

Chapter 2

What Went Wrong with the Euro?

The first fact has to do with the “creative accounting” of EU bureaucracy. The creation of the euro zone was largely a political decision in the altar of which they sacrificed actual deficits, actual rates of inflation and public debt as a percentage of GDP. These aggregate indicators are easy to monitor but they are not always transparent to the public. More importantly, as aggregate indicators are only rough measures of the fiscal burden or economic efficiency.

The second fact is that to talk about markets and competition or contestability, one must first and foremost have, and apply, for a long period, anti-monopolistic laws and anti-monopolistic practices. But nowhere in the EMU such practices were ever adopted or applied. The Greek economy, for example, is completely under the influence of monopolies or cartels and the actual work produced by the Competition Committee is quite small. Five hundred job descriptions or occupations are “protected” in Greece, since the 1920s, including for example taxi drivers, dentists, pharmacies, lawyers etc. In industry or retail, oligopolies rule freely the entire market. It is not surprising then, that since 2008 prices have remained high for most if not all retail products without any tendency to fall, despite the dramatic reduction in household incomes.

Nominal wages in Greece are beginning to slide, three years after mid 2008. With prices staying the same, real wages will of course go down. In that sense, productivity is expecting to rise but most importantly, new comparative advantages will begin to develop. This makes it more likely for prices to increase, not decrease, in the next few years, given the cartel structure of most Greek markets. This will put even more pressure on actual Greek inflation (estimated to be around 10 %) but it is hard to claim that this bad for short-run costs of the industry. This is one side of the coin. The other side is that with falling demand most firms find themselves operating at higher levels of short-run average costs, a tendency that will be reinforced through reduction in real wages. What is the resolution of this puzzle? None other than restructuring of the production conditions to lower average short-run costs—innovation, different forms of factor substitution etc, overall restructuring of relative prices.

To conclude this discussion, in terms of increasing inflation in one country member of the EMU, like Greece, and stable inflation in other members, the euro

cannot be sustained since the initial exchange rates of national currencies against another are now completely wrong, they are artificial and bureaucratic and the markets do not in fact work. Is it probable then that *the Euro might be restructured into more stable currencies*? This question is superfluous. Of course if the Euro were to dissolve a number of currencies would arise, some of which would necessarily be more “stable” than others. But what does this *mean*? Private agents are already free to choose the currency in which they complete their most important transactions and there is no lack of “stable” currencies or, at least, stable contracts in which such transactions can be completed. In addition, under conditions of increasing inflation in one country and stable inflation in other members, it is certain that relative prices have adjusted extensively to reflect the correspondence between the distribution of resources and consumption. The question remains whether this is a structural phenomenon, a necessary implication of the common currency, or merely an effect induced by specific monetary and credit policies.

These inflationary pressures are associated to a large extent the explosion of the public debt and the inability of countries like Greece, Spain, Italy, Ireland and Portugal to commit to solvency. Not because there is an inherent relationship between the two but rather because they both signal the same underlying phenomenon. The adoption of common currency did not change the fundamental factors that determine the national demand and supply for goods and services. Monetary stability, of course, helped to consolidate the South and make economic policies more predictable, which is essential in several respects. But the common currency by itself cannot change underlying economic structures, harmonize incomes and prices or equate rates of profitability in the Eurozone. Tendencies that were already there to move resources across Europe were affected only slightly by the introduction of the Euro. The abolition of tariffs in earlier years was far more important from this perspective.

Relative inflation rates will not only determine relative nominal interest rates but also exchange rates, if national currencies were allowed to exist. Of course, interest rates also determine inflation through aggregate demand, and if the mechanism is allowed to converge to the market solution, the outcome will be a stable national currency, *ceteris paribus* on foreign trade. When the markets are not left to operate freely, all sorts of imbalances arise. The actual interest rates are too low, the actual exchange rate is too large, and inflationary pressures are accumulating.

In that sense there is no question of how to restructure the euro. By itself any monetary union is “stable” provided economic policies are not adopted that adversely affect one member but not others. An optimal currency area implies the full operation of market forces to yield stable rates of inflation, reasonable *but not necessarily stable* exchange rates, and market—determined interest rates of all sorts. This is easier said than done. What is a *mechanism* that can yield the dissolution of the euro into different national or group currencies? Independently of the specific economic policies that will be adopted, the question is impossible to answer and has little meaning.

