

MAY 23, 2000

TRANSCRIPT: Robert Mundell @ the Canadian Club

Thank you very much, Henry, for those warm words. It's a great pleasure for me to be here, speaking in Toronto, one of the few occasions I've done so. And I'm going to speak on the subject of the, well, it'll relate to key trends in the world economy at the beginning of the millennium. I want to go over these rather quickly, in sort of capsule fashion, so I can get on to more detailed discussion of some aspects of currency areas.

The first trend I want to talk about is what's called the new economics, the new economy. Maybe we should call it the new technology. It's the invasion in economic life of information technology, including the computer, the Internet, cellular telephones, and the integration perhaps of television, the new broadcasting opportunities through the Internet. What is the significance of this? It's... is it just another innovation? Well, yes, it certainly is that. Maybe it's so important though that it's right to focus attention on it, and to... because it's affecting all aspects of economic life. It's affecting how people do things inside firms. Nowadays people can take different areas, subgroups within firms, do cost-accounting of a kind that was never possible before, and to see which parts of firms are making money, which are losing money, they can spin things off, they can reorganize things in a way that will increase profit. It's affecting individuals. It's unbelievable how much the productivity of professors has increased, at least if not in terms of their thoughts, in terms of words. It's something that could never exist before. In my new schedule, since the Nobel Prize, I don't know what I'd do without being able to book my tickets on the Internet and do everything through the major. It's affecting government institutions, every aspect of it. Lowering costs, increasing productivity, and it's going to be with us for a long time, because even if there were no new inventions to take place, just the mere penetration of existing technology into the rest of the economy would take us another two decades. Maybe the leading point, leading element in this is the United States, close second in a way, certainly by per capita, would be Canada. Canada has about the same number of computers as Britain does, even though it is a population of half the size, or a little more than half the size. And Japan. But it's also very democratic, because it makes suddenly information very cheap.

Information is really very, historically it's been very expensive. Now information is becoming very cheap, and what it means is that there's a kind of equalization process that's going on. It's possible now... it *will* be possible, if it isn't now... in the next year of two, three years, four years, for poor countries who don't have access, can't buy information, to acquire the tools that will allow them to leapfrog ahead in a wide range of different areas. It's a great opening for the poor people, because information is now cheap. Computers are cheap. The things that are the most... raw material is so cheap that... so this will be very democratizing. It means that the difference between the knowledge that the elite universities of the world will be much less compared to the not-so-elite universities of the world. There'll be a spreading – the difference between the Harvards of the world and the Osh-Kosh colleges of the world will be much less than it ever was. It will be possible to... it won't matter so much where you go when this revolution really spreads. So that's a fundamental new trend in the world economy.

Second trend is globalization. Globalization has been with us before, it comes about every century or so, when the world economy strikes something (?). The Romans must have talked about globalization, when you found that every city in the empire had a coliseum and every city had more or less the same institutions. This was globalization within the context of the Roman Empire. And at different times in history, we've had that too. We had globalization in the early part of this decade, with the gold standard, and free movement of capital, low tariffs, and you had a high degree of mobility of factors of production, many factors of production, and you got globalization. But now we've got it in a way that's a new phase of it, and it means something quite different now, because the new phase of globalization comes with a much greatly enhanced technology and communications, so it's much more rapid, much more quick. You don't have, one hundred years ago, the instant movement, so that, you see, when something happens in one part of the world, you instantly get it all over. The CNN Revolution, if you think of it as an application of that, now that's a very disturbing phenomenon, too. It's like a small village, small towns, you see, to them it means the influx, into towns, of worldwide chains, supermarkets, that gut the inner-city life, the inner-town life. It hurts the local merchants. It's a challenge. In the long run it's got to be beneficial, but in the short run, it involves adjustment and a change in the way of life. And that magnified through every country in the world means that every country is going to have to face the challenge of globalization in their own particular and unique way. It's going to be there and every country will have to treat it differently.

