THE THEORY AND PRACTICE OF EUROPEAN MONETARY INTEGRATION:
LESSONS FOR NORTH AMERICA*

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With the Advent of the Euro, Have National Currencies Now Become Obsolete?

It is commonly agreed that the international monetary system is a hierarchical system dominated by a few key currencies, such as the dollar, the euro and the yen. However, some economists, especially those of whose research has been influenced by the work of the 1999 Nobel Prize winner in economics, Robert Mundell, have tended to go a step further. These Mundellian writers generally espouse a geo-deterministic logic and argue that there exists an ineluctable tendency towards a tri-polar world made up of three major currency blocs: the Dollar bloc for the Americas, the Euro bloc for the European continent and its satellite regions, and the Yen bloc for Asia. Indeed, to paraphrase Mundell (2000), with the possible exception of these three major currencies, most of the other 175-odd currencies in the world today should be classified as mere “junk” currencies without long-term viability.

While the case for a single world currency is not usually embraced because of the benefits that may arise from the existence of some competing currencies à la Hayek (cf. Hayek 1976), for the advocates of optimal currency areas, regional currency blocs are presumed to be welfare enhancing to its constituents. Given the alleged rapid pace of market dollarization, particularly on the American continent, national governments must by force majeure abandon their sovereign currencies. In their place, they ought to seek to negotiate alternative currency arrangements that would allow Canada and other countries of the Americas to improve their economic welfare within a North American Monetary Union (NAMU) specifically patterned on the European Economic and Monetary Union (EMU). One has only to quote the well-known paper by Courchene and Harris (1999) to deduce this deterministic logic:

“While a NAMU is not on the immediate horizon, there is nonetheless an urgent need to place the currency union issue on the public policy agenda. Policy developments within the NAFTA and elsewhere in the Americas appear to be moving quickly in the direction of dollarization. Since widespread dollarization could preclude the emergence of the NAMU by reducing the advantages the United States would garner from it and since, ...., a NAMU would be preferable to dollarization from a Canadian perspective, Canada must become engaged on this issue with its NAFTA and hemispheric partners --- and sooner rather than later.” (Courchene and Harris 1999: 3-4)

Much like the debate over the original Canada-U.S. Free Trade Agreement during the 1980s, the argument in favour of monetary union is not dissimilar. Given the spread of regional currency blocs, one must acquiesce to the logic of monetary globalization. Hence, one must endeavour to negotiate a monetary union with the United States under more advantageous terms than the more rigid ones that would ultimately be imposed by default on Canada and its other NAFTA partner, Mexico, via either market or unilateral policy dollarization. In the case of the latter policy dollarization, this could take several routes. It could entail either the Panamanian route with the outright loss of seigniorage, the Argentine model of retained seigniorage with its currency board structure or, perhaps, the model of shared seigniorage revenues along the lines proposed by Senator Connie Mack's "International Monetary Stability Act" recently proposed to the American Senate and U.S. House of Representatives.

While no one could seriously question the significance of dominant currencies in the world economy, the inescapable trend in favour of such regional currency melting pots is less clear. For instance, from the information provided in a recent study by BogetiÈ(2000) of the International Monetary Fund, the number of either fully "dollarized" countries or countries with official bi-monetary systems are significant but few. They generally tend to be either former colonies that had adopted another country's currency long ago or geographically tiny protectorates or vassal states incapable of having their own viable currencies (such as Puerto Rico, the Virgin Islands, Panama, Liechtenstein, Monaco, and more recently, among others, the Republic of Montenegro). Moreover, if one takes a longer-term perspective, since the collapse of Bretton Woods the general tendency internationally has been towards the adoption of flexible exchange rates.

The obvious exception to what appears otherwise to be an international monetary landscape somewhat at variance with the views of those who profess this Mundellian geo-deterministic logic in favour of regional currency blocs are, of course, the member countries of the EMU. The countries of the EMU have joined together not to adopt any one dominant currency but to create a new one --- the euro. To the defenders of this regional determinism, the creation of the euro in 1999 represents an endorsement of immense proportion which has brought a strong burst of political wind in the sails of all those who envisage hemispheric dollarization in the Americas. Indeed, the advent of the euro, at the end of a turbulent decade plagued by significant currency crises in the world economy, such as the recent currency crises in Asia, Russia, and Latin America, has spurred interest in the European project of monetary integration. This is not only for the euro's much-talked-about "stabilising" role in world currency markets, due to the supposed narrowing of the foreign exchange space within which to speculate internationally, but primarily for the presumed material benefits that would accrue to those nations that would follow the route of monetary integration.

