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COMMON CURRENCY LESSONS
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5 Common currency lessons from Europe

Have member states forsaken their economic steering wheels?

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Introduction

In 1941, Abba Lerner wrote an essay entitled "The Economics of the Steering Wheel." In the opening paragraph, he invited the reader to enter a fantasy world, where mad motorists on Mars perpetually flirted with death by substituting themselves to the mercy of an unconventional interplanetary highway system. In the scenario he described, automobiles were guided by a high-tech system of specialized braking devices and cleverly crafted roads rather than by living beings (Martians) who could skillfully direct their vehicles by employing the use of a steering wheel. Instead, these motorists relied on high curbs that were designed to maneuver wayward vehicles back onto the road. Most autos would bounce erratically from curb to curb, their passengers averting disaster despite having forsaken the power to control their own destiny. Likening this state of affairs to a bad dream, Lerner suggested that Earthlings should be grateful that their fate is governed by more sensible (if less sophisticated) methods.

While the transportation system on Earth was deemed preferable, Lerner maintained that "when it comes to maintaining their economic system, humans are as reckless as the mad Martians, because they allow "their economic automobile to bounce from the curb of depression to the curb of inflation in wide and uncontrolled arcs" (1941, p. 271). Specifically, he indicted the human race for failing to devise a mechanism capable of systematically regulating the level of employment.

Lerner's approach was generally consistent with Keynes's. Most importantly, he maintained that the level of output and employment (i.e. effective demand) was determined by the amount of total spending, and, like Keynes, he believed that capitalist economies were inherently demand-constrained. Thus, Lerner viewed unemployment as the result of insufficient aggregate demand, which, he believed, could be eliminated by adopting a "functional" approach to public policy. Lerner explained this approach in his 1943 article "Functional Finance and the Federal Debt." He said:

The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions and not to any established traditional doctrine about what is sound or unsound.

This principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science as opposed to scholasticism. The principle of judging fiscal measures by the way they work or function in the economy we may call Functional Finance.

(Lerner, 1943, p. 39; emphasis in original)

Thus, if full employment was to be achieved, the government would have to abandon any preexisting bias toward "sound" finance and grip hold of the steering wheel of Functional Finance. Like a motorist with the ability to control the speed and direction of its automobile, Lerner suggested that policymakers could guide the pace of economic activity, steering the economy away from danger (recession) and toward prosperity by implementing policy according to two fundamental principles (or "laws").

The first law of Functional Finance placed upon the government was the responsibility for maintaining the total rate of spending on goods and services at the level necessary to purchase all of the output that a fully employed labor force could produce. In elucidating this law, Lerner explained that when spending was at the requisite level, it would prevent both inflation and unemployment (i.e. there would be full employment and price stability). In order to increase total spending, he suggested that the government should increase its own expenditures or reduce taxes so that private spending would increase. Similarly, the government could cut its spending or raise taxes in order to reduce the total rate of spending.

The second law of Functional Finance decreed the specific manner in which the shortfall in total spending was to be eliminated. Specifically, Lerner proposed that the government borrow only in the event that private spending would otherwise generate excessive aggregate demand. Since he believed that there would ordinarily be insufficient aggregate demand, he felt that under ordinary circumstances it would be unnecessary for the government to offer bonds in exchange for existing funds. Instead, he believed that bonds should be sold to the central bank or to private banks "on conditions which permit the banks to issue new credit money based on their additional holdings of government securities, [which] must be considered for our purposes as printing money" (Lerner, 1943, p. 41).

In Lerner's view, policymakers were not taking full advantage of the economic steering wheel. Too much of the time the economic auto was allowed to stray from a full employment path. But, said Lerner, the government could prevent this by keeping its hands on the wheel so that it could react appropriately to unforeseen obstructions in the road. Thus, by adjusting its taxing/spending, purchase/sale of

books, and creation/destruction of money, the government could keep the economy on a path toward full employment.

Although Learner's approach appeared to be tenable regardless of the monetary system in place, it will be argued in this chapter that a nation can undertake Functional Finance only under certain specific monetary arrangements. Since I have already demonstrated that the US monetary system is amenable to Functional Finance (see Bell, 2000), my objective here is to consider the prospects for Functional Finance under an alternative monetary system. If Functional Finance represents the ultimate in policy freedom, then it is instructive to inquire whether countries that adopt alternative monetary arrangements retain this degree of freedom. Although we could apply our analysis to a variety of monetary arrangements (i.e. currency boards, a gold standard, or other systems of fixed exchange rates), our focus here will be on the monetary system that now governs the Eurozone.²

Why a currency union but not political union?

Monetary union was considered a logical and necessary counterpart to establishing a economic union.³ Indeed, EMU stands for "economic and monetary union," not "European monetary union," as it is often mistakenly translated. Moreover, because Europe had been moving toward an economic union for some time, plans to introduce a single currency began well before the Treaty on European Union (or Maastricht Treaty) was drafted. Indeed, as Coffey notes, "a full economic and monetary union (EMU) was agreed upon by the Heads of Government of the original six founder Member States of the European Economic Community (EEC) in Den Haag at the end of 1969" (1993, p. 1). Table 5.1 illustrates that a broad process of integration actually began even before 1969.