The third factor that I want to emphasize is the U.S. economy. The U.S. economy has been nothing short of miraculous over the past eighteen years. If you look back to 1980, '81, from 79-81, three years back-to-back, two-digit inflation. In 1980, the inflation rate was 13% for the full year in the U.S. economy. A little while later, 1982-83-84, you found this inflation rate coming down, and you saw the American economy really growing. This was the period of the supply-side revolution and it involved... the problem existed from an incorrect economic philosophy, an incorrect policy mix – easy money and an escalating tax rate through inflation, and the correction of it was the reverse of those mistakes. Tight money to stop the inflation, tax cuts to free up the economy and get the economy moving again. So you had in the Reagan period, you had in 1980 the marginal tax rate at federal level was 70%. But in 1988 when Reagan left office, the marginal tax rate, the tax rate at the highest income tax bracket was not 70%, it was 28%. A complete slashing of tax rates, and the corporate rate was slashed from 48% to 35 or 36%, something like that. So you got this complete change in the economy which made the U.S. economy much more efficient, with the consequence that in the 1980s the U.S. economy had falling inflation rates, from the 13% of 1980 down to 3% at the end of the decade, combined with very steady expansion, the creation of no less than 19 million new jobs in the U.S. economy in the 1980s, between 1982 until 1990. Then there was a nine-month recession, 1990 to 91, but expansion resumed again in the spring of 1991 and the economy again soared.

And now the U.S. economy is... now, this time, still maintaining some of these elements, of the supply-side elements that kept the economy efficient, they have also got the Internet economy and the cost reductions and productivity improvements that have made

growth something like 4% look to be a possibility for a long, long time to come, not forever, but no way are people going to say again that growth has to be imprisoned by this long-term, long-run average, historical average of 2.5% for the world economy, for the U.S. economy and for other economies. So you've had now the longest expansion ever in the current period and it looks as if it might continue on for a long time. But over the whole period, you've had a creation of over 38 million new jobs, more jobs than the entire labour force of the third largest economy in the world, Germany's. So this has been a great period, and this has been a period of... where the U.S. economy has been pioneering, has been the backstay, the mainstay, of the world economy, because it's during a period when in the 1990s, the Japanese economy was stagnating, and in the 1980s and 90s the European economy was not performing very well.

So – this is an important thing now – doesn't mean because there's been eighteen years this, it's going to go on forever. The new economy doesn't mean we'll never have recessions again. We'll always have recessions, we'll always have periods of slow down; they're inevitable. You can't stop them. There's always bunching that goes on, mistakes are made, policy mistakes and so on. But so far, it's been a very good run for the U.S. economy.

Now, the next thing, very important to my subject today is the advent of the Euro. We had, we started off in the beginning of this century, we had an international monetary system that unified the world under a gold standard. Before that, in the early centuries, there were bi-metal... bi-metallic systems, which in some respects were even better, because it unified the world whether a country was on a gold standard or a silver standard. The exchange rates were all fixed between them, and interest rates were more or less the same. This was a world that gave low inflation, and high degree of economic growth, freedom of capital movement, low tariffs, globalization that I talked about. But then that standard broke down, and it was never created again. I'll come back to that maybe a little later. It was never created successfully again.

The fact is that what happened in the 20th century, the U.S. economy became more important than any other economy. In 1914, the U.S. economy was already three times as large as the British economy, and three times as large as the German economy, which was in 1914 about the same as the British economy, and in the 1920s that dominance was even greater. The U.S. was well on its way to becoming a great superpower, and in 1945, with the wreckage of Europe, the U.S. economy was producing 85% of world manufactures. Now this was a temporary thing because Europe and Japan hadn't recovered yet, but it showed this great dominance of the U.S. economy.

In the process of that dominance, the, uh, another big event was the... I sometimes say that the, well, I sometimes quote the... Bismarck once said that the most important event of the 19th century was that Britain and America spoke the same language. In the same sense, the most important event of the 20th century might well have been the creation of the Federal Reserve System in the United States, in 1913. Why was that important? Well, suddenly you got the biggest economy in the world, suddenly with the power to create or destroy or maintain the gold standard. And it flubbed that issue, it really ended

up with, in the long run, to make a long story short, not going into the details of monetary history, the dollar elbowed out gold in the system. Gold was put aside, and the dollar took over as the principal medium of accounting systems. This didn't fit, uh, suit well with Europe, who were used to, in the 19th century, a much more important role. And if you think of the first important book written by another Canadian economist, Kenneth Galbraith, *The American Capitalism* or *The Theory of Countervailing Power*, he said that there's a great weakness over there, in an oligopoly, there's a tendency for the other groups, other companies to form and find some... to make a bulwark to contest the leadership of the big group. This is what happened in the world economy in Europe.

