



One Market, One Money – A Mistaken Argument (post factum)?

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Why should Europe opt for monetary union? ‘One Market needs one Money’! This is, at first sight, the key argument of the influential report by the European Commission entitled “One Market, One Money”, published in 1990. Closer examination reveals a somewhat different picture, however. The extended subtitle is rather more agnostic: “An evaluation of the potential benefits and costs of forming an economic and monetary union”. A closer inspection of the report reveals that the key argument was the other way round: one money would create one market. Unfortunately, the authors of 1990 did not recognise that ‘one money’ would foster huge cross-border financial flows that would one day lead to a very costly financial crisis.

Contents

Introduction and background.....	2
1. The structure of the report.....	3
2. ‘One Market, One Money’ or, ‘One Money, One Market’?.....	4
3. One money and financial markets.....	6
4. Did the euro foster real integration?	9
5. Conclusions.....	12
References	13
Figure 1. IIP (assets) as % of GDP.....	7
Figure 2. Intra-EU trade as % of GDP.....	10
Figure 3. Intra-EU trade as % of total trade (goods).....	11

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Introduction and background

In modern terms, ‘One Market, One Money’ (hereafter ‘OMOMO’) can be considered as an *ex ante* impact assessment of Economic and Monetary Union (EMU). It was published in 1990, before the political decision to agree an EMU had been taken but after the publication of the Delors Report, in which the Central Bank presidents of all the (then) EU members had agreed on the terms under which they could consider a Monetary Union. The political decision to move towards an EMU came with the Maastricht Treaty one year later, and largely reflected the analysis of OMOMO.

The title has to be understood in its historical context: in 1990 the biggest integration project was the completion of the ‘internal’ market by 1992. The ‘1992’ project, as it was called, comprised hundreds of directives aimed at integrating markets through a novel approach; namely mutual recognition of national regulations, which were subject only to a minimum of common standards. This was a major innovation. Until the mid-1980s integration had stalled because it proved impossible to agree on detailed common standards for many goods.

Another feature of ‘1992’ was the abolition of capital controls. This had already been foreseen in the original Rome Treaty, but had never been implemented because France and Italy, for example, wanted to keep a lid on capital outflows, which occasionally threatened their weak currencies. Academic economists and prominent policymakers (most notably Tommaso Padoa-Schioppa) had warned that full capital mobility was incompatible with fixed exchange rates and the national autonomy of monetary policy. The reason is simple: in an area with stable exchange rates and free capital mobility, there can only be one interest rate.

Countries such as France or Italy, which had to open their capital markets by 1992, logically faced the choice to let their currencies float (if they wanted to maintain monetary sovereignty) or to keep their exchange rates tied to the DMark. But in this case they would have had to follow the monetary policy of the Bundesbank. Accepting EMU with a common central bank –Europeanising the Bundesbank’s role – seemed to provide the best way out of this dilemma.

The present contribution does not attempt to provide an overall evaluation of OMOMO. It first briefly presents the structure of the entire report in section 1. The following sections then examine selected different key elements, namely the assertion that one market needs one money, the crucial importance of financial market instability and the evidence that one money did indeed foster market integration.

1. The structure of the report

OMOMO was divided into three main parts.

Part A contained, besides the synthesis, the basic economics of EMU; of course, as understood at the time. The key insight is on page 45 of the report:

the analysis of EMU cannot be based on a simple, unified, ready-to-use theory of the benefits of monetary integration. The two issues of economic integration and monetary integration are indeed treated very differently in economic theory. The case for economic integration is based on a unified and secure microeconomic approach since whatever the latest developments in the theory of international trade, the basic rationale for the internal market programme is still rooted in the approaches of Adam Smith and David Ricardo.²⁵ Monetary integration, however, immediately raises a more complex set of theoretical and empirical issues.

The same message was repeated by appeal to a higher authority in footnote 26 of the OMOMO report, which refers to a contribution by Paul Krugman:

Paul Krugman states: The economics of international money, by contrast [to those of trade integration], are not at all well understood: they hinge crucially not only on sophisticated and ambiguous issues like credibility and coordination, but on even deeper issues like transaction costs and bounded rationality.