It is not coincidental that it began just after the Second World War. Indeed, economic and political cohesion became important after the war; however, the idea of a United States of Europe, which was revived by Churchill in 1946, had to be abandoned due to resistance from the communists bloc.⁴ Thus, Europe's integration plans were limited to Western Europe, where a number of post-WWII treaties and agreements helped to pave the way for economic and monetary union. But it was

Table 5.1 Pioneers of the 1992 Treaty on Monetary Union (Maastricht)

- 1951: Union of coal and steel-producing industries
- 1957: Treaties of Rome – established a European common market
- 1965: Treaty on European economic union
- 1973: Alignment of European currencies – adopted after the end of the Bretton Woods system
- 1979: European Monetary System (EMS)
- 1990: Delors proposals – suggested a program for future monetary integration

the Maastricht Treaty agreed upon by the European Community (EC) heads of government in December 1991 and signed on 7 February 1992, which actually laid out the process by which the euro was to be gradually implemented.

Today, eleven of the fifteen countries in the European Union (EU) have relinquished control of their domestic monetary policies and abandoned their individual currencies. Table 5.2 shows the three-phase process by which this change has been taking place.

With the completion of stage 3, sovereign currencies, which have been gradually withdrawn from circulation, have ceased to carry the status of legal tender, and the introduction of the euro as the common currency of the eleven participating countries has been completed.

As the heading indicates, the purpose of this section is to explain both the reasons for adopting a single currency and the rationale for stopping short of full political union. A general answer to the first part of this question has already been given: a single currency was believed to be a logical and necessary counterpart to economic union, something Europe has been moving toward since the mid-twentieth century. More specific support for the single currency often focuses on two (related) benefits – the reduction of transaction costs and the elimination of exchange rate risks. The former is considered by Eudley to be "the most important" benefit of moving to a single currency (1998, p. 14).

The benefits, of course, is that a single currency makes it possible to move within a single monetary area "without having to exchange money every hundred kilometers" (Vaclav, 1997, p. 1). In other words, a French citizen bound for Italy need not exchange francs for lire in order to purchase goods and services while in Italy, since the euro will circulate in both regions. The other oft-cited benefit – the elimination of exchange rate risks – means that this same traveler will not become a

Table 5.2 Stage 3 of the Treaty on Monetary Union (Maastricht)

- Phase 1 – 1 January 1999
- Conversion rates between national currencies and the euro become irrevocably fixed.
 - Legislation on the euro comes into force.
 - Foreign-exchange and money markets switch over.
- Phase 2 – 1 January 1999 to December 2001
- The ECB begins to operate.
 - All new issues of public debt are denominated in euros.
 - Financial markets switch over.
- Phase 3 – 1 January to July 2002
- Euro notes and coins are brought into circulation.
 - National currency notes and coins are gradually withdrawn.
 - All bank accounts are euro-denominated.
 - The euro is used for salaries, welfare services and retail trade.

victim of an unexpected devaluation or revaluation. Additionally, it is often believed that monetary union will strengthen the single market, promote convergence of national economies, and encourage investment in the eurozone.

Against these benefits, a host of costs have also been identified. The loss of independent monetary policy (i.e. the ability to control interest and exchange rates) and the resulting constraints imposed upon fiscal flexibility typically rank high when inventorying the costs of monetary union. The EMU-11, having chosen to adopt the euro, must have believed that the benefits of monetary union outweighed the (non-trivial) costs of moving to a single currency. This belief was based on the Optimum Currency Area (OCA) theory, which suggests that the benefits of monetary union should be balanced against the costs of forfeiting interest and exchange rates as adjustment mechanisms.

The most notable contributions to the study of optimum currency areas have been made by Mundell (1961), McKinnon (1963), Kenen (1969), Fleming (1971), Onda (1972), Corsetti (1973), Magalificio (1973), and Presley and Dennis (1976). For Mundell, an optimum currency area "is precisely a region in which there exists factor mobility" (Goffey, 1977, p. 43). According to Mundell, exchange rates would fluctuate to equilibrate conditions between *different* currency areas, but factor (labor) movement would equilibrate conditions *within a particular* currency area.⁵

McKinnon (1963), while not rejecting the role of factor mobility, tended to emphasize the degree of "openness" of the economy as a criterion which should be used to define an OCA. The idea seems logical, as Colley notes, "since these countries - whose economies are open or very open ones - were conducting half of their trade with each other" (1993, p. 1). Kenen (1969), in contrast, focused on the degree of "complementarity" as a crucial characteristic. Magalificio (1973), like Kenen, also emphasized complementarity, arguing that it was important for nations to exhibit a similar propensity to inflate.

In sum, Mundell originally maintained that as long as labor was highly mobile, it would not be risky to relinquish monetary sovereignty in favor of a common currency. Since then, others have extended this criterion to include openness to trade, capital mobility, and wage/price flexibility. Together, these criteria form what many economists today use to determine the feasibility of an OCA. Thus, in its modern form, a currency union is considered advantageous if goods and services, capital labor, and prices move in the appropriate directions following asymmetric shocks.⁶ Assuming these adjustments take place as required, the regions would become *self-stabilizing*, and the loss of monetary sovereignty would become irrelevant. As the OCA theory is frequently used to justify European Monetary Union, an expectation that the EMU-11 satisfied the OCA criteria could be listed as a final reason for the adoption of the euro.

Now that we have some understanding of the various forces that influenced the decision to adopt the euro, we must inquire as to why the EMU-11 decided to stop short of full (i.e. political) union. As Eric Helleiner notes, "most nation-states in the

contemporary world have attempted to maintain a distinct currency which is both homogeneous and exclusive within their territorial boundaries" (1997, p. 2). However, in the case of European Monetary Union, the currency union spans "a set of sovereign states with relatively little federal centralisation of either political powers or fiscal competences" (Goodhart, 1996c, p. 1083). Our objective is to understand why, in an environment where "all separate nation states larger than Panama, Liberia or Liechtenstein have a single currency" (Goodhart, 1996c, p. 1084), the consensus became "one market, one money," rather than "one nation, one money."⁷

Along with the argument that "one market needs one money" (European Commission, 1990), the EMU-11 concurred to the idea that a single federal authority should have the exclusive right to manage this money (Treaty, Article 105a). However, they did not demand an analogous transference of power with respect to fiscal authority. In fact, says Wilhelm Nolting, "the political intention of the Treaty is to subordinate the Community's economic and fiscal policies" (1991, p. 143). Thus, fiscal authority remains the responsibility of individual member states, while monetary policy, which is primary, is now the responsibility of the European Central Bank (ECB). This separation has created an unprecedented divorce between the monetary and fiscal authorities, a divorce motivated by a desire to establish a monetary authority with "absolute independence from government" (Goodhart, 1998, p. 409).

