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EMU AS CONTRACT

A Constitutional Law and Economics Analysis

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Authorship Declaration

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I acknowledged on this page hereinafter the supervision and guidance I have received from Prof. Dr. Jonathan Yovel.

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Introduction

The assumption of neoclassical economic theory concerning the neutrality of money implies that monetary arrangements are of no (economic) significance. To study the *Economic and Monetary Union* (EMU), we therefore have to appeal to institutional economics. In this thesis, we take a constitutional Law and Economics approach. We observe that money is both a creation of the legal system (the view of the German historical school) and an unintended outcome of history (the view of the Austrian school)¹. We consider European monetary integration from a broad interdisciplinary standpoint (involving law, economics, philosophy, and political science), and we draw both normative and positive conclusions. The metaphor of a contract is our guide. In the discussion, the focus is on an option to exit the EMU as a device to induce the monetary authority to weigh the preferences of the different EMU member countries appropriately.

The idea to write a thesis about monetary integration stems from my studies of Licentiate in Economics (specializations in international and monetary economics) at the Katholieke Universiteit Leuven (2000-2004). The European Master in Law and Economics programme inspired me to study a macro-economic phenomenon from a Law and Economics perspective. Also interested in constitutional economics, the concept of a “monetary constitution” was intriguing to me. After being informed about my admittance at the College of Europe (next academic year), I moreover decided to focus on the EMU.

¹ See Richter (1999,1).

The thesis is structured as follows. In the first section, the EMU is introduced. We consider the historical background of European monetary integration, the costs and benefits of EMU membership, and the institutional setting of the European (System of) Central Bank(s) (E(S)CB). In the second section, we consider the delegation of monetary authority as a three-tier contractual configuration. Citizens decide to grant the state a monopoly franchise in money creation (conceptualized by introducing Buchanan's normative constitutional model). Politicians consequently cede to control to an independent central bank (to be able to credibly pre-commit). Finally, the national central banks, together with the ECB, constitute the ESCB, responsible for monetary policy in the Eurosystem. To conclude this section we consider conceivable alternatives to EMU and observe how monetary sovereignty is shared. The third and final section concentrates on breach of the "monetary contract". Again the three principal-agent relationships are considered in turn. We concentrate on the possibility of "monetary exploitation", on safeguarding mechanisms to guarantee contractual performance by the holder of monetary authority, and on the relationship between political integration and monetary integration.

Section I: The Economic and Monetary Union

In this section we briefly introduce the Economic and Monetary Union (EMU). To do so, we firstly consider the main historic Treaties that laid down the way to European monetary unification. Secondly we look at the costs and benefits of membership of a monetary union. We conclude this section by considering the institutional setting of the European (System of) Central Bank(s) (E(S)CB).

1.1. Historical Background

Different answers can be given with regard to the roots of monetary unification. We approach the history of EMU briefly by focusing on different attempts to set up a supranational institutional framework for monetary cooperation.

- The drive towards European monetary unification was initiated by European leaders meeting at The Hague in December 1969. Prime Minister Pierre Werner of Luxembourg was appointed to head a Committee that would draw up a plan for Economic and Monetary Union. The aim of this plan was to eliminate intra-European exchange rate movements, to centralize EU monetary policy decision-making, and to lower remaining trade barriers within Europe.² Completed in 1970, the *Werner Plan* proposed a three-stage transmission to fixed EU exchange rates and a European monetary authority that would integrate the national banks. The plan called for completion of monetary unification by 1980. Although in 1971 the proposal was adopted, no agreement had then been reached on the implementation of the first stage.³ The plan failed because of the turmoil in foreign exchange markets (1971-1973 dollar crises) that made European leaders unwilling to give up the ability to target monetary policy on domestic goals. One element of the Werner Report survived: the “snake” agreement on an informal joint float of European currencies⁴ against the dollar

² Krugman and Obstfeld (2003, 605).

³ Views differed especially in Germany and France. Germany believed that a single currency could only be viable if all participating countries are economically stable. France wanted monetary cooperation, but without a transfer of monetary sovereignty (cfr. infra). It was also irritated about the growing dominance of the Deutsche Mark (and wanted to have more influence on the Bundesbank policy).

⁴ Germany and the Benelux countries were joined periodically by other countries; French, Italian and British participation was rather brief and sporadic. See Krugman and Obstfeld (2003, 607).

(bilateral exchange rate fluctuations were reduced to a narrow band around a central rate and the participating currencies move together within a band established for the USD).

- The “snake” was not very successful but it served as the prologue to the *European Monetary System* (EMS). Continuing foreign exchange unrest in the 1970s called for more intense monetary cooperation. French president Valérie Giscard d’Estaing⁵ and German Chancellor Helmut Schmidt took the initiative for a new system of fixed but adjustable exchange rates. The EMS took off in 1979, with the *Exchange Rate Mechanism* (ERM) as its cornerstone: a formal network of mutually pegged exchange rates, with in addition a complex set of EMS intervention arrangements to enforce the fluctuation margins⁶. A novelty was the introduction of the *European Currency Unit* (ECU) as a unit of account. Initially it was predicted that the ECU would play an important role in the ERM, but actually it played a larger role in international financial markets (as many ECU-denominated loans were issued).

“In contrast with the Werner Plan, the EMS was not intended to be a stepping-stone towards Economic and Monetary Union” (Eichengreen 1997, 28). Many capital account restrictions remained, and no agreement existed to eliminate differences in national policies. As both inflation rates and fiscal policies diverged substantially in the early 1980s, there were frequent and substantial realignments within the ERM (just as before with the “snake”). Eijffinger and De Haan (2000) distinguish five phases the ERM went through: a turbulent start (1979-1983), a calmer intermediate phase (1983-1987), no realignments (1987-1992), crises (1992-1993) and tranquillity restored (1993-1998). We lack space to go into detail.

- In the 1980s the discussion focused again on EMU. Growing dissatisfaction with the German dominance in the EMS (the ERM has often been conceived as a DM zone), the signing of the *Single European Act* (SEA) in 1986 and the commitment to realize the internal market by 1992⁷ were important stimuli for European monetary integration. In 1988 history repeats itself, as the European Council established a committee to propose stages leading towards EMU. Chairman Jacques Delors, then

⁵ Later on (at the meeting of the European Council in Laeken in December 2001) in the « Declaration of Laeken » appointed president of the European Convention on the future of Europe – responsible for drafting a Treaty on the establishment of a Constitution for Europe. See *infra*.

⁶ See Eijffinger and De Haan (2000, 8-16). All European countries were members of the EMS, whereas only those countries that were able to enforce the fluctuation margins were part of the ERM.

⁷ This became clear when the White Paper of EC Commissioner Lord Cock was published. This paper indicated which trade barriers still had to be removed. See Krugman and Obstfeld (2003, 610-612).

President of the *European Commission* (EC), presented his report in 1989. Just like the Werner Plan, it was a worked-out plan for EMU focusing on irrevocably fixed exchange rates, a single monetary policy, a *European System of* (independent) *Central Banks* (ESCB) and a *European Central Bank* (ECB) with the explicit goal to strive for price stability. Concerning fiscal policies the plan was less far-reaching (the Delors Report does not mention fiscal authority, although the financing of budgetary deficits would be subjected to rules).

The Delors Committee did not specify a timetable, but proposed a gradual process towards EMU in three stages. In the first stage, an effort had to be made to coordinate national monetary policies (e.g. liberalization of capital controls). Realignments of currencies destined to enter EMU would be prohibited in the second stage, save “in exceptional circumstances” (narrowing of the exchange rate margins in the ERM). In the third and final stage, the single currency would come under a new central bank’s authority. The Delors Report contained a proposal to shift monetary sovereignty. Therefore the Treaty of Rome would have to be modified, requiring unanimity (the UK opposed the transfer of powers to a supranational institution). A compromise to start with the first stage of EMU in 1990 could be reached on the Madrid Summit in 1989.

- After the fall of the Berlin Wall, The German desire for reunification gave political momentum to the proposals of the Delors Report. The motive for pursuing EMU is thus not exclusively economic, an observation we have to bear in our minds throughout the whole thesis. Wolf (1997, 2) asserts that “*before, during and after negotiation of the Maastricht Treaty, EMU was justified as a way to bind Germany into Europe – to create a European Germany rather than a German Europe*”. Both the German Chancellor Kohl and French President François Mitterand were in favour of a common European future and considered EMU as a route towards a more political union.

Apart from EMU, the Maastricht Treaty (also known as Treaty on the European Union – TEU) has two more “pillars”: common foreign and security policy as well as domestic and legal affairs. We stay with monetary integration, and mention that governors of central banks of the Member States drafted a statute for the ESCB. A strong political consensus existed about monetary policy, but opinions differed about the assignment of exchange rate policy responsibilities. All Member States wanted the political authorities (in close cooperation with the ECB) to be responsible for the

choice of the exchange rate regime. In the absence of an international agreement, such delegation could however undermine the pursuit of internal price stability⁸. Various intergovernmental conferences resulted in three conclusions. First, that a single currency requires a common monetary policy to be conducted by the ECB. Second, EMU also requires more extensive convergence in the Member States' economic policies. Third, the accomplishment of EMU was accepted as an obligation on the Member States that signed the Treaty. In the concluding Conference in Maastricht (December 1991), it was decided that both the EC and the Council of Ministers had a substantial role to play. The UK negotiated an opt-out clause to the third (single currency) stage of EMU.

Ratification of the Maastricht Treaty turned out to be difficult. The negative outcome of the referendum in Denmark as well as uncertainties with regard to the results of the forthcoming referendum in France resulted in EMS currency crises in 1992. The Sterling and the Lira were forced to leave the ERM, the Peseta was devalued. These obstacles to EMU were ultimately overcome: French voters approved the Treaty in September 1992, albeit with a water-thin majority (51%). Denmark organized a new referendum that included an opt-out clause for the third stage of EMU (as well as for participation in the common defence policy). This referendum was approved by a modest majority of Danish voters in May 1993. In other countries, ratification was contentious and tortuous too⁹. The Maastricht Treaty came into force in November 1993. The collapse of ERM parities in the EMS crises in 1992 and 1993 raised doubts with regard to the viability of a monetary union between countries that had serious difficulties in keeping their currencies aligned. With the start of the second stage of EMU in January 1994, the monetary union was becoming increasingly likely.

During this second stage, the Member States reduced excessive deficits and prepared the establishment of the ESCB. Another prerequisite for entering the third stage concerned the "convergence criteria"¹⁰. Stage three would start at the latest in 1999

⁸ As opposed to external price stability: the European Council is responsible for decisions about formal *exchange rate agreements* for the euro vis-à-vis non-Community currencies. See Eiffinger and De Haan (2000, 36).

⁹ Growing anti-Maastricht sentiment in Germany resulted in a number of appeals to the Federal Constitutional Court alleging that the Treaty was in violation with the German Constitution. The Court ruled that this was not the case, which enabled German ratification of the Treaty.

¹⁰ Four criteria : (1) Inflation rate in year before admission not higher than 1.5% above average of three EU Member States with lowest inflation; (2) Country must have maintained stable exchange rate within the ERM without devaluation on own initiative; (3) Country must have public-sector deficit not higher than 3% of its GDP (except in exceptional and temporary circumstances); (4) Country must have public debt below or approaching reference level of 60% of its GDP. See Krugman and Obstfeld (2003, 614).

with as many Member States that satisfied these criteria by that time. “The surveillance and sanctions over high deficits and debts place national governments under constraints in the exercise of their national fiscal powers”¹¹. On the European Council in Amsterdam in 1997, an additional *Stability and Growth Pact* (SGP) supplemented the convergence criteria. It tightened the fiscal straitjacket further by setting out “*the medium-term budgetary objective of positions close to balance or in surplus*” as well as a timetable for the imposition of financial penalties on countries that fail to fulfil their fiscal obligations. The SGP was not always strictly enforced in practice, an issue we shall return to. Another decision taken in Amsterdam concerns a new exchange-rate mechanism between the euro and the currencies of EU Member States non-participating in the single currency, the ERM II. This mechanism replaced the ERM at the beginning of Stage Three.

Discussion continued on a possible delay of the start of EMU, as several Member States were using one-off measures as well as accounting tricks to satisfy the convergence criteria. On a special meeting in Brussels in May 1998, the European Council nevertheless decided on EMU membership. The convergence reports indicated that 11 countries would be able to participate as founding members in EMU. These countries were: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. As noted supra, both Denmark and the UK stood apart from monetary Union. Sweden was not a member of ERM and did hence not satisfy the convergence criteria. Greece failed to qualify any of the criteria in 1998, but ultimately passed the test and entered EMU in 2001.

