THE EURO AS A STABILIZING AND HARMONIZING FORCE IN THE INTERNATIONAL MONETARY SYSTEM:

ANALYTICAL FOUNDATIONS AND FUTURE PROSPECTS

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The creation of the euro should lead to radical changes, which are likely to bring about systemic effects on the organization of the International Monetary System (IMS). Will such profound changes in the world monetary order foster stability or instability with respect to exchange rates?

This question is not new. A similar debate emerged in the early 1970s, notably in the United States (Krause and Sulant, 1973), when the collapse of the Bretton Woods order seemed to impose a serious reform on the IMS. The question was then to know what European monetary unification, recommended by the Werner plan, would mean in terms of competition between the major currencies. The most widely-acknowledged scenario was that a reinforced competition between the European currency and the dollar would create instability, thus increasing the need for a reform of the IMS. History has allowed us neither to confirm nor refute this view. The Bretton Woods order completely fell apart and the project of a European Monetary Union was abandoned. The shift towards flexible exchange rates, and the easing of collective discipline, took the place of systematic reform.

More than twenty-five years later, the same questions have reemerged, but in a new context. The euro is already a reality, but if it is generally believed that it will change the evolution of the IMS, it is no longer a question of reforming the European Monetary System (EMS). However, the dominant perception of the future could once again be refuted. The creation of the euro and the shift from the current multi-currency regime dominated by the dollar towards a bipolar regime could imply more than mere adaptations of the IMS, and put the need to establish new rules on the agenda.

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Table 1  
The Relative Weight of Euro 11  
Real and Financial Indicators (1998)  

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Euro Area</th>
<th>United States</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of world GDP (at market)</td>
<td>22.3%</td>
<td>29.2%</td>
<td>13.0%</td>
</tr>
<tr>
<td>Share of world GDP (at PPP)</td>
<td>18.5%</td>
<td>20.8%</td>
<td>7.4%</td>
</tr>
<tr>
<td>Shares in world exports</td>
<td>90.1%</td>
<td>16.8%</td>
<td>7.6%</td>
</tr>
<tr>
<td>Bank deposits (% of GDP)</td>
<td>6.0%</td>
<td>54.0%</td>
<td>122.0%</td>
</tr>
<tr>
<td>Domestic credit (% of GDP)</td>
<td>120.0%</td>
<td>81.0%</td>
<td>152.0%</td>
</tr>
<tr>
<td>Domestic bonds (% of GDP)</td>
<td>91.0%</td>
<td>235.0%</td>
<td>232.0%</td>
</tr>
<tr>
<td>Stock-exchange capitalization (%</td>
<td>63.0%</td>
<td>172.0%</td>
<td>62.0%</td>
</tr>
<tr>
<td>European Central Bank (1999)</td>
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Will such changes foster greater stability or, on the contrary, greater instability of exchange rates? Simulation models lead inductively to mixed results, highlighting an increase as well as a decrease in volatility. However, the theoretical grounds on which such predictions are based seem fragile.

The most appropriate theoretical framework for such a debate is hegemonic stability, according to which the shift from a unipolar organization of the IMS based on the dollar to a multipolar organization should lead to an unstable equilibrium.

In this article, we develop the ideas that, in the long run, the euro should exert a stabilizing influence, contributing to the creation of a cooperative monetary regime favorable to greater stability. This forecast requires a reformulation of the theory of hegemonic stability.

A DESTABILIZING EURO: LESSONS FROM THE THEORY OF HEGEMONIC STABILITY

After showing how the euro alters the distribution of powers within international monetary relations, we shall shed light on the effects of the creation of the euro according to the stability thesis.

Challenging the Supremacy of the Dollar

The creation of the euro has two main effects on the international monetary scene: a size effect and a balance of payments effect. These combined effects may threaten to undermine the dollar's supremacy. If the appearance of such a bipolar system is the most interesting scenario, we stress that it is unlikely that the euro will become the dollar's alter ego in the short run. Indeed, taking into account the fact that "history matters" (Eichengreen 1997) and that institutional factors exert a decisive influence, the internationalization of a domestic currency is a very slow process.

"The Size Effect." The creation of the euro area has a significant size effect. Real indicators (GDP, world exports share of goods and services) and financial indicators (banking deposits, domestic credit, etc.) show that in terms of economic weight, the euro area is similar to the United States (Table 1).

