

EUROPEAN MONETARY UNION AND THE NEED FOR NEW INSTITUTIONAL STRUCTURES

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INTRODUCTION

The problems caused by the globalisation of capital flows together with the reduction in capital controls that have been introduced in many countries have created a new source of instability in the international monetary system. This problem was highlighted by the Asian financial crisis in 1997 and the subsequent currency crises in Russia and Latin America. The Asian crisis in particular has cast doubt on the ability of the international monetary order to deal with the problems that have arisen from large increase in short-term capital movements (Furman and Stiglitz, 1998; Radelet and Sachs, 1998; Soros, 1998). Against this background the introduction of a major new currency with the potential to displace the dollar from its dominant role in the international monetary system has raised further questions about the viability of the present institutional frameworks to limit the potential for crises to emerge and to manage crises when they occur.

The role of the euro as an international currency and its future as a challenge to the dollar as an international currency has stimulated considerable debate both in the USA and in Europe. One of the early studies, sponsored by the European Commission, implied that the introduction of a single currency in the EU would not (in the near future) dramatically affect the dominance of the dollar in the international monetary system (Emerson et al, 1992). This study suggested that European monetary union would have a beneficial, but gradual, effect on the evolution of a new international monetary order. The study did not foresee a need for significant changes to the institutional frameworks that underpin the international monetary system. The possibility that the introduction of a new major currency may lead to the emergence of a new and possibly more harmonious international monetary system has been accepted by some of the economic advisors to the President (US Government, 1999). However, other American commentators consider that changes to the institutional frameworks are necessary to achieve such a beneficial outcome and that failure to create such institutional frameworks could lead to serious instability in the world economy (Henning, 1997a, 1997b and 1998). Others regard the exercise as one of the most significant economic and political developments in transatlantic relationships since World War II and that it is likely that serious instability in the international monetary order will follow unless appropriate steps to reform institutional frameworks are taken (Bergsten, 1997a, 1999a 1999b). A number of commentators have suggested that the introduction of the euro will lead to crises in the international monetary system and imply that any moves towards the euro becoming a major international currency should be resisted (Feldstein, 1997; Connolly, 1998; Walters, 1998).

This paper examines the problems that may emerge if the euro becomes a major international currency and assesses the ability of the current institutional frameworks to successfully handle such problems. The proposed plans to restructure the international financial architecture are considered in the light of the analysis of the paper and an assessment is made on the suitability of these plans to cope with the strains that are likely to emerge in the new environment that will arise from the introduction of the euro.

THE EURO AND THE INTERNATIONAL MONETARY SYSTEM

The literature identifies at least six criteria that are necessary for a currency to be a major international currency (Bergsten, 1997b; Eichengreen, 1997; McCauley, 1997).

1. Deep, broad and liquid capital markets that lead to low transaction costs when using the currency for international business activities and for official reserves.
2. Regulatory and taxation regimes for financial markets and a monetary policy that is conducive to the creation and maintenance of confidence in the domestic currency and financial assets denominated in that currency.
3. A large domestic economy with a level of external trade and financial transactions that results in significant influence in the world economy.
4. An economy that has a significant degree of independence from external constraints on the macroeconomic policy targets.
5. A strong and stability domestic economy that has a strong external position.
6. No exchange rate controls.

Capital and Money Markets

There is common agreement in the literature as to what the criteria for an international currency are, but there is no agreement as to the relative importance of the different criteria. However, the consensus is that the size, liquidity and management of the money and capital markets have a great influence on the role a currency plays in the international monetary system (Bergsten 1997b). In the case of the US dollar, for example, it has been the prudent management of money and capital markets that has sustained the dollar as the main international currency for trade invoicing as a vehicle currency and for official reserves. The principle cause of the yen not becoming a truly international currency, despite the strength and stability of the Japanese economy through the 1980s and early nineties, is considered to be the lack of deep and liquid capital markets (Garber 1996). The money and capital market for the euro are only beginning to develop, but they have a long way to go before they reach the size and depth of the US markets. In 1995 the combined debt and equity markets of Euroland was 50 per cent of that of the US and for all 15 Member States was 70 per cent. Equity markets are particularly small relative to the US market - 30 per cent for Euroland and 55 per cent for all the Member States (IMF, 1997). Clearly it will take sometime before the money and capital markets of the euro can provide the depth, breadth and liquidity of the US markets.