1.2. Costs and Benefits of EMU Membership

In the previous subsection, we described the European monetary unification briefly from a historic perspective. Apart from the political rationale behind EMU, we did not question *why* exactly countries (other than Denmark and the UK) were so eager to form a monetary union. In this subsection we consider some (perceived) costs and benefits of EMU membership from a purely economic point of view.

¹¹ Krugman and Obstfeld (2003, 614).

1.2.2. Costs of EMU¹²

The costs of EMU membership are derived from the fact that by giving up its national currency, a country also relinquishes an instrument of economic policy¹³. An independent monetary policy enables a country e.g. to use the exchange rate as a policy instrument. In this subsection we consider how national differences may require exchange rate adjustments. We follow the analysis of De Grauwe (2003). Six costs of EMU are briefly dealt with.

1) A first cost involves *shifts in demand*. This argument stems from the Optimum Currency Area (OCA) theory (Mundell, 1961). Suppose that for some reason European consumers shift their preferences away from French to German products. If the output markets are competitive, this shift implies that the aggregate demand curve for German products shifts upwards while the aggregate demand curve shifts downwards. As a result, output declines in France and increases in Germany. This is likely to lead to additional unemployment in France and a reduction of unemployment in Germany.

Given that the French social security system automatically pays unemployment benefits, the disposable income of French residents doesn't decline to the same extent as the output. This entails that France will have a current account deficit (domestic spending exceeds domestic output). The French government budget deficit increases.

In Germany, the story is a mirror of the French situation. The output increases, and it is likely that the total spending by German residents does not increase to the same extent. At least partly, the additional disposable income is likely to be saved. Germany faces a current account surplus.

As a consequence, both countries have an adjustment problem. The question arises whether a mechanism exists that leads to automatic equilibration, without resort to devaluations and revaluations. The answer is positive: wage flexibility and labour mobility constitute two mechanisms that can bring back equilibrium in the two countries. The first mechanism works as follows: a reduction in the wage claims of French workers and an increase in those of German workers shift the French aggregate supply downward and the German aggregate supply curve upwards. These shifts bring back equilibrium. The second mechanism implies that the French unemployed workers move to Germany where excess demand for labour exists. This movement eliminates the need of declining wages in France and increasing wages in Germany. Equilibrium is attained.

¹² This subsection is entirely based on Eiffinger and De Haan (2000, 18-20) and De Grauwe (2003, 5-23).

¹³ The ability to conduct a national monetary policy, i.e. the ability to change price of its currency, to determine the quantity of national money in circulation.

If wage flexibility and labour mobility are not sufficiently high, however, the adjustment problem does not vanish. In this case, the adjustment process that solves the disequilibrium situation exclusively comes through price increases in Germany. French goods become more competitive again, which leads to an upward shift of the French aggregate demand curve. The German authorities now face a *dilemma*: If they want to resist the inflationary pressures, their current account surplus won't disappear. If they want to eliminate the surplus, however, they have to accept the higher inflation. This dilemma can only be solved by a revaluation of the mark against the franc. This reduces the aggregate demand in Germany, and increases aggregate demand in France. The French unemployment problem as well as the inflation problem in Germany is solved by this single instrument.

The cost of monetary unification thus consists for Germany in the inflation it will have to accept while for France the cost consists of a sustained unemployment problem. Note that the problem could in principle be solved by fiscal means (like the system of *Finanzausgleich* in Germany), but De Grauwe (2003) argues that this system is unlikely to function between sovereign states (as opposed to regions in such a state, see also *infra*). Conversely, a monetary union between two or more nations is desirable if either wage flexibility or labour mobility is sufficient.

2) *Different inflation/unemployment preferences* constitute a second cost of monetary union. Some countries are more averse to inflation than others. This can increase the cost of a common currency. However, such an analysis assumes stability of the Phillips curve (inverse correlation between unemployment and inflation), an assumption that was challenged by Friedman and Phelps¹⁴. This discussion lies outside the scope of this thesis. We stress the likelihood that divergent preferences regarding monetary policy arise.

3) Some labour markets are characterized by highly centralized labour unions (e.g. Germany) whereas in other countries labour unions are decentralized (e.g. the UK). Such *institutional differences in labour markets* may imply significant costs of monetary union, as they may lead to divergent wage and price developments (given the same disturbances).

4) *Differences in the legal systems* of EMU members can have profound effects on the way markets function. De Grauwe (2003) gives the example of the mortgage market¹⁵. As the legal protection of banks differs across countries, mortgages are very different products from one

¹⁴ Nowadays it is accepted that the Phillips curve shifts upwards when inflation expectations are taken into account.

¹⁵ De Grauwe (2003, 18).

country to another (with different degrees of risk). Legal differences also lead to a different frequency of interest rate adjustments in different Member States.

5) *Different growth rates* impose a cost of EMU on the fast-growing members. They will find it more advantageous to have a national currency, which gives them an option to depreciate when they find themselves constrained by unfavourable developments in their trade accounts.

6) *Different fiscal systems* constitute a final cost on EMU (seigniorage problem). Briefly put, this argument says that rational governments will use different sources of revenue so that the marginal cost of raising revenue is equal for all sources. As we return to this argument in section III, we do not deal with it here.

1.2.1. Benefits of EMU¹⁶

Whereas the costs of EMU are of a primarily macro-economic nature, the benefits are mostly situated at the micro-economic level. De Grauwe (2003) asserts that the benefits of EMU include lower transaction costs, more price transparency, reduced exchange rate volatility/uncertainty, and a better functioning internal market. We consider these in turn.

The most visible (and most easily quantifiable) gain from a common currency is the elimination of the cost of exchanging one currency into another. Direct gains arise because such *transaction costs*¹⁷ are a deadweight loss (public gain is not offset by loss of the banks). “*They are like a tax paid by the consumer in exchange for which he gets nothing*” (De Grauwe 2003, 61). If banks can find other profitable activities, society gains: the bank’s employees previously engaged in foreign exchange transactions then can perform more socially useful tasks. According to optimistic estimates, this gain amounts to 0.3 to 0.4 per cent of European GDP.

An indirect effect of the lower transaction costs is an increase in *price transparency*. Indeed, the ability of consumers to compare prices across different countries has increased by the denomination in the same currency. This is supposed to induce European consumers to shop around, which in turn should increase competition. Price discrimination between different countries is still practised widely in Europe, and it is unclear whether the introduction of the euro will be a sufficiently strong force to eliminate the impediment to trade formed by the mere existence of borders (given the abolition of import tariffs and other explicit trade barriers). De Grauwe (2003) concludes that if the single currency contributes to price

¹⁶ This subsection is entirely based on De Grauwe (2003, 60-77) and Eiffinger and De Haan (2000, 16-17).

¹⁷ It is important to note that transaction costs are interpreted here in a narrow way. See *infra*.

convergence, it will not be because of the ease of comparing prices, but rather because it contributes to further economic integration in other ways.

Reduced *exchange rate volatility/uncertainty* results in welfare gains too. Static welfare gains (improvement of allocative efficiency of the price mechanism) are prone to discussion. The world is populated with risk-averse individuals. Exchange rate volatility introduces uncertainty about future revenues of firms, and a certain return is preferred to an uncertain return with the same expected value. Elimination of the exchange risk can therefore increase welfare. One consideration is however troublesome for this analysis: if we recognize that an exchange rate change does not only represent a (downside) risk, but also an opportunity to make profits, exporting can be seen as a put option (to be exercised when the exchange rate turns out to be favourable for a firm). From finance theory we know that the value of an option depends positively on the variability of the underlying assets. This implies that a firm with an option to export benefits from a more volatile exchange rate¹⁸. With regard to consumers one can reason analogously (call option). From this static welfare analysis it is thus unclear whether welfare ultimately increases or declines with less exchange rate uncertainty. A more substantial benefit of less uncertainty could lie in the improved quality of information provided by the price system. Economic agents base their decisions based on this information. If prices become more uncertain, the quality of these decisions decreases¹⁹. We are talking about the *real* exchange rate here: the uncertainty arises because the exchange rate does not reflect price changes (deviations from Purchasing Power Parity). *“Although this effect cannot easily be measured, it is likely to be an important benefit of the introduction of a single currency in Europe”* (De Grauwe 2003, 68).

A third alleged gain of monetary union is that the functioning of the internal market would be improved by the single monetary policy. It is clear that this effect is connected to/interacts with the gains we dealt with supra (especially with price transparency). The most compelling argument in this respect is that competitive positions within the EU would be strongly affected by currency fluctuations. According to Buti and Sapir (1998), this could trigger protectionist policies (that endanger the Single Market). Van Bergeijk et al. (2000) illustrate the corrosive effect of currency fluctuation with the 1992 depreciation of the Italian Lira. This caused a substantial depreciation of Italy's real exchange rate as well as a sharp appreciation of the real exchange rates of France and Germany. This helped Italy to moderate its recession,

¹⁸ For a more extensive line of reasoning as well as a graphical illustration, see De Grauwe (2003, 64-66).

¹⁹ E.g.: a firm that wants to invest in a foreign country bases this decision (inter alia) on the expected future exchange rate. If the actual future spot rate differs from the expected one, the investment can become unprofitable. It is clear that such errors are costly.

but had strong negative repercussions abroad. According to Rose and Van Wincoop (2001), national money serves as a barrier to international trade. They estimate that EMU will cause European trade to rise by over 50%, and assert that these benefits constitute the real case for monetary unification (they may swamp the costs of foregoing an independent monetary policy).

De Grauwe (2003) mentions some other (potential) benefits of EMU we didn't consider. These include the benefits in the form of government revenues and an expansion of the financial sector if the euro would become a truly global currency. Finally, a strong positive effect of monetary unions on trade flows within the union has been found by recent econometric research.

1.3. The European (System of) Central Bank(s)

The European System of Central Banks (ESCB) consists of the European Central Bank (ECB) in Frankfurt and the national central banks (NCBs). It was assigned the following tasks²⁰: to define and implement monetary policy in EMU, to conduct foreign exchange operations, to hold and manage the official foreign reserves of the countries participating in the single currency and to promote the smooth operation of payment systems. The term Eurosystem refers to the ECB and the NCBs of the countries that adopted the euro²¹. As we saw in section I, the Statute of the ESCB is set out in a protocol to the Maastricht Treaty. Hence it has a very solid legal basis: most of the provisions in the protocol can only be changed by an amendment of the Treaty itself. Furthermore the ECB has its own budget, independent from that of the EU. We reflect on the decision-making bodies of the ECB (that govern the ESCB), on its objectives as stipulated in the TEU, and finally on the nature of price stability, the good that traditionally justifies the existence of independent central banks.

1.3.1. Decision-making

The most important decision-making body of the ECB is the *Governing Council*, consisting of the ECB's Executive Board (cfr. infra) and the governors of the 12 NCBs of the euro area²² (Article 106 TEU). The members of this Council are responsible for monetary policy,

²⁰ Eiffinger and De Haan (2000, 32).

²¹ If all countries would adopt the euro, « Eurosystem » would be synonymous to « ESCB ».

²² Countries that adopted the euro are : Austria, Belgium, Ireland, Italy, Finland, France, Germany, Greece, Luxembourg, the Netherlands, Portugal, Spain.

including decisions about intermediate objectives and interest rates. The principle of decentralization stipulates that, “*to the extent deemed possible and appropriate, the ECB shall have recourse to the national central banks to carry out operations, which form part of the tasks of the Eurosystem*” (Eiffinger and De Haan 2000, 33). As operational arms of the ECB, the NCBs have to act in accordance with ECB guidelines and instructions. If it comes to monetary policy-making, the 18 members of the Governing Council are supposed not to act as a national representative but instead in a fully independent way. Also the voting system in the Governing Council is decentralized: 12 from the 18 members come from NCBs²³. To stress the collective responsibility of the Council, a “*one (wo)man, one vote*” principle is adhered to (Article 102 TEU). The Governing Council meets every two weeks.

The Executive Board of the ECB is responsible for the day-to-day implementation of monetary decisions taken by the Governing Council. It consists of the President, the Vice-President, and (up to and currently) four other members (appointed by the European Council for non-renewable terms of 8 year). In fulfilling its tasks, the Board gives instructions to NCBs.

The General Council of the ECB consists of the President, the Vice-President and the Governors of all fifteen NCBs (thus also of non-Eurosystem countries²⁴). The General Council has no role in monetary policy, but contributes to the work of the ESCB in different areas (e.g. collecting statistics, employment conditions of ECB’s staff etc.). The Council meets every three months.