Moreover, in the long run, a decline in the relative weight of the United States in the Group of Ten is noticeable (Figure 1).

This trend can mainly be explained by the "size effect." The increase in a country's size mechanically results in the increase of the relative weight of its currency in the world reserves. For every 1 percentage point of economic growth increase that one of the G3 major countries experiences as a share of gross world product (measured at purchasing power parity rates), its currency experiences a 1.33 percentage point increase in its share of central bank reserves holdings" (Eichengreen and Frankel, 1997, 364). According to these authors, this phenomenon explains a 5 percentage-point decrease of the dollar for the total decrease observed between 1970 and 1992.

"The Balance of Payments Effect." Figure 2 shows the external disequilibria between the United States and the euro area. Since 1993, the current account of the euro area has shown an increasing surplus, whereas that of the United States has moved into deficit. The European surplus can be explained by structural factors, the impact of which will be absorbed only slowly: an aging population keeping up the saving rate, budgetary discipline with the growth and stability pact, a structural growth gap favorable to the rest of the world, and low inflation prospects. Thus, beyond the excessive current surplus of 1997, linked to the time-lag of the cycle between continental Europe and Anglo-Saxon countries, the International Monetary Fund predicts in the medium term a strengthening of the saving-investment ratio in countries of the euro area, and thus of their current surplus (along the same lines, see Green and Swagel 1998). This situation, combined with the expected credibility of the European Central Bank in terms of price stability, could lead to a strong demand for assets...
drawn in euros, pushing the European single currency above its fundamental equilibrium exchange rate. Similarly, current imbalances in the United States speed up the deterioration of its net external position. This translates into an increase in external indebtedness, which produces a significant increase in American liabilities abroad.

Given the current surplus, the optimal balance of payments for the Economic and Monetary Union (EMU) should, then, be characterized by a significant net outflow of capital in the long run, exceeding the current surplus, in the style of 19th century England. Net capital outflows should increase the supply of the rest of the world in euro reserves. On this point, it can be noted that since the mid-90s, the euro area has been a net supplier of portfolio investments, and that it has increased its net outflows of direct investment (Table 2).

The influence of the balance of payments of the euro area on the restructuring of international monetary relations can be twofold. Firstly, it helps the internationalization of the euro, since the net surplus of the current account is a factor of credibility of the European currency. Secondly, it may lead to a reaction from the United States towards a new international monetary regime. The extent of the external debt of the United States could indeed bring the Federal Reserve (the Fed) to change its monetary strategy (Artus, 1997). Any increase in the volatility of the dollar—related to international portfolio restructuring in favor of the euro—translates into an increase in the spread between short-term and long-term rates through the risk premium mechanism for American debt. The spread increases to compensate international investors, encouraging them to hold American debt. This movement could push up long-term interest rates in the United States, which would most likely affect American output, and hence encourage the Fed to stabilize the dollar.

**A Long-Run Process.** If we favor a scenario in which the euro could be an international currency equivalent to the dollar, it does not mean that we underestimate the presence of inertia effects and the role of institutional factors in the internationalization process of the European currency.

As suggested by numerous historical studies, the emergence of a new international currency does not result from a fast process. For example, the decline of the pound sterling after World War II does not correspond to the economic decline of the United Kingdom after 1890. Indeed, network externalities exert a decisive influence to explain the path dependency effect linked to the fact that a currency is already an international currency. Thus, an economy with efficient capital markets encourages capital inflows, which increase the liquidity of markets. The currency of its country is used more as a vehicle currency. In turn, the rise in liquidity and the fact the currency becomes a vehicle currency improves the efficiency of the financial markets.
This virtuous circle explains the inertia identified in the internationalization currency process. In an empirical study over the period 1971-1985, Eichengreen [1997] tests the influence of each country's share in global GNP, its share of global exports and a lagged dependent variable on the share of its respective currency in global foreign exchange reserves. His main result is that the influence of the lagged dependent variable is integrated in the regressions, the weight of the size factors expressed through the shares in global GNP and global exports significantly decreases. In other words, if the size effect influences the competition between domestic currencies, it is not decisive.

