The Euro, the Dollar, and the International Monetary System: Editor’s Introduction

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This Special Issue of the Journal of Policy Modeling on “The Euro, the Dollar, and the International Monetary System” arose out of the Session that I organized at the Annual Meeting of the American Economic Association held in Boston on the 5th of January 2000 in honor of Robert A. Mundell, who was awarded the 1999 Nobel Prize for Economic Science for his path-breaking work in international finance.

The creation of the euro as the common currency of 11 of the 15 members of the European Economic and Monetary Union, or more simply, the European Union (EU) on January 1, 1999, is the single most important event in international finance since the collapse of the Bretton Woods System in 1971—perhaps the most significant event of the entire post-World War II period. Never before had a group of sovereign nations voluntarily given up their national monies for a common currency.

The creation of the euro will have a significant impact on the economies of the participating nations as well as on the nonparticipating members of the EU and on the rest of the world. The exchange rate between the euro and currency of the other nonparticipating EU members and between the euro and the U.S. dollar, the Japanese yen, and the other important currencies has become one of the most crucial and watched financial relationship in the world today, and the creation of the euro has affected the operation of the entire international monetary system in a fundamental way.
This Special Issue contains the papers that were actually presented at the AEA Session in Boston as well as others that were prepared specifically for this Issue. The aim is to present in one place and in a very accessible way the most up-to-date views of some the world’s leading experts in the field. Besides Robert Mundell, the other contributors are: Paul De Grauwe (Louven and CEPR), Rudi Dornbusch (MIT), Michael Eichengreen (Berkeley), Martin Feldstein (Harvard and NBER), Otmar Issing (European Central Bank), Ronald McKinnon (Stanford), Michael Mussa (IMF), Thomas Willett (Claremont Graduate University), and this author (Fordham).

The first part of this Special Issue opens with Mundell’s “Currency Areas, Volatility, and Intervention,” in which the Honoree presents his case for a single World Central Bank and a single world currency. Realizing that this is not likely to occur in the foreseeable future, Mundell opts for the second best solution of returning to a fixed exchange rate system “a la Bretton Woods,” but with countries not sterilizing changes in their money supply resulting from balance of payments disequilibria (which would rob the system of its adjustment mechanism). As a first step in that direction, Mundell advocates fixing the exchange rate of the dollar with respect to the euro and the yen, and intervening in foreign exchange markets to moderate the volatility in those exchange rates. Mundell has consistently advocated these reforms over the years (Mundell, 1961, 1967), and in his piece he provides a sweeping and compelling case in support of his views.

In the second contribution, entitled “Robert Mundell—Nobel Laureate in Economics,” Rudi Dornbush surveys Mundell’s path-breaking contributions and paints an affectionate picture of a brilliant, if unconventional, teacher who stimulated and encouraged most of today’s leading experts in the field during their formative years and afterwards. My
contribution, entitled “Robert Mundell: Three Brilliant Ideas—One Nobel” (which greeted Mundell’s Nobel in a leading financial European newspaper; Salvatore, 1999), briefly reviews Mundell’s three major contributions to economics, in general, and international finance, in particular—each of which is deserving of a Nobel. The first part of the Special Issue concludes with McKinnon’s review of the evolution of Mundell’s views on the euro in a paper entitled “Mundell, the Euro, and the World Dollar Standard.” McKinnon points out that there are two Mundells: the 1961 one of “The Theory of Optimum Currency Areas,” in which Mundell (1961) argues in favor of making currency areas smaller rather than larger, and the 1973 one of “Uncommon Arguments for Common Currencies” (see the references in McKinnon’s paper), where Mundell argues that the larger a currency area the better it is.

The second part of this volume presents an evaluation of the operation of the euro during its first year of existence in the light of Mundell’s theory of optimal currency areas. This part opens with the article by Otmar Issing, the Chief Economist of the European Central Bank (ECB), entitled “The ECB’s Monetary Policy Experience After the First Year,” which provides an insider’s convincingly positive evaluation of the first year’s operation of the ECB. Issing points out that the ECB set the inflation target at less than 2 percent, but it has no exchange rate target for the euro. In “The European Central Bank and the Euro: The First Year,” Martin Feldstein looks more broadly at the EU, and states that we can commemorate but should not celebrate the creation of the ECB, because the introduction of the euro is likely to give rise to major problems for the participating countries and lead to political conflict with the United States. Barry Eichengreen points out in his “The Euro One Year On” that the euro has not overtaken the dollar as the leading international and vehicle currency (as many had predicted), but that it did lead to a revolution in European finance
to an extent that no one anticipated. In time, Eichengreen believes that the euro will challenge the dollar for international financial supremacy.

The third part of this Special Issue deals with broader theoretical and political economy aspects of the creation of the European Central Bank and the introduction of the euro. In the first contribution, entitled “The Relationship Between the Euro and the Dollar,” Michael Mussa presents data that show that the volatility of the exchange rate of the euro with respect to the dollar and the yen was almost exactly what would be predicted from a “random walk,” rather than being larger (as many anticipated based on the relatively low trade linkages between the EU and the United States and Japan). In his paper “Some Political Economy Aspects of the EMU,” Thomas Willett concludes that, despite the enormous stakes involved in the creation of a monetary union in Europe, political leaders were motivated much more by a grand but fuzzy political vision than by careful analysis and comparison of its benefits and costs. He finds little basis for optimism that labor markets will become significantly more flexible during this decade, and expects the Growth and Stability Pact to become a source of contention in the EU. Paul De Grauwe’s “Controls on Capital Flows” explores the effects of capital controls on the functioning of the international monetary system in a world of high capital mobility in which the euro shares the international currency role with the dollar. He comes out squarely against the Tobin tax, and concludes that capital controls can only be useful to enforce a temporary “standstill” in a banking and liquidity crisis, and to shield domestic markets from excessive capital inflows when markets are not fully liberalized. In the last paper, this author examines the relationship between the euro and the dollar and the functioning of the international monetary system.
BIBLIOGRAPHY