This was the quandary faced by the authors of OMOMO. Any evaluation of the balance of costs and benefits of a monetary union must necessarily be subjective and based on debatable assumptions about future policy reactions. This fundamental difficulty has not gone away, and is unlikely to be resolved any time soon. The debate about whether it was a good idea to proceed with EMU will thus never end.

The second part (B), which constitutes the main body of analysis, then discussed the main benefits and costs.¹

Chapters 3 and 6 of part B thus discuss the efficiency gains (from EMU) and the costs of adjusting without the nominal exchange rate. These are the standard key issues one finds in any textbook on monetary integration (see also for de Grauwe, 2014).

Chapter 5 discusses the implications for public finance and chapter 7 the 'External dimensions', i.e. essentially the potential for the ECU (as the future euro was called in OMOMO) to become a rival to the US dollar as a dominant global reserve currency.

The authors of OMOMO were actually quite cautious (for the standards of their time) in not exaggerating the potential benefits from EMU to create something of a rival to the US dollar, whose supremacy in the global monetary system – the exorbitant privilege – was resented at

¹ This part also contains a separate chapter, on the benefits of stable prices, which does not really fit the sequence of arguments. The purpose of this chapter was mainly political: to convince the German public and authorities that the conversion of the EU authorities to the price stability mandate for the future European

the political level. Outside Germany, one key argument for EMU had been that this would create a European rival to the US dollar – which would lead to some redistribution of global *seigniorage*.

What is interesting from today's perspective in the chapter on the external aspect is that OMOMO was based on a very trans-Atlantic view of the global economy. It was natural at the time (and remains so today) to take the US as the implicit point of comparison for how a continent-wide monetary union should work. But the view that the euro and the dollar would continue to dominate the global monetary and financial system was based on a static perception of the world. Few at the time anticipated the fundamental transformation of the global economy that would occur a few years later. China is not mentioned once in OMOMO, and Japan only a few times.

At the time, the US and the 'ecu area' together accounted for more than two-thirds of world GDP (measured at market exchange rates, see Table 7.5, page 187 of the report), with another 20% for Japan and barely 12% left for what were then called 'less developed countries'. Today, the euro area accounts for only 15% of global GDP and has already been overtaken by China, whose currency now seems a much more likely contender to the US dollar than the euro.

Part C, entitled "The impact through time and space" is perhaps of lesser interest in the present context. It dealt with the potential problems during transition, potential differences in the impact of EMU across countries and regions and national attitudes towards EMU. This last chapter 10 is of some historical interest since it shows that the hopes and fears of the time were often very different from what transpired later. National attitudes have thus changed almost completely. This is especially true for the two polar cases of Germany and Italy. The Germans feared a loss of price stability, which did not materialise, whereas the Italians looked forward to a better economic performance based on price stability. But the underperformance of Italy (in terms of growth) throughout the EMU period constitutes perhaps the biggest disappointment from the point of view of the analysis of OMOMO: solid price stability and the disappearance of the inflation risk premium should have delivered a boost to the economy. But Italy's growth rate remained constantly below the euro area average, even before the financial crisis and the return of risk premia.

2. 'One Market, One Money' or, 'One Money, One Market'?

The key argument: one market needs one money to function well appears plausible, even today. But it has always been difficult to justify on purely theoretical grounds, and the empirical evidence has remained elusive.

The authors recognised the impossibility of proving in any scientific sense that one market needs one money when they admitted in the passage cited above that there is no "unified, ready-to-use theory of the benefits of monetary integration".

But this passage is immediately followed by:

This may seem paradoxical since, as pointed out by various authors,²⁷ the use of a single money seems to be as essential to the unification of the US internal market as the absence of any direct or indirect trade barriers. Though the diversity of industrial structures among US states or regions is as great as among the Member States of the Community, the idea of appreciating the Texas dollar when the price of oil rises, or depreciating the Michigan dollar when Detroit is outpriced by Japanese car exports, sounds as pointless as introducing custom duties inside the US market.