The point of this essay is to suggest that creating such a mechanism is not the business of EU bureaucracy but the European and world market itself. Otherwise, any artificially created currency groups (one of which is a “two-speed euro”) will be destroyed in practice by the operations of the markets. What the bureaucracy does not understand is that there are deeper, real economic forces behind “speculative attacks” on the euro. These forces, in the final analysis, are reflected in actual inflation, interest rates and exchange rates. As long as the “fundamentals” of a given group are at odds with the common currency, *and economic policies are adopted whose affects adversely affect the different groups*, the common currency is not sustainable. To the extent that affects cannot but be different and adversely affect the different sectors of the European economy, the sustainability of the euro depends on avoidance of such policies which, in the final analysis, relate to policies of money and credit.

The mechanism that will lead to more stable and reasonable currencies depends on the “fundamentals” of a given group. If we allow, for the sake of discussion, each country of the EMU to choose its own currency and abolish the Maastricht Treaty, then in the long run there will be so many currencies as it is necessary, and *market-based currency groups* will be formed. Yet the “fundamentals” cannot but be different. The whole discussion about different currencies boils down to different economic policies that will be adopted in terms of fiscal, monetary and credit configurations. In the absence of such policies the markets can establish easily stable exchange rates. In this context a stable currency is a source of financial stability for the entire global financial system and the source of its own stability lies at the commitment of abstaining from harmful economic policies. Without coordination there is always the danger that one government can deviate from the common practices in terms of economic policies whose harmonization is, more or less, ensured in the context of a monetary union. But even under harmonization, for example the one set forth by the Maastricht Treaty, the monetary union can still embark on monetary and credit policies whose effect can be detrimental.

For example, Greece will revert back to the drachma, with an initial exchange rate of GRD/EUR = 1:1 relative to the euro, assuming only Greece leaves the eurozone. In a short time the exchange rate will stabilize at the actual exchange rate *dictated by economic conditions and market forces* which will be, say, 5:1. The devaluation will allow a quick recovery of the Greek economy and less strain will be placed upon public deficit and public spending. Exports will improve and the much desired reduction in exports will be accomplished. Of course the new exchange rate will be compatible with a higher equilibrium level of nominal interest rates. It is quite possible that expansionary monetary policy will be used along the path of the transition from the old to the new exchange rate equilibrium. At work is also the mechanism of the so-called “J-curve” which implies a temporary worsening of economic conditions before recovery.

Will the euro devalue relative to US dollar? The answer is yes. Nothing is wrong with this in terms of the European economy since exports will increase and imports will decrease. This, of course, will increase actual inflation in the eurozone

and the ECB might increase interest rates or reduce money supply but it is highly unlikely that a reduction in money supply (suicidal during a deep depression) will be necessary: The exit of Greece will guarantee that automatically. The only problem for the new eurozone will be its own structural imbalances, not the “announcement effect” before or after Greece’s way out of the EMU. *The misconception of the EU bureaucracy is that appearances and “announcement effects” affect the euro more than the fundamental features and structural imbalances of the eurozone.*

The exit of Greece from the EMU *might* devalue the new currency. We know, of course that, in the short run, this will relieve the current account, and improve the exports of certain goods and services. Provided the exchange rate is free to float, the international markets will reach a new equilibrium between demand and supply. But unless import substitution takes place in the sector of capital goods and energy, the current account will deteriorate and there will be detrimental for output and employment effects from the price of imports that will rise considerably. In fact, under the inflationary pressures of a devaluation, interest rates will have to raise, favoring the concentration of production at the later rather than the earlier stages, thus making the pressure from imports even more significant. The situation is likely to be made worse by Central Bank interventions favoring lower interest rates and / or a credit expansion that will create malinvestments in the earlier and more “capitalistic” or intermediate sectors. Moreover, there is no guarantee that the new Central Bank will follow a policy of commitment to stable monetary and credit conditions or conditions of price stability. Therefore, *it is not to the best of interest of Greece to abandon the euro unilaterally.*

We claimed that the exit of Greece from the EMU *might* devalue the new currency. It has been shown by Rosa (2011a) that, in fact, a depreciation of the euro relative to other currencies, for example the US dollar, *preceding* the exit from the euro would make a major devaluation unlikely. In fact the announcement effects that will precede the exit will impact so negatively on the euro that any short—run advantage from increasing exports will disappear since the *ex post* devaluation of the national currency will be significantly smaller, if it happens at all. As Rosa (2011b) argues:

The euro lost about 25 % of its value between 1999, when it was introduced, and its lower bound of 2001. What is required today, after its 12 % decline since the beginning of 2010, is a further decline from \$1.30 to \$1.00 for instance (a 23 % decline) or even better to \$0.85 (a 34 % decline).

