

# EUROPEAN INTEGRATION AND THE EURO: FISCAL SUSTAINABILITY AND MACROECONOMIC STABILITY

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## ABSTRACT

The purpose of this paper is to explore the extent to which the institutional framework of the EMU is able to facilitate endurance for responding to potential economic shocks and future challenges of the EU. We discuss factors of macroeconomic stability and financial sustainability in the Euro region and evaluate the monetary and fiscal policies of the EU in regards to the effectiveness of the institutional framework for being able to facilitate endurance and respond to potential economic shocks and macroeconomic challenges within the growing interdependence of the Euro region. The findings of the study reveal that the EMU has the glue that is necessary for the success of a monetary union. It has the political will and vision that often proved to be the crucial sustaining factor in history for the success of monetary unions. The rules of the Maastricht Conversion Criteria and the Stability and Growth Pact (SGP) aim to protect against inflation, also likely to prevent inflationary bailouts and excessive deficits by focusing on price stability as a primary objective of macroeconomic policy. However, the study also reveals that to maintain fiscal sustainability and macroeconomic stability, the EMU needs a system of credible coordination of monetary and fiscal policies that allow for economic goals other than price stability. This is a necessary condition for success because any type of monetary union will sooner or later run into hard times that will test the endurance of the union. The extent to which the EU policies allow for structural reforms of labor, capital, and product markets, will mark the level of responsiveness of the system for handling potential economic disturbances and asymmetric shocks in the region.

## INTRODUCTION

On January 1, 2002, the Euro was physically introduced in the form of banknotes and coins. This event marked the conclusion of the changeover to the Euro which was initiated almost three years ago when the Euro was successfully introduced in the 12

countries called "Euro area." The Euro is definitely a tangible currency not only for the more than 300 million citizens of the Euro area, but also for travelers, tourists, and investors from all over the world.

Measured in terms of population, the Euro area is one of the largest economic entities in the world, with a total of 302 million inhabitants. By comparison, the population of the United States and Japan are 272 million and 127 million respectively. The GDP of the Euro area is equivalent to 16 per cent of the world GDP, about 6 percentage points less than the share of the United States but more than twice the share of Japan (Solans, 2002). Even more important than the current figures is the potential for the future development of the Euro, when Denmark, Sweden and the United Kingdom join the Euro system and the Union is further enlarged by the full membership of the accession countries of Eastern Europe.

The international role of the Euro is determined by the decisions of market participants. Future developments with regard to the private international use of the Euro are likely to be heavily influenced by two main factors: size and risk. The broad, deep and liquid Euro capital market may lead to a greater use of the Euro through lower transaction costs. This may facilitate the development of the Euro as a vehicle currency for trade and commodity pricing. In addition, if international investors consider the Euro to be a stable currency, they will hold Euro assets to minimize risk in their portfolios. Only if investors outside the Euro area are confident that their purchasing power will be preserved over time will they engage in euro-denominated financial activities.

The European Monetary Union will have effects on practically every area of economic policy-making in Europe: it will influence the allocation of resources, the distribution of income, stability and growth, as well as the formal and informal institutions of labor, product and financial markets within the Euro area. The purpose of this paper is to explore the extent to which the institutional framework of the EMU is able to facilitate endurance for responding to potential economic shocks and future challenges of the EU policies.

## LITERATURE REVIEW

The stability of the Euro system has been in the center of theoretical analysis and policy debate since the first plans of the establishment of the single European currency were announced. Eichengreen (1997a) identified a number of challenges, weaknesses and flaws in the construction of the EMU. Obstfeld (1998) proposed alternative policy measures to remedy these. Ongoing challenges to the EMU include coordination of monetary and fiscal policies, labor market reforms, coordination of labor market regulations, wage policies, pension and welfare systems, integration of financial and capital markets, liberalization of accounting standards, tax harmonization, liberalization of service sectors such as the energy and utility industries, structural economic reforms in product markets, industrial policy coordination, and infrastructure development.

