## Contents

| Li | ist of abbreviations |                                     |      |  |  |
|----|----------------------|-------------------------------------|------|--|--|
| Li | ist of tables        |                                     |      |  |  |
| A  | cknowlec             | xi                                  |      |  |  |
| Pı | reface               |                                     | xiii |  |  |
| 1  | Introdu              | ction and summary                   | 1    |  |  |
| 2  | Treaty               | on economic and monetary union      | 4.5  |  |  |
|    | 2.1                  | Introduction                        | 15   |  |  |
|    | 2.2                  | Principles                          | 16   |  |  |
|    | 2.3                  | Capital and payments: globalisation | 17   |  |  |
|    | 2.4                  | Monetary policy                     | 23   |  |  |
|    | 2.5                  | Economic policy                     | 27   |  |  |
|    | 2.6                  | Rules on excessive deficits         | 28   |  |  |
|    | 2.7                  | Exchange rate policy                | 34   |  |  |
|    | 2.8                  | Rules on passage to third stage     | 37   |  |  |
|    | 2.8.a)               | Price stability criterion           | 41   |  |  |
|    | 2.8.b)               | Excessive budget deficit criterion  | 44   |  |  |
|    | 2.8.c)               | Long-term interest rate criterion   | 45   |  |  |
|    | 2.8.d)               | No-devaluation criterion            | 46   |  |  |
|    | 2.9                  | Convergence criteria reconsidered   | 47   |  |  |
|    | 2.9.a)               | Index of convergence potential      | 48   |  |  |
|    | 2.10                 | Institutions                        | 52   |  |  |
|    | 2.11                 | European Monetary Institute (EMI)   | 53   |  |  |
|    | 2.12                 | European Central Bank (ECB)         | 54   |  |  |

|   | 2.12.b)<br>2.13<br>2.14<br>2.15<br>2.16<br>2.17 | ECB independence Prudential supervision European Currency Unit (ECU) European Monetary Cooperation Fund (EMCF) The private use of the ECU | 55<br>57<br>58<br>62 |
|---|---|---|----------------------|
|   | 2.14<br>2.15<br>2.16<br>2.17                    | European Currency Unit (ECU) European Monetary Cooperation Fund (EMCF)  | 58                   |
|   | 2.15<br>2.16<br>2.17                            | European Monetary Cooperation Fund (EMCF)   |                      |
|   | 2.16<br>2.17                                    |   | 62                   |
|   | 2.17  |   |                      |
|   |   |   | 64                   |
|   | `   | How others have seen EMU  | 65                   |
|   | 2.17.a)   | Two speed EMU   | 67                   |
|   | 2.18  | Concluding remarks  | 70                   |
| 3 | A monet   | ary-theoretic approach to EMU   |                      |
|   | 3.1   | Introduction  | 76                   |
|   | 3.2   | Hypotheses stated and applied to ECU and EMU  | 79                   |
|   | 3.2.H1  | The Hicksian proposition  | 79                   |
|   | 3.2.a)  | H1 applied to the EMS and EMU   | 80                   |
|   | 3.3.H2  | The Aristotelian notion of evolving money   | 86                   |
|   | 3.3.a)  | H2 applied to the ECU and interdependence   | 90                   |
|   | 3.4.H3  | The Cipolla thesis  | 93                   |
|   | 3.4.a)  | Cipolla criteria and the ECU  | 95                   |
|   | 3.5.H4  | The Triffin postulate   | 98                   |
|   | 3.5.a)  | H4 applied to the private use of the ECU  | 100                  |
|   | 3.6.H5  | The Essentiality criterion  | 106                  |
|   | 3.6.a)  | H5 applied to EMU and the ECU   | 111                  |
|   | 3.7   | Concluding remarks  | 113                  |
| 4 | Walras's  | theory of money and the ECU   |                      |
|   | 4.1   | Introduction  | 121                  |
|   | 4.2   | Neo-Walrasians and the ECU  | 123                  |
|   | 4.3   | What are the relevant issues?   | 126                  |
|   | 4.4   | Assumptions of Walras's general equilibrium   | 127                  |
|   | 4.5   | Walras's circulating fund   | 128                  |
|   | 4.6   | Equations of circulation and money  | 130                  |
|   | 4.7   | Equation of the demand for money  | 133                  |
|   | 4.8   | Walras's paper money  | 135                  |
|   | 4.9   | Role of the circulating fund  | 136                  |
|   | 4.10  | Role of money savings   | 140                  |
|   | 4.11  | Tâtonnement of money's service of availability  | 142                  |
|   | 4.12  | Walras's bimetallic standard  | 146                  |
|   | 4.13  | A dual anchor for the second stage of EMU   | 148                  |
|   | 4.14  | The ECU is Walras's paper money: the lessons  | 149                  |
|   | 4.15  | Conclusions   | 152                  |