Rosa’s argument seems to be quite convincing. Furthermore it offers an alternative to what would happen with the increased public debt burdens after a possible exit from the euro and the subsequent devaluation of the new currency. The *extent* of devaluation would have to be rather small, if any at all, especially for France and other major economies of the eurozone. For the South we have some evidence from the purchasing power parity of the euro against the dollar from Mongelli (2008, p. 32) so in fact *we can quantify Rosa’s argument in more precise terms.* As of 2007, one US dollar would be equivalent to about € 0.60 in Greece

and Portugal, € 0.83 for Italy and close to € 0.85 for Germany, Austria, Belgium and France. This purchasing power is remarkably close to Rosa's prediction for what would be a natural exchange rate of the euro, and justifies his argument that, in fact, there can be no excess burden from servicing the public debt of countries that leave the eurozone.

Let us look at this argument more closely. It is based on the fact that the euro has already lost 25 % of its value and that it might end up at an exchange rate of \$0.85 which is "optimal". In what sense it is optimal we are never informed. We are informed that it is "likely" or even "desirable" to end up with an exchange rate of \$0.85 and after all, a depreciation of "only" 34 % is required. However, this analysis is quite simplistic in that the simple algebra is, in fact, refuted in case a drastic reduction of demand for euro takes place. Such shifts of demand are quite possible and take place almost instantly making it possible that devaluations of more than 34 % are possible. It is unlikely that other national governments will tolerate their drastic over-valuation with detrimental effects on exports and the balance of payments despite the fact that, for example, German exports will increase considerably. A "balance" of policies will be adopted in the short-run to minimize the fluctuations of the exchange rate close to what Rossa suggests—although for reasons that have nothing to do with his algebra.

Even slight fluctuations of the euro exchange rate will make it impossible to accommodate interest payments for the debts of the South. Fiscal consolidation will be put in danger and additional austerity measures will have to be adopted to restore the fragile fiscal equilibria. Of course there are other issues as well: Although it is in the best interest of the South to remain within the eurozone, the accumulation of public debts and their accommodation by the ECB cannot continue forever. The debts of the South necessitate a diversion of credit from the North which, in fact, is nothing else but a policy of protection of their own commercial banks, exposed to the Southern debts. What, according to the ECB, appears to be financial contagion of destruction of northern European banks is, in fact, the result of risks taken by the commercial banks in the past. It would be reasonable to let some banks go bankrupt *rather than proceed with credit expansion* letting the commercial banks conduct business as usual. The consumer savings can be guaranteed, but it must be explicitly recognized that some investment decisions of the commercial banks were totally wrong. Unless such decisions are to be made by the ECB, financial contagion will continue since public debts are accumulating at alarming rates and the eurozone will not be able to survive.

Since a large part of the public debts of the South is, in fact, malinvestment on the part of European banks and European governments, *the markets should be allowed to correct the financial malinvestment*, through new contracts, or by erasing part of the public debt, recognizing explicitly the losses that were incurred in the process of bad financial decisions. In actual markets, firm that were involved in unsuccessful investment will close, and the banks that financed their investment plans will, naturally, incur a loss. There is no point for a government to prefer bailing out a bank instead of bailing out the firm, since both failed on the same

ground. If the government intervenes by expanding credit to the firm just to repay the bank, and investment plans are not profitable, the situation cannot lead to a satisfactory equilibrium. The firm will keep borrowing, increasing its debt, while the bank will appear profitable and solvent. The expansion of credit is a bad idea, as always, since it inflates the malinvestments instead of providing a solution to the problem.