Lessons from the history of monetary unions indicate that the sustainability of a monetary union is crucially dependent on how it is constructed from the outset. Centralized monetary unions as a rule seem to be more durable, specifically better able to adjust to and survive shocks and disturbances than are decentralized monetary unions, which have a stronger tendency to break up under economic and political turmoil. For example, the United States, a centralized monetary union, is divided into a number of Federal Reserve districts, each headed by a Federal Reserve Bank issuing dollars. The Scandinavian monetary union, founded in 1870s lasted into the 1920s is an example of a decentralized monetary union where three countries, Denmark, Norway and Sweden formed a union but each maintained a central bank that issued Scandinavian kronor. The Scandinavian monetary union lacked a central monetary authority which eventually proved to be a fatal flaw (Jonung, 2002).

A comparison of centralized (U.S., Germany, and Italy) and decentralized (Scandinavian, Austro-German, and Latin-American) monetary unions indicate that when subjected to major shocks, the lack of coordination mechanism in the decentralized monetary union eventually brought the union to an end (Jonung, 2002). As political unity is commonly the glue that holds a monetary union together, the disappearance of political unity as a rule usually spells the end of monetary unity. The break-up of states like Yugoslavia, the Soviet Union, and Czechoslovakia in the 1990s illustrates this point.

The literature also indicates that centralized monetary unification does not require fiscal unification. In federal states like the US, Germany, Canada, and Switzerland, monetary policy-making is centrally coordinated while fiscal powers are decentralized to varying extents (Jonung, 2002). In the European nation state, monetary and fiscal policies are centrally determined. The European Central Bank (ECB) system is constructed as a centralized monetary authority while fiscal policy-making remains in the hands of the individual member states of the Euro within the rules set out in the Maastricht Treaty and the Stability and Growth Pact (SGP).

History proves that the economy of a country or group of countries is always subject to negative macroeconomic disturbances. Therefore, there is no foolproof or fail-safe monetary arrangement that can guarantee a shock-free future. Thus any type of monetary union will sooner or later run into hard times that will test the endurance of the union. The extent to which fiscal and monetary policies are responsive to the unforeseen challenges of the union will mark the level of sustainability and legitimacy of the common currency and the economic union.

In terms of macroeconomic stability, economic theory holds that macroeconomic stability is ensured when economic cycles are smoothed and the internal dynamism and resilience of an economy are reinforced by a culture of entrepreneurship, innovation, and adequate level of savings and investment. By maintaining price stability, monetary policy plays an important role in stabilizing output and creating an environment conducive to strengthening the economy's supply side and potential growth. Increases in labor productivity, standard of living, and balancing labor demand and supply in general are important aspects of macro-economic stability.

In addition, a sound budgetary policy is an important pillar of macroeconomic stability. The norm for budgetary policies is to allow for the symmetric play of automatic stabilizers over the economic cycle. Sustaining sound budgetary positions implies that tax reforms need to be properly financed and matched with reduction in public expenditures where appropriate. The study of the evolution of macroeconomic policies in the EU by Jonung (2002) indicates that the 1970s and 1980s marked the era of Keynesian paradigm of full employment and high growth. In the 1990s the economic policy focus was stabilization by stressing the benefits of low and stable inflation through a rule-bound macroeconomic policy

framed for medium and long run. At this time, inflation targeting was introduced as the proper strategy of the European central banks. This explains why the German stability approach focusing on low inflation appeared attractive within the European Union

The EMU budgetary policy is stated in **Figure 1, Stability and Growth Pact (SGP)**. According to the SGP, member states must achieve budgetary positions close to balance or in surplus. An “early warning system” is designed to detect problematic developments through the economic recommendations of the Ministers of Finance of the EU (ECOFIN) and the European Commission (EC). EMU members must achieve three goals simultaneously: (1) price stability interpreted as the annual rate of inflation not to exceed more than 1.5 percentage points of that of the three best performing member states, (2) public debt to GDP ratio not to be more than 60 per cent, and (3) budgetary positions close to balance or in surplus over the medium term maintained by a deficit to GDP ratio of not more than 3 per cent. These fiscal rules, listed in **Figure 2**, are commonly known as the **Maastricht Convergence Criteria**. By fulfilling the above requirements, EMU members follow fiscal rules that pertain to normal circumstances. Under exceptional circumstances, the general government deficit is allowed to exceed the 3 per cent limit, thus there is an escape clause in the rules.