At the same time, institutional structure matters because financial factors are prevalent in the internationalization of a currency. In this perspective, the depth and liquidity of financial markets are very important characteristics of an international currency. Another characteristic is the ability of the authorities to intervene as a lender-of-last-resort to stabilize the markets in periods of liquidity stress. This ability is a significant precondition to ensure stability in the financial markets. "The Maastrecht Treaty does not provide for last-resort lending by the European Central Bank (ECB). Indeed, according to the subsidiary principle, the Maastrecht Treaty considers that bank supervision depends on the national authorities of members states. As a corollary, the ECB has no specific lender-of-last-resort facilities. According to Eichengreen, it is "unlikely that European securities markets will rival New York in the absence of a central bank which stands ready to backstop the market" [1997, 22]. Overall, path dependency and institutional structure lead us to conclude that the internationalization of the euro may only take place gradually. So, the scenario of a euro with an influence similar to that of the dollar is obviously not in sight.

However, we attach particular importance to this perspective in this paper as far as the possible emergence of a real rival to the dollar raises some interesting questions in terms of stability or instability of the international monetary system.

**Hegemonic Stability and Creation of the Euro**

The theory of hegemonic stability goes back to the studies of Brown [1940] and Kindleberger [1973] on the gold standard and the interwar crisis respectively. These studies suggest, on the one hand, that there is a relationship between the decline of the leading economy and international monetary disturbances [Brown, 1940], that the disappearance of international leadership is the main determinant of international financial instability [Kindleberger, 1973]. More precisely, the presence of several economies capable of exercising an influence on the other countries appears as a factor of instability at an international level. The theory of hegemonic stability is a continuation of these works [Krasner, 1978, 1983; Peace, 1980]. This theory fits within the more general framework of the theory of collective action [Olsen, 1955]. As the international economy is composed of many states of various sizes, the absence of a supranational authority capable of imposing cooperation on these states makes any durable collective action impossible. Only the presence of a hegemonic country—a so-called hegemon—is able to ensure the stability of the international economy in the long run.

**The Euro as a Stabilizing and Harmonizing Force**

The historical and theoretical foundations of the theory of hegemonic stability make it a useful framework for our analysis, although it also has indisputable drawbacks.

**Analysis.** The link between hegemony and stability originates in the capacity of the hegemonic country to establish an international monetary regime, in the sense given by Krasner, that is "sets of implicit or explicit principles, norms, rules and decision procedures around which the actors' expectations converge in a given area of international relations" [1983, 2].

The crucial point here is not necessarily the constraining power of the hegemon, but rather its capacity to exert a decisive influence on the behavior of the other actors, or in other words, its power to make the other countries adopt operational rules and procedures which organize international relations. The leading country thus supplies a public good—stability—to the rest of the world. If the hegemonic country benefits from its position, small economies often gain even more. Following Olson's words, "the small exploit the large"; the hegemon is thus a "benign leader" [Suidal, 1988].

In a certain way, by setting up an international regime, the hegemonic country helps other countries identify their mutual interests and allows them to fulfill these interests [Kochoane, 1984]. When the international economy has no leading country, the international regime loses its stabilizing virtues and tends to collapse.

In this perspective, and given the size and balance of payments effects, it appears that the main theoretical prediction of hegemonic stability is that the creation of the euro will probably bring greater stability into international economic relations. However, the relevance of such predictions rests on both the actual conditions related to the internationalization of the European currency and on the strength of the theory.

**Drawbacks.** The theory of hegemonic stability has been the subject of numerous historical and conceptual critiques, which help underline the complexity of international economic relations and specify the analytical impact of hegemonic stability [Strange, 1980; Suidal, 1988; Eichengreen, 1989; Walter, 1991; Oye, 1992].

At a historical level, international monetary organizations since 1870 have seemed to rest more on a logic of "hegemonic cooperation" stability than on the existence of a unique hegemonic country [Kochoane, 1984]. The adjustment of the world economy before 1914 thus rested on the collective leadership exercised by the main European nations (Germany, France and the United Kingdom) over the countries of the periphery [Allegret, 1997].

Eichengreen [1989] highlighted the ambiguity of the concepts used by the theory of hegemonic stability. This limits the possibilities of developing a relevant framework for the analysis of international economic relations. Suidal [1986] questioned the public-good nature of international stability provided by the leading country on the grounds that two important features of public goods—non-exclusion and indivisibility—may be absent.