The argument is thus made essentially with reference to the US and other historical examples. The process of German unification during the 19th century was also considered a key experience (footnote 29):

A classic example is that of the German monetary unification in the nineteenth century, which followed a few years after the trade and economic unification under the Zollverein.

While it was impossible to ‘prove’ a general theorem that one market needs one money to function properly, OMOMO did provide a careful estimate of the microeconomic gains from a common currency. But it was recognised that the direct savings from not having to exchange currencies could at most represent a (miniscule) fraction of GDP. The benefits from the elimination of exchange rate uncertainty were already much more speculative, since financial markets offer many ways in which exporters and importers can hedge against exchange rate volatility, though at significant cost, substantially increasing with duration/time. Nevertheless, it was widely expected that EMU would foster trade – exchange rate volatility was seen as equivalent to a tax, reducing cross-border trade – among the participating economies, which would lead to additional benefits. All of this was impossible to quantify, however.

The key argument was that monetary union would ultimately lead to significant macroeconomic benefits in terms of price and exchange rate stability. This seemed to be the winning argument, given that maintaining or achieving price and exchange rate stability was considered the key economic problem of the day. In Italy inflation had come down from over 20% in previous decades, but had reached a floor of about 5%. Achieving price stability according to the German standard appeared very difficult. Converging to the German price stability standard was considered key to the survival of the European Monetary System (EMS) once capital controls were removed. The authors of OMOMO felt that an area with floating exchange rates driven by a combination of inflation differentials and erratic capital flows would not constitute an integrated market. The key line of argument in OMOMO was thus the opposite of what is implied in the title, namely that ‘One Money’ would create ‘One Market’.

It is in this part of the analysis that the authors made the crucial oversight.

3. One money and financial markets

The Achilles heel of OMOMO was to neglect the inherent instability of financial markets.

The microeconomic benefits of lower transactions turned out to be greater in the financial than in the real sector. The detailed analysis of foreign exchange transactions costs in OMOMO revealed that they were of second-order importance for trade in goods. But for financial transactions, where even hundredths of a percent (so-called basis points) matter, the elimination of even small transactions costs can have a large impact. This explains why the expansion of intra-area trade was tiny when compared with the expansion of intra-area financial flows.

This expansion of financial flows was partially expected, and was expected to bring microeconomic benefits in terms of a more efficient allocation of capital and better risk sharing. That unfettered financial markets should lead to a better allocation of capital was the dominant view in 1990. It was also driven by experience with capital and credit controls in countries like Italy and France, which led to political interference with no visible benefit in terms of higher growth. The view that financial markets are efficient actually became even more widespread during the 1990s and the early 2000s, as capital began flowing into the poorer euro area periphery. Blanchard/Giavazzi, 2002, described this as “capital flowing downhill”. The authors of OMOMO had argued that a major benefit of monetary union for the lagging countries would be their ability to borrow at lower cost because of the disappearance of the exchange rate premium.

Until 2008 it appeared that the analysis of OMOMO had been correct in that the elimination of exchange rate uncertainty and transactions costs would yield small, but non-negligible microeconomic gains, with macroeconomic stability as an important additional benefit. The largely congratulatory evaluations of the first ten years of EMU were based on a track record of high growth in trade and monetary stability, with the ECB achieving almost exactly the goal it had set itself, namely an inflation rate of below, but close to, 2%.

The financial crisis that started in 2007-08 spoiled this pretty picture. Two aspects of the financial crisis were difficult to reconcile with the philosophy underlying OMOMO: the global financial crisis had struck in the absence of any inflation; and it had a second leg in the euro area, which had no parallel elsewhere.