The institutional framework and goal orientation of the European System of Central Banks (ESCB) consists of the European Central Bank (ECB) and 15 National Central Banks (NCBS). The primary objective of the ECB has been to maintain price stability in the Euro area. Solans (2002) notes that the launching of the single monetary policy and the Euro produced an unprecedented stability in the Euro area, created a strong monetary policy player on the global scene, and provided a strong impetus to fiscal and structural improvements in the economies of the Euro. However, conventional challenge to price stabilization questions how a major economic disturbance might affect the Euro system as it would likely expand budget deficits and pose a risk to price stability. Such a negative shock would reduce the incentives of the members to support the goal of price stability by a policy of fiscal prudence. The present macroeconomic paradigm in the EU is likely to be questioned if macroeconomic disturbances in the region were to challenge the goal of price stability over other macroeconomic priorities.

## EMU POLICIES AND OPERATIONS

The Stability and Growth Pact (SGP), Figure 1, requires *fiscal positions to be balanced or being in surplus in normal times so that automatic stabilizers can operate*. The Pact also clarifies the criteria of the Excessive Deficit Provision. The Maastricht Convergence Criteria, Figure 2, required EU members to *reduce their budget deficits below 3 per cent of their GDP and maintain debt levels of less than 60 per cent of GDP*. Considerable debate has been about whether having such strict rules for the continued success of the Union are beneficial or a mere hindrance to EU members? Given the recent developments in France and Germany, the two largest economies of the EU where the budget deficit has already exceeded the 3 per cent GDP limit, the EMU policy debate has rekindled.

A basic question in the debate is why fiscal responsibility is such a major issue in the EU? To address this, it is important to emphasize that policymakers as a rule use fiscal, monetary and exchange rate policies for macroeconomic stabilization. With entry into the Union, the independence of individual member countries over monetary policy has been lost because decisions over monetary policy are determined by the European Central Bank (ECB) and not by the national central banks. The ECB’s policy mandate is to maintain price stability rather than providing adjustments according to the cyclical conditions of the EU in the aggregate or in individual EU countries. Since national currencies have already been given up in favor of the Euro, the exchange rate cannot be altered to boost exports for growth. Hence, fiscal policy is the only tool that is left for the EU nations to stabilize demand and supply in their respective countries, given the limited flexibility of prices and wages.

This policy tool, however, is not without constraints. The principles of macroeconomics clearly state that huge budget deficits lead to high long-term interest rates that crowd out private investment and depress output growth. Giavazzi and Pagano (1990) demonstrate that the usual Keynesian prescription of counter cyclical fiscal policy may not work in the presence of huge fiscal imbalances. Moderate budget deficits or surpluses boost the confidence of consumers and producers alike and bring their expectation of future inflation down. This, indeed, is conducive to long-term growth. Therefore, the question is when smaller budget deficits are pro-

growth, why is there an uproar about the SGP? To answer this, we will discuss the meaning and implication of the SGP for the EU nations.