Arcelus and Sawyer (1998) argue that the monetarist theory underlies the desire for strict central bank independence. Goffey also sees the monetarist influence, suggesting that "it took a group largely composed of bankers" (the DeLoors Committee) to decide that "governments are unable, and therefore should not try, to achieve any of the traditional goals of economic policy, such as growth and full employment" (1992, p. 39). All that can legitimately be done, according to this view, is to "control the money supply and balance the budget" (ibid.). Both of these beliefs - that the central bank can control the rate of inflation and that the levels of output and employment are set on the supply side of the economy - are central tenets of monetarism. Under the monetarist view, the economy is naturally driven toward equilibrium by a set of highly efficient and fast-acting forces so that activist policies are both unnecessary and unwise. Thus, at least part of the reason for the "divorce" has to do with the fact that monetarists do not believe there is a role for fiscal policy.⁸ A compatible motivation is given by Jerry Jordan, who argues that "Europe's move to a single market for capital, goods, and labor is part of a worldwide trend toward greater reliance on unfettered markets for the allocation of productive resources" (1997, p. 1).⁹

The terms of the divorce

In a very real sense, the Maastricht Treaty is like a divorce contract; it allocates various rights and responsibilities among the "divorcing" fiscal and monetary

institutions. By submitting to the conditions laid out in the Treaty, member states have agreed to hand over certain powers and to abstain from certain behaviors. As Ramon Torrent notes, "one does not need to be a specialist to understand the extraordinary importance and implications [of this] not only in terms of the institutional equilibrium and balance of powers within the European Union but also in terms of economic policy" (1999, p. 1229). The purpose of this section is to describe the institutional framework within which fiscal and monetary policies are to be conducted and to explain the terms (i.e. the rules and conditions) under which they must be carried out.

The establishment of the European System of Central Banks (ESCB) marks the most important institutional modification to have occurred on the monetary side. Comprised of the European Central Bank (ECB) and the National Central Banks (NCBs) of all fifteen countries within the European Union (EU), the ESCB is controlled by the Governing Council and the Executive Board, the decision-making bodies of the ECB.⁹ The Executive Board consists of the President, the vice-president and four other members, while the Governing Council includes the members of the Executive Board and the governors of the national central banks (NCBs).

Under Title II, the Treaty states that "the primary objective of the ESCB shall be to maintain price stability"¹⁰ (Article 105).¹⁰ This objective is to be pursued indirectly, through control of the money supply. In addition, the Treaty specifies a number of secondary responsibilities, which include:¹¹

- defining and implementing monetary policy within the Community
- conducting foreign exchange operations consistent with the provisions of Article 109
- holding and managing the official foreign reserves of the member states
- promoting the smooth operation of the payments systems.

Under the new framework, NCBs – like the Bundesbank and the Banque de France – have been relieved of their authority to conduct independent monetary policy. Under current arrangements, the Governing Council formulates monetary policy for the entire Eurozone, while the Executive Board is charged with the implementation of the Community's monetary policy (Article 109a). The NCBs, having lost the power to conduct independent monetary policy, are primarily operating arms of the ECB.¹² Figure 5.1 depicts these relations.

In order to achieve its objectives, the ESCB has a variety of policy instruments at its disposal. First, it has the power to conduct open market operations. In addition to initiating these operations, the ESCB also decides on the instruments to be used and the terms and conditions under which the operation will be executed.¹³ The *General Documentation on ESCB Monetary Policy Instruments and Procedures* (1998), specifies four kinds of open market operations:

- *main refinancing operations* – regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks
- *longer-term refinancing operations* – liquidity-providing reverse transactions with a monthly frequency and a maturity of three months
- *fine-tuning operations* – executed on an ad hoc basis in order to smooth the effects on interest rates caused by unexpected liquidity fluctuations in the market
- *structural operations* – executed whenever the ECB wishes to adjust the structural position of the ESCB vis-à-vis the financial sector.

A second instrument of monetary policy, the short-term interest rate, follows from the ESCB's willingness to provide or absorb overnight liquidity at marginal lending/deposit facilities, known as standing facilities. Two standing facilities are available to eligible counterparties on their own initiative:¹⁴

- *borrowing facility* – counterparties can use the marginal lending facility to obtain overnight liquidity from the national central banks against eligible assets. The interest rate on the marginal lending facility normally provides a ceiling for the overnight market interest rate
- *lending facility* – counterparties can use the deposit facility to make overnight deposits with the national central banks. The interest rate on the deposit facility normally provides a floor for the overnight market interest rate.