Regulation of financial markets and the conduct of monetary policy

The system of regulation of financial markets in Euroland is characterised by a variety of regulatory and taxation regimes. The diverse rules and taxation systems hamper the development of a pan-EU financial area. The problem of removing all barriers to the creation of a single financial area and the difficulties in reaching a compromise on the taxation of

capital and savings highlights the reluctance of the Member States to give up control of their national financial markets (Commission, 1999). The impetus created by the launch of European monetary union will stimulate greater integration of financial markets, but it not clear whether the Member States are prepared to accept the loss of control over regulatory and taxation systems that is necessary to permit such integration. Furthermore, the plans for a withholding tax on savings cast doubts on the wisdom of the policies being pursued by the Commission and some of the Member States in connection to providing structures that are conducive to euro denominated financial assets becoming a major part of global portfolios.

The conduct of monetary policy by the ECB is constrained by the Maastricht Treaty to be mainly concerned with the pursuit of price stability. The Treaty requires the ECB to take into account considerations on sustainable growth and employment, but price stability is the main priority. Statements by senior figures in the ECB suggest that the pursuit of price stability is regarded as the only real priority and that the conditions for growth and employment to flourish are largely determined by sound monetary policy (the responsibility of the ECB) and sound fiscal and structural policies (mainly the responsibility of national governments). The exchange rate of the euro is the responsibility of the ECOFIN and the ECB, but it is implied that the exchange rate will be largely determined by the monetary policy of the ECB which will be determined by the need to sustain price stability in Euroland (Padoa-Schioppa, 1999a and b; Duisenberg, 1998). The President of the ECB appears to regard the pursuit of price stability as the only real policy goal of the ECB. *"The purpose of the introduction of the euro is to promote economic integration and economic welfare in the Member States, and the objective of the ESCB - and the of the ECB as part of this system - is to maintain price stability within the euro area. The ESCB will take a neutral stance towards an international role of the euro. It will neither hinder nor encourage the development of this role, but will rather leave this to market forces."* (Duisenberg, 1998). In circumstances of low growth and high unemployment such a strong focus on price stability may not contribute to the building of confidence in the euro. Investor may consider the markets of Euroland to have poor growth prospects and therefore will skew their portfolio holdings towards higher growth areas.

To develop capital markets that can compete with those in the US there will have to be fundamental change in regulatory and taxation regimes and possibly a change in the current stance of the ECB towards the pursuit of price stability as the only real priority. These types of changes are unlikely to happen in the short-term. However, in the medium to long-term it is possible that Euroland could develop capital and money markets that could successfully challenge the markets in the US.

The size of Euroland and the use of the euro as an international currency

The currency of a large economy offers economies of scale and recognition that allow exporters to invoice goods in their domestic currency. The weight of the euro in the world economy means that it will be backed by a large economy that will be significantly independent from external constraints. In terms of GDP the EU is slightly larger than the US and has a marginally greater share of world trade. The size of the economy of Euroland provides the euro with a strong base as a domestic currency and the size of its external trade (slightly above that of the USA) is a sound basis for the use of the euro for invoicing purposes (see table 1). Furthermore, enlargement of EU to include many of the countries of Central and Eastern Europe will increase the lead of the EU in terms of GDP and share of world trade. If the UK joins European monetary union, Euroland would significantly increase the size of its money

and capital markets from 50 per cent of that of the US to 63 per cent (IMF, 1997). Furthermore, if the UK joined European monetary union Euroland would gain, in the City of London, a major international financial centre.

Table 1: The European Union and the World Economy

	GDP¹	world	world
	bn USD	GDP	trade
		%	%
EU 15	8361	29.9	20
USA	8179	29.3	18
Japan	3797	13.6	10.3
The rest	7620	27.2	51.7
World	27957	100	100
Total			

Source: OECD national statistics January 1999, UNCTAD, World Bank, WTO

At current prices and exchange rates.