- The SGP outlines that a deficit in excess of 3 per cent is considered exceptional if a country's GDP declines by at least 2 per cent in the year in question. In addition, a recession in which real GDP declines by less than 2 per cent or more than 0.75 per cent may qualify for exception with the concurrence of the European Council. While EU countries are obliged to correct these fiscal deficits as quickly as possible, the Pact provides for running deficits in excess of 3 per cent for at least two years without incurring fines (Eichengreen and Wyplosz, 1998). According to this, the Pact seems rather flexible and may not hinder the fiscal policy making of the EU countries in general.
- The economic argument for price stability is that the SGP provides extra protection for not pressuring the ECB into providing inflationary debt bailouts. The following illustrates this point. Let us assume that one EU nation has fiscal problems which creates panic among investors as payments on public debt may be suspended or modified. The likely reaction is to sell the government bonds of this country. The selling of the bonds could create problems in bank holdings. Since the cost of fiscal profligacy in one country is borne by all EU members, EU governments can have an incentive to run riskier policies which in turn might create a moral hazard problem. Hence, there is an economic rationale for keeping the fiscal deficit low.
- According to Dornbusch (1997), the Maastricht Treaty makes full sense: debt is a risk factor for sound monetary policy, hence limits on debt and deficits can be safeguards against inflation temptations. Also, to maintain an environment free of inflation temptations, the control of deficit after accession justifies the "Stability Pact."
- The provisions of the Treaty assure that the ECB remains independent, it cannot solicit or accept guidance nor can it finance governments. The extra provision of no bailouts of public debts eliminates an immediate spillover effect of poor public finance to central banks or countries' budgets. Bean (1998) argues that high debt countries will not press for inflationary policies because members of the Governing Council of the European Central Bank are not supposed to work in their narrow national interests. Proponents of the SGP claim that despite the theoretical independence of the ECB, any nation would be "too fat to let fail." Some economists doubt that the ECB could always resist the pressure to inflate away debt.
- Dornbusch (1997) cautions that high levels of debt invite high levels of inflation and unemployment. Based on this, the economic outcome of the anti-inflationary policy of the SGP could put limits on unemployment levels as well.
- One side of the debate claims that the SGP has a solid rationale to offset Europe's bias towards excessive deficits. Continuous deficit spending in Europe has led to debt/GDP ratios in excess of 70%. High debts make public finances more fragile, reduce the effectiveness of monetary policy, increase fiscal crowding out, and make funding social security liabilities more difficult (Eichengreen and Wyplosz, 1998). As Eichengreen (1997b) states it, the effectiveness of the SGP is questionable without curing the underlying disorder. This is especially important for assuring financial stability in countries that run tightly controlled budgets for gaining membership in the Union.
- Some believe that the policies and fiscal rules of the SGP seem to encourage rule compliance because of the fear of punishment rather than by the use of positive incentives. Bean (1998) contends that the "all stick and no carrot" policy might not be as effective as rewarding good fiscal behavior.
- The SGP's 3 per cent deficit ceiling can interfere with the full and free operation of the national automatic fiscal stabilizers if the numerical constraints become binding.

According to Buitier (2002), a country can reduce the risk of the deficit constraints by positioning its budgetary stance over the cycle. This would require running a sufficiently large surplus to ensure that the likelihood of hitting the deficit ceiling becomes acceptably low. However, this remedy has both short-run and long-run costs: the government could be enforced to exercise fiscal tightening which may not be cyclically appropriate, and the acceptable level of deficit ceiling could lead to a long-run negative government debt position.

- The numerical constraints on deficits and debt rule of the SGP imply that “one size fits all” (Buitier, 2002). This policy does not allow much for differences in economic structure and initial conditions. There are sizeable and persistent differences among the growth rates of the current 15 EU and 12 full EMU members. The variation in growth rates will further increase with the entry of the 10 accession countries, 8 of which are transition countries, former centrally planned economies in Central and Eastern Europe. A low initial stock of capital in these countries is likely to increase the need for a period of high, “catch-up” public sector investment.
- Regarding macroeconomic stability, Jonung (2002) raises concerns that the preoccupation with fiscal stability has been diverting attention from labor market reforms, debt management and bank regulation. Flexible labor markets mitigate the effects of asymmetric shocks through labor mobility. Debt management implies that lengthening the maturity period of the debt will minimize the likelihood of financial crises. To preserve the independence of the ECB and improve bank regulation, policy alternatives should strengthen banks rather than limit the flexibility of fiscal policies. Concerns about the degree of responsiveness of EU policies to possible economic shocks include the possibility of high unemployment, slow growth, economic disturbances in member countries, structural adjustments, inflationary, and budgetary problems.