Indeed, alternative currency arrangements, such as fixed exchange rates, currency boards, and policy dollarization, have been put forth by partisans of this Mundellian logic as possible short-term half-way houses towards greater North America monetary integration. However, it is the EMU that remains the model of choice for those advocates who favour the abandonment of national currencies in North America. For instance, in extolling the virtues of the EMU, Grubel (1999) imagines:

"On the day the North American Monetary Union is created --- perhaps on January 1, 2010 --- Canada, the United States, and Mexico will replace their national currencies with the amero. ... In all three countries, the prices of goods and services, wages, assets, and liabilities will be simultaneously converted into ameros at the rates at which currency notes are
The quality of management of their respective economies. The transaction space of a currency reflects the number of transactions.

ii) The Neo-Mengerian Theory of Monetary Union

The modern neo-Mengerian theory of monetary union, as best elaborated by Mundell (1961, 1968, 1971) and Mundell and Swoboda (1969), simply extended the earlier Mengerian analytics to a multi-currency economic space. Hence, instead of going from barter to a single-currency monetary economy, Mundell employed the same Mengerian methodology of minimising transactions costs to explain why a multi-currency economy spontaneously evolves out of an optimal common currency one. Complying with Menger's theory of intrinsic "saleability", Mundell referred to two fundamental characteristics of existing currencies: their specific transaction spaces and the "quality of management" of their respective economies. The transaction space of a currency reflects the number of transactions exchanged.

At the same time, the national central banks of the three countries will be replaced by the North American Central Bank. The operations of that bank will be governed by a constitution like that of the European Central Bank, which makes it responsible solely for maintaining price stability. It is not required to pursue full employment or maintain certain exchange rates. Its personnel policies will be free from political influences, in particular those arising out of partisan national politics in member countries. As in Europe, membership in the union will require that countries do not incur persistent budget deficits.

The amero notes and coins will have in common abstract designs on one side. Notes and coins will be produced in each of the three countries according to their own demand and show national symbols on the other side. ..." (Grubel 1999 : 5)

This long quotation from Grubel sketching out the basic institutional structure of the proposed NAMU is also highly representative of the views of most other partisans of monetary union. For instance, Courchene and Harris (1999) view the NAMU as "the North American equivalent of the European Monetary Union (EMU) and, by extension, the euro" (1999: 22).

This model of currency union based on the European engineering blueprint for monetary integration would bring forth numerous presumed benefits to the three countries of the NAMU. These would be the traditional static gains in terms of lower transactions costs, as well as lower interest rates that would supposedly arise from the elimination of exchange rate variability, including further dynamic gains in terms of lower inflation rates, expansion of trade, increased labour market discipline, and higher productivity. Interestingly these were also the type of benefits that would supposedly accrue to the members of the EMU which were stated repeatedly in the latter's construction and monetary design. However, as we shall discuss below, the European engineering blueprint, with its assumed cornucopia of welfare benefits, is based on a specific view of money and the monetary system that does not square very well with reality. Founded on this view of the monetary system, we believe that the EMU's derived institutional structure has, in turn, placed its member states in an untenable policy straitjacket.

The Underlying Mengerian Economics of a Monetary Union

The structure of the EMU stemming from the treaties of Maastricht (1991) and Amsterdam (1997) is the logical consequence of its underlying economics. A careful reading of the quasi-official literature --- of particular interest, the Emerson Report (1990) and the Fitoussi Report (1998) --- suggests that what could be dubbed "Euro Economics" has two major theoretical foundations.

On the one hand, it is deeply rooted in the traditional theory of monetary union which had been spelled out in the 1960s by Robert Mundell. As pointed out by Goodhart (1998), however, Mundell had done little more than extend to the question of currency union the neoclassical theory of money first put forth by Karl Menger at the end of the nineteenth century. Indeed, Menger (1992) wished to demonstrate why a monetary economy evolved out of barter as the free choice of individual transactors seeking to maximise their wealth. By a similar reasoning, following Mundell it ensues that a common currency must itself also evolve out of a multi-currency transaction space in accordance with the Mengerian methodology.

On the other hand, this neo-Mengerian project has materialized at the institutional level in Europe in large part because of the influence of a powerful group of French (and some German) economists and technocrats on the historical process leading to the establishment of the euro. What Parguez (2000) has dubbed the "techno-classical" group transcribed the abstract Mengerian theory into a set of economic principles that would constitute the infrastructure of a European monetary union. However, this techno-classical group could not succeed without the undaunted support offered by European political leaders. In fact, from the very inception of the euro project in the late 1990s, the project of monetary unification was seen by Europe's political elite as the path to an enlightened new order that would protect economic management from the narrow interests of the elected representatives.

(i) Mengerian Monetary Economics

Menger's (1892) original theory of money attempted to explain how the emergence of money was the logical outcome of a tâtonnement process of indirect barter exchanges. Menger assumed that individual agents across a given transaction space sought to minimise costs by ultimately choosing a unique commodity that would serve as medium of exchange. Consequently, a monetary economy evolves as the "spontaneous outcome" of barter as commodities progressively are discriminated by economic agents according to their "different degrees of saleableness" (Menger 1892: 250). As long as rational wealth-maximising individuals seek to minimise their losses via indirect exchange, they will ultimately come to bestow on the most "saleable" of commodities the nature of money as circulating medium. Assuming that all individuals can have access to the same information set regarding what Menger called the objective "saleableness" of commodities, there would be only one commodity that would best objectify the intrinsic characteristics needed to minimise transaction costs. Moreover, since money is the endogenous outcome of a market process, it cannot be generated by law and thereby emerge from the exogenous actions of the state along chartalist lines. Indeed, much like later Austrian economists, the state and money were natural adversaries since the former seeks arbitrarily to constrain the behaviour of economic agents by tinkering with the latter by means of monetary debasement.