Nevertheless, the large size of the EU does not guarantee that the currency will have a prominent place in the international monetary system. In 1995, only 40.1 per cent of Japanese exports were denominated in Yen and 46.6 per cent in dollars. The import ratios were even lower with 17.7 per cent in Yen and 75 per cent in dollars (Ilzkovitz 1996). Global trade in crude oil and basic industrial and agricultural commodities are almost exclusively invoiced in dollars. A reputation for stability and increased use in global trade should provide the euro with economies of scale, positive externalities and network effects, as well as lower transaction and information. However, the dollar already offers these benefits in invoicing and as a vehicle currency. Moreover, compared to the EU the US has lower transaction costs derived from large well managed and open capital markets. The benefits of the dollar were clearly indicated, in the 1990s, by its use, rather than the deutsche mark, as the main invoicing and vehicle currency for intra-European trade. The euro will capture a significant share of the current market for dollars for intra-European trade and the elimination of eleven currencies has reduced the use of the dollar as a vehicle currency in Europe. However, the inertia effect is likely to keep the dollar as the main invoicing and vehicle currency, at least in the short to medium-term (Tanzi 1998).

These factors mean that although Euroland has the potential to be a larger economy than the US (if the UK joins European monetary union) is likely to be several years before the euro is equal to the dollar in invoicing or vehicle currency terms. Estimates of the time necessary for the euro to be a significant alternative to the dollar in these areas range from several years to decades (Alogoskoufis and Portes 1997). The slow decline of sterling, from being the dominant international currency to its replacement by the US dollar provides an example of the inertia effect of an established international currency. Others suggest a serious shock to the international system would be needed before the euro could possibly dominate the dollar as the major international currency (Vanthoor, 1996; Gros and Thygesen 1998). Nevertheless

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some have suggested that EMU is a large enough shock to the world economy to propel the euro to overtake the dollar very quickly (Buitter 1998). If all 15 EU countries join EMU and the predicted expansion eastwards continues the evolution of EMU will provide the international monetary system with a series of shocks. The euro is likely to become the main currency for a very large domestic economy, but also for most of Europe, the Mediterranean area and those parts of the world (such as the former colonies of the Member States) that has large trade with the EU.

The euro as a reserve and private portfolio currency

The dollar is the major reserve currency - 61.5 per cent of the total in 1995 compared to 14.2 per cent for the deutsche mark and 7.4 per cent for the yen (Henning, 1997). Most of Euroland countries have large dollar reserves that were necessary for intervening in the market under the European Monetary System. However, now that exchange rates are fixed and intervention against other currencies is directed by the ECB there is less need to hold such high reserves. It is expected that governments will be slow to shed their excess reserves for fear of destabilising the international system (Commission, 1990). In their Annual report the IMF agreed that the euro would constitute an attractive reserve currency that might come to rival the dollar. Whether the euro becomes a major international currency is deemed to depend on developments in financial markets in Europe, the regulatory environment and the confidence that the markets place on the underlying strength of the economy of Euroland. The introduction of the euro could be accompanied by a significant restructuring of the financial markets and possible instability in money demand relationships. They further observed that transparency in monetary policy would be important in securing and maintaining the credibility of the European Central Bank, but that the greatest threat to stability is the free flowing private capital, which are several times larger than official portfolios (IMF 1998).

The dollar is the most commonly used currency for denominating international private financial portfolios - 52 per cent compared to 26 per cent for all EU currencies (Henning, 1997a). A euro capital market is already in existence since bonds denominated in the currencies of Euroland are being re-denominated in euros. However, if the share of world portfolio holdings denominated in the currencies of the EU 15 (using 1995 figures) were all transferred to euros this would amount to 18 per cent of the total. For the euro to have the same share of the total market as the US another \$795 billion would have to be transferred from dollars to euros (Henning, 1997a). In time if the euro proves a stable currency and the euro zone offers growth, investors will want to balance their portfolios by buying euro assets. Portfolio changes could be very large, but the general expectation is that the shifts will take place gradually. Cooper (1992) suggests a "tipping point" may be reached where investors may move their assets into euros in large volumes, a shift that could be sudden given the rapid movement of global capital. Others argue that, as the US government securities and bond markets have the advantages of being large, well established and highly liquid, the dollar will maintain its prowess as the major currency for private capital holdings (Garber 1996).