With hindsight, the increasing likelihood of a financial crisis is apparent in the sharp increase in leverage, or debt-to-GDP ratios, almost everywhere during the period of what was called the Great Moderation. The increase in leverage had both a domestic and a cross-border aspect. The domestic aspect, which concerns mostly the banking sector, is key for Europe. The trend is well described in ASC (2014), which noted that:

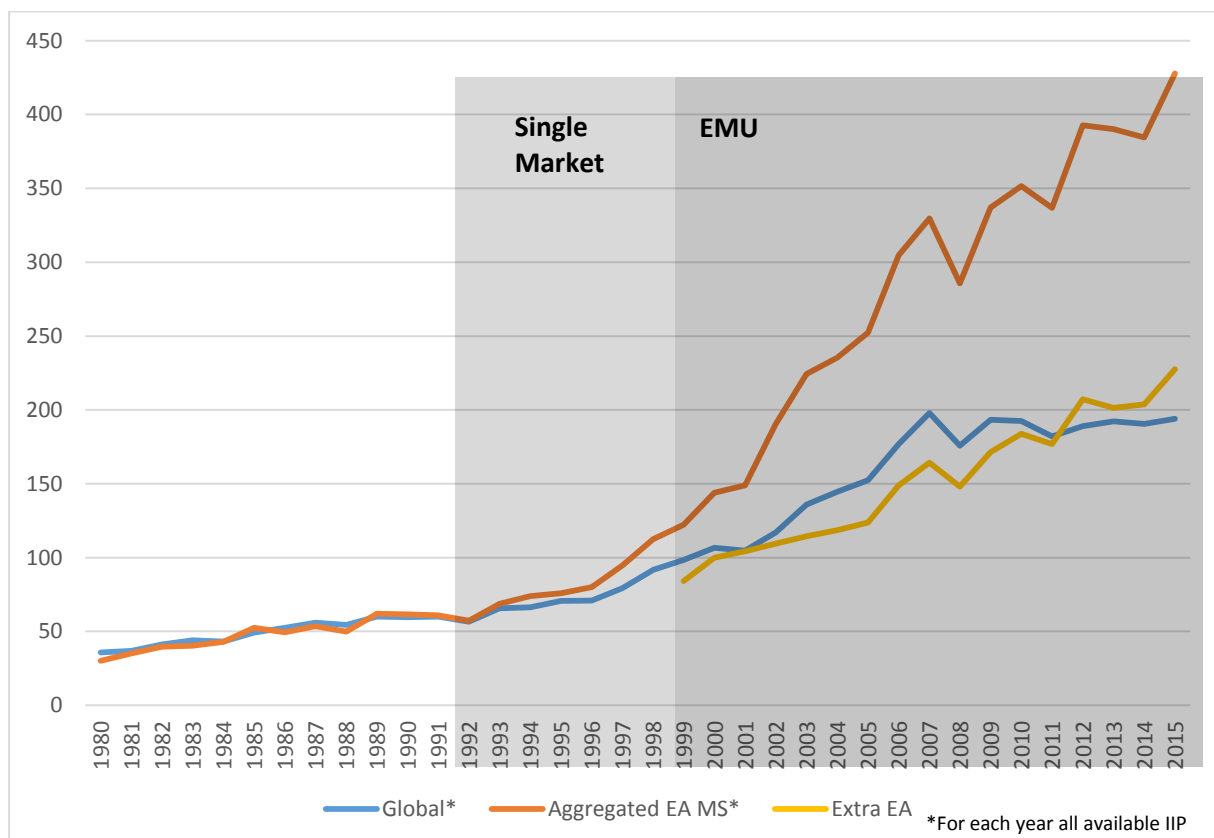
bank credit-to-GDP had increased everywhere in Europe, but the extent of the increase varies. Four EU countries (Finland, Germany, France and Austria) experienced only modest increases in credit to GDP over 1991-2011. Elsewhere, bank credit grew very substantially relative to GDP: in nine countries, the ratio more than doubled. Five countries where bank credit grew most substantially – Cyprus, Ireland, Spain, Portugal and Greece – needed (and received) financial assistance during the crisis (2010-14).

This observation illustrates what has now become conventional wisdom: that a sharp increase in the credit-to-GDP ratio is the best predictor of a financial crisis.