(ii) The Neo-Mengerian Theory of Monetary Union

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involving this currency that each transactor can expect to undertake to reach an optimum under the constraint of cost minimisation. This optimum space is determined by the respective size of the underlying economy in terms of real income, trade balance and available savings. The quality of management, on the other hand, is reflected in the long-run behaviour of the inflation rate, which depends primarily on the size of the budget deficit and its degree of monetisation. Much like Menger himself, neo-Mengerians believe that, since money arises spontaneously from the activities of market participants, inflation would arise primarily from the deficit spending of the state in its attempt to exact seigniorage revenues.

When applying this neo-Mengerian theory to a highly integrated economic space such as North America, the ensuing solution would be obvious --- a single currency would be welfare enhancing and the currency to be adopted should be the U.S. dollar. This is because the latter's own transaction set is of such magnitude that it is incommensurate with the Canadian dollar and the Mexican peso transaction sets; while in terms of sound management, it may be argued that the U.S. economy has succeeded in out-performing the Mexican and Canadian ones.

When this theory is applied to European economic space, however, the solution becomes somewhat indeterminate. Neither of the major European currencies, such as France or Germany, has a transaction set incommensurate relative to the other. Moreover, none can be considered significantly "better managed" in relation to one another. Under such circumstances, no one currency can come to dominate and it ensues that rational wealth-maximising agents, seeking to minimise transaction costs, must choose a distinct composite commodity to serve as the new money --- the euro. However, Mundellian analysis is quite analogous to the earlier Mengerian methodology applied to a given economic space. Within the Mundellian logic, the adoption of the euro among the European states of the monetary union is conceived as the implicit outcome of a tâtonnement process with the action of some Walrasian auctioneer merely finalising this underlying optimising procedure.

The Mengerian Plan for an Effective European Monetary Union

This Mengerian theory was successfully implemented in Europe because it became the key element of a long-term plan spanning over sixty years from the late 1930s to its finalisation in the Treaties of Maastricht (1991) and Amsterdam (1997). This European plan for monetary integration was carefully promoted by a powerful lobby of both politicians and economists. In the case of distinguished French economists, this began with François Perroux and Jacques Rueff during the war and early post-war years, and it went all the way to modern players such as Michel Aglietta and Jean-Paul Fitoussi. The importance of the European "Techno-Classical" School is discussed in great detail by Parguez (2000). However, it will suffice to say that it was the activities of this group, principally in France, but in later years also in Germany, that prepared the ground for the political implementation of what we would like to describe as the Mengerian plan for European monetary integration.

As shown in the chart below, this plan was implemented in four stages with the final outcome being the expected monetary union:

<table>
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<td>Building the transactions space.</td>
<td>The determination of an equilibrium relative price of currencies.</td>
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The first stage was implemented according to three guiding principles. The first was the Free Market Rule. With the creation of the European Common Market and its enlargement, the European Union, all individuals can freely engage in economic transactions, namely commodity, financial, and foreign exchange transactions, without any institutional impediments that would obstruct the workings of the free market. The second principle can be described as the Market Order Rule which, according to the techno-classical elite, would be the first step towards the "New European Order". Laws can now be enforced by a set of dominant institutions that would largely escape local government control. Indeed, with the legislative control of the European Council and the executive and legal powers bestowed on the European Commission and on the European Supreme Court, decisions taken by the democratically-elected national governments can now be nullified if they contradict European laws and decrees. The third principle can be described as the Enlargement Adjustment Rule, in which the effective integration of countries into the European Union would depend, in Mengerian terms, on the objective "saleability" characteristics of the respective countries; but which in practice would guarantee the spatial hegemony of the Franco-German axis.

The second stage, with the establishment of the European Monetary System (EMS), was a transitory phase during which the long-run "equilibrium" relative prices of the respective national currencies would be determined, to lead eventually to a monetary union (cf. de Cecco and Giovannini 1989: 2). Once established, these equilibrium exchange rates would then be the anchors upon which the national currencies could be converted into the new supra-national composite currency. The EMS followed a Walrasian tâtonnement process in which the two main players were the European central banks and the currency markets. Central banks first agreed on a band, with maximum and minimum values, within which could fluctuate the relative price of the respective currencies. As early as the late 1970s...
and early 1980s, all members of the EMS then pledged to undertake domestic policies aimed at convincing the financial markets of the sustainability of the targeted exchange rates. The policy requirements included fiscal restraint and high real interest rates so as to attain low inflation. If the targeted set of relative currency prices were not to be endorsed by the markets, thereby leading to excessive volatility, two alternatives were open to the member countries during this stage. Either the member countries would impose more severe monetary and fiscal austerity, or a downward (or upward) adjustment of the currency rates would take place to satisfy the financial markets. By the mid-1990s, this tâtonnement led to the establishment of a set of relative exchange rates that were deemed to be the "long-run equilibrium levels" consistent with market expectations of low inflation and fiscal soundness. As discussed by Parguez (1998), during the eighties and nineties all EMS countries had sufficiently deflated their economies, with the respective countries' inflation rates converging to the low German inflation rate (see Bleaney and Mizzen 1997), to convince the financial markets of the long-run stability of these targeted exchange rates.