Of course, a country is different compared to the firm, not only from the political standpoint but also because there are thousands of investment plans and investment decisions that took and still are taking place. Some of them are profitable and others are not, thus suggesting that commercial banks should, first of all, make sound and informed decisions. In the case of Greece, the bail out plan was confined solely to facilitate the Greek government to pay pensions and wage bills in the public sector; this is an unprofitable “investment” and works only to the best interests of European commercial banks and the ECB. *The bailout plan supports government consumption and the European commercial banks but not the stability of the euro.*

In the theory of optimal currency areas, Mundell (1961, 1969) three conditions are known to be necessarily for optimality. First, labor mobility. Second, wage flexibility. Third, in the absence of these two conditions, there is a case for flexible exchange rates and separate monetary policies. Kenen (1969) has also argued for the necessity of similar economic structures, fiscal integration, and the degree of product diversification. Incidentally, Mundell argued that currency competition would result in high transaction and informational costs, so it would not be a practical solution unless there is “money illusion”. The argument is hard to accept. If consumers can rationally choose bundles of goods and services and portfolio, why should not they be able to choose an optimal composition of currencies to hold at any given period given their expectations about future exchange rates?

Of course, “shocks” will always be asymmetric and inherently unforeseen, for the most part. In this environment, the shock can be absorbed by a system of flexible exchange rates but it will otherwise have a detrimental effect. Consider for example two countries as in Mundell (1961), the East that produces cars and the West that produces lumber. Suppose there is a positive productivity shock in the East. According to Mundell (1961) this leads to *increased demand* for lumber in the East. There will be current account surplus and excess demand for labor in the West, and the opposite effects in the East. This has been criticized by Dellas and Tavlas (2009) who argue as follows: The positive productivity shock in the East, will increase the marginal productivity of labor and the demand for labor, and will shift to the right the aggregate supply curve, along with a raise in the marginal product for capital. The net effect will depend on the underlying parameters of the two structures, as the authors conclude.

Under conditions of labor immobility, the increased production of cars should be followed by a reduction of their price, as well as an increase of the demand of lumber from the West, if lumber is an input in the car production. If exchange rates are flexible, it is clear that the Eastern currency will devalue and the Western currency will appreciate. Since cars are exchanged for lumber in the international

market, the positive shock will be beneficial for all and similarly a negative shock will be detrimental to all.

If we allow for free capital flows the situation is somewhat different. The positive shock in the East increases the marginal productivity of capital and interest rates, making investment in more “capitalistic” or “round about” processes (like cars) more profitable compared to the near—to—final products, like lumber. Capital will shift from the West to the East, and more capital from the East will be invested in the car industry. The structure of relative prices will change accordingly to signal to the investors the different profitability opportunities that arose. More cars and less lumber will be produced resulting in increased employment in the East and unemployment in the West, if the wage rates cannot be adjusted immediately. If the shock is permanent, the increased production of cars will require more lumber as well, making the situation better in the West, requiring more labor and an increase of wage rates. If the shock is only temporary, the East will find itself with considerable malinvestment (if the expectations were the shock to be permanent) and a corrective movement will take place: The decrease in the marginal productivity of capital and interest rates, will imply a flow of capital from the East to the West, since the production of close—to—final or less “capitalistic” processes is now more profitable.

If expectations are “correct”, temporary shocks cannot have an immediate effect and persistent or permanent productivity shocks will generate business cycles, similar to those produced from real business cycle models. However, the reason for the fluctuations is the change of relative prices and the resulting change of profitability in the various sectors of the international economy. Without changes in the relative prices or the rate of interest, it is not possible to have capital flows as a result of a positive productivity shock. All investors, domestic or foreign, make their calculations in monetary terms including prices, interest rates, and exchange rates. It is true that the final or equilibrium value of exchange rate may well stabilize to a level similar to the previous one, but this cannot come about unless there are first movements in the exchange rates and prices that are consistent with the changes in the relative marginal productivities of the factors of production.¹ These movements can, of course, be considerable.