The neglect of the importance of financial markets and systemic instability is also apparent in the very short section in OMOMO on the role of the current account in EMU. The conclusion was that the current account – adieu to Feldstein/Horioka – would cease to be a constraint at the macro-economic level, but that individual units (banks, enterprises, households) would of course be subject to their individual budget constraint. This was correct, but also irrelevant since the crisis has shown that the simultaneous insolvency of a large group of firms or banks threatens the survival of the entire financial system, which in turn has very high economic costs. This cross-border source of a financial crisis turned out to be crucial during the euro crisis.

The increase in cross-country financial activity was even larger than the domestic one mentioned above. As Figure 1 shows, external assets of the euro area countries amounted to little more than one-half of GDP when OMOMO was published. By the time EMU started this had more than doubled, lifting the ratio of external assets to GDP to over 100%.

Figure 1. IIP (assets) as % of GDP



Source: IMF.

At the outbreak of the financial crisis the figure had again more than doubled, exceeding 300% of GDP in 2007-08.²

Figure 1 also shows the same ratio of external assets to GDP at the global level. It is apparent that until the mid-1990s, approximately, Europe was not special in terms of cross-country financial activity. However, starting a few years after the completion of the internal market (and thus the complete lifting of capital controls in the EU) the European line increases much more sharply than the global one. At the global level, cross-border assets peaked at close to 200% of GDP just before the outbreak of the financial crisis, considerably lower than the value of over 300% for the euro area countries mentioned above.

A large, and increasing, part of the cross-country assets of the euro area countries concerned intra-area financial activity, as can be seen from the third line in Figure 1, which shows the ratio of external assets to GDP of the euro area. The difference between the line for the euro area and that for euro area countries considered individually shows the importance of intra-area cross-border financial activity. These cross-border claims increased from about 50% of GDP at the start of EMU, to over 150% of GDP just before the outbreak of the euro crisis (and have now risen above 200% of GDP).

This extraordinary increase in intra-area cross-country financial activity was not recognised as a potential danger until it was too late. On the contrary, as mentioned above, as late as 2008, the explosion of cross-border lending was viewed as a benefit of the euro since it supposedly allowed for a better distribution of risks.

The explosion of cross-border lending had two aspects: first, inside the euro area a group of countries began running very large current account deficits, mirrored essentially in a growing German surplus, and, second, the gross positions of all countries, even those without a current account deficit or surplus increased rapidly. Obstfeld (2012) argues that both aspects deserve attention. In the case of the euro area the crisis was also caused by this combination of large gross positions, coupled with net debtor positions of some countries, which, *ex post*, appeared unsustainable. In the, 'naïve' (also *ex post*) or 'consenting adult' view of OMOMO, the fact that large net debt positions run up through large current account deficits in the periphery might have been unsustainable *ex post*, should not have been too much of a concern since the individual debtors (firms, banks or even governments) would then simply have gone bankrupt. What neither OMOMO, nor most policymakers, appreciated was the fact that with large gross positions the insolvency of a large group of borrowers could bring down the entire financial system. It was this threat to systemic financial stability, coupled with an outsized financial system overall, that made the bail-outs inevitable.

² Figure 4 in the 2014 ASC report also shows that cross-border assets of the European banks (a subset of all foreign assets) grew exponentially during the 1990s and up to 2008.

4. Did the euro foster real integration?

A key argument of OMOMO was that the elimination of transaction costs through the introduction of a single currency should provide a noticeable boost to real economic integration. At the time of the publication of OMOMO the internal market programme had not yet been fully implemented and one could only guess its ultimate economic impact, which was, however, expected to be large. The argument was thus that the euro would provide an additional boost to intra-area trade.