1.3.2. Objectives

In the Maastricht Treaty (Protocol on the Statute of the ESCB and of the ECB), we read that “*the primary objective of the ESCB shall be to maintain price stability*” (Article 105.1 TEU). A precise definition of price stability is however not given. In October 1998 the Governing Council defined price stability as a year-on-year increase in the *Harmonised Index of Consumer Prices*²⁵ for the euro area of below 2 percent. We note that this target implies that deflation is not considered to be consistent with price stability either. The formulation “*for the euro area*” emphasizes that are-wide developments are the only determinants of monetary

²³ This is a relatively large number in comparison with the Bundesbank (9 out of 17 members from the Land central banks), as well as with the FED (5 out of 12 members from the regional Federal Reserve Banks). See Eiffinger and De Haan (2000, 34).

²⁴ Countries that belong to the ESCB but did not adopt the euro, i.e. Denmark, Sweden and the UK.

²⁵ This is a comprehensive measure for inflation that reflects the general public’s focus on consumer goods. It is moreover the only harmonized price index currently available in the euro area. See Eiffinger and De Haan (2000, 61).

policy decisions. As a secondary, subordinate objective, the ECB is supposed to support the general economic policies in the EU, “with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2”. A look at this article demonstrates that these goals are numerous²⁶. According to Richter (1999), we deal with a “magic octagon or decagon” here:

*“Even though the aim of price stability is primary for the ECB, Keynesians will argue for a trade-off with the level of employment, and socially-orientated partners for a trade-off with social policy. How far the ECB accedes to such wishes or notions is a question of judgment. Its decision depends upon the basic attitude of the members of its Governing Council towards economic and social policy, and those members’ domestic problems”.*²⁷

1.3.3. Price Stability as public good

Price stability is considered a public good by many (Voigt 1999, 191). Indeed, it seems to be both non-rivalrous and non-excludable. Preferences are however not homogeneous with regard to the good: debtors will consider it a public bad instead of a public good. For some EMU members price stability offered by the union can turn out to be a ‘bad’, as they may prefer a more lax monetary policy to stimulate economic activity. Similarly, exporters profit from an undervalued currency while importers suffer.

In general we can regard price stability as socially beneficial. In absence of cooperation, border-crossing externalities result from currency competition (justifying regulation). A race to the bottom in currency devaluation has prisoner’s dilemma properties: although stability in prices and exchange rates makes everybody better off, policy-makers of a particular country have an incentive to defect and increase money supply (lowering interest rate, devaluing currency). A European common currency is one institutional means of addressing this problem (of Pareto inefficiency). *Infra* we return to this issue (subsection 2.3.).

²⁶ They comprise for example common policies “to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth, respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social cohesion and solidarity among Member States” (Article 2 TEU).

²⁷ Richter (1999, 15).

Section II: European Monetary Contract?

In this section, monetary authority is considered from a broad contractual perspective. We make use of instruments from both social contract and (contract) law and economics. The contract is conceptualized as a three-tier principal-agent problem²⁸. The *citizens* are the ultimate principals. They delegate monetary power to the *state* (politicians), which constitutes the first stage. We will rationalize this delegation mechanism from a normative perspective by using Buchanan's contractarian notion of the constitution. The politicians, having been assigned the monetary power by the polity, may decide to cede control in turn to an *independent central bank*. This forms a puzzle for political theory (Buitter and Sibert 2001): even if CBI is desirable, it is not clear from a positive perspective why independent central banks are created in the first place (not every desirable policy gets implemented in practice). A crucial feature of this second delegation is its constitutional nature. The final transfer of responsibility for monetary policy is supranational. As we mentioned before, the TEU moves monetary authority from the NCBs towards the *ECB*.

In this section we discuss the three "contracts". We then go into some detail on the notion "monetary sovereignty", and conclude with a brief look at alternatives for EMU.

2.1. Constitutional Choice and Delegation of Monetary Authority

"C'est une expérience éternelle que tout homme qui a du pouvoir est porté à en abuser; il va jusqu'à ce qu'il trouve des limites".

Montesquieu, *De l'Esprit des Lois*²⁹

Rules concerning monetary policy-making are *constitutionalized*, i.e. set up in such a way that they cannot be easily modified by the executive or legislative powers³⁰. This suggests that the constitutional economics discipline – with the basic rules of the social order as its research

²⁸ This idea arised by combining Buitter and Sibert (2001, 2.), who discuss CBI from an analogous perspective (I just add one more level – the transfer of power from a NB to the ECB), and Hodson and Maher (2001, 4)

²⁹ Quoted by Brennan en Buchanan (1980, v).

³⁰ In the case of the EMU, the Maastricht Treaty contains provisions for the ESCB. This Treaty was enshrined in the "*Treaty establishing a Constitution for Europe*" proposed by the European Convention (also known as Convention on the Future of Europe), but afterwards rejected in Dutch and French referenda. Constitutional features of the monetary union are thus not to be doubted (even though national constitutions often do not mention either the central bank or monetary policy). A stable pattern of rules exists (explicitly enacted or implicitly evolved) that structures and influences social interaction.

object³¹ – is useful if we want to clarify the first transfer of monetary power (from the public to the state). More specifically, we draw on the constitutional model of James Buchanan.

The starting point of this model resembles the Hobbesian state of nature, a hypothetical (i.e. *as if*) pre-societal state of anarchy in which people's life is "*poor, solitary, nasty, brutish, and short*"³². Property rights are not generally accepted, and the "natural distribution" is the result of producing, stealing and protecting goods. In this "anarchistic equilibrium", the marginal cost of protection equals its marginal utility. The waste of resources for stealing and protecting is socially inefficient. The unattractiveness of this situation induces individuals to accept constraints on their liberty. The rationale for doing so is self-preservation (fear for a violent death). In Hobbes' theory, people escape anarchy by drafting a social contract with only one clause: all individuals' subjective rights are transferred simultaneously to a third party, the *Leviathan*. This is the (exogenous) origin of state sovereignty (Agnew 2005). In return, the only obligation of this sovereign is to do what he was originally created for: to rule. External to the contract, the Leviathan is still "in the natural state". Given the psychological characteristics Hobbes assigns to people in this state, we can interpret the Leviathan concept as a "*malevolent despot*" instead of the "benevolent despot" that the state is usually assumed to be in orthodox economic theory (see subsection 3.2.2.).

Questions arise with respect to the content of the social contract. What would rational individuals stipulate? Contrary to Hobbes (whose theory allows the sovereign to rule in a fully discretionary way), Buchanan assumes that the sovereign "performs" the contract, credibly constrained by the constitution drafted in the hypothetical pre-societal "constitutional stage"³³. The focus is here on the "choice of rules" (as opposed to the choice *within* rules – the usual object of economic analysis). Brennan and Buchanan (1980) introduce an analogy with the rules of a game. A game is described by its rules – its constitution. These rules establish the framework within which the playing of the game proceeds; they set boundaries on what activities are legitimate, describe the objects of the game and determine who wins. A player's choice of a strategy in the course of a game is categorically quite distinct from her prior choice of a set of rules. "*A tennis player after hitting a particular shot may reasonably wish that the net was lower, yet prior to the game he may have agreed to a set of rules in which the height of the net was specified*" (Brennan and Buchanan 1980, 3).

³¹ See Buchanan (1998, 585).

³² Decorte et al.(2001, 417).

³³ The question to which extent Buchanan is a real *Hobbesian* lies outside the scope of this thesis.

This hypothetical “choice of rules” is similar to the choice behind a Rawlsian “*veil of ignorance*”. Ignorant about their future in society, individuals select the social contract clauses such that it constrains the budget-maximizing Leviathan once the “*societal game*” starts. When entering the contract, each individual is uncertain about her postconstitutional productivity, and thus about the postconstitutional decisions she will take. The individual does not know to which specific group, sector or class it belongs, thus egoism and altruism coincide behind the veil. A related consequence of the informational assumption is that it allows for unanimous consent. Unwilling to allow for interpersonal utility comparison, Buchanan borrows the unanimity principle proposed by the Swedish economist Knut Wicksell³⁴. Conceptual unanimity is the criterion for the assessment of a (change of the) constitution: as the rights of *all* individuals are to be transferred to the external sovereign by means of the contract, consent of each single individual is required. By definition, this criterion assures that the constitution (or the constitutional change) is a Pareto-improvement. An individual in the constitutional choice situation, when evaluating the efficacy of granting the government a monopoly franchise in money creation, might consider the possibility of Leviathan exploitation of the revenue potential of the money-creating power³⁵. Constitutional rules for money creation might be selected, and if fiscal instruments are chosen such that an efficient level of public goods is supplied when the government maximizes its revenues, then the citizen will wish to guard against additional revenue-raising through an inflationary policy (see *infra*).

For a contractual analysis of the EMU, this social contract notion is necessary but insufficient. It is necessary since individuals operate and interact with one another within a set of stable monetary rules/institutions that cannot be modified easily (see *supra*). It is however insufficient for at least three reasons. First, we deal not with a multitude of individuals that are bargaining on a hypothetical social contract, but with an explicit monetary agreement between a finite number of contracting parties (in subsection 2.2. as little as two)³⁶. Second, other approaches of (monetary) sovereignty are not exogenous but instead look at sovereignty as “socially constructed as states interact with, imitate, and conflict with one another” (Agnew 2005)³⁷ (see *infra*). A third reason concerns the informational assumptions.

³⁴ In his *Finanztheoretische Untersuchungen* (Jena, Gustav Fisher, 1896).

³⁵ Brennan and Buchanan (1980, 128).

³⁶ See also Voigt (1999, 107).

³⁷ Agnew (2005, 440).

*“Individuals must be fully informed about the alternative positions available to the society under cooperative action, positions described by a vector of total production and distributive shares. They cannot, however, know anything at all about their own roles or situations relative to those of others in the community”.*³⁸

Robert Cooter criticized this assumption that individuals have to know everything in general but nothing in particular with regard to Rawls’ “original position”, and Stefan Voigt extended this critique to Buchanan’s constitutional choice situation³⁹. The discrepancy between the normative constitutional model of Buchanan and European monetary reality necessitates more positive contract concepts.

2.2. Central Bank Independence

The independent monetary authority is an agency of the state. According to Buiter and Sibert (2001, 2), “[d]elegating monetary policy to a collective of appointed technocrats means opening the door to a principal-agent problem between the government (the principal) and the agent (the independent central bank)”. This second “contract” transfers monetary authority from the state to an independent NCB. In a second-best world, it is conceivable that a two-stage principal-agent configuration might produce superior outcomes to a one-stage configuration between the citizens and the State (Buiter and Sibert 2001). At first sight it is however unclear (both from a positive public choice as from a normative constitutional Leviathan perspective⁴⁰) why politicians – whose interests seem negatively affected by CBI – would be willing to give up monetary policy in practice. Even if an independent central bank is in the public interest, why do politicians establish one? It must be that institutions matter. Monetary and international economists traditionally justify CBI by referring to the model of Barro and Gordon (1983). These authors claim that the bank’s purchasing power commitment is enforced by the money users’ implicit threat to destroy its president’s reputation⁴¹. Miller (1998) provides us with a rent extraction explanation similar to the famous paper of Landes and Posner (1975) on the role of the independent judiciary. These authors argue that judges are more credible enforcers of political deals than the politicians themselves, since the latter have an incentive to undo the deals ex post. The same holds for central banking: it is

³⁸ Buchanan (1977, 205).

³⁹ See Buchanan (1977, 205) and Voigt (1999, 113).

⁴⁰ The latter of course assumes that the Leviathan is assigned the monetary authority in the constitutional stage (since otherwise there is simply nothing to give up). This is far from certain, as we will see infra.

⁴¹ Barro and Gordon (1983, 108).

insufficient for a politician to promise not to inflate the currency in the future because, given the ex post opportunity, self-interested politicians will do so anyway⁴² (this is a typical example of a *time-inconsistency* problem). “*In the absence of an independent central bank, politicians can benefit in the short run by creating an unanticipated burst of inflation that unravels many interest-group deals*” (Miller 1998, 433)⁴³. By transferring the monetary power to an independent NCB, however, politicians gain the ability – at the time of bargaining with interest groups – to make *credible pre-commitments* not to change the price level. Miller (1998) concludes that this gain exceeds the rent that can be extracted from the unravelling of political deals in case politicians have independent authority to set monetary policy⁴⁴. Quaglia (2003) asserts analogously that politicians decide on self-limiting constitutional rules concerning macro-economic policy because of the gain that can be obtained by a mechanism to reliably pre-commit not to engage in inflationary actions.

One such mechanism is the stipulation of CBI in the constitution. The sovereign (the state) cannot credibly commit itself to a particular delegation structure, and therefore neither to a particular set of rules/actions to be implemented by the agent, if the sovereign is unable to commit itself to that set of rules⁴⁵. Politicians therefore resort to constitutional change: “*It seems that there are occasional, infrequent interludes of ‘extraordinary politics’ or windows of constitutional opportunity, during which otherwise opportunistic actors can commit themselves to enact certain broad, quasi-constitutional principles or rules, embodied in institutions*” (Buiter and Sibert 2001, 2)⁴⁶.