The third instrument is control over minimum reserve requirements in accounts with the ESCB.¹⁵ The ESCB's minimum reserve system applies to credit institutions in the euro area and is based on a system of lagged reserve accounting (LRA) similar to the US system.¹⁶ These three things – open market operations, overnight lending/borrowing rates, and minimum reserve requirements – make up the set of

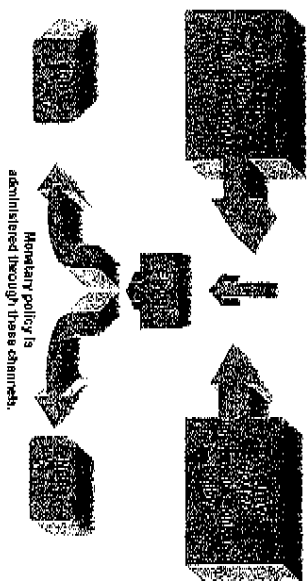


Figure 5.1 Decision-making bodies of the ESCB

instruments through which the Treaty grants the ECB power to conduct monetary policy.

While the Treaty clearly describes the manner in which monetary policy is to be implemented, it does not include such a precise blueprint for the implementation of fiscal policy. This is not only because fiscal policy remains the responsibility of member states but also, as argued above, because the Delors Committee was comprised primarily of monetarists, who tend to view the economic system as inherently stable and who consider fiscal policy a fairly important and unreliable tool. Thus, rather than sketching out a program for the implementation of counter-cyclical fiscal policy, the Treaty imposes a set of rules and guidelines that are designed to constrain the use of discretionary fiscal policy. Specifically, by agreeing to the terms set out in the Maastricht Treaty, member states have subjected themselves to three distinct fiscal constraints.

First, member states have agreed to exercise a certain degree of self-restraint when it comes to matters of fiscal policy. The Treaty encourages "close coordination of Member States' economic policies" (Article 3a), asking member states to "regard their economic policies as a matter of common concern and ... [to] coordinate them within the Council, in accordance with the provisions of Article 102a" (Article 103).

To be convinced that member states have responded to this plea for self-restraint, one need only consider the position of the French government.¹⁷ At the close of 1998, French officials published a document titled *Multi-annual Public Finance Program to the Year 2002: A Strategy for Growth and Employment*. In it, officials laid out the principles that they believed should govern public policy over the following three years. With respect to fiscal policy, they openly committed themselves to the principles of "sound" finance, stating that "larger deficits occurring in years of low growth are to be offset by smaller deficits in years of high growth" (French Republic, 1998, p. 9).¹⁸ For the period 2000 to 2002, the officials set targets for real expenditure for the general government. The targets were set in line with what the officials believed represented a desirable trend in the government debt ratio over a full economic cycle. Assuming their targets would be met, general government expenditures in France would grow at just 1 percent per year (in real terms) over the three years of the program.¹⁹

The government's budget policy follows from the conventional wisdom that government deficits, by raising prices and interest rates, will "crowd out" private-sector activity. Two controversial elements are central to this view. The first is the (positive) correlation that is supposed to exist between budget deficits and prices. The problem with this argument is that deficit spending, like additional spending by households or firms, should put upward pressure on prices only if the additional demand is borne by an already fully employed industry or economy, hardly a concern of the present-day EUR-14. Second, the conventional view requires a (negative) correlation between investment and the rate of interest. But this too is

problematic, as demonstrated by the capital critiques and by Fazzari (1993). Nevertheless, the French position is consistent with the ideological bias embedded in the Treaty and, hence, with the monetarist/sound finance perspective that favors fiscal discipline rather than Functional Finance.

The second constraint on fiscal policy derives from the Stability and Growth Pact. Proposed by former German Finance Minister Waigel, the pact makes more explicit the budgetary limits and financial penalties for non-compliance with Maastricht rules regarding fiscal discipline. The pact, which was ratified at the June 1997 Amsterdam Summit, strengthens the surveillance of member states by forbidding countries from running deficits in excess of 3 percent of GDP and requires that debt-to-GDP ratios be maintained below 60 percent. One reason for these limits is the European Council's belief that they mark "an essential condition for sustainable and non-inflationary growth and a high level of employment" (quoted in Spiegel, 1997, p. 1).²⁰ Kohlhauser (1997) and Semmler (1999) recognize that member states are not encouraged to take advantage of the "freedom" to persistently run small deficits but, instead, are to offset deficits by running surpluses in subsequent periods in order to generate balanced budgets over the business cycle. Issing, who is the chief economist of the ECB, notes:

If, for instance, the 3 percent criterion for the budget deficit were prescribed as a statutory upper limit for national governments having joined the monetary union, the authorities in each country would be responsible for ensuring the necessary leeway. In buoyant economic conditions, the budget deficit would thus have to be much lower in order to provide fiscal policy makers with the appropriate scope for running up higher deficits in periods of recession.

(Issing, 1997, p. 11)²¹

As Parguez (1999) contends, encouraging balanced budgets is related to the fear of negative spillover effects (i.e. externally effects), which are thought to occur as one country's budget deficit, working through its impact on interest rates, affects economic conditions in other EU nations.

In the event that a country does not fulfill the two fiscal criteria ... for the budget deficit and public indebtedness - the excessive deficit procedure pursuant to Article 104(c) will apply. Under the Excessive Deficit Procedure, deficits exceeding 3 percent of GDP are subject to a fine as declared by the European Council upon a report by the European Commission and a judgment by the Monetary Committee. Specifically, the Growth and Stability Pact commits EMU members to government budget positions that are close to balance, and the Excessive Deficit Procedure allows the Council to:

- demand that recalcitrant governments "publish additional information, to be specified by the Council, before issuing bonds and securities; to invite

- the European Investment Bank to reconsider its lending policy towards the Member State concerned;
- require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in view of the Council, been corrected;
 - impose fines of an appropriate size.