Under a system of fixed exchange rates or a common currency between the East and the West, as in Mundell (1961), the free flow of capital between the two regions will necessarily show up in the form of distortions in the money and credit markets, if the interest rates are predetermined. Accommodating the inflow of funds in the car industry (East) will result in a credit expansion. If the shock is persistent but not permanent but expected to be so, the credit expansion and growth will soon revert to their opposite as the result of changes in relative prices and relative marginal productivities. The malinvestment will be corrected with capital outflow and detrimental effects on output and production. To the extent that the credit expansion was not artificial, in the sense that world savings cover world

¹ In that sense the argument of Dellas and Tavlas (2009, p. 23).

investment, the economy will correct the mistakes through fluctuations in outputs and relative prices. *In a monetary union, it is exactly the goal of price and monetary or credit stability that cannot be achieved:* The fluctuation of exchange rates, in a flexible environment, would reflect the changes in relative prices but with a common currency inflationary pressures will arise and the burden of correction will fall (1) on capital markets and (2) on money and credit.

Even in a monetary union, one may claim, that different resources like capital and labor, denominated in a common currency, still provide the markets with the right signals for relative profitability of activities in different countries and sectors. In the Mundellian universe there is, of course, little problem with that. But the hidden issue is that, under free capital mobility, chances are that investors would prefer to conduct operations using a third, more stable currency, if the currency of East-West is likely to depreciate relative to another currency, say that of the North. With a positive shock in East (cars) that raises the prices of Eastern relative to Northern cars, the malinvestment will correct itself sooner via the importing of cheaper Northern cars and a switch to less “capitalistic” methods of production. The East-West will appreciate at first relative to North, but will depreciate in the immediate future, reflecting the relative profitability of investing in the North. Much depends, naturally, on the time structure of producing cars in the North relative to the East-West union. Part of the correction of investments, involves the changes of exchange rates of the East-West (say EW) relative to North (N). The demand for N will rise after the depreciation of the EW, and this will affect the reserves of foreign currency in East-West. To appreciate the EW, the Central Bank is likely to make various mistakes, including a credit or monetary expansion, whereas in fact nothing of the sort is required, besides letting the international markets clear at a point where the demand for currency reflects current demand for the various activities or “aggregate demand” and “aggregate supply”.

The reason why the Central Bank is worried by this situation is that a large portion of the increased reserves in foreign currency might be the result of “speculative” considerations. The Central Bank believes that speculative attacks on its currency are conducted, in order to profit later on from the appreciation of the currency. This notion is consistent with a scenario where the EW (or the euro) has depreciated as the result a change in relative marginal productivity of capital relative to the North (or the US) but this change is expected to be temporary. If the deterioration in relative marginal productivity of capital is persistent then so will be the depreciation; but what is of concern is the opposite: The euro has been “attacked” in order to depreciate and then let it appreciate freely, so that speculative gains can be realized. But the question is, why should the euro appreciate after the speculative attack? An increase in “aggregate demand” or a positive productivity shock must be forthcoming and expected in order for things to happen in that way. But there is no rational foundation for this expectation particularly when economic policy is organized around austerity measures.

From the recent literature it turns out that a monetary union is recommended mainly to avoid inflationary pressures or biases (Barro and Gordon 1983) or monetization of debts and accommodation of the financing needs of the national

governments (Alesina and Barro 2001). This involves two (related) assumptions: *First*, that the Central Bank is, somehow, better equipped than national governments, to accomplish these goals. *Second*, that a system of freely floating currencies is worse than a monetary union. Of course, the Central Bank of an economic union can solve the coordination of national policies only to the extent that the political and economic authorities of the Union can do so. Commitment in this game of coordination, is a problem that is to be solved by the political and economic authorities themselves. However, commitment is not the only problem to be solved in this game, and the Central Bank may have its own objectives; an issue that we examine later on in this essay. The other problem concerns the effects of asymmetric shocks and also the recent problem of explosion of public debt in certain European countries.

The adverse effects of “asymmetric shocks” can be corrected by the markets in a system of floating exchange rates. This is common knowledge but it is also precisely why an economic union encompassing different economic structures cannot be sustainable. Suppose a member of the economic union (like Greece or Spain and Italy, the South in short) is hit by a negative productivity shock which implies lower marginal productivity of capital across all industries. If the shock is expected to be highly persistent, and interest rates are harmonized, it would take some time to realize this development. Effectively, interest rates in the South should be lower in order to maintain profitable current investments in the margin. Since this is not possible, planned investment will be postponed but at the same time, less “capitalistic” or less “round about” processes will be favored implying negative net capital flows for the South. The concentration of production near the later stages will decrease the demand for capital from the North and will increase the demand for intermediate materials or products that are closer to the final product sector. Employment, in particular, will shift from the early to the later stages. In the process, the demand for capital will also increase but since the sectors producing goods close to final require less capital, the net increase will not be sufficient to compensate for the reduction in investment.