With respect to the effects of the euro on international monetary relations, the main drawback of the standard version of hegemonic stability is in its underlying representation of international economic relations. Although the theory of collective
action correctly stresses how difficult cooperation is when many actors are involved, we cannot conclude that it is impossible to achieve cooperation without a hegemon. Indeed, we feel it is crucial to bear in mind that international economic relations lead to repeated games between the actors. Thus, governments must take their own interests, as well as the potential reactions of the other countries that may affect their welfare, into account. In this view, governments are not necessarily endowed only with immediate rationality, as the theory of hegemonic stability suggests. They may also be endowed with strategic rationality (Snidal, 1985) encouraging them to take the reactions of the other countries into account. Cooperation after hegemony is possible, if the actors understand that the payoff matrix is modified by the existence of a situation of mutual cooperation or mutual defection (Guerrieri and Padoa, 1988). Payoffs must be higher in the first situation than in the second.

The question of the players' gains must hence be clearly integrated into the analysis of the effects of the euro on the restructuring of international monetary relations. As the theory of rational participation suggests, each decision unit—taken individually—is induced to participate in a collective action if the expected benefit is higher than the expected cost. Thus, if challenging a country's hegemony may lead to significant welfare losses in the absence of cooperation, the creation of the euro may lead to a situation of cooperation after hegemony.

**BEYOND HEGEMONIC STABILITY: A STABILIZING EURO?**

The idea that the euro competing with the dollar could be stabilizing conflicts with the theory of hegemonic stability, as it has been developed since the 1970s. Therefore, using this theoretical framework to support our argument is surprising, but only an apparent contradiction. We are thinking of a dynamic approach to hegemonic stability, which would break with the too simple one-to-one correspondence between hegemony and stability. In this dynamic approach, contrary to the prediction of the standard version of hegemonic stability, the fact that the dominance of the dollar is called into question by the internationalization of the euro could have stabilizing effects on international monetary relations.

**The Theory of Hegemonic Stability: A Dynamic Perspective**

The relation between hegemony and stability should not be analyzed in a static way as the standard version of the hegemonic stability theory does, which simply associates the presence (absence) of a hegemon to stability (respectively instability). Instability is, essentially, a dynamic phenomenon. Therefore, it is more the changes in, rather than the state of, relations themselves that is more or less favorable to stability or instability. When applied to international monetary relations, our point of view is that the degree of stability or instability of the international monetary system during the 21st century cannot be appreciated by using a simple comparison between the final anticipated state of bipolarity (likely to be induced by the creation of the euro) and the current situation. Conditions of this path towards bipolarity have a greater impact on stabilization (or destabilization) of the IMS, and in particular on the evolution of exchange rate volatility.

In this dynamic perspective, it seems that an underlying relationship could be established between stability (or instability) and the concentration of power, but this link is neither linear nor uniform. One of us has highlighted such a relation to explain volatility in different international raw material markets during the 20th century (Sandretto, 1994; 1995). Instability appears to be correlated with the emergence of oligopolistic behaviors in an originally competitive market (Figure 3), with the process of industrial and financial concentration and the intensification of the oligopolistic competition which accompanies it. As one moves from a relatively competitive structure with a free market such as the London Exchange Market or the New York Commodity Exchange (type 1) to a non-coordinated oligopoly structure (type 2) with a plurality of competitive pricing mechanisms (free market, price/producer price), the level of instability grows significantly. However, as the market progresses toward its ultimate end (a monopoly or coordinated oligopoly), the system of price determination becomes exclusively that of the "producer price" and its level of instability falls suddenly. To avoid competition, which could only be destructive, the "price war" of the previous phase is replaced by a more or less peaceful coexistence, which can lead to market sharing agreements.

In short, while the concentration process (passage from phase 1 to phase 2) increases instability, the resulting monopoly (or coordinated oligopoly) destroys it (passage to phase 3).

This is the dominant evolution observed in most raw material markets, but the reverse development (move from phase 3 to phase 2) can also sometimes be observed. In it, the firms that were previously in a dominant position lose market control and return to oligopolistic conflicts over prices and instability.

Obviously, the foreign exchange market is quite different from raw material markets. However, we suspect that the validity of this "instability law" extends far be-
yzed primary goods markets and can be stretched to cover other types of international markets. Indeed, the instability of primary product prices and the instability of foreign exchange rates share many common characteristics. In particular, we believe that this interpretation framework can shed light on the potential future effects of the euro.  