The final two stages pertain to the advent of the euro. Indeed, once the relative equilibrium prices of currencies were established, the time was ripe for monetary union with the new currency to be created as a composite commodity. Given the established long-run values of the exchange rates, the conversion of assets denominated in former national currencies into assets denominated in euro would now be achieved without any asset holder suffering a windfall gain or loss from the conversion process. The new composite currency is recognised by the Maastricht Treaty as well as the follow-up Growth and Stability Pact that instituted the mandatory rules of the new European Monetary Union, whose object was to convince the markets of the desirable intrinsic value of the new composite commodity-money. The new currency would not survive unless there would materialise a permanent demand that would arise from the choices of individual transactors. According to the architects of the euro, the latter would remain unscathed in the long run if it could be protected institutionally against the narrow domestic policies of national governments. Once achieved, the markets' endorsement of the new currency would provide clear economic benefits in the form of more efficient resource allocation and market flexibility while, henceforth, the new European Union would evolve into a leading world power whose currency --- the euro --- would supplant the U.S. dollar as the world's premier currency (Wyplosz 1997: 15).

Implementing the European Plan: The Effective Rules of the European Monetary Union

The structural design of the European plan for monetary integration is based on three sets of rules. The first set defines the role and power of the supreme guardian of the currency, the European Central Bank (ECB). A second set of rules pertains to the limitations imposed on the fiscal policy behaviour of the member states. Finally, a last set of rules ensures that employment and welfare programmes no longer constrain the economic policy behaviour of the member states. These policy rules should remain unaltered over time so as to prevent the narrow national interests from dismantling the new supra-national monetary order.

(i) The Supreme Stewardship of the European Central Bank

The underlying theory of the euro is premised on well-known neoclassical postulates regarding the exogeneity of the money stock. The ECB is presumed to fix at will the supply of euros with the commercial banks being understood to play no role in its creation. For instance, in the first section of the Maastricht Treaty, the role of the banking sector is not even addressed because of the traditional presupposition that banks are mere intermediaries that recycle savings for the purpose of investment. At the same time, the ECB has to use its discretionary power over the supply of the euro to ensure that, in the long run, all rational transactors can expect price stability. Although this commitment to a permanent zero expected inflation had not characterised the behaviour of the former national central banks, zero inflation is to be achieved when the ECB creates just enough money to meet the public's estimated long-run portfolio demand for money.

To attain this goal the central bank must thereby fix short-term rates of interest. In particular, the ECB must increase interest rates when it fears that the exuberant expectations of commercial banks have led them to supply loans in excess of their deposits, which reflects an excess of ex ante investment over ex ante saving. On the other hand, the underlying economics of the Monetary Union rejects the notion of exogenous interest rates set by the Central Bank that is postulated by many critics of Mengerian orthodoxy, going back to the work of Post-Keynesian writers such as Nicholas Kaldor (1980). In the Wicksellian sense, when the ECB has to increase interest rates, it is because existing rates are too low to maintain equilibrium in the capital markets, i.e. the market for savings (cf. Seccareccia 1998). The role of the Central Bank is to curb the profligacy of commercial banks in supplying loans in excess of savings by forcing upon them the natural rate of interest --- a purely endogenous variable.

Finally, the ECB is ultimately also responsible for setting the normal relative price of the new currency vis-à-vis the U.S. dollar, the U.K. pound, the yen, and other important international currencies. In its leadership role, it must seek to guide participants in the foreign exchange markets and encourage them to hold euros rather than other currencies. As long as participants in the foreign exchange markets are convinced of the ability of the ECB to achieve price stability (their faith being reinforced by relatively higher rates of interest), this would ultimately lead them to perceive the euro, in Rueffian terms, as the "quintessential gold" (Parguez 1999). From this vision, it ensues that the euro should come to replace the U.S. dollar as an important reserve currency. In accordance with Rueffian logic, the United States would lose its hegemonic power and Europe would reap seigniorage rewards from euro's status as an international reserve currency (even though as argued by Alogoskoufis and Portes (1992) such benefits would not be very large).

(ii) Protecting the ECB Stewardship: The Subordination of Fiscal Policy

The ECB is forbidden to create money at the request of member states and the European authorities. While this prohibition had never been an explicit element of the constitution of its member states, it is now enshrined in the constitution of the European Union. It undoubtedly fits well the Mengerian logic that underlies the basic structure of the European Union. It prevents the creation of money to finance state outlays in excess of tax revenues. However, to understand the harshness of the fiscal constraints accompanying this
prohibition, we have to integrate the Maastricht rules and the *Growth and Stability Pact* into a consistent framework germane to the underlying economics.