(Article 104c)

There is strong disagreement regarding the severity of the deficit-to-GDP and debt-to-GDP constraints. For example, Pisinetti argues that "the pack may entail severe costs on two counts: because it prevents expansionary policies in periods of recession and mass unemployment . . . and because, on top of that, it even imposes heavy fines" (1997, p. 9). Areitis and Sawyer (1998, p. 2) concur, suggesting that the objective deficit-to-GDP "constraint on the budget deficit clearly limits the use of national fiscal policy for demand management purposes." DeGrauwe (1996) and Eichengreen and von Hagen (1995) also oppose the objective constraint, arguing that member states should be free to pursue independent fiscal policy without arbitrary limits or penalties.² In contrast, Mosler (1999) suggests that the objective constraints are relatively unimportant, since member states are unlikely to be able to secure financing for deficits in excess of 3 percent of GDP except, perhaps, over relatively short periods of time.³

The final constraint on fiscal freedom, mandated under Article 104 of the Maastricht Treaty, is the requirement that central governments abandon the use of "overshoot facilities or any other type of credit facility with the ECB or with the central banks of the Member States" (Article 104). Article 104 forbids both the ECB and the NCBs from lending directly to member states or buying securities directly from them. Moreover, it states that the ECB should be mindful of this rule when carrying out monetary policy so that it does not engage in operations that would amount to the indirect monetization of debt.⁴ Additionally, Article 104 includes a provision that neither the Community nor any other member state shall be "liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies' government by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project" (Article 104b). This provision is often referred to as the no-bailout clause, because it implies that even if a member state finds itself unable to service its debt commitments, the ECB is not permitted to assist it by purchasing a portion of its outstanding bonds.

Since NCBs are now forbidden to issue Treasury bonds on behalf of the government and the ECB is forbidden to monetize (directly or indirectly) government debt, governments wishing to deficit spend must now float bonds on the capital market, where they must compete with the financing needs of private borrowers. It

is for this reason that Mosler (1999) wonders whether the Stability and Growth Pact and the Excessive Deficit Procedure are even needed in order to constrain government spending. It may well be that financial markets -- if they can price risk correctly -- will be able to impose discipline by constraining public spending without the need for penalties for fiscal violations (Eichengreen and von Hagen, 1997).

Focusing on the role of the Excessive Deficits Procedure, Eichengreen and von Hagen (1995, p. 224) contend that it exists because the Treaty's no-bailout provision is not considered credible. If it were, it would be sufficient, they maintain, to warn member states that the ECB will not step in to save off a crisis that might result from a scenario such as the one described below:

The scenario the framers of the treaty had in mind presumably runs as follows . . . Imagine that a government of a member state -- call it Italy for illustrative purposes -- experiences a revenue shortfall. It finds it difficult to service its debt. Bondholders concerned about the interruption of debt service begin to sell their bonds, depressing their price and forcing the Italian government to raise the interest rate. It offers when it attempts to roll over maturing issues. The rise in interest rates further widens the gap between government revenues and expenditures, exacerbating the fiscal problem. Problems in the bond market threaten to spill over to other financial markets, because, for example, higher interest rates depress equity prices. In the worst-case scenario, the collapse of asset prices and the impact of higher interest rates on corporate profitability and the performance of outstanding loans can threaten the stability of the banking system.

(Eichengreen and von Hagen, 1995)

Kenen (1995, p. 70) argues that the purpose of the financing constraint is either intended to "reinforce the ban on 'excessive' budget deficits" or to "reinforce the independence of the ECB by giving it better control over the money supply."⁵

In sum, the Maastricht Treaty specifies the responsibilities and limitations of the newly created ESCB and the individual member states. The decision-making bodies of the ESCB are responsible for the formulation and implementation of a single monetary policy within the eurozone. Thus, NCBs can no longer alter interest or exchange rates in response to changing domestic conditions. Rather, they must accept the policy that is formulated by the Governing Council and implemented throughout the eurozone. In addition to assenting to the loss of monetary autonomy, member states have consented to a variety of constraints that limit their fiscal autonomy. They have agreed to pursue fiscal policy in accordance with the guidelines established by the European Council and to implement it without recourse to overdraft accounts or financial assistance from any central bank.

Implications for Functional Finance

The purpose of this section is to demonstrate that despite the attention that critics have paid to the second constraint — the 3 percent deficit-to-GDP limitation — the third constraint — the one imposed by financial markets — actually results in a far more serious limitation of policy choice. Specifically, by forsaking their monetary independence and agreeing to the terms set out in Article 104 of the Maastricht Treaty, the national fiscal authorities of the EUR-11 voluntarily relinquished the power to conduct fiscal policy according to the principles of functional finance.

Godley (1992, p. 39) recognizes the significance of this, arguing that the abdication of monetary authority has brought "an end to the sovereignty of its component nations and their power to take independent action on major issues." Sawyer (1999) also appreciates the relationship between sovereignty over policy choice and sovereignty over money. He recognizes that, by severing this relationship, "national governments will no longer have the ability to 'print money' to pay interest on bonds, and their ability to pay depends on their ability to levy the necessary taxation" (Sawyer, 1999, p. 11). This means that member states must (ultimately) rely on tax revenues in order to finance spending and/or validate past spending (i.e. service debt).

Thus, unlike the US government, which really faces no external budget constraint, the EUR-11 governments truly do face financing constraints. Two important implications follow from this. First, member states must secure the funds required to spend in excess of current receipts before they can engage in deficit spending. Although the US government could spend first and draw reserves later (by selling bonds), EUR-11 governments must sell bonds first. Thus, their ability to deficit-spend depends upon the willingness of private banks to extend credit in advance. Second, unlike the bonds issued by the US government, the obligations that are now issued by EUR-11 governments are no longer default-risk-free. As Parguez recognizes, this means that markets will make lending decisions on the basis of their perception of member states' creditworthiness, which is based on a state's ability to "pledge to balance its budget, to get a zero *ex post* deficit, so as to protect the banks against the risk of accumulating public debt" (1999, p. 72). Since markets will perceive some members of the EUR-11 as more creditworthy than others, financial markets will not view bonds issued by different nations as perfect substitutes. Therefore, high-debt countries may be unable to secure funding on the same terms as their low-debt counterparts. This was recognized by Lemmen and Goodhart (1999, p. 77), who suggest that "governments with above-average deficits and debt will find that they have less financial flexibility within EMU than [was previously] the case."