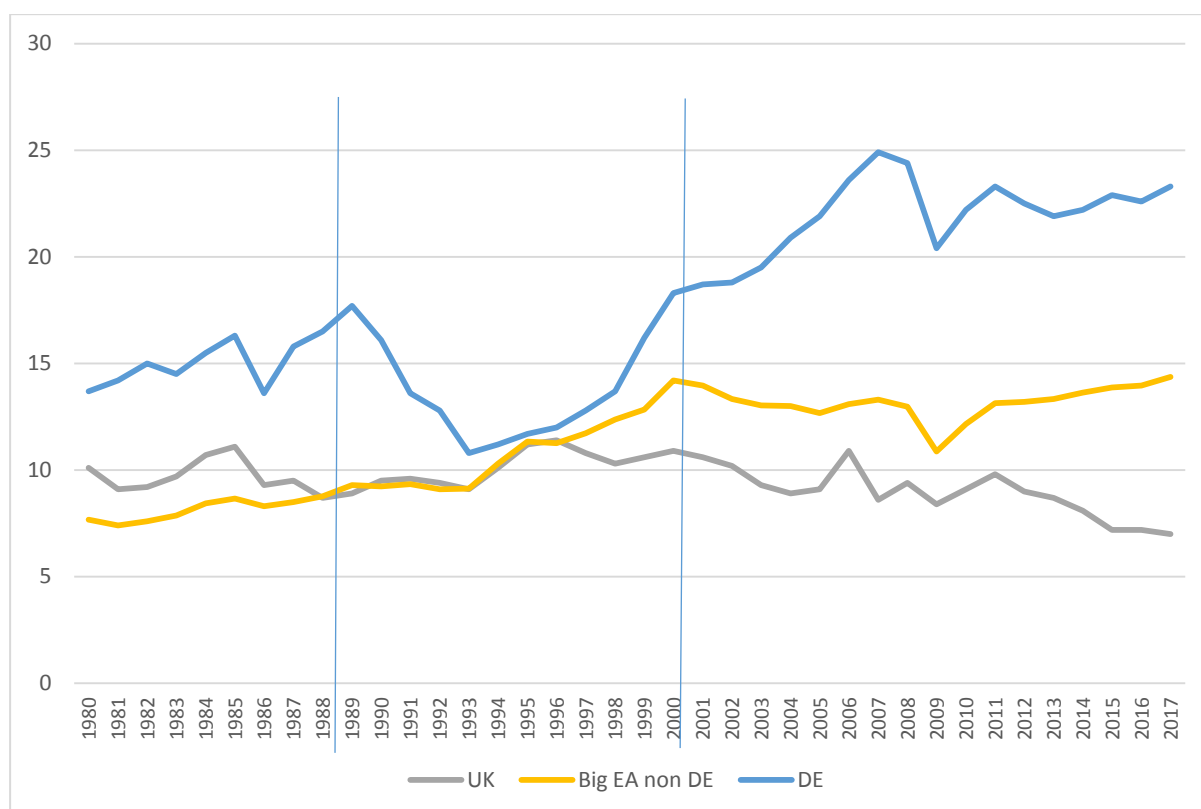
However, the raw data, at least at first sight, does not support this view. Figure 2 below shows intra-EU trade as a % of GDP for key EMU countries.³ The reason for showing different countries separately is that different countries reveal quite different patterns. One finds that, indeed, for the average of three of them (France, Italy and Spain) the importance of intra-trade grew continuously during the 1990s. OMOMO would have expected that this trend should have continued after the start of EMU. Unfortunately, one observes the opposite: during the early years of EMU intra-trade actually declines somewhat (relative to GDP).

The case of Germany is quite different, influenced heavily by the reunification boom and bust. During the early 1990s, intra-trade declines in importance (despite the completion of the internal market programme), but after about 1995 intra-trade recovers and this trend continues during the first decade of EMU. This illustrates a general point: German reunification represented such an asymmetric shock for the European economy that it affected any evaluation of the 1992 programme and the early years of EMU (Gros and Steinherr, 1995).

Given this vast difference in the experience of different EMU member countries it is difficult to draw clear conclusions from the data – except that the introduction of the euro did not have a strong generalised impact on intra-area trade flows. The data for the UK, also reported in Figure 2, is also interesting as it shows a stagnation (at best a marginal increase) in the importance of intra-EU trade over the 1990s, i.e. the period during which the creation of the internal market should have fostered intra-EU integration.

³ Intra-EU data is used here since data on intra-euro area trade alone is not readily available. But intra-EU trade also represents the bulk of intra-euro area trade. Preliminary calculations of the intra-euro area shares using only manufacturing goods yield a similar picture: the increase in the importance of intra-area trade stops just when the euro is introduced.