We end up with a kind of *monetary constitution*. Friedman (1962) contends that proponents of CBI implicitly argue that control over money is an essential governmental function comparable to the exercise of legislative, judicial or administrative powers⁴⁷. In all these forms of authority, it is crucial to distinguish between the basic structure and the day-to-day operation within that structure (see subsection 2.1.). Regarding monetary powers, the idea behind CBI is that “*the monetary structure needs a kind of a monetary constitution, which*

⁴² Miller (1998, 433).

⁴³ Many political/interest-group deals are (implicitly or explicitly) tied to nominal price levels (e.g. subsidies, transfers, certain tax rules,...). Ex ante politicians have an incentive to sell deals to interest groups, in exchange for rents. Ex post they are however induced to undo the deal (aiming at future rents – the interest groups have to return to the politicians and to renegotiate the deal). See Miller (1998, 436-445), “*The Rent-Extraction Motivation for Inflation*”.

⁴⁴ “*If they do not inflate the currency ex post, they can obtain more in payments for their services ex ante because the interest group or groups that are paying for the deal will not discount their upfront compensation by the risk that the deal will lack durability due to future inflation*”. Ibidem.

⁴⁵ Buiter and Sibert (2001, 2).

⁴⁶ We remark that constitutions can be changed (re-interpreted or amended) in many different ways. This discussion is too extensive to include in this thesis. I refer the interested reader to Voigt (1999).

⁴⁷ Friedman (1962, 224).

takes the form of rules establishing and limiting the central bank as to the powers that it is given, its reserve requirements, and so on”⁴⁸. The central bank is thus seen as an independent branch of government, just like the legislative, executive, and judicial branches.

If CBI is indeed desirable, the question rises why we do not observe the most extreme form of CBI. Economic theory suggests a market decision instead of a political decision, i.e. competition between different currencies with the most stable emerging as the preferred one instead of a governmental monopoly on money creation (Backhaus 1999)⁴⁹. The Bank of England, entirely private and not formally part of the government until after World War II, constitutes an excellent example (Friedman 1962)⁵⁰. Greenspan (2001), the President of the American Federal Reserve System (FED), is known as an advocate of currency competition. Referring to the free-banking era before the American Civil War, he asserts that “*market discipline is, and always has been, the first line of regulatory defence in protecting the safety and soundness of the banking system*”⁵¹. We do not go into detail here on the viability and desirability of currency competition. We however mention that Hayek (1976), whose constitutional model competes with that of Buchanan⁵², argues in favour of a system of free, private banking outside of government influence⁵³. Personally I sympathize with an argument favouring a non-private central bank that is similar to the argument of Nozick (1974). This philosopher-economist departs from the ideal of a functioning *anarchy*⁵⁴. Realizing that a coercive monopoly will arise automatically, he recognizes the desirability of a minimal “night-watchman *state*”⁵⁵ as a “framework for *utopia*”⁵⁶. One can reason similarly that

⁴⁸ Friedman (1962, 225).

⁴⁹ See Backhaus (1999, 262-263): “*In principle, a common market requires not a single currency; it is rather compatible with a large number of different competing currencies, as long as the different units of exchange can be compared through a common unit of account*”. Wolf (1997, 6) argues analogously.

⁵⁰ Friedman (1962, 226). See for a US example Mundell (1997, 219): “[...] *Andrew Jackson resolved a [...] regional controversy over monetary policy by killing off the Second Bank of the United States, thereby initiating eight decades of the ultimate in central bank independence: no central bank whatsoever*”.

⁵¹ Greenspan (2001, 6). In the mentioned era, banks issuing currencies were supervised by the market: they competed for a reputation of safe and sound banking.

⁵² See Voigt (1999, 7-36), “*Two Competing Approaches to Constitutional Economics – A Comparison of Buchanan and Hayek*”.

⁵³ It must be said that Hayek radically changed his opinion in this respect only after he received the Nobel Prize in 1974. Before he asserted that “no sensible person would deny that the monetary system must be under central control” (NBC radio broadcast, April 1945). See Ebeling (1999).

⁵⁴ This corresponds to a great extent with the position of Buchanan. Readers interested in the differences between the philosophies of these authors are recommended to read Buchanan’s critique of Nozick (1974) in Buchanan (1977, 50 – 63): Chapter 4: “*The Libertarian Legitimacy of the State*”. See also Buchanan (1977, 11) who describes himself in the first place as a “philosophical anarchist”, but on a second and more realistic level as a “contractarian constitutionalist”.

⁵⁵ Nozick (1974, 26). See also p. 149: “*The minimal state is the most extensive state that can be justified. Any state more extensive violates people’s rights*”.

⁵⁶ See Nozick (1974, 297-334).

assigning the responsibility to a separate, monetary branch of government is preferable to an emerging monopoly of a private issuer of a dominant currency.

2.3. A Supranational Contract

According to Raz (1986), “*the case for the legitimacy of any political authority rests to a large extent on its ability to solve co-ordination problems and extricate the population from prisoner’s dilemma type situations*”⁵⁷. In the first situation, all of us are supposed to want the same course of action, since this leads to the efficient outcome (convention/network externalities). In the second situation, however, the Nash equilibrium is Pareto – suboptimal. It is remarkable that both explanations are given for the third transfer of monetary powers – that from the independent NCBs to the ECB. We consider the arguments in turn.

Hasebe (1999) asserts that, by choosing a single currency, a *co-ordination game* is solved⁵⁸. Indeterminacy is reduced, and people incur less transaction costs (see Section I). From this perspective, the euro is a convention much like driving on the right side of the road. To my opinion this interpretation of the contract is inferior to the one that is offered infra. Conventions arise (and survive) spontaneously, and are of an arbitrary nature. At least under certain conditions, this kind of norms tends towards efficiency by coordinating human behaviour in long-run relationships (Cooter and Ulen 2004)⁵⁹ – people imitate the majority of their reference group. If this is the case, the analysis again points towards currency competition rather than monetary union. Restricting the social value of EMU to the solution of a co-ordination problem, therefore, seems too reductionist an approach (since the problem would be solved also without any legislative intervention).

Quaglia (1993) contends that politicians supranationally tie their hands in macro-economic policy-making because they want to address a *prisoner’s dilemma* problem. Independent NCBs exclusively focus on the performance of the domestic economy. In effect, they have no incentive to internalize cross-country externalities. The threat is that inflation becomes a beggar-they-neighbour policy⁶⁰: if policy is uncoordinated, “*frictions in the domestic economy may cause or exacerbate the temptation to inflate*” (Sibert 1999, 79). The creation of the EMS was motivated by the desire to rule out competitive devaluations between

⁵⁷ Raz (1986, 132). See also Hasebe (1999, 114).

⁵⁸ Hasebe (1999, 114).

⁵⁹ See Cooter and Ulen (2004, 438).

⁶⁰ This term is used for a domestic measure that benefits the home country only because it worsens the economic conditions abroad. See Krugman and Obstfeld (2003, 544).

participating Member States⁶¹. Also during the negotiations for the Maastricht Treaty the avoidance of *free-riding* was a major concern: the independence of the ECB, the convergence criteria, and the SGP all aimed at tying the hands of policy-makers in Member States that were considered to be potential free-riders. Again the rationale of the contract is *credible pre-commitment*. It enables cooperation, and may compel policy-makers in other countries to behave in a particular way. Quaglia (1993) also asserts that it is better to have some room to move than to be apparently free but *de facto* constrained⁶². According to her, another rationale of the contract is thus a country's desire to *increase the room for manoeuvre*. With regard to the EMS, Gros and Thygsen (1998) demonstrate that the System successfully insulated participating countries from extra-EC (particularly US) monetary and exchange rate policy. This increased these countries' autonomy. Certain members moreover used the EMS as a "*disinflationary device*": they effectively "*borrowed credibility*" from an independent NCB with a strong anti-inflationary reputation (in the EMS case: the German Bundesbank). Concerning the EMU project, it is noteworthy that countries that were not the leader of the EMS (thus all except Germany) gained a voice in now common policy. Previously they followed the Germany-targeting monetary policy of the Bundesbank and were excluded from decision-making⁶³. The downward convergence of interest rates in the eurozone also increased room for manoeuvre, since it lowered the cost of outstanding public debt. Additionally, rating agencies gave better rankings to public debts of several EMU countries. Consequently, fiscal policy discretion is widened in the medium/long run, since funds can be used for different purposes. One caveat should however be made: the fiscal constraints of the SGP already prove to be loose, and are likely to be made more flexible in the future. Quaglia (1993) identifies a third rationale of a supranational contract: monetary integration can serve as an "*external constraint*" on the domestic environment⁶⁴. Both the EMS and the EMU projects brought about domestic reforms and instilled discipline in national economies, especially in countries with an outdated industrial sector and strong militant trade unions. Another contractual interpretation of the EMU is given by Sibert (1999). Her analysis is inspired by research in the theory of the firm by Hart (1993), who considers ownership as a

⁶¹ Intra-EC trade had increased enormously since the creation of the EEC in 1957, and suffered from exchange rate instability. See section I as well as Quaglia (1993, 239).

⁶² Quaglia (1999, 240-241).

⁶³ That they also lose autonomy is the focus in section IV.

⁶⁴ Quaglia (1999, 241).

substitute for firms to write complete contracts⁶⁵. A monetary union may play a similar role to ownership in resolving problems associated with incomplete contracts.

*“If nations could write and commit themselves to contracts specifying optimal policies in every state of the world, then it is difficult to see the allure of a monetary union. It imposes a single inflation rate on potentially asymmetric nations and any outcome that could be achieved with a common currency could be achieved with country-specific currencies”*⁶⁶

In section I, we learnt that the uncoordinated monetary policy in Europe caused negative spillovers across countries (not to forget that we also discussed the negative externalities that result from EMU). Once it is assumed that complete contracting is infeasible, i.e. that the NCBs are unable to credibly pre-commit, a threat emerges of *ex post* renegotiation and therefore also of *ex ante* opportunistic behaviour. The challenge is to address this hold-up problem by an appropriate European monetary framework. In theory all gains from trade could be captured if this framework can be designed to enforce “*ex post* optimal monetary policy contract”⁶⁷. This statement of course assumes efficient bargaining (zero transaction costs) as well as fiscal transfers between Member States⁶⁸. The conclusion of Sibert (1999) is consistent with the OCA Theory of Mundell (1961): if countries are sufficiently similar with respect to their costs of reform, EMU is welfare-enhancing; if not, then countries are better off if they maintain their national currency.

2.4. Alternatives to EMU

From the discussion it became clear that EMU can be regarded as an extremely far-reaching contractual agreement. The Maastricht Treaty, a supranational constitutional charter, was used as a device to tie the hands of macro-economic policy-makers among Member States. The rationale is credible pre-commitment. Before we focus on monetary sovereignty, it is

⁶⁵ Ownership provides a means of filling gaps in incomplete contracts (if one firm buys another, it acquires the residual right of control and can make all decisions that were previously not specified in the contract).

⁶⁶ Sibert (1999, 79).

⁶⁷ Sibert (1999, 80).

⁶⁸ This is related to fiscal federalism literature that suggests that in case efficient bargaining is feasible, a decentralized confederation of states can achieve a first-best outcome. Also the Coasean nature of the argument is clear.

interesting to consider which alternatives to EMU are conceivable. Richter (1999) suggests five such alternatives⁶⁹:

- 1) Return to a pre-1945 gold standard;
- 2) A paper standard with fixed exchange rates against some member country à la Bretton Woods⁷⁰;
- 3) A paper standard with flexible exchange rates, both within and without Europe;
- 4) A paper standard with free competition between the national currencies of the member countries (see proposal of Hayek supra); and
- 5) A paper standard with free competition between the national currency and the “euro”.

This scholar assesses the alternative monetary systems using three criteria: the verifiability of the currency commitment, its enforceability, and the transaction costs involved. The latter are interpreted in a broad sense. Transactions costs not only include the direct costs of using money (the interpretation of macro-economists – in our context primarily the cost of exchanging one currency for another), but also e.g. the (inter)national administrative costs, the negotiation costs, etc. This interpretation corresponds with the broad notion of transaction costs in Law and Economics scholarship. Two assessments are made: one without and one with regard to the initial situation.