The fundamental principle is that, in the medium term, each member state must *de facto* target a fiscal surplus. If in the short-term the economy goes into a slump, the government can, of course, allow "automatic stabilisers" to follow their course and generate a budget deficit as long as the accounting deficit does not exceed 3 per cent of GDP. At the same time, three other conditions must be met by each member state incurring a deficit. Firstly, the deficit ought not to be a structural one resulting from a persistent expansionary fiscal stance. Secondly, the resulting increase in the public debt must not exceed the threshold level of 60 per cent of GDP. Finally, the government must ensure that there will be future surpluses high enough to permit the state to exact a cumulative net budgetary balance over the cycle. Indeed, according to the *Growth and Stability Pact* (interpreted by the European Commission and the European Central Bank), the initial slump must be of "abnormal magnitude". In particular, it must have occurred while the national government was undertaking a policy of "fiscal responsibility", that is to say, targeting at least a balanced budget. However, since future surpluses cannot be guaranteed, prudent policy would advise that governments target budget surpluses.

Therefore, much like in Canada, since budget deficits are assumed to impact negatively on growth in accordance with neoclassical theory, for contingency reasons all member states have permanently to target surpluses since one cannot be sure that fully offsetting future surpluses will evolve out of destabilising deficits. Based on this neoclassical logic, a sound fiscal policy is one, consequently, that targets a permanent surplus as insurance against disequilibrating shocks. However, unlike Canada, failure to respect these criteria could result in serious penalties for the guilty member states. The implications of this provision are quite startling since the constitution of the European Union now bestows absolute supremacy to neoclassical economics as the ultimate source of law. Hence, any state can be indicted for excessive deficits before the European Council in its capacity as Supreme Court and can be condemned to pay a fine equal to 0.5 per cent of its GDP per year of excessive deficits!

**iii) Removing Employment and Welfare from Macroeconomic Policy**

This major aspect of the European Monetary Union is dealt with in Appendix II of the *Growth and Stability Pact* largely at the request of France. Much like the early doctrines of Rueff and of current neoclassical orthodoxy, unemployment is a supply-side phenomenon due to the absence of flexibility in the labour market. The solution, in Appendix II, is that unemployment is a purely *social* problem, which must be addressed directly by removing the causes of the supply-side constraints. It includes an agenda of reforms, which is strongly advocated by both the European Commission and the ECB. Since high unemployment could encourage politicians to adopt "misguided" Keynesian policies, over the long term, the monetary union would be jeopardised if labour-market flexibility is not achieved (Fitoussi 1999). Reforms could include lower minimum wages, the replacement of welfare programmes that create labour-market disincentives by job training programmes, the more efficient organisation of work and the suppression of all such obstacles that restrain employers' right to dismiss inefficient employees. The effect would be to reduce the equilibrium level of unemployment, or what Parguez (1999) has termed the "Non Expected Inflation Rate of Unemployment" (NEIRU), that would be critical to the success of the monetary union. The NEIRU is not explicitly mentioned in the *Growth and Stability Pact* but it is the logical consequence of its underlying economics. In a sense, the NEIRU can be conceived of as that rate of unemployment that removes any Keynesian temptation to engage in more activist fiscal and monetary policies. By combating unemployment via supply-side policies, it is thus deemed by the architects of the euro as the best route to a sustainable non-inflationary state of full employment.

**iv) The Protective Institutional Structure**

Given the concerns of the European political elites, EMU institutions have been shrewdly built to remove any damaging intervention of the elected representatives. Money must thus be protected from the perils of democracy! It is for this reason that the ECB is independent of both member states and European institutions. While the ECB is obliged to present reports to the European Commission and the European Parliament, this obligation conflicts with the rule of absolute secrecy that forbids the ECB to *explain* its policy.

To guarantee its independence, the Maastricht Treaty carefully shaped the organisation of the Bank. The President, the Directory including the Vice-President and four other members exercise supreme authority. All are appointed for eight years by the European Council and are selected amid those who are "perfectly known within the financial community for their outstanding expertise" (paragraph 109A of the Treaty of Maastricht). They cannot be dismissed during their mandate even by an unanimous decision of the European Council. While the last of these regulations is common for central bankers, the first is crucial because it is the guarantee that the President and the Board must be either former central bankers or presidents of private commercial banks. Moreover, national central banks form a part of the European Monetary System of central banks, regulated by the ECB (paragraph 8 of the Maastricht Protocol on the ECB). Since the ECB enjoys complete independence in relation to member states, national central banks must enjoy the same independence relative to their respective countries (paragraph 14-3 of the Maastricht Protocol on the ECB). National central banks are merely the national branches of the ECB. Member states as such do not participate in the Council of Governors, which is a purely technocratic assembly. Indeed, national governors are sworn to ignore the special interests of their respective countries (paragraph 14-3 and 14-4 of the Maastricht Protocol on the ECB).