Figure 2. Intra-EU trade as % of GDP



Note: goods trade only.

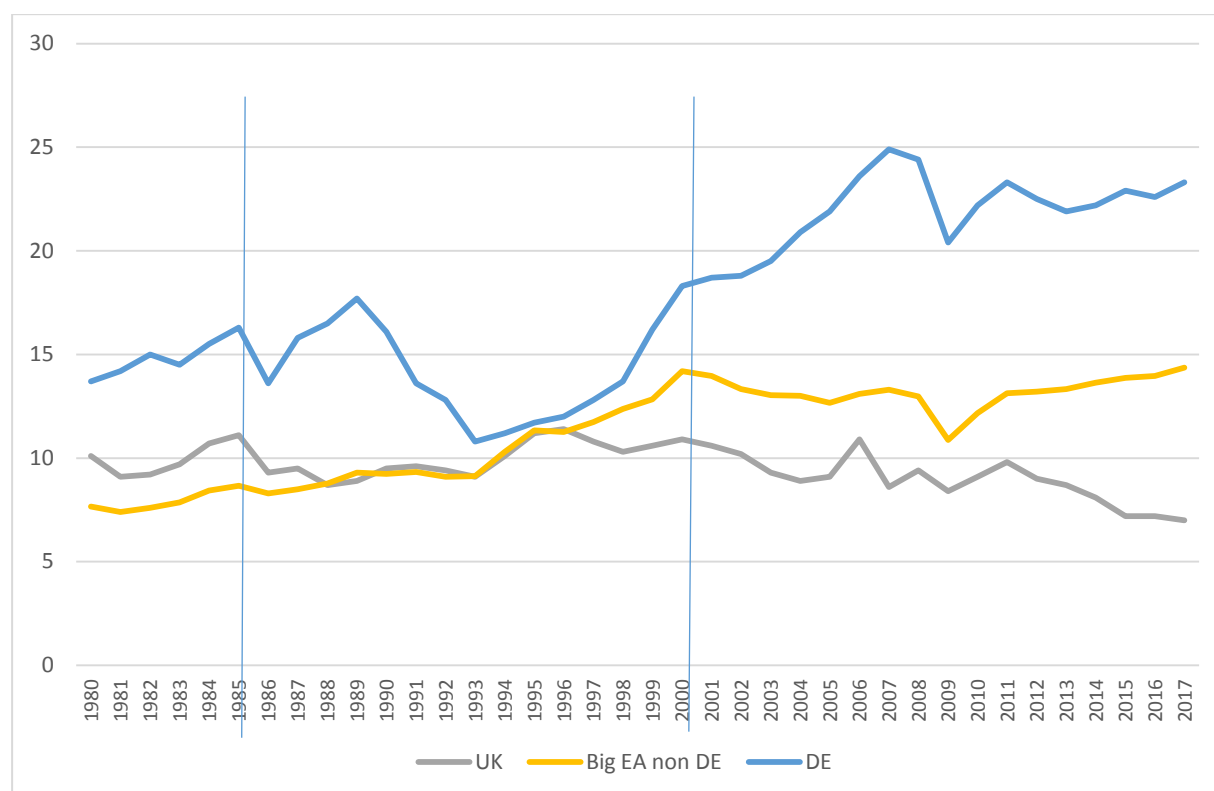
Source: AMECO.

Just looking at the absolute importance of intra-EU trade as a share of GDP might be misleading since the share of manufacturing in GDP has also been declining. This effect might explain in particular the decline in the importance of EU trade for the UK as its economy increasingly specialised in services (*particularly financial services*). This asymmetry, which arose gradually over the last two decades, likely constitutes one of the factors that contributed to the negative outcome of the Brexit referendum of 2016.

Another measure of the impact of the euro on trade flows is the share of intra-trade relative to all trade. This variable is not affected by changes in the share of manufacturing in GDP because this should affect the overall importance of all trade in goods.⁴ Figure 3 below thus shows the ratio of intra-EU trade as a % of all trade. A comparison of the two figures reveals a very similar pattern: the three lines (for the UK, Germany and the remaining three large euro area economies) are very close during the mid-1990s, but diverge thereafter (and had a different dynamics beforehand). In general, Germany shows a higher propensity to trade with its EU partners than others, but this feature is temporarily interrupted by reunification. For the other euro area countries one sees a steady increase in integration, which actually stops with the start of EMU.