Europe collected together the big... these weren't small economies of the world – they were medium-sized economies, medium-sized economies now that used to be big powers like Britain, France, Germany, and Italy – formed together their monetary union; they created the Euro. We won't go into that... long story. They created the Euro; it was... maybe it wouldn't have happened completely in 19... the Euro, it was... the question was whether Europe disliked the United States more than they disliked each other, the other countries, in a way. There's always this sense of the role of the dollar, the almighty dollar, which they never liked, but it was always exacerbated whenever the dollar was weak. Whenever the dollar was weak, Europe moved towards monetary integration; whenever the dollar got strong again, they backed away from it, they couldn't find a role for it, they couldn't get into it. In the late 1960s, when the U.S. balance (bounce?) of payments was very strong, you had the Hague Summit – that's when they first promogated (??) the idea of an economic and monetary union. In that same month, December of 1969, I made the first plan for an explicit currency, European currency – I called it the Europa. Then, after... Europe was quite closely integrated at that time, because exchange rates were fixed around the dollar. But after the movement to floating exchange rates, European rates were all very different and Europe became disintegrated. In the 1970s, there was a movement of European disintegration, away from monetary integration, even though they were trying for integration, because they lacked that central pivoting role of fixing their currencies around the dollar. So nothing really happened. It was only when they, after 1976, with the Carter administration, the inflationary monetary policies, playing out the Phillips Curve, expansion, fiscal policies and monetary policies expanding, and the dollar flopping around Europe, going down, making the U.S. currency more competitive, that Europe in defence... Diskard de Seng (??) and Elmwood Schmidt (??) had their meeting in Braym (?) in 1978, and established the European Monetary System. The weakness of the dollar in the late 1970s. And then came Reagan, and Bob Mundell, Jude Winisky (?), Arther Laffin (?), all those people who helped to push supply-side economics – tight money to stop the inflation, putting on the brakes, the expanding U.S. economy – and then nothing happened in Europe toward monetary integration. It was only after the cycle turned again – the dollar got weak after 1985, the dollar started to go down again – *then* you got the plans for the European, all-European system, and then the plans for the Delore (?) Report, which brought out the plans, first *explicit* plan, for a European money. And that plan was unique because it said not just, "This is a plan for European currency", but "This is a plan for a *single* European currency." What that meant was that countries with currencies that they'd had for a

thousand years would scrap their currencies, a great heritage of nationhood, and instead go for a common currency.

I don't think that plan would've gone through at all, been implemented, if it had not been for this great event – the end of the Cold War, another of the things I probably... Reagan should be partly credited with. The end of the Cold War, the fall of the Berlin Wall and German unification. And now German unification meant that here again in Europe you'd see the tendency for Germany to dominate in Europe, and the only antidote to that would be to wrap Germany into a European framework. And the instrument for doing that was political union in Europe, but that was too extreme, so monetary union was the second best means. And Cole accepted that plan, and the plan came off, and in 1999 we got the Euro.

So this Euro now exists, with eleven countries. Quite amazing that eleven countries would actually get into the Euro zone and they were successful in doing it, and then, maybe there's four more countries that will come into it. Greece is already on board. I myself believe, will be better now that Mr. Blair's child has been born, he'll be able to get onto the role of bringing Europe, bringing Britain into the Euro area, but I think it will come in. I'll be making a speech there next month, and there's a bit of a campaign for a real discussion in Britain of what the issues should be for Britain. I don't want to go into those things, but suffice it to say, that the Europe of the eleven is probably going to be the Europe of the fifteen in about three... two or three of four years. It's soon going to be the Europe of the 28, because the thirteen countries that have lined up have been invited to apply for admission to the European community. And that includes the central European countries, the usual suspects which you could name, plus Malta and Cyprus. And those will become in... at the same time, there are thirteen countries in Africa, the CFA franc countries, they have been tied since 1946 to the French franc, are tied now to the Euro zone. And there are probably another ten countries on the north side of the Middle East that will tie their currencies to the Euro zone.