Spill over effects

Empirical estimates of trade reducing effects of exchange rate volatility are rare and where they do exist are rather tentative (De Grauwe 1988). A number of empirical studies have been conducted to determine the volatility of the euro against the dollar using a selection of variables, but the results have proved inconclusive. Using a two-country model De Grauwe (1997) suggested volatility would increase and some research has suggested that the ensuing volatility could be on the scale of that between the US dollar and the Japanese yen (Bergsten 1997b). Using the IMF MULTIMOD model, Masson et al (1997) found that the euro-dollar relationship could be slightly more variable than the former relationship between the dollar and the German mark. However, as Gros and Thygesen (1998) have pointed out none of these models are inappropriate for the new era of EMU, because Euroland will be a much more self-sufficient, and therefore a more closed economy than was the case pre-EMU and as such there will be less concern about the external exchange rate. Although the US and the EU will account for more than 70 per cent of the GDP of the OECD, they are also fairly closed economies large enough to face only limited external constraints. The global market in this sense may not be a theatre dominated by two competitive players, but by two very large economies too self-contained and too introspective, to be concerned with international coordination. Without an agreed framework for coordination and cooperation, the longer term result could be greater volatility for smaller economies, a repetition of peso, rouble crises or a major restructuring of trade agreements around the two or possibly three major trading blocks.

However, the spill over effect from the Asian crisis and the effect of low growth in Japan and in the EU on world trade and growth has clearly highlighted the problem of inconsistent macroeconomic policies. In the post-war period the US played an important part in the evolution of the world economy. This has been carried out on the basis of a hegemony that stemmed from the dominance of the US economy (including the major role of the dollar) and the dominance of the US in security and defence issues in the Cold War period. This hegemony was based on a set of international institutions such as the IMF, GATT and the international monetary order that was created at Bretton Woods (Eiengreen and Kenen, 1994). The end of the Bretton Woods system and the gradual decline in the power of the US to act in an hegemonic manner has led to concern that a stable new world order that is based on the existing international institutions has been and will continue to be difficult to maintain (Keohane, 1984 and 1994) The rise of regional integration agencies, particularly the EU has also added to the complexity of this problem (Portes, 1994). The advent of European monetary union has led to the emergence of two large economic blocs that have significant spill over effects to each other and the rest of the world.

It is possible that the establishment of European monetary union will stimulate a greater degree of cooperation in international monetary and economic affairs. In particular, monetary union could lead to a tri-polar G3 type institutional framework composed of the US, Japan and the EU that could be more effective than the current G7 system in creating the conditions that would allow for a more stable international monetary order (Alogoskoufis and Portes, 1990). Gains of approximately 0.5 to 1.5 per cent of the GDP of the members of the G7 have been estimated to be possible from effective co-ordination among the countries of G7. (Currie, Holtham and Hughes-Hallet, 1989). Benefits from cooperation arise from the existence of significant policy spill over effects that lead to the possibilities of significant inefficiencies unless institutional arrangements are in place to ensure that policy inconsistencies are removed (Cooper, 1985). Arguments of this type are based on a rational and functional view of the process of interrelationships between states. The theoretical case for such an approach is based on game-theoretic modelling of cooperation that predict the evolution of institutional

frameworks that can lower the transaction costs of finding solutions to problems arising from interdependence (Axelrod, 1984; Nicholson, 1989). In this type of scenario Euroland would act as one powerful player within a G3 based institutional structure that would promote a more effective means of solving the problems of cooperation (Henning, 1997a and b). Such a regime would be symmetrical rather than based on hegemony. The attraction of this approach would be that actors would be forced to find acceptable solutions rather than operate the take it or leave it choice that characterised the hegemonic system that prevailed under the Bretton Woods arrangements, but which no longer functions effectively since the end of that system and the relative decline in the power of the USA (Williamson and Henning, 1994).

BUILDING INSTITUTIONAL FRAMEWORKS

These types of approaches to institutional building down play the difficulties of resolving internal conflict within the EU institutions and between the Member States and assume that there are no significant differences among the bargaining partners on the underlying nature of the problems that are faced and about possible solutions.