**Application of the Instability Law on the Expected Consequences of the Introduction of the Euro**

Will the appearance of a true competitor to the dollar have a stabilizing or destabilizing influence on exchange rates in the future? To answer this, we need to distinguish several types of international monetary systems (IMS) organizations, depending on the degree of asymmetry and hierarchical organization of international monetary relations. The international impact of the euro can thus be more precisely appreciated by distinguishing short-medium term from long term. The limits of alternative organizations have been identified, to underline the likelihood of a co-leadership between dollar and euro.

**Types of IMS Organization.** Different IMS structures, which imply different IMS operating modalities, are directly linked to the phases of the preceding analysis. Structure No. 1: Hegemonic Structure, characteristic of a unipolar IMS, in which one country, in general, the most influential, imposes a monetary order based on substantive rules that are universally accepted. The “center currency” dominates the system's running and assumes, de facto, its regulation. Other countries participating in the system (satellite currencies) adapt to the situation and to the decisions of the central country by adapting their monetary and exchange rate policy. The typical illustration of this first organization type is given by the Bretton Woods system during its first period (1945-1964). This organizational mode guarantees, in general, an exchange rate stability.

Structure No. 2: Unequal Hierarchy with cooperation or conflict. This organization is more representative of the current situation. It is based on the leadership of a center currency submissive to the competition of many second rank currencies which limit the hegemony of the first, but without being able to really rival it. A small number of countries (and currencies) therefore benefit from a preeminent position under the leadership of one of them. They participate in the regulation (more divided than in the previous case), of the system in different domination areas. The building of monetary areas (sterling area, franc area, etc.) during the 1930s and, more recently, the regionalization of the IMS, with the constitution of “exchange areas,” is the most explicit materialization of this structure. The variable intensity of competition between currencies (leader, suzerains, satellites) gives a great variety of possible forms to this structure. For example, we can distinguish a hierarchical structure with a dominant characteristic of conflict (example: from 1973 to 1985) or, on the contrary, a dominant characteristic of cooperation (a “sticky” exchange rate regime like the cooperative phase of the Plaza or Louvre agreements).

**Short-Medium Term versus Long Term.** The law of instability summarized by Figure 3 can help us to understand the stabilizing or destabilizing influence of the European single currency. To this end, we differentiate between international impacts of the euro in the short/medium run and in the long run. We assume in this paper that the euro will eventually become a full international currency. It will compete with the dollar, but it will not replace it. As a result, the international monetary system will move from the current unequal hierarchy (under dollar dominance) to a bipolar system based on the dollar and the euro. If we base our analysis on the bipolarity scenario, it is of course because we consider that the implementation of the euro is likely to succeed, making this scenario a fairly probable one. Another important reason for choosing this premise is that the bipolar organization is also complex and thus a very interesting analytical perspective.

In the short/medium term, the competition of the euro and the dollar will lead to a non coordinated bipolar structure. This would logically create a greater instability of the exchange rate (evolution shown by arrow 1, Figure 4). The strengthening of the position of the European currency in comparison to the weight of ex-European national currencies will contribute to this, as will the fact that this rise in power of the euro will work to the relative detriment of the dollar. This forecast agrees with findings derived from the arguments presented more traditionally. However, our interpretation is quite different from these usual viewpoints. We believe that the major cause of this increased volatility in the short/medium term is basically linked to the breakup of the former monetary system, to the restructuring of the power positions of the United States and the European Union and to the competition between the two main monetary powers. The upsurge of monetary and exchange rates tensions between the euro and the dollar will probably accompany the restructuring of the balance of power. In other words, our analysis emphasizes the importance of the "macrostructure" of the international monetary system in order to explain the evolution over years of market instability, completing thus the explanations of the short (very short) run instability based on the microstructure of the foreign exchange market.
have destabilizing effects (increase in the exchange rate volatility), we think it will probably produce both effects or, more precisely, one effect after the other.

Limits of Alternative Organization. The long-term evolution of the EMS towards a co-leadership seems to be one of the most viable possible solutions. But this does not mean that this bipolar scenario is the only possible evolution. Several other alternatives have to be considered.