So, over the next ten years, for a Euro zone of over 450 million people, and the GDP larger by perhaps 20-25% than the United States, it's going to be a very large and successful area. Of course in that period the U.S. is not going to stay constant; already Europe had created the expansion of the Euro zone, and its scheduled expansion has created a demonstration effect all over Latin America. For a long time, Latin American countries have been, and the Asian countries have been listening to the IMF and other people saying, "You have to have flexible exchange rates", but suddenly they see the eleven countries in Europe not just having fixed, absolutely fixed exchange rates, absolutely locked exchange rates, but planning to even give up their own currencies. So they realize that what the IMG and American leaders have been preaching to them just isn't being followed by them, and they look at this differently. Merkiur (??) has already begun a discussion about moving towards coordination, towards a wider currency area. There's an English-speaking area in Africa, and the French-speaking, the francophone area is already tied to the Euro zone, to form by 2002, another currency area. Asia is struggling, moving in this direction.

So what we end up with are three islands of stability in the world right now: the dollar area – the U.S. dollar area I'm talking about; the Euro area, and the Yen area. These three areas... the U.S. economy counts for less than 25% of world GDP, the Euro area for less than 20% of the world GDP, and the Japanese area less than 15% of the world GDP – somewhat less than 60% of world output. These three areas are the core of the world economy. If you talk what the new buzzword of the 1990s is, the changing and improving of the international financial architecture. But as Paul Boker (?) said, "Most people aren't talking about architecture, they're talking about interior decorating," improving the way compliance, or surveillance and details like that has nothing to do with architecture. If you're talking about architecture, you have to be talking about something that has to do with the exchange rates of the dollar, the Euro, and the yen area, which is now the core of the mainstream of the world economy. Now, we can call these three islands of stability, because over the last five years, the inflation rates in all these areas has been below 2.5%. So stability has been achieved in these areas.

The astonishing thing, though, is that you have high-volatile lead exchange rates in these areas. It's incredible, if you have big differences in price levels, movements, then you expect differences in exchange rates. You have stability; you shouldn't have big movements in exchange rates. Keynes, in his book in 1923, *Tract on Monetary Reform*, argued that the most important thing was internal balance, internal stability, meaning by that a stable price level. But if the rest of the world is stable you can have both internal and external stability. And the basis of his book was to say that the second thing is external stability and it's very important, even if it's not as important as internal balance. Now, look at what's happening with the in dollar rate. 1985 the dollar was 250 yen. Ten years later it was 79 yen, in April, 1995. And then three years later it was 148 yen, in June, 1998 [Note: this is what he said, but common sense leads me to believe this was meant to be 1998], and it was... speculators were saying it was going up to 200. It didn't... it went down to 105 or less, and it's now in that range, 105, 110. So you have big fluctuations in the dollar-yen rate that has nothing to do with the price level movements in these countries.

If you look at the dollar-Euro rate – now we've seen the big fall of the Euro in the past... 25% drop of the Euro... if you look at the history of the dollar-Euro rate, of course you can't go back before 1999, but you can use as a surrogate of it the deutschmarks. If you look at what happened with the dollar-deutschmark rate over the past 25 years, it would be shocking to duplicate that procedure. 1975, 25 years ago, the dollar was about 3.5 deutschmarks. Five years later, in 1980, it was half that – 1.70 deutschmarks. Five years later, in 1985, it was double that, again – went back up to 3.4. Then, seven years later, in 1992, the dollar went down below 1.4, it's lowest ever against the deutschmark. And now it's over two, 2.15. You have these wild fluctuations that have nothing to do with price levels. Our international monetary system is for the birds, it's working badly, and it's destabilizing financial markets. That's why in my *Wall St. Journal* article on April 30th of this year, the title of that was "Threat to Stability", and this is, I believe now.