The latter problem emerges if there are disagreements on the fundamental causes of problems or on proposed solutions. The existence of symmetrical institutional frameworks will not guarantee, or even help, in the search for a mutually acceptable solution if such differences exist (Cooper, 1994). Indeed, Bergsten maintains that the creation of a consensus on the solutions of problems arising from interdependencies between states and regional integration agencies is essential if international institutions are to be effective in finding acceptable solutions (Bergsten, 1994). The key to such a consensus is regarded as a G2 group composed of the US and the EU with Japan joining to form G3 as the second tier. This system cascades downwards to G7, G10 and G22 and embraces the IMF, WTO and BIS to ensure wide participation in the search for acceptable solutions (Bergsten, 1999a). This proposal has similarities to the hegemonic system of Bretton Woods, but with a partnership between the US and the EU as the driving force in the search for acceptable solutions. Another weakness of this proposed method of constructing new international institutional frameworks is that no clear indication is provided as to how conflicts between the various actors that would be involved in G2 could be resolved. The other institutions in these types of proposals would be in a take it or leave it position with the hegemonic G2

The literature on multi-level political systems (Bulmer, 1993; Marks, 1993; Marks et al, 1996; Sandholtz, 1996) suggests that analysis of the dynamics of the functionalist approach can provide insights into the ways that interaction between actors in institutional structures leads to shifting and complex outcomes. In this type of analysis actors (states, intergovernmental and supranational agencies) act and react in complex ways to the attempts to find solutions to problems that arise from interdependencies. This analysis indicates that the characteristics and evolution of institutional frameworks are uncertain and appear to be determined by processes that are not fully understood. An effective multi-level institutional framework of the type suggested by Bergsten could conceivably emerge as a result of concerted attempts to construct such a system by the US and the EU. However, the major characteristics and effectiveness of institutional frameworks constructed by such processes is largely unknown and indeed may be unknowable. It also possible that a symmetrical institutional framework could be constructed around a G2 or G3 type of grouping. However, it is not clear how such a multi-level political system could be built unless there is consensus on the nature of the

problems to be tackled and on the methods of solving these problems. A model of the main determinants (and the interaction between them) of the creation and evolution of institutional frameworks may cast light on how either partnerships between the US and the EU or symmetrical institutional frameworks might be constructed.

The new institutional economics provides such a model (North, 1990). The new institutional economics is based on the seminal work of Coase (1960). At the heart of the Coasian analysis are the transaction costs of reaching mutually beneficial outcomes from human interaction. In a world of zero transaction costs, market based exchange will generate an efficient solution - the best possible mutually beneficial outcome. If transaction costs are not zero, markets are likely to fail to provide efficient solutions. However, institutional structures can reduce transaction costs by providing the means whereby problems connected to human interaction can be solved at a cost low enough to enable mutually beneficial exchange to take place. Effective institutional frameworks are those that enable efficient outcomes to be reached. The question that exercises the new institutional economics is why inefficient institutional frameworks can be created and sustained.

The answer to this conundrum is that the creation of institutional structures involves large sunk costs that are lost if institutional structures collapse and that the feedback on outcomes to the various actors involved in institutional structures is incomplete and slowly disseminated. In these circumstances changes to the formal and informal constraints on human interaction, that are the essence of institutional frameworks, normally change slowly. They change in response to feedback that indicates persistently unacceptable outcomes. Institutional evolution is largely the result of the gradual realisation by actors that a new round of institutional building, or modification, is necessary and that sunk costs must be incurred in this process. Such costs are justifiably incurred if the unacceptable outcomes lead to costs to actors that exceed the sunk costs necessary to build new institutions or to modify existing institutional frameworks. In most cases change will be incremental because the various actors are likely to have different ideas about the size of the relative costs and disparate information on the size of these costs. Furthermore, if actors have very different estimates of these costs it will be difficult to agree on change to institutional structures.