At the same time, rules governing fiscal policy cannot be amended. They are monitored and interpreted by the European Commission and the ECB. According to paragraph 4 of the Maastricht Protocol on the European Central Bank, the ECB "has the power to issue advisories on all matters related to its mission". Since the Bank monitors fiscal as well as social policy in the member states, if some domestic legislation is seen to jeopardise the value of the currency, according to its own sovereign "judgement", it issues an advisory requiring the repeal of this piece of legislation. It is also required to issue advisories on domestic budgets when they are not explicitly targeting surpluses. Such advisories are not mandatory regulations, but no member state can choose to ignore them. This is because the Bank has the right to ask the Commission to issue mandatory directives that would impose the required change. Since all European institutions must help the ECB to fulfil its mission, the Commission is obliged to issue the desired directives.
Finally, the European Parliament is deprived of any powers over the ECB. It does not participate in the appointment of the President, the Board or the Council of Governors of the ECB. The Bank has regularly to present a report to the European Parliament. However, this report cannot be discussed and, in any case, cannot include any material that could inform the Parliament of its policy because of the secrecy provision. Moreover, if members have some disagreement with the Bank’s policy, the European Parliament is obviously forbidden to issue directives to the Bank.

**The Lessons of the European Monetary Union for North America**

We have shown thus far that the Mengerian theory of money offers a logical explanation for an optimal currency area or monetary union. Since its inception, the European plan has been rooted in Mengerian theory. A composite commodity-currency that fits the fundamental principles of Mengerian theory has necessitated a precise institutional structure which, over the course of the sixty years of unfolding, the European plan has gone from the abstract Mengerian theory to the economic and institutional rules of the new European monetary order. How would a similar structure be fashioned in North America?

Although there exists no long-run political process in North America in favour of a single currency, it has already been shown that, on the basis of Mundellian economic logic, the common North America currency would be the U.S. dollar. However, establishing the U.S. dollar as a common currency requires the determination of the rates of conversion of assets and liabilities denominated in Canadian dollars and Mexican pesos. As we saw in Europe, it was through the long tâtonnement process of the EMS that such equilibrium exchange rates were finally worked out. Presumably, within the North American integrated economic space (NAFTA), a similar trajectory would be followed. As many advocates have defended (see, among others, Courchene and Harris 1999), the first stage of this process of monetary integration ought to be the setting up of a fixed exchange rate structure that would solidify the long-term depreciation of the Canadian dollar and the Mexican peso relative to the U.S. dollar. Only after a certain process of realignment of these exchange rates until a desired "equilibrium" is struck in accordance with EMS-type arrangements (and convergence criteria) would a fully-fledged monetary union be finally achieved.

Once the new North American Monetary Union is in place, however, a slightly revamped U.S. Federal Reserve would play the part of the ECB with a similar strong commitment to a zero expected inflation via its control of the rate of growth of the money supply. Like its sister union, the NAMU would be logically committed to a strong version of the exogeneity of money as a mere consequence of the Mengerian analytics. Since Euro Economics postulates that banks cannot create money, the architects of the NAMU are poised to rely on a similar postulate, without which the whole economics of monetary union would unravel. This strong exogeneity theory of money explains why debates over monetary union in North America ignore the role of banks and only address the supply of "legal tender" by the Federal Reserve (see von Furstenberg 2000, Laidler 1999, and McCallum 2000).

For the same reason as in Europe, however, the Federal Reserve can indirectly control the money supply only via interest rate policy, by setting the level of interest rates that would adjust ex ante saving to ex ante investments --- the supposed prerequisite to a sound currency characterised by zero inflation. However, money supply targeting via the setting of interest rates could prove to be more difficult in North America than in Europe because of a long-run discrepancy in inflation rates among the three presumed members of the NAMU. In fact, unlike stage I of the European plan of monetary integration, there has not been the same structural long-term preparatory adjustment in North America.

Furthermore, since in the European system the ECB is sovereign in relation to its member states, the same absolute independence would have to be bestowed on the new Federal Reserve. Indeed, since the ECB is not a central bank dependent on its member states, then neither would the new Federal Reserve be the central bank of the NAMU members. Hence, Canada and Mexico would lose their national central banks and would now be integrated into the American system under the supreme authority of the new Federal Reserve. The new Federal Reserve would be granted constitutional independence in relation to all member states, including the U.S. government, and the former central banks of Canada and Mexico would become mere domestic branches or districts of the new Federal Reserve (see Courchene and Harris 1999, and Grubel 1999).

At the same time, the new Federal Reserve would probably have to be protected by more stringent fiscal rules than in Europe. This is because neither Mexico nor Canada have passed through the same degree of fiscal austerity as in Europe during the twenty years prior to the official implementation of the single currency. This would mean that any financing of state outlays by the new Federal Reserve would be prohibited and Canada, Mexico and the United States would have to commit themselves to achieving permanent budget surpluses (including social security) in accordance with EMU-type fiscal rules. Given their past fiscal excesses, required surpluses would have to be higher for Mexico and Canada than for the United States. These fiscal constraints would be enshrined in the NAMU, and there would be sanctions imposed on countries running insufficient surpluses.

