its great predecessors. First, the euro starts off as a pure fiat currency not linked to gold. Second, the euro is not produced by a strong central state. These weaknesses would be potentially lethal were it not for two mitigating factors: Europe's large gold reserves will help to overcome the first weakness. The second weakness will be overcome in the short run by the military alliance of NATO and in the long run--perhaps--by European political integration.

If the euro contributes to the stability of the international monetary system in the long run, it could present problems in the transition. The new euro will create changes in currency preferences of central banks and other portfolio managers. Diversification effects are inevitable. Imagine the impact on exchange rates if new currency preferences were such that countries wanted to keep their official reserves divided equally between dollars and euros. The problem is magnified by the likelihood of a massive diversification into euro-denominated deposits in the offshore currency markets and in the bond markets.

Both the EU and the U.S. would need to take strong defensive action to ease the transition. Neither area would welcome a significant depreciation of the dollar. It is unlikely, however, that bilateral handling of the problem would be amicable. It would be safer to recognize that a problem will exist and create an institutional framework for dealing with it. (One possibility would be to establish a "conversion account" under the auspices of the International Monetary Fund, authorized to accept deposits of gold, dollars and euros in return for credit balances denominated, perhaps, in Special Drawing Rights, redesigned to account for the euro.)

The euro is now virtually certain to come to pass. My own view is that a well-run monetary union encompassing most of the members of the EU today, and most of Europe in the future, will be of enormous benefit to the people of Europe and also to the people of the rest of the world, including the U.S. Members of the EMU will get not just a currency on a par with the dollar and the right to a share in international seigniorage but also greater influence in the running of the international monetary system. The rest of the world will get an alternative asset to the dollar to use in international reserves and a new and stable currency that could be used as the focus for stable exchange rates or currency boards. The U.S. will get a needed relief from the eventually debilitating overuse of the dollar as an international currency, a single-currency continent that vastly simplifies trade and investment, and a strong partner in Europe with an equal stake in constructing an international monetary system suitable for the 21st century.

Politics Too

A case for the euro can be made on economic grounds alone. But other factors are always involved. Europe's geography makes it also a political entity. The political case for the euro is not distinct from the general case for European integration. In the postwar years, the case rested on three pillars: the need to put to rest the Franco-German conflict, fear of invasion by the Soviet Union, and emulation of the U.S. The end of the Cold War did not invalidate the case. EMU provides the key and the catalyst to a more secure political Europe.

In the dark days of October 1942, Winston Churchill already talked of "a United States of Europe" with free travel and a united economy. "I hope to see a Council of perhaps ten units, including the former Great Powers," he wrote. A year after the great conflict ended, in a speech made in Zurich on Sept. 19, 1946, he was even more explicit:

"If Europe were once united in the sharing of its common inheritance there would be no limit to the happiness, prosperity, and glory which its 300,000,000 or 400,000,000 people would enjoy." A series of "frightful nationalistic quarrels" wrecked the peace and threaten to mar the future. "Yet all the while there is a remedy which, if it were generally and spontaneously adopted by the great majority of people in many lands, would as by a miracle transform the whole scene and would in a few years make all Europe, or the greatest part of it, as free and happy as Switzerland is today."

Much of Churchill's dream has already come true. EMU would help to make it last.

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