Suppose, for example, that Italy or Belgium — with debt-to-GDP ratios of 115.1 and 116.1, respectively, at the close of 1999 — decided to pursue an expansionary fiscal policy in order to stimulate GDP and combat high domestic unemployment. If

capital markets demand high rates of interest in order to hold Italian or Belgian government debt, then it is easy to see how these governments could be forced to abandon expansionary policy. As Kregel (1999, p. 40) notes, an attempt by Italy to expand domestic demand would lead to a deterioration of the Italian fiscal deficit and, hence, "credit risks rising on Italian securities." Jordan (1997, p. 3) states the implications succinctly:

The risk for the fiscal authorities of any member country is that the "fiscal arithmetic" of the budget constraint leaves few palatable alternatives. If the yield on government securities demanded by markets exceeds a country's nominal income growth, then interest expense on the outstanding debt must become a relatively larger burden.

Again, the "burden" can persist because EUR-11 governments cannot create spendable deposits internally (i.e. "print" money) in order to avert rising interest costs. Thus, unlike the US government, which can always meet any dollar-denominated commitment as it comes due, the EUR-11 governments must finance their excess spending by selling bonds. Looking at the budget constraint $G - T = \Delta B + \Delta M$, then, we see that deficits must be covered by borrowing (i.e. $\Delta M = 0$ for purposes of government finance). But if interest payments are becoming a significant portion of a member state's total outlays, it may be difficult to convince financial markets to accept new issues in order to service the growing debt.³⁸

While some (e.g. Eichengreen and von Hagen, 1995) have argued that member states can still service higher debt levels because they retain the power to alter tax rates, others recognize that EUR-11 governments are seriously constrained in this regard. Jordan (1997, p. 3), for example, argues that "the prospect of higher taxes would cause the factors of production to migrate . . . so that . . . higher tax rates could, eventually, shrink the tax base."³⁹ Taylor also disagrees with Eichengreen and von Hagen (1995, p. 16), suggesting that, despite "their substantial revenue-raising powers," member states will "be increasingly constrained by the pressure of 'fiscal competition' operating" under EMU. Again, this "fiscal competition" is the direct result of Article 104. Because member states can no longer create spendable deposits internally (i.e. "print" money), they must compete for euros by selling bonds to private investors (including private banks) who will not view the various obligations as perfect substitutes. Thus, governments must float bonds on the capital market, where they must compete with debt instruments offered by other (government and non-government) entities. The result, as Taylor (1999, p. 16) recognizes, is that "debt issuance by central governments will take place in a new environment of market discipline."

The ability of financial markets to impose discipline on member states depends upon two important factors. First, the no haircut rule must be seen as reasonably credible. If it is, then markets will "treat lending to EMU governments in much the

same way that they approach lending to the regional governments of existing federal monetary unions" (Taylor, 1999, p. 16). Second, markets must be well informed and efficient in their pricing of credit risk. If they are, they will be able to "exert effective new safeguards against persistently high borrowing" (ibid.).

To the extent that these conditions are met, lenders may assign different quality or risk premiums to the obligations of member governments "whose ability to service debt seems less assured than other nations" (Stevens, 1999, p. 5). Thus, even though the ECB, through its willingness to provide (absorb) liquidity at marginal lending (deposit) facilities, will set the short-term interest rate, "bonds issued by different national governments, denominated in euros, may attract different credit ratings and hence different interest rates" (Sawyer, 1999, p. 14). As Lemmen and Goodhart (1999, p. 77) note, this means that "credit risks will replace market risks . . . as the principal source of relative risk in government debt markets in EMU." As a consequence, obligations issued by EMU-11 governments begin to resemble those issued by state and local governments in the United States, where risk premiums "rise sharply with the ratio of state debt to state product. States with high debt-to-output ratios can become effectively rationed out of the market" (Jordan, 1997, p. 3).

Thus, the traditional (institutional) link between the Treasury and the Central Bank has been severed under the new monetary arrangements, which means that, unlike currencies that are "creatures" of their issuing states, "the euro will be a private money, created at the sole request of private agents by banks obliged to comply with the targets set by the Central Bank, [and] sustained by the expectations of the financial markets" (Berguez, 1999, p. 66). Whereas the franc, the mark, the lira, etc. used to derive their legitimacy from the state (i.e. from their acceptance in payment of taxes), financial markets are now "the ultimate source of legitimacy for the euro" (ibid., p. 72).

Having broken the (charitable) link between sovereignty over currency and sovereignty over public policy, member states must rely on the willingness of commercial banks or other financial institutions when floating new issues; they cannot create spendable balances the way the US Treasury can. Therefore, government debt issued by the EMU-11 countries is forced to compete with other forms of debt (e.g. commercial paper, bonds issued by private firms, the debt of other member states, etc.). In the event that a member state finds itself unable to locate sufficient financing, it will be forced to run a balanced budget. Imposing fiscal constraints on member governments in order to encourage discipline is, of course, wholly inconsistent with the idea of Functional Finance.