We assign number 6 to EMU, and introduce a vector (a,b,c,d,e,f) with a the best and f the worst outcome. Without taking the situation at the break-up of the EMS into account, Richter (1999) gives the following overall ranking⁷¹: (1,3,5,4,6,3). We remark the low score for EMU. The author asserts that under this institutional arrangement, the verifiability of the monetary commitment is very difficult, since little relevant information is conveyed by a Europe-wide price index. He also argues that enforceability is very low, which surprises us somewhat given the statutory independence of the ECB. The reason is the absence of a European “voice” as well as the high cost of exit. We shall return to these issues (subsection 3.4.2.). Transactions costs in the narrow sense are by definition eliminated by EMU. In a broader sense, however, EMU can also raise transaction costs (because of the negotiation and administrative costs that Member States incur to balance out the effects of asymmetric shocks)⁷².

The second evaluation is inspired by Douglass North. This NIE scholar asserts that “[m]uch... of history is path dependent simply by nature of constraints from the past

⁶⁹ Richter (1999, 3).

⁷⁰ The Bretton Woods agreement was the basis for the postwar international monetary system from 1944 until 1973. It consisted of fixed exchange rates vis-à-vis the U.S. Dollar and an unvarying dollar price of gold. See Krugman and Obstfeld (2003, 546-567).

⁷¹ He assigns the same weight to all three criteria. We lack space to go into detail.

⁷² See Richter (1999, 12).

imposing limits on current choices and therefore making the current choice set intelligible” (North 1990, 137). Richter (1999) starts from the situation in 1989-1990: the time of the beginnings of the German reunification process as well as of the upheavals in Eastern Europe (see section I). He concludes that EMU represents a somewhat exaggerated form of “taming the German Leviathan”⁷³. Other options were available to bind Germany further into the Western alliance than an EMU with the prospect/necessity of incorporation of additional countries. Richter (1999) regrets that the trade-off between “expenditure of resources for the foundation and administration of EMU” and “additional political coherence of the Western alliance” was never scientifically scrutinized. Again we underline the political momentum as an extremely important driving force of European monetary unification.

2.5. Shared Monetary Sovereignty

The EMU contract implies a denationalization of currencies, long seen as the badges of state sovereignty. The empirical regularity outside EMU is indeed “one country – one money” (Mussa 1997, 217). *“In conventional political discourse, sovereignty is about central state authority”* (Agnew 2005, 439). It is seen as state-based and territorial. In this conventional story, the state is given an ontological and moral character that is equivalent to that of the individual in classical liberalism. Agnew (2005) emphasizes that statehood and personhood are not pre-given phenomena, but instead subjectivities formed out of social interaction and mutual recognition. Statehood is the outcome and not the pre-existing basis of struggles for control. The state is in other words not ontologically prior to a set of interstate relations, and sovereignty results from mutual recognition among states.

This interpretation clearly opposes our normative view of the individual in the constitutional choice situation as the ideal designer of the monetary constitution. Sovereignty results from states in interaction and not from the war of all against all in the Hobbesian state of nature. I nevertheless believe that Buchanan’s constitutional model is useful as a normative benchmark for evaluating a contractual right to exit the EMU (see next section). Our three-stage conceptualization of the monetary contract is moreover broader than the Leviathan approach. The transfer of monetary powers from the state to an independent NCB causes a *democratic deficit*⁷⁴. Indeed, the constitutionalization of macroeconomic rules constrains the exercise of majoritarian democracy. This enhances credibility, but decreases the accountability of the

⁷³ Richter (1999, 13).

⁷⁴ See Backhaus (1999, 264-265).

monetary authority, which in turn might trigger political tension. We observe a trade-off in monetary coordination policy between credibility (with its audience of the markets) and legitimacy (with its audience of the general public). A central bank is fully independent if the cost of “calling it back” politically is prohibitively high. The ECB enjoys a higher level of independence than both the Federal Reserve in the United States and the German Bundesbank. The bank is however less accountable than either of these two institutions (De Grauwe 2003)⁷⁵. On the one hand, CBI is generally seen as a prerequisite for price stability. On the other hand it provoked much critique on grounds of lack of accountability in a broader sense⁷⁶. The ECB is explicitly designed not to be directly accountable to the governments of the eurozone states (see section I), and formal accountability to the European Parliament (EP) is weak. A meaningful democratic governance mechanism seems to be absent in EMU.

The supranational character of the monetary contract aggravates the democratic deficit: as long as economic policy remains within national competence it retains its legitimacy *prima facie* through the usual democratic mandate. The more economic policy is an EU creature, however, the further we move away from this source of legitimacy, and the more an alternative basis for legitimacy is needed (Hodson and Maher 2001)⁷⁷. Again a trade-off arises, i.e. the constitutionalization of macro-economic policy-making brings about credible pre-commitment (benefit) at a cost of reduced legitimacy. In the monetary realm, an exception to the conventional rule of absolute, indivisible sovereignty is made. Currencies, traditionally regarded as a symbolic and key material feature of central state authority, lost their national character. Agnew (2005) emphasizes the impact of globalization on the “geography of money”. As a medium of exchange, “*money is a belief that has to be shared with other people*”⁷⁸.

The question concerning the origin of sovereignty is essentially of a philosophical and political nature, and lies outside the scope of this Law and Economics thesis. We nevertheless note that, in the case of the EMU, monetary sovereignty is neither territorial (national-state currency dominates state territory, e.g. China) nor transnational (currency issued by powerful state circulates widely among world financial centers, floats freely and is a reserve currency in relation to which other currencies are dominated, e.g. United States and dollarization in Latin America). We observe instead a formal monetary alliance that operates through full monetary

⁷⁵ See De Grauwe (2003, 159-163).

⁷⁶ *Ibidem*.

⁷⁷ Hodson and Maher (2001, 4). In our concluding remark we mention the opinion of Max Weber.

⁷⁸ Agnew (2005, 447-449).

union with an external floating exchange rate. Sovereignty is *shared*⁷⁹. This is noteworthy, as with increasing economic and political interdependence the question rises to which extent members of the EMU are entitled to re-introduce their domestic currency. This question is addressed in the next section.

⁷⁹ Agnew (2005, 447-449).

Section III: Breach of the contract

“For a monetary union, ‘What the Lord hath joined together, let no man put asunder’.”

Mussa (1997, 218).

“Raus aus dem Euro, volldampf zurück, weg von Brüssel, heim in die trauten Nationalstaaten?”

Der Spiegel, May 6th 2005.

In this section, we discuss breach of the separate contracts. The focus is on the third, supranational contract: should members of the EMU be entitled to regain monetary sovereignty by withdrawing from the union? We start by observing that the current EMU is not an OCA. Subsequently, we return to the Leviathan model and consider how a budget-maximizing monetary authority can be constrained by a secession option. Afterwards, we revisit CBI and think about the effects of a right to exit the EMU. We conclude by critically examining how “irrevocable” European monetary integration is indeed.

3.1. EMU and Optimum Currency Area Theory

We referred to the OCA theory of Mundell (1961) in section I. In this subsection, we briefly address the question whether the EMU fits the criteria for such an OCA. A basic axiom of international monetary economics is incompatibility of full international capital mobility, exchange rate stability, and national monetary policy autonomy. Of these three goals that most countries pursue, only two can be attained simultaneously, i.e. open economies face a “*policy trilemma*” (Krugman and Obstfeld 2003)⁸⁰. The decision to adopt the euro is consequently the result of *constrained* optimization. “[G]iven the freedom of capital flows, the choice is between freely floating exchange rates and monetary union” (Wyplosz 1997, 6).

⁸⁰ Krugman and Obstfeld (2003, 699). This is also known as the “*inconsistent trinity*”. It arises because, under full capital mobility, a nation’s domestic interest rate is tied to the world interest rate (i.e. at least the case for a country that is too small to influence worldwide financial conditions). More precisely, the difference between the domestic and the world interest rate is equal to the expected rate of depreciation of the exchange rate (of the domestic currency)..

This choice involves a look at three criteria⁸¹. Firstly, EMU scores well on the *openness to mutual trade* criterion (intra-European trade). More openness implies that more prices are determined on the European level, which reduces the impact of an exchange rate adjustment on relative prices, and hence favours EMU (as the benefit of an independent national monetary policy declines). Also on the second criterion, *diversification of individual economies*, EMU does well. The general result of empirical research on this issue indicates more co-movement in macroeconomic variables among EMU Member States than between individual countries and the U.S. or Japan⁸². Other research suggests that Europe is much less an OCA than the U.S.⁸³. The same conclusion is reached regarding the third criterion, *labour mobility*. Not only European nations, but even European regions lack labour mobility (Eichengreen 1991). It is therefore no surprise that EMU scores bad here. We recall that the choice is not between EMU and heaven. The choice is instead between EMU and free-floating exchange rates. In the latter case, monetary policies are potentially poorly coordinated (see our discussion about the supranational features of the monetary contract), and that within an area that gradually becomes as tightly integrated as the US⁸⁴. In the former, the difficulty remains to draw a borderline between countries that form part of an OCA, and countries that do not belong to it.

*“For some countries with a large degree of openness relative to the other EU partners, the cost-benefit analysis is likely to show net benefits of being in the EMU. This is most likely to be the case in Benelux countries and Ireland. For countries at the other end of the ranking, the UK and Greece, it is less clear that they belong to an optimal currency area with the rest.”*⁸⁵

Observing that the current EMU members do not constitute an OCA, a potential enlargement of the EMU – foreseeable since the accession of the *Central and Eastern European Countries* (CEEC) to the EU – is particularly challenging (De Grauwe 2003)⁸⁶. Indeed, the more members in a “monetary club”, the more likely the occurrence of asymmetric shocks. An optimal first-best configuration probably exists only theoretically. The result is that the unique

⁸¹ Wyplosz (1997, 7-8).

⁸² Wyplosz (1997, 8) gives examples of such empirical research.

⁸³ A caveat must be made: would the U.S. have passed the OCA test a century ago? This is all but certain. Also now it is doubted that the U.S form an OCA.

⁸⁴ Wyplosz (1997, 9). Bayoumi and Eichengreen (1993) however find a coherent group around Germany that sufficiently fulfils the OCA criteria.

⁸⁵ De Grauwe (2003, 80).

⁸⁶ De Grauwe (2003, 92-97).

monetary policy from time to time imposes uncomfortable inflation or deflation on member countries. This can be a source of political stresses within the EMU. Friedman (1997) predicts that “[t]he likely result is that the euro will exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues”⁸⁷.

The question whether the current EMU arrangement is optimal transcends the realm of academics. All principals in our three-tier configuration (individual, government and NCB) can indeed be dissatisfied with the ECB’s monetary policy, i.e. frustrated with a policy that does not (and can not) take the different economic conditions of the member countries into account (De Grauwe 2003, 92). The question of an exit option arises: a member might judge the burden of EMU too heavy. In Italy, Roberto Maroni (welfare minister in the Berlusconi government and leading man in the Northern League party) started collecting the necessary signatures for a referendum to reintroduce the Italian Lira (Economist, June 11th 2005). Berlusconi, facing parliamentary elections next spring, did not condemn the action. The French and Dutch rejections of the Constitution also jeopardize the durability of the monetary union (the Maastricht Treaty was part of this rejected Constitution, and therefore also the Protocol on the ESCB). Where ECB President Jean-Claude Trichet may dismiss the thought that the EMU might break up as “absurd”, Europeans cannot longer wave the idea away as mere impertinence. A poll by Stern showed that 56% of the Germans want the Deutschmark back. The Euro area is perceived as becoming less cohesive, which is also reflected in the bond markets: spreads between yields on Italian and German ten-year government bonds have widened considerably. In the next subsection we return to constitutional choice.

⁸⁷ The Wall Street Journal, June 20th 1997.

3.2. An Exit Option to Constrain Leviathan

“There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency.”

J.M. Keynes⁸⁸

*“You shall not press down upon the brow of labor this crown of thorns;
You shall not crucify mankind upon this cross of Gold”*

William Jennings Bryan⁸⁹

What can we say about an exit option from EMU from a normative contractarian and constitutional perspective? One could argue that such a point of view is entirely inadequate. European states are real and identifiable, as opposed to individuals in the constitutional choice situation. Both concepts are also opposite with regard to the number of contracting parties. We however make an attempt to rationalize a right to secede from the EMU on grounds of Buchanan’s constitutional model. We do so to underline that, ideally, individual citizens are the ultimate principals in our approach. The use of the imaginary constitutional choice situation is functional, since impartiality of real individuals in assessing monetary arrangements cannot be guaranteed (they possess knowledge about (the monetary equivalent of) their endowments). The argument requires that we start by establishing that the monetary authority resembles the fiscal authority. Afterwards we revisit the constitutional choice situation and record some features of the “*fiscal constitution*” that Brennan and Buchanan (1980) derive, as well as the implications for monetary policy. We conclude this subsection with a discussion on some arguments of James Buchanan concerning the relationship between an exit option and exploitation.