Unequal hierarchy under euro dominance. As we have already underlined, even a total success of the internationalization of the euro leaves no chance for this scenario. For the euro to replace the dollar, one should suppose a significant economic, financial, and political decline of the United States, an American economic policy inappropriate and devastating to the acceptability of the dollar (for example establishing exchange controls), an explosion of the American budget deficit, and a growth differential structurally favorable to Europe. It is impossible to bring these conditions, deduced from Bergsten’s criteria, together. As the former President of European Monetary Institute, A. Lamfalussy, put it: “the euro won’t supplant the dollar but it will compete with it” [NewswEEK, 2 February 1997 quoted by Bergsten (1997), similarly see Fratianne and Hauskrecht, 1998].

The bipolar scenario based on the leading position of the dollar, the euro and the yen (or, eventually in the long run, on the Chinese yuan) corresponds to a possible evolution. However, we did not pay much attention to this alternative, because for now it seems less likely than dollar-euro leadership and also because it can be considered as a variation of the “monetary oligopoly” (coordinated or not) that we described. Presumably, the most important difference with the bipolar scenario would be a greater difficulty in developing a cooperative monetary organization around three main equal full currencies.

The resurgence of dollar leadership (from phase one to phase one). This possibility should not be excluded. This is even the most probable end in the event of a failure—always possible—of the European Monetary Union and, subsequently, a return to square one (or a structure close to square one). However, we deliberately base our analysis on the assumption of the success of the euro, analytically more complex. In this event (failure of the euro), the most likely organization would be the current one (sticky exchange rate regime) occasionally stabilized by exceptional temporary international agreements in order to overcome the most violent speculative episodes.

The path towards a symmetrical multipolar system. This scenario is even more improbable than the others. It would assume the emergence of new currencies that become equal to dominant currencies (which ones?) or the institution of a supranational currency and of a worldwide governance (assumed by whom?), which corresponds to a totally utopian scenario.

In short, with only two credible alternatives (either a return to the dollar leadership or a tripolarity), the path towards the cooperative scenario of a dollar-euro co-leadership offers the greatest plausibility for at least two reasons:

- the fall in the number of actors participating in the international monetary system, resulting from the EMU (disappearance of many national currencies,
including many first rank currencies) pulls down the dialogue and coordination costs;
• the choice of a collective action principle is not founded on a norm notion of altruism in international relations. It is rather based on the consideration of the long-term specific national interest and real capacity of the actors to capture a high share of benefits from the cooperation, while blocking temporary free rider behaviors. These conditions should be brought together more easily in a truly bi- (or tri-) polar world.

CONCLUSION

For the euro to contribute to the institution of a harmonious monetary system, it still has to become a key currency similar to the dollar, and Europe must have the capacity to make itself heard and carry weight during international negotiations. This assumes that it succeeds in making the European Union a first rank actor in world politics. Brecher and Vogler (1999) refer to such an EU global role as the construction of a European "actorness." This is, obviously, a necessary condition of the emergence of a monetary h linguisticization.

The construction of an European monetary global actorness relies on a reinforced political identity of Europe which is now probably the weakest link in the chain leading to the accomplishment of a bipolarization. Indeed, the euro area is specific in that, unlike the dollar, it has no political integration in return. Therefore, the absence of a political dimension to the euro can be an important brake on internationalization. As a result, surprisingly, the euro will prove to be useful to the global monetary stability, if it really contributes in creating an European citizenship; the real-life expression of the community of destiny the European people have freshly chosen.

NOTES

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2. Brecher (1997) defends a similar point of view. He focuses on the definition of the current account that must be financed, which should not leave the Fed much room for maneuvering. Let us recall that the EMU has an external surplus.

3. Richingsgreen (1997) calls this phenomenon "the advantage of insolvency".

4. Burns and Nay (1998) express this idea in the following manner: "The more agents who use a given money, the more attractive it will be for other agents to use it. The more transactions that in currency, the easier and quicker, the less resources needed to find a match for any given supply or demand. The entry of any trader into the market therefore confers a positive externality on all other traders."

5. We can refer to the worldwide stock crash in October 1987 where the injection of liquidity by the Federal Reserve System led to further financial markets. Consider also the recent experience of financial crises in emerging economies; the ability of the Fed to inject massive dollars (as in the Mexican experience) is an important characteristic of its international currency.