The reduction in investment can be detrimental for the Northern industries, so the Central Bank is likely to respond by announcing lower interest rates and also a credit expansion program, as the ECB recently did. The lower interest rates will sustain a portion of investments at the margin but if the shock is severe it is unlikely that it will be sufficient to attract new investment in the more “capitalistic” sectors of the North. Prices of consumer and intermediate or close—to—final goods will increase in the South, and prices of investment goods in the North will decrease. It is clear that depression and inflation will prevail in the South, a fact that appears to be puzzling to many. The changes in relative prices will affect the relative profitability of different stages of production and different goods in the Union, and will imply capital flows to the service or close—to—final goods in the South, but only with considerable time lags. Lower interest rates announced by the ECB will, of course, shorten the amount of time required for the shifting of capital to the South and the lowering of the “average length of production” in the Union as a whole.

To conclude, a negative productivity shock will initially be detrimental to the country that experiences it and the countries that supply goods necessary for production, in proportion to the importance of the country in total exports from those that did not experience the shock. To an extent, the shock will affect all members of a Union, but the country that received the shock is likely to move towards less “capitalistic” processes of production, enlarging its close—to—final goods sectors. The initial outflow of capital from its capital—intensive sectors will be followed by inflow of capital or increase of investment in the service / final goods sector. In the absence of other shocks or policy changes from the ECB, the shock will be “absorbed” by the shifts of capital across the Union.

What then is *the* problem? Moving towards less “capitalistic” processes of production for the Union as a whole, makes it necessary to increase imports of capital from countries outside the Union, at higher prices. In the short—run, this is equivalent to a positive shock in the marginal productivity of capital for the US or the UK. But if the restructuring of the time—profile of production is not to the liking of the political authorities, the necessary corrective actions in the international capital markets will not take place, and the appreciation of the dollar or the pound, resulting from the increased imports of capital goods, is likely to imply policy measures by the ECB. *There lies, finally, the danger for a monetary Union: The monetary authority is likely to find the short run effects of a negative “asymmetric shock” too important to let the interest rate move freely, or the exchange rate to float freely relative to the currencies of the US or the UK.*

The issue for a monetary Union is not so much what happens internally, but what happens in relation to the rest of the world. Inside the economic and monetary Union, free movement of capital (and other resources, to the extent possible) may guarantee a structure of production that is compatible with the given system of relative prices, interest rates, and marginal productivities of capital (or factors used early on in the time structure) in the absence of policy distortions. The fact of the matter, however, is that capital may also move freely between the Union and the rest of the world. This will, naturally, affect the exchange rates, as well as the real pressure exercised on its debt and the current account.

After all, a monetary Union is primarily a political decision. If the Union is sustainable or not, it depends on how the political authorities and / or the Central Bank will react to a shock (asymmetric or not, has no significance) when its currency is devaluated relative to a foreign, important currency like the dollar or the pound. In nominal terms, the exchange rate of the euro relative to the dollar is free to float, but the exchange rate appears also to be a main concern for the ECB. Policy measures on behalf of the ECB, under the influence of shocks, are likely to propagate the volatility of the shock among its members, when a policy of “competitive euro” is adopted: *In fact, the euro should be allowed to float as a result of a shock, asymmetric or not, in order to maintain relative profitability in the different stages of production in the international markets, and thus absorb the greatest portion of the adverse effect of the shock.*

We will argue later on that there is no such thing as an “asymmetric shock”. The concern with exogenous shocks at the expense of ignoring policy shocks is

quite detrimental for an economic analysis of monetary unions and currency areas. Mundell's argument that in the absence of capital and labor mobility it is optimal to have different monetary policies should be read in a different way: In the absence of resource mobility monetary policies *will* be different because governments have every incentive to do so. However, resources that are internationally less mobile or no mobile at all (a) cannot become more mobile because common currency is adopted, and (b) they are mobile within a given country. The international movements of resources that cannot take place will be made under a different form through movements across various uses in the same country, through shifts across the time-distribution of investment and also via liquidation and crises.

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Tsionas, E.

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