The Euro: How Important?

Robert Mundell

How important will the euro be in the framework of world international monetary events? It certainly will be as important as anything since the breakup of the Bretton Woods system in 1971 or the movement to floating exchange rates in 1973. But one can make a case that it will be much more important because, in fact, the shift from fixed to flexible exchange rates did not change the configuration of the international monetary system. Before and after that change, the dollar was the major international currency and, if anything, the dollar is more important in the international monetary system today than it was in 1973. One has to go back to the shift from sterling to the dollar, in the period from 1915 to 1974, to find a comparable case. But even then, one could argue that the demise of sterling was not really all that important because by 1914 the United States was already three times as large as the British economy, and it was inevitable that the 20th century was going to be a dollar century and not a sterling century. So one may have to go back to the shift from bimetallism to the gold standard in the 1870s to find a monetary event as important as the launch of the euro.

Features of a Great International Currency

To see how significant the euro is, one has to consider its position as a great international currency. What are the features of great international currencies? There are seven. The first is a large transactions area. The second is a stable monetary policy. Switzerland has a stable monetary policy but a small transaction area, so the Swiss franc could never be a great international currency. Large transactions areas are important because only then do you have a flat, marginal utility schedule for the demand for money, and only then do you get the stability properties of a large system. The third feature is the absence

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of controls. Of course, no country is absent from controls, and there is always the threat that governments may use political events to establish controls. Gone are the days when George Washington, in the middle of the Revolutionary War, could keep his account at the Bank of England, even though he was the enemy. But the European Monetary Union is going to be very large, and it will have a stable monetary policy. And, at least in the first round, there is no reason why there will be any more controls imposed in Europe than would be the case in the United States. So, with regard to the first three features, the euro stacks up well as a major international currency.

The fourth feature is a strong central state. The United States is a strong central state, Europe is not—and that is a potential weakness. If a country is about to be invaded, its currency will collapse. But Europe is under the U.S. umbrella and the Cold War is over, so the risk that the euro will collapse due to invasion is low.

Fifth, all the great international currencies of the past were initially backed by gold or silver. And that holds also for the dollar. The euro is starting off with no backing whatsoever, except for its market exchange value in the United States and the European Central Bank's commitment to price stability. Nevertheless, members of the monetary union do hold substantial gold reserves (400 million ounces) compared to the United States (250 million ounces), representing 40 percent of the world's gold reserves, and members have foreign exchange reserves (of about $450) that are three to four times as large as U.S. reserves—all of which give the euro some fallback value.

The sixth factor is a sense of permanence. You have to have a belief that the euro is going to be here not just tomorrow and 10 years from now, or 30 years from now, but 100 years from now. It has to have that sense of permanence, otherwise no one will want to hold euros or euro bonds.

That leads us to the seventh feature, low interest rates, which are always associated with great international currencies. If one looks back at different currency areas, one would see that there was never a single currency that dominated everything. In the ancient world, there were the Roman, Greek, and Egyptian currency areas, each with its own unit of account. And, in the Middle Ages, there was the Islamic currency area, the Pagan area, and the Christian area in Central Europe. In the 19th century, from 1873 to 1914, there was a gold bloc, a silver bloc, and a bloc of paper currencies. In the future, I predict there will be a dollar bloc, a euro bloc, and a yen bloc.

Liquidity Effects and the Value of the Euro

The euro will have a number of liquidity effects that are going to affect its value. The first two will be inflationary, the last four will be deflationary.

First, the mere act of replacing national currencies with euros will make the euro more liquid than the national currencies. So there will be an inflationary factor. Second, there will be an increase in the money multiplier as members of the monetary union try to profit by creating substitutes for the euro and expanding credit. That too will be inflationary. Third, there will be excess reserves because pooling reserves of member countries will give European central banks more gold and foreign exchange than they need. This will create an urge for expansion. The head of the previous government in Italy already said, "Let's spend some of those excess reserves on solving the unemployment problem," which is not good news for Europe.

Fourth is the "exorbitant privilege" argument, which is reminiscent of Charles DeGaulle's argument in the 1960s that the United States can go out and spend and pay for its imports with dollars, which people could then hold and use as money. That arrangement gave the United States an exorbitant privilege and free interest-bearing loans, or what was called "a deficit without tears." Europe will now be in a similar situation with respect to the euro.

The fifth factor, foreign demand for euros, will be deflationary, as will the sixth, diversification from dollars into euros.

The Future of the Euro as a Reserve Currency

My projections of the future demands for reserves are as follows. Today world GDP at current exchange rates is about $30 trillion, with the United States at $9 trillion, the European Union at $9 trillion, and all other countries at $12 trillion. By the year 2010, GDP is projected to be $60 trillion, with the United States at $18 trillion, the European Union at $18 trillion, and all other countries at $24 trillion. Foreign exchange reserves are about $1.2 trillion held in dollars and about $0.4 trillion held in other currencies. Leaving aside gold, that makes a total of $1.6 trillion in foreign exchange reserves. By 2010, those reserves will grow to approximately $3.2 trillion.

Reserves double every 10 to 12 years. They have in the past and they will again. The demand for dollars in 2010 will be about the same. The demand for euros will be about the same as the demand for dollars. If true, then in 2010 world foreign exchange reserves will consist of $1.2 trillion in dollars, $1.2 trillion in euros, and $0.8 trillion in other currencies. That means U.S. dollar reserves would not grow in the next 10 years, while euro reserves would grow by about $100 billion a year, which would have a big impact on trade balances, if not offset by compensating capital movements. Even if there is no diversification, if nobody sells dollars, but just holds them, there will be a shift into euros and other currencies.

Conclusion

The euro area: How big will it be? My own prediction is that by the year 2002 the European monetary Union will include its current 11 members plus Greece (which is already committed to join), Sweden, Denmark, and Britain. By 2005, Slovenia, the Czech Republic, Poland, Hungary, and Estonia will also be in. And by 2010, assuming all goes well and the monetary union is prosperous, no country in Europe will want to, or be able to, afford to stay out. Thus, Slovakia, Croatia, Lithuania, Latvia, Romania, and Bulgaria will all join the monetary union.

The dollar-euro exchange rate is going to become the most important price in the world, and neither Europe nor the United States is going to want to have big fluctuations in that price. My own belief is that there will be a movement toward stabilization, institutional or otherwise, de facto, to stabilize and reduce fluctuations. When that happens, Japan will not want to let its exchange rate diverge very much from the dollar-euro rate, so that by 2010 we will be back to a world where we get more fixed exchange rates, and the International Monetary Fund will be dragged back to its original function.