Concluding remarks

Before entering the currency union, NCUs had command over their own currencies and could alter interest and/or exchange rates in an attempt to stabilize their

economies. Now, however, they must accept the monetary and exchange rate policies that are handed down by the ESCB. Moreover, member states have agreed to allow the ESCB to make the pursuit of price stability its overriding objective in implementing monetary and exchange rate policies. They did not, however, insist that a federal agency be made responsible for stabilizing output and employment in times of crises.

Currently, "the federal budget for the European Union is not used as a tool to address recessions or overheating, either in particular countries or in Europe as a whole" (Endery, 1998, p. 17). It is as if policymakers decided to set the economic speedometer at 55 mph, even though it might be wise to speed up (or slow down), depending on current (economic) driving conditions. Although some groups (e.g. monetarists) probably find this limited role for fiscal policy comforting, others have been critical of the lack of attention it has received.

Godley (1992, p. 40), for example, states that "the incredible lesson in the Maastricht program is that, while it contains a blueprint for the establishment and smooth operation of an independent central bank, there is no blueprint whatever of the analogue, in Community terms, of a central government."

This is significant because, as Jordan (1997, p. 40) notes, "the sustainability of any monetary regime depends on the fiscal regime in which it operates." The reader will recall that the fiscal regime in which the EMU-11 must operate is characterized by three distinct constraints that have been imposed as part of the currency union. However, as Hughes-Hallett and Scott (1993, p. 72) note, "empirical research has shown that monetary union is particularly dependent on its supporting fiscal policies in that, in the absence of sufficiently large or frequent interventions, economic performance will rapidly deteriorate in the union's constituent economies."

Because of the deficit-to-GDP constraint, many critics of the European currency union have concluded that it will be impossible for the constituent governments to provide the kind of large-scale intervention that would be needed to stimulate depressed economies. These critics do not seem to be objecting to the existence of fiscal discipline in general, but to the particular upper limit -- 3 percent deficit-to-GDP -- that has been imposed under the Stability and Growth Pact.

This view begs the question: is the upper limit the primary obstruction to flexible policy? If it were, then raising it (or lifting it all together) should renew significant fiscal flexibility. But it is not clear that the 3 percent limit is really constraining deficit spending in the EMU-11. Indeed, one might conclude, given that the unemployment rate in the euro area averaged 10 percent in 1999, that many member states would have at least exercised their right to run deficits equal to 1 percent of GDP. As shown in Figure 5.2, however, none of the EMU-11 governments have even come close to running up against the 3 percent deficit-to-GDP limit.

We cannot know for sure whether each member state's budgetary position reflects its preferred stance or whether larger deficits would have been run in the absence of financial market discipline. It seems clear, however, that even if member

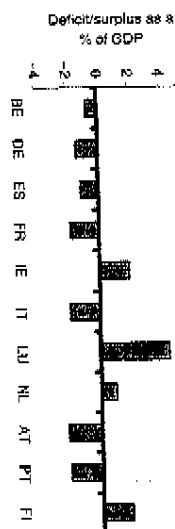


Figure 5.2. EUR-11 deficit-to-GDP (1999).

Source: Monthly Bulletin (September), <http://www.ecb.int>.

states were able to jettison the objective deficit-to-GDP limit and to abandon any self-imposed fiscal restraints that stem from a bias for "sound" finance, no member of the EUR-11 would be capable of conducting policy according to the principles of Functional Finance.

The reader will recall that Lerner proposed that the government undertake two functions. First, it was to ensure that the level of total spending was sufficient to purchase all of the goods and services that a fully employed system could produce. Now, if spending by households, firms and foreigners typically generated a spending gap of no more than 3 percent of GDP and governments were able to borrow enough to close this gap, then it would be possible for the EUR-11 governments to implement Lerner's first law. However, Article 104 prevents member states from closing the gap in accordance with his second law, which precludes borrowing unless the private sector would otherwise spend enough to bring about full employment.

Implementing policy according to the principles of Functional Finance means using taxes and bonds "simply as instruments, and not as magic charms that will cause mysterious hurt if they are manipulated by the wrong people or without due reverence for tradition" (Lerner, 1943, p. 51). It means deciding whether to tax/spend/buy/sell bonds, create/destroy money, etc. by considering which operation is likely to yield the most desirable effects on the macroeconomy. In other words, policymakers should decide on a policy objective — for Lerner this was full employment and price stability — and then use whatever means are deemed most constructive, given the goal. As the EUR-11 "possess none of the instruments of macro-economic policy, their political choice is confined to relatively minor matters of emphasis — a bit more education here, a bit less infrastructure there" (Godley, 1992, p. 39).

There are, perhaps, only two ways to regain control of the economic steering wheel.¹ First, the institutional arrangements could be returned. For example, the ECB (or a newly established lending institution) could be required to aid member states in their pursuit of a broad set of policy objectives by assisting in the coordination of monetary and fiscal policy.² This has been proposed by Arestis et al. (2000), Sawyer (1999), and Kregel (1999). The crucial point is that member states

need to be able to avert the financial constraint imposed under Article 104. This would enable them to regain control over their individual steering wheels. Second, the EUR-11 could unite politically. As Godley suggests "the counterpart of giving up sovereignty should be that the component nations are constituted into a federation to whom their sovereignty is entrusted" (1992, p. 40). Under political union, the power to tax would be transferred to the EU, and its budget could be used to coordinate policy according to the principles of Functional Finance. This, essentially, means allowing a federated European government to control the economic steering wheel on behalf of the entire EUR-11. Either way, it seems that the link between control over money and control over policy must be reestablished if nations are to recapture control of their economic steering wheels. Countries considering a currency union of their own should study the European experiment carefully, so as not to find themselves unable to steer their economies in the future.