6. In the period between the two world wars, we can refer to the dollar-franc-sterling triangle in which the former leader, the United Kingdom, was challenging by two economies in a position to compete with it: the United States and, to a lesser extent, France. The pressure of these three economies on the international arena is interpreted as a decisive element of the instability during this time. The United Kingdom was no longer in a position to control international economic relations, while the United States and France had neither the capacity nor, doubtless, the desire to do so. See Brown (1994) and Giddens (1973).

7. Which could partly explain the fact that hyperinflation has often been the object of developments devoted to specific fields of international relations.

8. And in this perspective, the hegemonic supplies a mark good in the sense of public economics.


10. For more than half a century, the prices of aluminum and nickel were remarkably stable (the most stable among all mineral resources). This stability was associated to the dominant position of the "top seven" companies (for aluminum) and the "top two" (for nickel). After the arrival of new entrants, these companies lost their leadership. The prices of aluminum and nickel became highly volatile almost overnight (since 1978 and 1979). These examples, among others, suggest that the "law of instability" can be read in both directions (from phase 1 to phase 2 or, conversely, from phase 2 to phase 1).

11. As a major feature of international markets in general, it is instability not fundamentally inherent to the very nature of such markets where conflicts, inelegant plans (and notably national policies), and antagonisms which are difficult to arbitrate are transferred without any transnational regulating authority?

12. We consider a possible extension of this research by tracing (on historical data) the explanatory power of this "instability law" on the foreign exchange market, as we did on raw material markets.

13. The consequences of the other possible evolutions, including a failure of the euro, will be presented further.

14. The most common explanation of a possible increase in the exchange rate instability is known as the mutual foreign negotio argument: because Europe is going to be a more inward-looking area familiar to the United States, it will be structurally less sensitive to exchange rate fluctuations (partly as a result of the disappearance of intra-European exchange rates). In addition, for that reason, policy makers may be less inclined to pay attention to the exchange rates.

15. In a former paper (Allegret and Sandretto (2000)), we have explained why a return to the Bretton Woods organization is politically infeasible and practically unsustainable. However, we consider that a return to the underlying philosophy of this agreement (the "spirit of Bretton Woods") is both necessary and practicable.

16. According to Brecher and Vogler (1999), "actorness" means simultaneously presence in the coming debates (capacity to shape the perceptions and expectations of others), ability to formulate purposes and capability to make decisions and act.

REFERENCES


THE EURO: EXPECTATIONS AND PERFORMANCE

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THE CREATION OF THE EURO

At the beginning of 1999, the member states of the European Monetary System (EMS) joined stage 3 of the Economic and Monetary Union (EMU) of Europe with the introduction of the euro and a common monetary policy by the European Central Bank (ECB). The euro was introduced on 1 January 1999 as the common currency of eleven European countries (Austria, Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, Spain, Portugal, and the Netherlands). Britain, Denmark, Sweden, and Greece were not part of it (Britain and Denmark chose not to participate, Sweden was not eligible because it had not been part of the EMS, and Greece was not admitted because it was unable to meet four of the five Maastricht indicators). Greece was admitted on 1 January 2001. The official euro conversion rates for the participating currencies were decided in the fall of 1998 and are given in Table 1. The creation of the euro was certainly one of the most important events in postwar monetary history—never before had a large group of sovereign nations voluntarily given up their own currency for a common currency.

From 1 January 1999, the exchange rate of the euro fluctuated in terms of other currencies, such as the U.S. dollar, the British pound, the Japanese yen, and so on, but the value of each participating currency remained rigidly fixed in terms of euros. This meant that the exchange rate of the currencies participating in the euro fluctuated in relation to other currencies only to the extent that the euro fluctuated in relation to those other currencies.

BENEFITS OF THE EURO

Analyzing the benefits and costs of a common currency must inevitably start from the brilliant foresights of Mundell [1961] and McKinnon [1963], the originators of the theory of optimum currency areas. Using this theory, economists have analyzed and, on the whole, agree on the general benefits and costs from the establishment of the euro. The benefits are: (1) the elimination of the need to exchange currencies of EMU members (this has been estimated to save as much as $30 billion per year); (2) the elimination of excessive volatility among EMU currencies (fluctuations will only occur between the euro and the dollar, the yen, and the currencies of non-EMU nations); (3) more rapid economic and financial integration among EMU members; (4) a European Central Bank that may conduct a more expansionary monetary policy than...