Now, I myself believe that you would be, that just changes in procedure among the three central banks, you could get to a high degree of stability of exchange rates, without

relinquishing one iota of the element of stability of the price levels in that respect. You could... if you think it would be difficult to form a monetary union of Japan, the United States and the ECB, the Euro area, it would be much easier to form a union in terms of technically between those three areas, because they all have monetary stability, they all have price stability, then it was to create a monetary union of eleven countries as diverse as Germany, and Portugal, Italy, Spain, Greece, Belgium, and Holland, and so on. And yet those countries have done it. Now, it's true, of course, the Euro has gone down, it's gone down for reasons I don't want to talk too much about, partly because when you create a new currency, you get a liquidity effect that makes that currency more effective, and I think the European Central Bank should've used the falling Euro as a warning signal that its policy was too tight, too loose, and if they'd sold foreign exchange, if they'd supposed the Euro as it went down below one, that would've tightened markets and automatically kept the exchange rate where it was, and it would've mopped up that excess liquidity in the market. But there's also... it's an immature currency, there's no paper currency out there, there's no coins that everybody uses in terms of that currency, and that has had an impact on the whole thing.

The markets believe the Euro is very much undervalued now, because European interest rates are 1.5-2% lower than American interest rates, and that's been a surefire indication of the expectation that the Euro is going to appreciate. Euro bonds are a good buy at 4% compared to American bonds at 6 or 6.5%, as long as there's going to be an annual expected 2% improvement in the Euro rate against the dollar. So that's what governs the whole thing. Same too with the yen interest rate as low as it is.

What I would say then... first... I've gone on a little too long here... what I said in my Nobel lecture on December 8th was that the first and last decades are in some sense like bookends. The first decade you had a highly efficient international monetary system, price stability and high degree of movability of capital, etcetera, etcetera, under the gold standard, a highly efficient system. In the last decade, we've also got stability, all the OECD countries have had a low inflation rate in the 1990s. But two things are missing in this last decade of the century compared to the earlier decade, which is the violent volatility of exchange rates, which to me is completely unnecessary and counterproductive in the long run to our prosperity, and the second is that we no longer have the universal unit of account.

This is something really quite strange, that with all our modern technology and all the sophistication of modern economics, we're worse off with respect to a universal unit of account that we were 1000 years ago! When 1000 years ago, the Soladus (??), then called the Bezinct (??), was the universal unit of account, at least throughout Europe. Nobody used it in the Western Hemisphere, but there wasn't much going on at that time. And even 2000 years ago, in the days of Caesar Augustus, you had the Aurius, which is the same as the Soladus and the Bezin, that was the universal unit of account. And 1000 years ago you had it, but you don't have that today. We don't have a world currency today.

Think of it – at the time of Breton Woods, at the time of the Breton Woods meeting that set up the IMG, both plans, both the American and British plans, made provisions for a universal unit of account. In the Keynes plan, the British plan, it was called Bancor – B-A-N-C-O-R – and in the United States, it was Unitase. But what happened to it? A funny thing happened on the way to signing the agreement of Breton Woods. Whenever the British tried to bring up this issue of “What happened to the world unit of account?”, the Americans didn’t want to talk about it. They didn’t want to talk about it because then, they’d thought about this, I guess, and got the message that... a least some circles in the States had got the message, why do we need a universal unit of account when we have the dollar, or gold? It’ll be either the dollar or gold. Gold was shunted out of the system and the dollar came in. That dollar is no longer a universal unit of account. You’ve now got the Euro out, the, the future... I think you can believe that it’s going to be a worthy rival or associate, companion, competitor, whatever you want to call it, of the dollar, beneficial to the world economy because it’s better to have two islands of stability than one, and then you have the third island of the Japanese yen. So in two respects, we’re much worse off than we were 100 years ago, and that leaves that part of the agenda for this next, this current century. I hope it’s not going to take a millenium – and maybe, I hope even, something can be done about it in the next decade. Thank you.