Notes

- 1 I say "most" because the system tended to fail about 10 percent of the time. Burned wheels and despondent motorists were efficiently deposited in nearby fields.
- 2 The "eurozone" (or EUR-11) refers to the geographic territory throughout which the euro has been adopted. This geographic area includes Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The countries within the European Union that opted out of EMU — Sweden, Denmark, Norway, and the UK — retain the power to conduct independent monetary policy.
- 3 For an alternative perspective, see Goodhart (1996a), in which it is argued that a single currency is not a necessary consequence of a single market.
- 4 Although eleven countries have adopted the euro, Alan Meltzer argues that it is not really Europe (as a whole) but France and Germany (in particular) that are important. Specifically, he calls EMU "a way to bind France to Germany and Germany to France" (1992, p. 17).
- 5 Mundell received the Nobel Prize in Economics, in part for his 1961 article on "optimum currency areas."
- 6 Although our purpose is to provide insight into the decision to adopt a common currency (i.e. a monetary union), this also sheds light on the decision to adopt a common economic policy. The idea of a one-size-fits-all policy follows from the idea of factor mobility. Thus, as long as factors are viewed as sufficiently mobile, there is a symbiotic relationship between an OCA and an EMU. Peter Coffey, who is critical of this conclusion, points out that an optimum currency area is different from an economic and monetary union. The former implies the linking of individual currencies through fixed exchange rates, while the latter implies "common economic, fiscal and monetary policies as well as a common currency" (1977, p. 41). In Coffey's view, it does not necessarily follow that an optimum currency is conducive to a full economic and monetary union.
- 7 As Meltzer notes, another reason for maintaining fiscal power at the national level may have to do with the fact that "Europe, or even Germany and France, are unwilling to impositions political union or federation as a feasible near-term prospect" (1992, p. 17).
- 8 Both views are incompatible with Functional Finance, which views the reliance on

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- unfettered markets and the opposition to discretionary fiscal policy as conceptually similar to the removal one's hands from an automobile's steering wheel.
- 9 The ESCB "denotes all the central banks in the European Union that have access to Target, and includes not only the European Central Bank and the 11 euro-area central banks, but also the central banks of England, Sweden, Denmark and Greece" (Weller, 1999, p. 43).
- 10 In October 1998, price stability was defined as "a year-on-year increase in the Harmonized Index of Consumer Prices for the euro area of below 2%" (ECB).
- 11 Among the more conspicuous duties often conferred upon governments, but for which the ESCB bears no responsibility, are the pursuit of high rates of growth and employment and a responsibility to act as "lender-of-last-resort" in times of crisis. For this reason, many economists (Arestis and Sawyer, 1998; Zarutsky, 1998; Kirgel, 1999; Payeur, 1999; Lemman and Goodhart, 1999) have been critical of the duties with which the ESCB has been charged.
- 12 The MCBs will continue to perform many of their original functions, but they "now engage in monetary policy operations only when and as instructed by the ECB" (Stevens, 1999, p. 1).
- 13 Unlike the Federal Reserve, Stevens argues that the ECB lacks "a deep market for securities in which to conduct policy operations," requiring it to operate in a variety of public and private debts (1999, p. 2).
- 14 Use of the standing facilities is subject to the fulfillment of certain access criteria.
- 15 The reserve requirement went into effect at the beginning of stage 3. The requirement has been set at 2 percent of the individual credit institution's liabilities. The liabilities against which credit institutions must hold reserves include: overnight deposits, deposits with an agreed maturity or period of notice of up to two years, debt securities issued with an agreed maturity of up to two years and money market paper (MFI-assetshome@ecb.int). A lump-sum allowance of 100,000 euros can be deducted from this amount in order to determine the final reserve requirement.
- 16 Under the ESCB's requirements, "compliance with reserve requirements is determined on the basis of the average of the end-of-calendar-day balances on the counterparty's reserve accounts over a one-month maintenance period" (<http://www.ecb.int/publ/pdf/guide88eu.pdf>).
- 17 France was chosen because official documents (in English) were easily obtainable, not because the French government is unique in its commitment to fiscal restraint.
- 18 The French, then, are pursuing a balanced budget over the course of the business cycle. Interested readers are encouraged to consult a paper on the Australian experience by George Avgiros (1999), in which it is argued that "trying to eliminate a deficit and force a surplus through orderly reductions biases the business cycle downward so that on average a deficit persists" (p. 9).
- 19 Currently, public spending is over 50 percent of GDP.
- 20 Despite the Council's stated objectives, Kirgel (1999) maintains that the Stability Pact ensures that priority is given to wage and price stability over high growth and employment.
- 21 Payeur actually argues that the Stability and Growth Pact "leads to the conclusion that fiscal surpluses should be the rule to enhance the value of the currency" (1999, p. 66).
- 22 The limits are referred to as arbitrary because there was no technical (or even theoretical) reason for choosing 3 percent and 60 percent as the upper limits for the deficit-to-GDP and debt-to-GDP ratios. Indeed, as been (1997) notes, the limits were chosen primarily because 3 percent and 60 percent happened to be close to the average that prevailed when the Treaty was signed.

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- 23 As we will see, Mosler's position derives from the relative importance he places on the third form of fiscal constraint -- the one imposed by financial markets.
- 24 Payeur calls the suppression of any interference in the process of money creation the "zero-growth condition for the ability of the ECB to impose the Euro" (1999, p. 65).
- 25 Governments can attempt to match these rising expenditures by raising tax rates or by permanently reducing their non-interest outlays (or some combination of these).
- 26 Jordan's scenario is perhaps highly implausible since it is widely recognized that labor has been extremely immobile within the eurozone.
- 27 Abandoning the euro is not considered an option, since Europe's rules bar any country from doing so.

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