In these circumstances institutional frameworks that are inefficient can be constructed and maintained because the actors involved in the frameworks have inherited a set of beliefs, resources and power bases from their history that has largely shaped the institutional frameworks of their society. Institutional change is therefore 'path determined'. Furthermore, unless detailed information is available on the perceptions and views of actors on the relative costs of institutional change it is very difficult to predict the direction or pace of institutional change. However, it is unlikely that actors will make dramatic changes from the path they have been following. The main factor that affects the ability of actors to achieve effective institutional change in the face of significant changes to the conditions of human interaction is what North calls 'adaptive efficiency' (North, 1999). Adaptive efficiency is connected to the formal and informal constraints that largely determine the characteristics of institutional change. North regards informal constraint as most important because they shape the beliefs and perceptions of actors. Societies that have good adaptive efficiency have a 'culture' that is conducive to searching for and finding 'good' solutions to the problems of human interaction. This 'culture' is determined by the interaction between history and current and expected changes to the environment in which human interaction takes place. In this circumstance radical change to institutional frameworks are unlikely and inefficient frameworks (once they

have been created) can persist for long periods. Revolutions or crises that fundamentally alter the relative costs make radical change necessary and possible, but there is no guarantee that such dramatic changes will result in efficient institutional frameworks. Again history plays an important part in the effect of revolutions on institutional change, for history influences the evolution of the 'culture' in which revolutionary or radical reforms take place.

EUROPEAN MONETARY UNION AND INSTITUTIONAL CHANGE

It is unlikely that European monetary union will lead to radical change in the position of the dollar in the short-term, because of the inertia effects that encourage the continuing use of the dollar as the major international currency and the problems that the EU faces in making the euro as attractive as the dollar. However, problems connected to macroeconomic policy inconsistency have already arisen because of the Asian crisis and the low growth rate in most of Euroland. These problems are likely to continue and combined with the medium to long-term challenge presented by the euro to the current dominance of the dollar will exert pressure to reform international institutional frameworks. In these circumstances radical and fast changes to international institutional frameworks are unlikely.

Moreover, large scale problems are likely to arise in reaching agreement because the various actors in the EU and the US have different histories and therefore will probably have quite different perceptions about the relative costs of engineering institutional change. This is already evident as the Americans seem to be more concerned than the Europeans about the possible damage to the world economy (or American/European interests) of failure to modify the existing international institutional structures. The EU also has problems with the multi-level political system in the Union that is being subjected to pressure to change as a result of the creation of EMU. It is likely to be sometime before the EU agrees to new arrangements, between the ECB, ECOFIN, national governments and other EU institutions, to enable a united approach to be determined that could form the basis of a meaningful dialogue on reforming the international institutional structure. Major problems in this area are likely to be the ECB's narrow focus on price stability and the position of the large Member States if their role in international institutional structures such as G7 and the IMF must be reduced. In these circumstances change will probably be slow and possibly lead to inefficient institutional frameworks.

CONCLUSIONS

European monetary union is undoubtedly leading to significant changes to the international monetary order. These changes are taking place against a background of the globalisation of money and capital markets that is unleashing forces that are not fully understood. Furthermore, the hegemony of the USA in economic and monetary matters has and continues to decline. Nevertheless, the US remains the major economic power with the greatest influence in world economic and monetary matters. The introduction of the euro will probably lead to a significant decline in the current dominance of the dollar as the major international currency, but not in the short-term. In these circumstances it is unsurprising that there should be calls for reform of international institutional frameworks. However, reform of these frameworks will not be easily achieved and the prospect for the creation of inefficient institutional frameworks could be high. The major problem that must be resolved to lessen the risks of such inefficient outcomes is to create new institutional frameworks within the EU that are efficient and that deal appropriately with the new environment that has been created by EMU. This process may be prolonged as many new and complex interrelationships between

the institutions of the EU and national governments have been created by EMU. New and effective relationships with the US and to a lesser extent with Japan have to be worked out and implemented. A better understanding of the impact of the globalisation on capital and money markets is also necessary to ensure that new institutional frameworks are appropriately constructed and operated. Constructing and developing new international institutions that are efficient is unlikely to be accomplished in a short period. However, the onset of major financial crises could require quick institutional change. Given the difficulties of constructing efficient institutional frameworks such an outcome could well lead to the creation of inappropriate regimes that will prove very difficult to alter.

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