⁴ Data on the destination of services exports is scarce and unreliable.

Figure 3. Intra-EU trade as % of total trade (goods)



Source: AMECO. Note: goods trade only.

The share of intra-trade in overall trade used in Figure 3 is of course also affected by the fact that the rest of the world has become more important. China, in particular, started to emerge as a global trading power when it joined the WTO, which was only a few years after the start of EMU. One could thus argue that without the euro the relative importance of intra-EU trade would have declined even more. This argument is corroborated by the fact that intra-trade has held up much better on both measures used here for the euro area countries than for the UK. For Germany, the outsourcing of basic manufacturing to neighbouring countries might explain the increase in the intra-trade ratios. But it remains difficult to explain why this happened only in the case of Germany and not France, Italy or Spain. Moreover, the extension of the German supply chain was mainly towards the new member states from Central and Eastern Europe, many of which have not joined the euro. This implies that ‘One Money’ was not a decisive factor in this respect.

These considerations show that raw data cannot be conclusive since it neglects a host of other factors that might have an impact on trade flows. On balance, most empirical studies that employ more sophisticated methods (mostly so-called gravity models) do find a positive impact of the euro on trade (Rose (2008)),⁵ but the evidence is nowhere near as substantial, or as clear-cut, as predicted in OMOMO.

⁵ The same author had earlier found that a monetary union can double or triple trade between its members. But this result had been based on the data from small island states and has not been confirmed for Europe.

Another way to measure market integration is to look at the dispersion of prices across countries or regions. Allington et al. (2005) do this under the heading “One Market, One Money, One Price?” This line of research has generally yielded similar results in that there is some evidence of price convergence, but sophisticated statistical methods are also required to filter out all the other influences on price dispersion. Beck et al. (2015) provide a recent survey of the literature and an illustration of the practical difficulties of testing whether the ‘law of one price’ (LOOP) holds within the euro area. These authors do not find lower price differences across the German-Dutch or German-Belgian borders than across the German border with Poland (which is not in the euro area).

5. Conclusions

Does one market need one money to function properly? This became a widely accepted proposition after the publication in 1990 of the report by the European Commission. Subsequent developments have not vindicated this simplistic proposition, however, which would imply that all EU member countries should join (or at least have an economic interest to join) the EMU.⁶ The first departure came when the UK asked for and obtained an opt-out from Monetary Union. The UK (and other countries) were thus part of ‘one market’, but not part of ‘one money’. The UK might constitute a special case since it will be leaving the EU, and probably the internal market as well. But there are a number of other EU member states that have not adopted the euro, which show no visible signs that their economic performance, or participation in the internal market, has suffered.

Evidence that the creation of a common currency would contribute greatly to the integration of the real economy (and vice-versa) is thus weak. However, the creation of the euro clearly had an impact on cross-border financial activity. The conclusion I put forward is thus that ‘one money’ fostered cross-border financial activity much more than trade. The euro made a real difference in terms of financial market integration.

The integration of financial markets was more apparent than real, however, because the underlying supervisory and regulatory regime always remained national. Moreover, national governments remained the ultimate guarantors of the stability of the financial institutions headquartered in their country. The very large cross-border claims that had been accumulated during the first decade of EMU thus became a grave risk to financial stability and the integration of financial markets. This was the crucial oversight in OMOMO. Its authors did appreciate the potential for instability in financial markets and the need for a common supervisory and rescue mechanism for the common currency area. It took an existential crisis to force reluctant governments to agree to the formation of an, at least partial, Banking Union.

⁶ As so often, it is the ‘dog that did not bark’ that is most revealing. When the free trade pact between the US and Mexico (NAFTA), the American equivalent to the internal market, was discussed and then implemented, a common NAFTA currency was never part of the agenda.

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