Finally, since such fiscal surpluses would probably be exacted primarily from the social programmes envelopes of government budgets, North American fiscal deflation would help to suppress obstacles to market flexibility, especially in the labour market. It would also help create a highly flexible and single North American labour market. The obvious problem is that politically there would be strong pressures, particularly from the United States, not to eliminate in the short or medium term certain barriers to labour mobility because of fears of a mass exodus of workers from Mexico into the American neighbouring regions to the north.

**The Consequences of Establishing Such a North American Monetary Union**

(i) The Impact of the Exogeneity of Money Postulate

The vast majority of the discussions over either a NAMU or outright dollarization along the lines proposed by U.S. Senator Connie Mack have focused on the question of regulation of the stock of legal tender base money. The unbridled faith in the postulate of exogenous money explains why Canadian advocates of the NAMU (such as Courchene and Harris, 1999; and Grubel, 1999) never address the role
of banks. Since in modern monetary economies like Mexico and Canada, money is an endogenous variable, Canadian and Mexican banks will now create NAMU dollars to finance their loans. This is because banks are not mere intermediaries between savers and investors, but are active creators of deposit money. Since the new Federal Reserve will be committed to maintaining the stability of the North American financial system, it will provide new reserves to the system through open-market operations. Such a commitment would conflict, however, with the Mengerian principle to which the new Federal Reserve ought to subscribe. For instance, let us assume some profligacy of Mexican banks in their loans policy. The new Federal Reserve will detect an unexpected increase in monetary velocity that can jeopardise the value of the NAMU dollar and its zero inflation target. For this reason, it will start to raise interest rates in order to impose a fall in the demand for loans until they are again presumed equal to \textit{ex ante} deposits. In the process, both Canadians and Americans will suffer the same credit squeeze as the Mexicans even though the former may have been cautious in their credit worthiness rules. The more the new Fed is committed to this Wicksellian rule, the more it will react to the endogeneity of money by raising interest rates as a pre-emptive strike against the expected inflation.

This was exactly the interest rate policy adopted under the EMS which had led to a successful disinflation (cf. Bleaney and Mizen 1997) and which was subsequently followed under the EMU. In the name of defending the European fixed exchange rate system and now the euro, European countries consistently followed over the last two decades a policy of high real interest rates in relation to the United States. For instance, Chart 1 presents real prime interest rates series (as well as their underlying trends) for the United States and the average for the two core countries of the EMS, France and Germany, for the period 1979 and 1999.

**CHART 1**

\textbf{Evolution of Real Prime Rates}

\textit{in Two Core Euro Countries and the United States, 1979-1999}

\textit{(Nominal Prime Rates less CPI Inflation Rates)}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart1.png}
\caption{Evolution of Real Prime Rates in Two Core Euro Countries and the United States, 1979-1999}
\end{figure}

\textit{Source: IMF}

From this simple statistical evidence, we can infer that the institutional framework of the European system has generated much more restrictive
monetary policy than in the United States and with disastrous consequences over the same period in terms of unemployment and growth (see Chart 2 for the unemployment experience of the two regions).

Moreover since the central bank is now forbidden to finance any government expenditures of the member states, national governments are forced to rely exclusively on private banks as source of short-term financing. In the name of combating inflation that

![Chart 2: Unemployment Rate Performances of Two Core Euro Countries and the United States 1979-1999](chart2)

ensues from the process of acquiring seigniorage revenues via the "monetisation of deficits", the EMU arrangements have become a real cornucopia for private banks and have imposed an amazing burden on any member state since they have both to pay interest to the banks on their borrowings and comply with their credit-worthiness criteria. With interest rates being ultimately decreed by the supra-national ECB, the latter can at the same time increase at will the public debt burden in the member countries.

These same financial constraints will apply to all members of the NAMU. All members states of the NAMU will find themselves in the same relation to the new Fed as Canadian provinces are presently with respect to the Bank of Canada. The Canadian government will have no choice but to meet its short-term financing requirements by borrowing from private financial institutions. Moreover, any interest rate hike decreed by the new Federal Reserve to tame over-speculation, say, in Mexico will automatically increase the debt burden in Canada.