3.2.1. How Monetary Policy Resembles Fiscal Policy

The burden put on society by an inflationary policy resembles the burden of taxation. Indeed, the power to create money can be (and has frequently been) used to raise revenue by its holder. The assignment to the government of a monopoly franchise in the creation of money

⁸⁸ Keynes (1920, 236).

⁸⁹ Proclamation of Southern and Western discontent with the prevailing national monetary standard. See Mundell (1997, 219).

is equivalent with granting government permission to levy a tax on money holdings. To show this, we slightly adapt De Grauwe (2003)'s description of the government's budget constraint⁹⁰. Government has to finance the sum of its spending $G + rB$ where G is the level of government spending (excluding debt payments), r the interest rate and B the government debt. To do so, government can issue debt, dB/dt , issue money, dM/dt , or increase the fiscal burden on the population, dT/dt . Hence, the following identity must hold:

$$G + rB = dB/dt + dM/dt + dT/dt$$

Optimal public finance theory suggests that rational governments will use these different sources of revenue in such a way that the marginal cost of raising revenue through these means is equalized⁹¹. Neglecting bond financing, we find that if policy-makers are rational, the marginal cost of "monetary financing" (inflationary policy) equals the marginal cost of "fiscal financing" (tax policy).

The identity we derived has implications for a monetary union. We suggested supra already that different countries have different preferences regarding monetary policy. We did not yet mention that, in general, countries with an underdeveloped taxation system will raise more revenue if a relatively high inflation rate is decided upon⁹². If its EMU partners have a more developed fiscal system, such countries have to rely on too costly a way of raising revenues. The less developed countries in EMU thus suffer in this respect⁹³: the formation of a union with more developed, low inflation countries requires these countries to lower inflation too. For a given level of spending then, taxes must be increased (the different marginal costs of revenue-raising cause a welfare loss). According to some economists, the problem is particularly acute for southern EU countries. Sinn and Feist (1997) estimate the redistributive effects of seigniorage of the EMU formation for the case of an all-inclusive monetary union⁹⁴. In their paper, the biggest winners of seigniorage wealth would be France, Italy and the UK (which is remarkable given the non-participation of the latter in the single currency project). The biggest loser would however be Germany (which is also remarkable, given that this country has a highly developed tax system), followed by Spain⁹⁵.

⁹⁰ De Grauwe (2003) describes the government's budget constraint as given by $G - T + rB = dB/dt + dM/dt$. He thus takes the level of taxation as given (exogenous variable).

⁹¹ See De Grauwe (2003, 20) as well as Fischer (1982).

⁹² Ibidem.

⁹³ We already considered other ways in which membership of a monetary union might be beneficial.

⁹⁴ The calculation is made for all EU-15 members (thus assuming that Denmark, Sweden and the UK would participate in EMU).

⁹⁵ See Sinn and Feist (1997, 674).

3.2.2. A Fiscal-Monetary “Leviathan” Constitution

Given the similarity between taxation and inflation, it is interesting to look at the ways in which an individual in the constitutional choice situation could safeguard against “fiscal exploitation”. The monetary case then follows. The concern of Brennan and Buchanan (1980) is with a “fiscal constitution”, with alternative ways to constrain government’s power to tax and to spend⁹⁶. The authors reject the *“benevolent, potentially efficient despotism that is the implicit political model dominant in the conventional normative policy framework, in fiscal theory, and elsewhere”*⁹⁷. The Leviathan theory can to my opinion neither be categorized as public choice, since government is assumed to be exogenous and monolithic (the authors thus regard postconstitutional electoral competition as insufficiently effective in constraining the political process). We end up with a highly sceptical model of politics that the authors justify in the same way as (neo)classical economic theory justifies the *homo economicus* assumption: The model can be acknowledged to be useful, not necessarily because its predictive potential with regard to actual government behaviour, but rather *“because there are inherent tendencies in the structure of government to push it toward that sort of behaviour implied in the monopolistic model, tendencies that may emerge in settings where constraints are wholly absent”* (Brennan and Buchanan 1980, 16). Natural government thus equals monopoly government.

The citizenry is assumed to have no effective control over government, once established, beyond the constitutionally imposed constraints. In the constitutional choice situation, individuals have accurate predictions with regard to the aggregate level and the distribution of income and consumption patterns in all postconstitutional periods, but they do not possess any knowledge about their own future position. Under these assumptions of general, nonindividualized knowledge, individuals can estimate roughly the “efficient” level of public goods as well as the aggregate revenues that will be realized under alternative tax arrangements. The question is which constraints will be selected in the constitutional choice situation. Tax revenues R depend on both the tax base b and the tax rate r : $R = R(b,r)$ ⁹⁸. These b and r should be interpreted as conceptual descriptions rather than as parameters.

Three types of restrictions are constitutionally available: direct limits on R (absolute amount or percentage of GDP), limits on b , and limits on r . Without going into detail, we remark the authors reject the first kind of limits, since *“there is nothing inherent in the nature of share*

⁹⁶ Brennan and Buchanan (1980, 153).

⁹⁷ Brennan and Buchanan (1980, 14).

⁹⁸ Brennan and Buchanan (1980, 38).

limits which would give government the incentive to seek out broadly based, minimally distorting taxes”⁹⁹. Brennan and Buchanan (1980) therefore prefer other institutional devices to limit the revenue-raising potential of the fiscal system. More specifically, constraints on the size of the taxable base b as well as on allowable rate structures r (on any given base) seem desirable if a Leviathan-like postconstitutional fiscal process is expected. The difference with orthodox public finance theory is remarkable: whereas such theory points towards a broad tax base and low tax rates (as this minimizes distortions), the Leviathan approach suggests a narrowly defined tax base with high tax rates. The reason is clear: having access to a broad tax base, a budget-maximizing government will impose *high* tax rates¹⁰⁰. Concerning the desirable rate structures on a given tax base, the Leviathan theory coincides with orthodoxy, as both approaches recommend a progressive structure. The justifications however differ: in orthodox theory, progression is desired because of its redistributive effects (justice considerations). In the Leviathan model of Brennan and Buchanan (1980), progression is defended because of its revenue-raising implications (the authors show that from the Leviathan’s point of view, the ideal, budget-maximizing structure would be regressive). In discussing the divergence of their theory with orthodoxy, the authors ascertain that *“the equi-revenue assumption familiar from orthodox tax analysis only becomes institutionally relevant if there are appropriate constitutional restrictions to ensure that revenue cannot increase”*¹⁰¹. If individuals in the constitutional choice situation can appropriately constrain the Leviathan by fiscal means, guaranteeing an “efficient” postconstitutional level of public goods, the question rises as to which decision would be made with regard to monetary powers. We discussed that, just like taxes, inflation can be regarded as a coercive instrument that allows the government to levy charges on persons without any corresponding expression of willingness to pay¹⁰².

What is the relevance of these arguments for the delegation of monetary authority? An efficient level of public goods can be supplied by different fiscal-monetary arrangements. If one would decide to constitutionally forbid the government franchise in money creation, conventional tax instruments can be chosen that generate an efficient public good supply under Leviathan assumptions. Similarly, one could decide to finance public goods through an

⁹⁹ Brennan and Buchanan (1979, 16).

¹⁰⁰ Brennan and Buchanan (1979, 19). The authors look at constitutional constraints on tax base and structure. An orthodox “optimal taxation” view advises to allow the government to impose a low tax rate on a large number of goods. From a Leviathan perspective, a high tax rate on a small number of goods is preferable (as a budget-maximizing government with access to a broad tax base might consider imposing a *high* tax rate on *large* number of goods).

¹⁰¹ Brennan and Buchanan (1979, 19).

¹⁰² Brennan and Buchanan (1980, 37).

inflationary policy. If the first option is constitutionally chosen, it is sufficient to assign the adequate tax base to the government (cfr. supra). The latter is then given access to a tax base that is just broad/narrow enough such that – when maximizing revenues following the precepts of the Leviathan theory – the desired efficient amount of public goods is provided.

On grounds of this observation, one can argue for relying on (possibly imperfect) market alternatives, and for denying the government monetary powers under any circumstances. Again the justification for the state monopoly on money creation is questioned. We recorded the opinion of Hayek, who opposes this monopoly on grounds of individual liberty and argues that money should be issued by private entrepreneurs. Such currency competition is also suggested by economic theory. Taking these considerations into account, it is unclear why individuals in the constitutional choice situation – designing an “ideal” fiscal-monetary constitution – would decide to delegate money-creation power in open-ended sense to the government¹⁰³. Both a free market in money creation and limits on the prerogatives of government might be superior to such unconditional delegation.

Brennan and Buchanan (1980) favour a conditional delegation. They assert that inflation be seen as a “special tax” on money balances: “*whereas with most taxes the assignment of the base is sufficient, however, it seems likely here that rate limitations will also be desirable, probably even to Leviathan itself*”¹⁰⁴. According to the authors, a monetary constitution would embody some set of rules relating to the extent of monetary expansion. Postconstitutionally politicians are prone to time-inconsistency problems, and a constitutionally chosen money rule (inflation rate) seems desirable¹⁰⁵. CBI is one way to safeguard against Leviathan exploitation of the revenue potential of the money creation power, by improving the performance of this constitutional clause (cfr. infra). Buchanan also investigated the issue of secession. In the next subsection we briefly consider these arguments.

3.2.3. The Limits of Exploitation

Buchanan (1984) explores the “ethical” limits of taxation by stressing the lexicographic order of the Rawlsian principles of justice. The principle of *maximal equal liberty* is prior to the *difference principle* (in economics usually referred to as maximin principle), and “*a society in*

¹⁰³ Behind the veil, one can select a first-best outcome.

¹⁰⁴ Brennan and Buchanan (1980, 128).

¹⁰⁵ A similar argument was already given by Buchanan (1962) who focuses on predictability as most meaningful criterion for judging the performance of a set of monetary institutions, and thus as important consideration in the constitutional choice situation. A famous example of a money rule in monetary economics is Friedman’s “optimal” inflation rule.

which [...] equal liberty of secession exists clearly is superior, on grounds of the first Rawlsian principle, to a society where this liberty does not exist” (Buchanan 1984, 108). Beran (1987, 38) wonders why, if free will and consent in human relations are the fundamental principles of liberal democracy, these principles are not applied to the unity of the state: “Yet it seems that a commitment to the freedom of self-governing choosers to live in societies that approach as closely as possible to voluntary schemes, requires that the unity of the state itself be voluntary and, therefore, that secession be permitted where possible”. Just like his namesake, Allen Buchanan (1991) focuses on Rawls’ “Theory of Justice” to illustrate the failure of liberalism to take secession seriously. He critiques that Rawls’ “characterization of the hypothetical social contract from which principles of justice are supposed to be derived precludes the possibility that the issue of secession will be broached at all” (Allen Buchanan 1991, 5-6).

Buchanan (1984) claims that he develops a “Rawlsian” argument for “ethical” limits of taxation. Two considerations seem necessary. Firstly, the imaginary, idealized parties of the Rawls’ social contract have to assume that they are to be members of one cooperative scheme in perpetuity. The aim of the Theory of Justice is to derive principles for an *ideal* society, a society in which the principles are *fully implemented*. According to Rawls, secession can only be relevant in a “non-ideal normative theory”¹⁰⁶. We can criticize the “Rawlsian” character of Buchanan (1984) secondly by referring to Rawls’ notion of “*reflective equilibrium*”. Intuitions concerning endowment-insensitivity (distribution of primary goods should not be the consequence of brute luck) and ambition-sensitivity (people should “pay for their choices” are more important than the social contract construction)¹⁰⁷. By modifying the account of the original position behind the “veil of ignorance” as well as by revising our existing judgments, “[...] eventually we shall find a description of the initial situation that both expresses reasonable conditions and yields principles which match our considered judgments duly pruned and adjusted” Rawls (1971, 18). Buchanan (1984) stresses the lexicographic construction of the principles of justice, but neglects the fundamental intuitions behind this construction. By proposing an unconditional right to secede, he assumes that people are entitled to their productivity. It is however far but evident that a rational individual in the

¹⁰⁶ See for the distinction Rawls makes between ideal and non-ideal theory Rawls (1971, revised edition 1999, 7-8, 215-216 and 308-309). The point is that people behind a veil of ignorance *commit* themselves to the “ideal” postconstitutional society that is designed. It makes no point to grant them ex post (when they know their postconstitutional endowment) a right to secede from this society (this jeopardizes the whole idea behind the constitutional stage).

¹⁰⁷ See Kymlicka (2002), especially chapter 3: “Liberal Equality” (53-102). “*The intuitive argument is the primary argument, whatever Rawls says to the contrary*” (p. 69).

constitutional choice situation would stipulate such a right to withdraw from society in the constitution.