| 5 | State the               | ory of money and the ECU   |     |  |
|---|-------------------------|--|-----|--|
|   | 5.1                     | Introduction   | 158 |  |
|   | 5.2                     | Plato's theory of money  | 160 |  |
|   | 5.3                     | Knapp's chartalism   | 161 |  |
|   | 5.4                     | Keynes's controlled monetary system                                | 163 |  |
|   | 5.4.a)                  | Keynes's assumptions   | 164 |  |
|   | 5.4.b)                  | Keynes's interest rate   | 167 |  |
|   | 5.4.c)                  | Keynes's properties of money                                       | 169 |  |
|   | 5.4.d)                  | Determination of Keynes's interest rate                            | 173 |  |
|   | 5.5                     | Post Keynesians and world monetary system                          | 176 |  |
|   | 5.6                     | Institutionalists and the ECU                                      | 179 |  |
|   | 5.7                     | H1 to H5 applied to Keynes's General Theory                        | 182 |  |
|   | 5.8                     | Concluding remarks   | 184 |  |
| 6 | Money is an externality |  |     |  |
|   | 6.1                     | Introduction   | 190 |  |
|   | 6.2                     | Meade's externalities  | 191 |  |
|   | 6.3                     | Money externalities  | 195 |  |
|   | 6.3.i                   | Transaction costs externalities                                    | 199 |  |
|   | 6.3.ii                  | Price level externalities  | 205 |  |
|   | 6.3.iii                 | Confidence externalities   | 211 |  |
|   | 6.3.iv                  | Learning and technological externalities                           | 216 |  |
|   | 6.3.v                   | Seigniorage externalities  | 222 |  |
|   | 6.4                     | Two monetary conclusions   | 230 |  |
| 7 |                         | xternalities and the ECU   | 234 |  |
|   | 7.1                     | Introduction   |     |  |
|   | 7.2                     | Implications of M <sub>E</sub> for the perfectly competitive model | 235 |  |
|   | 7.3                     | The IS-LM model reconsidered                                       | 239 |  |
|   | 7.4                     | Money externalities and H1 to H5                                   | 246 |  |
|   | 7.5                     | Money externalities internalised by the ECU                        | 248 |  |
|   | 7.6                     | The ECB reconsidered   | 254 |  |
|   | 7.7                     | Last resort of managing risk                                       | 257 |  |
|   | 7.8                     | A European Fiscal Authority (EFA)                                  | 258 |  |
|   | 7.9                     | Overall conclusion   | 262 |  |
| В | Bibliography            |  |     |  |

## List of tables

| Table 1.1 | Categories of money externalities             | 12  |
|-----------|---|-----|
| Table 2.1 | Global market for capital and finance         | 19  |
| Table 2.2 | Shares in world exports, 1980-88              | 36  |
| Table 2.3 | Estimates of nominal convergence indicators   | 41  |
| Table 2.4 | EMU indicator for 1991                        | 47  |
| Table 2.5 | Estimates of convergence potential indicators | 49  |
| Table 2.6 | EMU convergence potential index for 1993      | 51  |
| Table 2.7 | Composition of the ECU basket                 | 59  |
| Table 3.1 | World reference portfolio                     | 99  |
| Table 3.2 | ECU bond market by nationality of issuer      | 101 |
| Table 3.3 | International bond issues in 1991             | 102 |
| Table 3.4 | Banks' foreign currency business in 1991      | 103 |
| Table 3.5 | Structure of ECU money                        | 104 |
| Table 3.6 | Diagram on the nexus of causality             | 107 |
| Table 6.1 | Taxonomy of money externalities               | 198 |
|           |   |     |

## Acknowledgements

This monograph is the product (an external economy to me, a diseconomy to those associated with it) of an effort of not less than twelve years, carried out at McGill, Cambridge and London Universities. During this period, the help and support, advice and counsel, encouragement and its opposite as well as knowledge that I have received and gained, are due to teachers, supervisors and friends, who are too numerous to mention.

I feel obliged to express my gratitude to my first supervisor, Jack R. Weldon of McGill University, who first taught me that examining monetary institutions without a good theory of money would be a futile exercise. The last time we met was on 19 September 1986. It was he who had said that 'the original idea of the five hypotheses had to be carried out without much compromise'. I have followed his advice, for it has been shown to be a precious guide.

To my second supervisor at McGill, Athanasios Asimakopulos, I am also indebted, not so much for his encouragement of my research, but mainly for his method which I have adopted in justifying everything for logical consistency and for his insightful comments on methodology.

There is one supervisor whose support no other student could have had: Victoria Chick of University College London. Not only am I indebted to her intellectually for the final version of this book but also materially for her undertaking to enrol me in the University of London as external student at a time when Tom Asimakopulos, due to serious illness, had to give up his supervisory role. She has been a model supervisor.

Two friends, Omar Hamouda of York University at Toronto and Geoff Harcourt of Cambridge University, have given precious encouragement. Omar has commented on almost all chapters and influenced its direction; he has been forthcoming whenever needed. Geoff invited me twice to Cambridge University and accorded me the status of a visiting scholar, not because of my research but because of my employment at the European Parliament. To these