(ii) The Impact of Fiscal Rules

Fiscal austerity is a twin of the exogeneity of money principle. The belief in balanced budgets and fiscal surpluses is rooted deeply in neoclassical thought with its rejection of the Keynesian principle of effective demand. Converting to the Mengerian principles of the monetary union entails the abandoning of Keynes and his legacy. Unfortunately, modern monetary economies are no more governed by Say's Law and supply-side neoclassical economics than in Keynes's times. The stringent fiscal rules of monetary union, as we saw
under the Maastricht Treaty, lead to a permanent reduction of aggregate demand and an increasing long-term problem of involuntary unemployment (as is displayed in Chart 2). Such has been the case for Europe for at least the last two decades prior to the official launching of the euro on January 1, 1999. Charts 3 and 4, which present indicators of the fiscal stance of the

**CHART 3**

*Share of Deficit (-)/Surplus (+) to GDP of Two Core Euro Countries and the United States, 1979-1999 (All Levels of Government)*

![Chart 3](chart3.png)

*Source: OECD*

countries (France and Germany) vis-à-vis the United States, are quite suggestive of the importance of the policies of fiscal austerity in Europe during the last two decades. Indeed, the sole member of the European Union which in the early 1980s refused to enter into a monetary union by rejecting the European monetary tâtonnement was the United Kingdom; and it is the only major European country to have enjoyed a significant decline in the unemployment rate since the mid-1980s (see Chart 5).
Canada, Mexico and the United States to agree on a monetary union along the lines of the EMU, they would have to deflate significantly their economies and accept a higher long-term rate of unemployment. Some may wish to invoke the miracle of the new economy of the late 1990s when, especially in the United States, rising budget surpluses had been matched by strong growth and quasi-full employment without inflation. However, as it has been discussed elsewhere (see Seccareccia 2000), in both the United States and Canada, the deflationary impact of fiscal surpluses has been mitigated largely by the accompanying
dramatic growth of private debt. Neither the U.S. Federal Reserve nor the Bank of Canada has shown much concern with explosive household debt ratios. This has been so largely because a rising share of this growing private debt has had as collateral company stocks, the values of which have been inflated by excessive speculation in the stock market via credit financing. There is no doubt, however, that a more over-cautious supra-national Federal Reserve would engineer a credit crunch by raising significantly interest rates. In fact, the deflationary "success" of the monetary union would be linked to the destruction of the compensating role of household indebtedness. While the U.S. economy would suffer from such a deflationary policy, the bulk of the credit crunch will be borne by Mexico and Canada, where the rise in real income upon which borrowing can be sustained has been lower than in the United States.

Concluding Remarks

To the question that was posed at the very beginning of this paper, as to whether national currencies in North America are destined to disappear, the answer can be only an ambiguous one. If one subscribes to Neo-Mengerian theory of optimum currency areas, a monetary union in North America should have preceded the European Monetary Union long ago (see, *inter alia*, Eichengreen 1997: 52). Canada and the United States are economies that are more integrated as trading partners than any of the major partners of the European Union with, for example, over 85 per cent of Canada's foreign trade being done with the United States. Moreover, the Canadian and American economies are structurally more homogeneous than most of the members of the EMU. If Mundellian logic would prevail, these two countries of NAFTA should have integrated monetarily much before the Europeans. Yet, at the dismay of the Neo-Mengerians, this has not happened. Indeed, despite the much greater economic integration between Canada and the United States, it is only since the launching of the euro in 1999 that concern with the issue of a common North American currency has actually surfaced among politicians and the public at large. However, this appetite by some for greater monetary integration has not been based on any prior political plan to which had subscribed the European political class for sixty years prior to the launching of the euro. Rather,
In North America, with the possible exception of some pro-NAMU sovereigntists in Québec, it is based primarily on what may be described as Veblen-esque desires of "keeping up with the (European) Jones".

The European governments have chosen to move in the direction of monetary union not because of any underlying Mundellian logic but because of strong political and ideological commitment on the part of a European "techno-classical" group who, throughout the early post-war period, had promoted a course of greater political, economic and monetary integration. There was thus nothing inevitable about that path and, indeed, as we have argued, the European member states have given themselves an institutional structure that, despite the political rhetoric to the contrary, has ironically weakened their economies since the advent of the EMS in 1979 (cf. Feldstein 1997).

In many ways, as argued by Parguez (1999), the European states are virtually repeating the old mistakes of the Gold zone during the 1930s. Since their restrictive monetary and fiscal policies have had the effect of compressing aggregate demand and employment on the European continent, the consequence has been to weaken and accelerate the depreciation of the euro and to trigger deflationary pressures in the world economy. By applying further doses of fiscal restraint to an otherwise ailing European economy, the process has further weakened the real economy and, accompanying it, the euro. Some may argue that a downward spiralling euro would ultimately stimulate exports from the euro region. While this may be true, the effect would also be to increase further the American trade deficit and, paradoxically, to reinforce further the holdings of U.S. dollars internationally. Instead of being the quintessential gold which international transactors would wish to hold, the euro could more likely become what the original advocates of the European Plan least desired --- perhaps just another one of the growing number of international "junk" currencies described by Mundell (2000). Is this really the model of a new monetary system for the 21st century that North Americans would wish to adopt? Are North Americans not better off with their existing national currencies? Or, to paraphrase former Governor Gordon Thiessen of the Bank of Canada, why would anyone want to give up their national currencies for what, to all intents and purposes, would become a more constraining supra-national monetary order (Thiessen 1998: 123)?

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CHARTS