The more “economic” argument of Buchanan and Faith (1987) seems more serious to me. These authors depart from Tiebout (1956)’s “*external exit*” model. In the limit, allocative efficiency in the supply of local public goods can be achieved by perfect mobility of individuals who “*vote with their feet*”¹⁰⁸. Competitive governmental units are then forced to supply local public goods in preferred quantities “priced” in line with relative-marginal evaluations. Buchanan and Faith (1987) observe the lack of attention to a similar “*internal exit*”, secession by a coalition of people from an existing political unit and establishment of a new political unit that then provides public goods to those who defect from the original unit. They acknowledge that the external-exit model is more “realistic” than its internal-exit counterpart, but stress that secession may be a “*road not travelled, safe under exceptional circumstances*” (Buchanan and Faith 1987, 1023). The mere existence of this alternative opportunity can affect the attitude of people in their acquiescence and/or criticism of political decisions beyond their individual control (see also Apolte 1997). With respect to the Leviathan’s fiscal powers this again implies that “*taxation beyond the limits defined by a plausibly estimated internal-exit option may erode the moral basis necessary for essentially voluntary tax compliance*” (Buchanan and Faith 1987, 1023). Pressure for internal exit may then exert effects on governmental behaviour. We assert *infra* that this argument can be extended to the monetary authority in the EMU.

If we assume that people possess legal-constitutional rights of secession, constraints are imposed by this liberty on the potentially exploitative behaviour of those in the dominant political coalition (by Buchanan and Faith (1987) called the *sharing* coalition, defined as all groups that are successful in obtaining net transfers from the government). People outside this coalition represent a potential for secession. The *minimal tax rate* is defined as that one that generates just sufficient revenues to finance the public goods production (assumed to be of an inherently monopolistic nature). The sharing coalition will however try to tax beyond this minimal tax rate in order to transfer revenues to itself. Under the highly stylized assumptions of proportional taxation on incomes of all members of society (both in and out the coalition)¹⁰⁹ and equal division of the fiscal surplus among all members of the sharing coalition, Buchanan and Faith (1987) derive the *maximum tax rate* that a sharing coalition can

¹⁰⁸ Tiebout (1956).

¹⁰⁹ This implies automatically some restriction on the Leviathan group, as noted by Buchanan (1976): “If taxes are levied generally on all persons, there are limits to the degree of fiscal exploitation, even if the majority coalition secures all of the benefits from public spending” (p. 24).

levy without inducing secession. Crucial is that this equilibrium rate is lower than the minimal, non-exploitative tax rate that secessionists would face after secession (notice the implied assumption about economies of scale in the provision of a public good).

We record finally that Buchanan (1990) proposed an explicit right of every EU member-state to secede. He claims that such a right would secure personal freedom as well as prevent excessive interventions and taxes from the central “Leviathan” government (this right was also proposed in the Treaty establishing a Constitution for Europe).

We derive analogous implications of secession on EMU: from a normative Leviathan perspective, monetary exploitation is as likely as fiscal exploitation. If we assume the nation as the society for which principles are designed behind a veil of ignorance, then citizens can be considered to be oppressed by a greedy supranational monetary authority if and only if the cost of providing price stability by a domestic independent NCB exceeds the cost of being bound by the single European monetary policy of the ECB. An excessive “*exploitation surplus*”¹¹⁰ legitimizes a claim to return monetary sovereignty to the national level. This is illustrated by the paper of Buchanan and Faith (1987). In their model, the tax is levied to finance a single public good, called “order”. Once this is replaced for “price stability”, the conclusion follows. We finally repeat that the right to secede mustn’t actually be exercised. The mere threat of a possible act of secession could put pressure on (the Governing Council of) the ECB to such an extent that it voluntarily and credibly commits itself to a limitation of its coercive power in order to avoid secessionist movements by NCBs.

3.3. Central Bank Independence Revisited

We only briefly consider the second stage of our configuration. As opposed to the previous subsection, we do so from a positive perspective. Predictability of the money supply is important for a proper functioning of the markets. The dominant strand of scholarship in this field (e.g. Barro and Gordon 1983; Kydland and Prescott 1977) emphasizes the danger of time-inconsistency and interest groups problems if the monetary authority stays in the hands of the government (see section II). A typical theme of institutional economics is the question how (pre)commitments can be made credible (Richter 1999). Applied to the monetary field, the challenge is to design the money order in such a manner that the prospective money user

¹¹⁰ We prefer this term of North to the “fiscal surplus” of Buchanan and Faith (1987). See Voigt (1999, 109).

is enabled to verify the fulfilment of the monetary authorities' commitment as well as to enforce that commitment.

We do not elaborate on the extensive discussion that exists in the literature about the “*rules vs. discretion*” debate. We emphasize once more that, so far as the fulfilment of the purchasing power commitment, the dominant view of economists is that the NCB of a paper standard must be independent of any governmental discretion. The delegation of the authority through “extra-ordinary” politics can solve the issue. Constitutional assignment of specific monetary tasks to an independent NCB ensures the elimination of electoral influence. Empirical evidence confirms that CBI significantly improves inflation performance¹¹¹.

Taking into account our discussion about CBI in the previous section, dissolution of this contract implies interference in the balance of power. The NCB is a separate, monetary branch of government. An exit from the EMU does not automatically imply a sacrifice of CBI¹¹². We mention that, according to the measure of Cukierman (1992), 25 countries have significantly upgraded their CBI since 1989¹¹³. It is unlikely in a contemporary modern and democratic state that a government would claim back monetary authority, as the impact on the country's economy would be deleterious. To illustrate we return to Mr. Maroni's referendum. It is tempting to imagine that if the Italian Lira were to be reintroduced and the monetary authority would be given to the government, Italy would turn back to its “*old habit of trying to devalue its way out of trouble*” (Economist, 11th June 2005). If only breach of the third (supranational) contract would occur, buyers of Italian government bonds would surely demand a risk premium against the risk of devaluation (insurance in the form of higher bond yields). If CBI would be given up, the impact would be more detrimental, as interest-group deals become incredible. Politicians would moreover maybe benefit in the short run, but in the long run they are worse off (see supra). We conclude thus by recalling that it is a rational course of action for policy-makers to self-limit their monetary sovereignty.

One alternative we didn't consider yet is breach of the contract in the form of removing the monetary authority from the independent NCB and transferring it to the market. In this case, the ultimate independence is reached. We do not consider here whether this is a viable alternative. It would in any case be a brave attempt of “*experimental federalism*”.

¹¹¹ See De Grauwe (2003, 151).

¹¹² The opposite case however holds: once a national government claims back monetary sovereignty, the country it governs cannot longer be an EMU member.

¹¹³ See Miller (1998, 433), Eiffinger and De Haan (2000, 44) and De Grauwe (2003, 151).

3.4. An Exit Clause for the EMU Contract?

According to paragraph 24 of the Delors Report, a single currency, although not strictly necessary for the creation of a monetary union, “*would clearly demonstrate the irreversibility of the monetary union*”¹¹⁴. In the Maastricht Treaty, the Protocol on the Statute of the ESCB and of the ECB similarly emphasizes the irrevocability of monetary unification¹¹⁵. EMU members thus entered into a supranational monetary contract without providing for an exit clause justifying the reintroduction of national currencies (in the case EMU would put too heavy a burden on a particular member country). Just like CBI solves time-inconsistency and lobbying problems, the supranational nature of EMU solves intra-European externalities by serving as a pre-commitment device. In this subsection we first address secession rules from the economic perspective of Bordignon and Brusco (2001). Secondly we ask whether mechanisms, other than an (internal) exit option, exist that can guarantee contractual performance. Finally we consider some lessons from Realpolitik.

3.4.1. An Economic Analysis of Secession Rules

Bordignon and Brusco (2001) propose to look at optimal secession rules (in general) as a trade-off between ex ante and ex post benefits. Making secession difficult corresponds on the one hand with an ex ante economic advantage, as the perception of the future duration of the federation determines its success. On the other hand the cost of the break-up, when this would occur, is increased. The reason why constitutional arrangements so rarely contain an exit option lies in ex ante considerations: if no provision is made for this option, the *stability* of the federation is enhanced. The absence of a secession rule thus works as a *commitment* device (the benefits that a country might enjoy by joining a federation today might be harder to obtain if the common perception is that the federation will not be there tomorrow)¹¹⁶. However, “*ex ante constitutional rules for leaving a federation could in principle play a positive economic role, by reducing the ex post cost of breaking up the federation*” (Bordignon and Brusco 2001, 1812)¹¹⁷. The authors formally model this “secession clause”

¹¹⁴ See Committee on the Study of Economic and Monetary Union (1989) as well as Eiffinger and De Haan (2000, 7).

¹¹⁵ Cfr. TEU Article 47.

¹¹⁶ See also our (Rawlsian) discussion about the discrepancy between ideal and non-ideal theory.

¹¹⁷ Allen Buchanan (1991) categorizes this argument as *strategically* used by proponents of a right to secede (it neglects the morality of secession). James Buchanan however considers facilitating entry by lowering the costs of exit the strongest practical argument for a right to secede. See Allen Buchanan (1991, 37 and 83f15).

trade-off. They do so by assuming that members of the union can write a “complete social contract” (constitution) in which transfers and secession rules in every possible future contingency are described. Conditional on the informational assumptions, they suggest different secession rules:

- Under the assumption of *complete information* and no renegotiation after the constitutional stage, the described trade-off materializes. A secession clause might be included in the optimal constitution. If this is the case, the right to secede is unconditional (no compensation to be paid). Once renegotiation is allowed for, the authors assert that “*in a sense, the constitution would be irrelevant*”¹¹⁸. Ex post efficient agreements would be achieved if countries are successfully able to renegotiate whenever a course of action is prescribed by the constitution that leads to an ex post aggregate loss. No ex ante agreement is actually needed.
- If *asymmetric information* about the realization of a postconstitutional state of the world is assumed (and renegotiation is not allowed for), the optimal social contract changes drastically. Without going into detail, we give the two basic conclusions¹¹⁹. Firstly, asymmetric information diminishes expected welfare and makes it more difficult to keep the union together. Secondly, the social contract may only allow for *conditional* secession rules (prohibition of exit at zero cost).

We established supra that the Maastricht Treaty does not consider the possibility that EMU members would decide to regain their monetary sovereignty in the future, and that a unique monetary policy might turn out to be unbearable for some members. The model of Bordignon and Brusco (2001) shows that, if this would lead eventually to a break-up of the EMU, economic and political relations in Europe would be seriously disrupted (in their model referred to as “secession war”). Once more we underline the stability consideration: “*forming a monetary union, rather than, say, agreeing to irrevocable fixed exchange rates, may be more advantageous exactly because it is more costly to break a monetary union than simply unilaterally change an exchange rate*” (Bordignon and Brusco 2001, 1812). In other words, the expected benefits of fixed exchange rates (see subsection 1.2.1.) are considered to be achieved more easily with a single currency. The implicit thought is that a paper standard with fixed exchange rates against some member country (à la Bretton Woods) is insufficiently

¹¹⁸ Bordignon and Brusco (2001, 1820).

¹¹⁹ Bordignon and Brusco (2001, 1827).

credible/too unstable for the markets. To my opinion, however, the argument does not exclude e.g. parallel currencies (competition between national currencies and supranational currency). In this case, the possibility of an “exit” to the domestic currency remains available, for each member state as well as for individual persons. Economic actors then are free to choose in which currency to deal and, as Richter (1999, 13) asserts, “[t]he free users of the euro are more likely to develop a common stability culture and euro-identity than will the members of an obligatory cartel”.

3.4.2. Alternative Contract Enforcement Mechanisms

So far we focused on an *internal exit* option as a means to constrain the exploitative potential of the ECB’s discretionary powers (and thus simultaneously as a device to induce the ECB to improve the institutional bundle – mainly price stability). In order to reason for such an exit clause, it is necessary to focus on some other mechanisms that can help to enforce the contract and to prevent exploitation (the internal exit option can only be relevant if these mechanisms are insufficient).

The exercise of an *external exit* option can in theory improve the ECB’s policy. Hirschman (1970) defined such an exit as “*withdrawing one’s factors from one jurisdiction to place them within another*”¹²⁰. This corresponds with the model of Tiebout (1956), in which mobility of citizens moving from one jurisdiction to another helps to reveal their preferences and induces policymakers to provide the desired public goods (see supra). This “*voting by feet*” model gave birth to the economic theory of federalism (e.g. Olson 1972). Market failures (in our case especially externalities, albeit one can also argue for imperfect competition) constitute a limitation of the Tiebout model (Stiglitz 2000), and favour a cooperative instead of a competitive solution. Internalization of the externalities at the higher (European) level is from this respect desirable, but this impedes external exit as a means to guarantee adequate performance of the ECB. Money is a convention in society (see supra). It is hence questionable to which extent an individual or group can credibly threaten to terminate one’s relations with the ECB. The threat to exercise the external exit option is at most credible in the mouths of foreign investors, not domestic (Richter 1999)¹²¹. For domestic money users the cost of switching to another domestic currency is equivalent to the threat of emigration

¹²⁰ See Voigt (1999, 183).

¹²¹ In this respect, the EMU decreases the impact of foreign investors’ threat to switch currencies: what formerly was considered as ‘abroad’ (another currency unit), has now become ‘domestic’ (single currency). See Richter (1999, 6).

(people move to jurisdictions that are most apt to satisfy their preferences)¹²². This is a very costly affair. We therefore conclude that the power of this mechanism to constrain the ECB is rather limited.

Another way in which citizens might reveal their preferences with regard to policy is *voice*. Institutional change might be explicitly asked for by the population. In democracies this corresponds with electoral pressure on the government. Can voice serve as a substitute (or complement) for exit in the case of monetary powers? We discussed CBI and the involved trade-off between credibility and accountability. The ECB is more independent than both the FED and the Bundesbank (see subsection 2.5.). It should be clear that the democratic deficit involved hinders effectiveness of the voice mechanism; albeit this does neither imply that voice is unimportant, nor that the mechanism doesn't influence policy at all. Referenda as well as opinion polls are of great interest for policy-makers. We note that the Dutch "nee" against a European Constitution was motivated to a large extent by the inflation caused by the introduction of the euro¹²³. The general feeling in Germany is similar¹²⁴. In case the "monetary exploitation" were to become unbearable, it seems likely that the voice of the people would indeed be powerful. In the end, the instrument of a *revolution* is available, a mechanism we do not deal with.

I believe we can find a third safeguarding mechanism in the institutional architecture of the E(S)CB. On the one hand, we observe a "*one wo(man) – one vote*" decision-making procedure in the Governing Council of the ECB, and we are informed about the negative relationship between a country's size and its openness for international trade. These factors make a monetary union attractive for small countries. On the other hand, especially the large countries benefit from the pre-commitment offered by EMU. Indeed, history shows that relatively small countries are able to successfully commit without a single currency (the Austrian and Dutch examples demonstrate that it is possible to maintain fixed exchange rates without EMU). Large countries are on the other hand unable to credibly and irrevocably commit to a fixed exchange rate (Wolf 1997, 12). The fact that small and large countries derive own specific benefits from EMU membership automatically stabilizes the union to some extent. Majoritarian exploitation becomes less likely, although not impossible.

¹²² Richter (1999, 6).

¹²³ Economists now estimate that the Dutch Guilder entered the EMU undervalued by about 10%.

¹²⁴ E.g. the pun "Teuro" instead of "euro", underlining expensiveness. See Der Spiegel, May 6th 2005: "*Schuldiger gesucht: Die Einführung des Euro hat Deutschland – bisher – mehr Vorteile als Nachteile gebracht*". We refer also to the poll by Stern.

Theoretically, a NCB could signal its dissatisfaction with the ECB's policy not only through its governor's vote in the ECB's Governing Council, but also by *cancelling performance of the contract*. We recall that the NCBs function in the Eurosystem is to implement the ECB's policy. Given the constitutional restrictions on the involved central banks, this is unlikely to occur (a NCB can however delay its performance just to the "nec plus ultra" level). A national government can however similarly choose to violate the GSP by incurring excessive deficits. De Grauwe (2003) argues that the enforcement of the fiscal rules may indeed be problematic. Von Hagen (1991) discovered that constitutional limits on budget deficits of US states had only a very limited effect on the states' fiscal policy outcomes¹²⁵. This "fiscal overriding" of the contract might well be a national government's most effective mechanism to signal dissatisfaction with the ECB's monetary policy.

Overall, the sanctions that are available to induce performance of the contract seem insufficient in a monetary union consisting of separate sovereign states where the ECB's statute can only be changed by renegotiating an international Treaty with a constitutional status (see supra). In order to render ECB politically acceptable, Van Bergeijk et al. (2000) deduct that steps toward political union might be needed that vest significant powers in the hands of the EP. We repeat once more that the rejected draft for a Treaty establishing a Constitution for Europe contained such steps. Without increasing the power of the EP, the stipulation of right to exit the EMU can be a device to improve the ECB's weighing of different interests.

3.4.3. Realpolitik and "Irrevocability" of European Monetary Integration

Regardless the emphasis on the irrevocability of monetary unification in the Maastricht Treaty, EMU is not a marriage in perpetuity. "*The common currency that Rome imposed throughout its empire did not survive the decline and fall of that empire*" (Mussa 1997, 217). Although monetary union may be far more irrevocable than e.g. a gold standard¹²⁶, ultimately disintegration is a realistic possibility. History provides us with examples of collapses of monetary unions: the successor states of the Austro-Hungarian Empire, the successor states of former Czechoslovakia, and the successor states of the former Soviet Union¹²⁷. In all these

¹²⁵ See De Grauwe (2003, 211-212) and Eiffinger and De Haan (2000, 90).

¹²⁶ Under a gold standard (or Austria's link to the DM before EMU), the cost of failure to abide by the rules falls on the errant country. Under EMU, the country cannot be driven off the euro. The gold standard also allows for "divorce by the free decision of any partner". See Wolf (1997, 13-14).

¹²⁷ See Mussa (1997, 217): "[...] the states that emerged from the breakup of the Austro-Hungarian and Ottoman empires after World War I rapidly moved to separate currencies. When the Soviet Union collapsed at

cases a political divorce triggered a monetary divorce. The successor states were eager to reassert their policy autonomy (to pursue different political and economic objectives).

Similar problems may arise in the framework of the EMU. A single monetary policy shackles member states with different preferences to one another (Feldstein 1997). The EU is not a political union insofar policy-makers are primarily concerned about the preferences of their national constituencies (in our case, it is conceivable that NCB governors in the ECB's Governing Council make decisions "with one eye on home". Compensation of the losers of a single monetary policy might be desirable, but the question remains to which extent this is a realistic possibility. According to Eichengreen (1991), "*Europeans are unlikely to accede to large-scale cross-border transfers prior to the creation of a real political union*". It is exactly the formation of such a federal "United States of Europe" that was obstructed by the recent rejections of the European Constitution. Another difficulty is that any attempt to impose draconian fines on countries that pursue laxer fiscal policies (and thereby fail to abide by the GSP rules), is likely to be politically explosive.

"[...] Political considerations, rather than purely economic concerns, are the predominant practical determinants of the domain of operation of currency regimes" (Mussa 1997, 217). Taking into account political integration as the primordial goal of EMU, the absence of an exit option is notable. Indeed, a paradox arises: whereas EMU aimed at furthering political unity in Europe, the result might be political divisiveness. Given the differences in national economies, a severe EMU crisis is likely at some point in the future. It is not to be doubt that such a (monetary) crisis would spill over to the (political) EU. The question then becomes what relation exists between political and monetary integration. Opinions differ: for some the motive for pursuing EMU has always been exclusively economic. For other advocates, EMU constitutes a new stage in the EU's political development. Wolf (1997, 3) asserts that "*EMU is neither a necessary nor a sufficient condition for further political integration; but some willingness to move towards further political integration is a necessary, if not sufficient, condition for a workable and enduring EMU*"¹²⁸. If this is the case, EU's current political crisis might have serious repercussions in the monetary field. The contradiction is that EMU without further political integration can function only if the will to political integration exists.

the end of 1991, some misguidedly thought that a ruble zone could and should be preserved; but reality prevailed, and the 15 sovereign republics of the former Soviet Union all now have independent national currencies".

¹²⁸ Van Bergeijk et al. (2000, 248) argue analogously that monetary integration without political integration might be problematic.

An EMU without further political integration risks however to be illegitimate¹²⁹ (considered unacceptable). We hence conclude that EMU is a project of uncertain economic benefits that carries with it large political risks for the EU. It is as likely to tear the EU apart as bring its members together.

¹²⁹ See Van Bergeijk et al. (2000, 264-265): “*monetary integration is not essential to realize the efficiency gains from economic integration, and political integration is not essential to derive efficiency gains from monetary integration. Still, monetary integration may be needed to make economic integration a political equilibrium, and political integration may be needed to render monetary integration acceptable*”.

Concluding Remark

Alesina and Spolaore (1997, 1028) contend that “*economic integration leads to political disintegration*”. This suggests that the abolition of trade barriers lowers the cost of secession, at least for political units. Bolton and Roland (1997, 1066) consent: “*a country like Belgium is more likely to break up when it is an integral part of a single European market since the economic cost of separation of Flanders and Wallonia is likely to be smaller than in the absence of participation in the European single market*”. Possible¹³⁰ secessionist movements would indubitably spill over to the monetary realm. History shows us how intertwined political and monetary integration are, and it seems indeed likely that – regardless the presence or absence of an exit clause in the EMU contract – in case a serious political crisis would occur someday, EMU membership will be affected. Taking in consideration the costs of a forced termination of monetary relations (think for example about the impact on financial markets), it seems worth to stipulate the conditions to leave the EMU in a kind of “European monetary constitution”, if only because this provides clarity and might “smooth the process”. The common perception is that, after the Dutch and French rejections of the Treaty establishing a Constitution for Europe, the EU’s future is predominantly economic. Instead of the political union that some strive for, Europe might well become a “*loose confederation of independent states*”¹³¹. Regarding monetary authority, one question is to which extent the fruits of the single market can be reaped without participation in the single currency. Opinions differ in this respect, and only the future will prove stability of the EMU. Monetary integration is clearly path-dependent (remind also Hayek’s proposal of currency competition), and one feature of the contemporary monetary institutional architecture that is to be expected to remain is CBI. Notwithstanding political objections referring to the acceptability of the concentration of monetary power¹³², CBI seems the only way in which political authorities can credibly pre-commit. Concerning the alleged “democratic deficit”, it is worth mentioning that Max Weber does not attach much weight to democratic accountability, but instead emphasizes other sources of legitimacy, i.e. charisma, tradition, and law. Van Bergeijk et al. (2000) apply these considerations to central banking, and conclude that democratic legitimacy

¹³⁰ See Newhouse (1997) for examples of secessionist movements in Belgium, France, Italy, Spain.

¹³¹ The prediction of Alesina, Spolaore and Wacziarg (2000).

¹³² See the discussion of Friedman (1962, 227).

is in a sense “superfluous”¹³³, i.e. the benefits of CBI are overwhelming, and a social and political consensus seems to favour the pursuit of price stability.

If we follow Buchanan’s normative approach, the key concern is with means of safeguarding against “monetary exploitation”. Countries are asymmetrically influenced by the unique monetary policy. The diverse economic heritages of EMU members combined with the decentralized decision-making procedures in the ECB’s Governing Council can raise conflicts of interests. From the discussion, we learnt that a (supranational de facto) constitutional right to exit the EMU could be one device to induce the ECB to weigh all actors’ preferences adequately. Whether social contract theory is appropriate to address secession issues depends ultimately on the discrepancy between ideal and non-ideal theory. If constitutional choice behind a veil of ignorance implies commitment “in perpetuity”, then it is by definition impossible to reconcile a social contract with an exit option. Once a non-ideal “Leviathan” view is taken, the selection of an exit clause is conceivable, and a (conditional) exit option can be argued for. If we would take this conclusion as recommendation, we come close to the proposal of Frey and Eichenberger (1989). These scholars advocate a more dynamic concept of European integration. In their *Functional Overlapping Competing Jurisdictions* concept, integration is partial on the basis of economic efficiency and democratic rules. To which extent stability worries disable viability of “flexible” EMU membership is eventually an empirical question. An agreement like the ERM provided the assurance of high exchange rate stability while retaining a parity change option, allowing for escape in case the circumstances would become too difficult. The institutional commitment implied in EMU membership is much firmer, but creates political tension and might be insufficiently credible for some members. Intra-European fiscal transfers would complement the EMU, but seem improbable to be implemented in the current EU. Ultimately the EMU’s future depends on how the political EU evolves.

¹³³ See Van Bergeijk et al. (2000, 262).

List of Abbreviations

CBI	Central Bank Independence
CEEC	Central and Eastern European Countries
EC	European Commission
ECB	European Central Bank
ECU	European Currency Unit
EMS	European Monetary System
EMU	Economic and Monetary Union
EP	European Parliament
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EU	European Union
NCB	National Central Bank
NIE	New Institutional Economics
OCA	Optimum Currency Area
SEA	Single European Act
SGP	Stability and Growth Pact
TEU	Treaty on the European Union (= Maastricht Treaty)

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