The pros and cons of economic debate of the SGP raise the question as to what extent can the policy better reflect the needs and conditions of the member countries. As with any rule, the SGP must be transparent and credible. To be credible, a rule should be self-enforcing or it has to be enforced consistently through external agents. Self-enforcing rules must be individually compatible, meaning, they must make sense at the level of the individual nation state. The SGP 3 per cent deficit rule is not self-enforcing. Enforcement by external agents is also questionable as the conditions under which warnings will be issued and penalties will be imposed are intensely political (Buitier, 2002). The problem with the current informal compromise seems to be that because of insufficient flexibility in the system, there is too much scope for opportunistic, politically motivated manipulation of the process.

### RECOMMENDATIONS

The discussion of the policies of the Stability and Growth Pact (SGP) provides insight in to how the EMU framework operates and what shortcomings need to be addressed. Alternative policy recommendations are listed below and in **Figure 3**:

1. Policy evaluation of the SGP should include commitment for ensuring credibility and enforcement of the framework. A more complicated but perhaps longer lasting solution could be a comprehensive revision of the SGP to address the specific concerns and inconsistencies as mentioned above. A more likely alternative is the on-going adjustment of the policy by balancing flexibility and ensuring adherence to the rules.
2. The EU should facilitate macroeconomic policy-making that emphasizes goals other than price stability. Naturally, the banking system should be strengthened to avoid financial crises. However, labor markets should be made more flexible in order to lower long-term unemployment rates. A flexible labor market generally complements sound fiscal policy, as lower unemployment levels also mean less spending on unemployment benefits.

3. A period of slow growth, high unemployment, and other disturbances in the EU at an aggregate level or in individual nation states will require macroeconomic policies that address structural adjustments in a pro-cyclical manner either through the automatic stabilizers or through other policy measures. The long-run stability and fiscal sustainability of the Union ultimately depends on appropriate macroeconomic measures. EU nations need to undertake extreme reforms in labor markets in order to make their economies flexible to deal with asymmetric shocks without running the risk of defaulting on the fiscal front.
4. A fairly common question when Europe is compared with the United States is whether the problems of the SGP could be minimized if Europe were to convert to a fiscal federation. Fatas (1998) argues that the potential to provide interregional insurance by creating a European fiscal federation seems to be too small to compensate for the many problems associated with its design and implementation. In the United States, asymmetric shocks are addressed by automatic interregional transfers through the federal budget. While individual states are required to keep their budgets in balance, they also have recourse to the federal budget. Sachs and Sala-I-Martin (1992) estimated that in the U.S., a fall in state income causes transfers (or reductions in taxes) in the amount of 30 and 40 per cent of the original fall in income. The EU budget is only about 1 per cent of its GDP compared to 10 per cent in the United States and most of EU's budget is devoted to the Common Agricultural Policy, hence it is not available for fiscal redistribution (Eichengreen, 1993). Labor mobility in Europe is about one-half to one-third that of the United States (OECD, 1986 and European Commission, 1990). These facts make the EU less of an optimal currency area compared to that of the United States (Salvatore, 1997). Counter-arguments to fiscal federalism in Europe (Eichengreen, 1997a) claim that this may discourage factor mobility while it would encourage the national labor unions to demand higher wages as the burden of unemployment

benefits would fall on the entire Union. This, in turn, may create more socially inefficient unemployment in the Euro region. According to this, it is not recommended for the EU to convert to fiscal federalism.

## CONCLUSION

The European Monetary Union is a gigantic experiment with no precedence in monetary history. Events of the EMU have effects on practically every area of economic policy-making in Europe as well as in the world. In this paper, we explore the extent to which the institutional set-up of the EMU can facilitate endurance for responding to potential economic shocks and future challenges of the EU system. Financial sustainability and macroeconomic stability of the Euro region are discussed to evaluate the monetary and fiscal policies of the EU in regards to the effectiveness of the institutional framework for being able to facilitate endurance and respond to potential economic shocks and macroeconomic challenges within the growing interdependence of the region.

The findings of the study reveal that the EMU has the glue necessary for the success of the monetary union. It has the political will and vision that often proved to be the crucial sustaining factor in history for the success of a monetary union. In terms of its design, we find many positive factors in ensuring and maintaining financial sustainability of the EMU. The European Central Bank (ECB) operates as a centralized monetary authority with decentralized fiscal policy-making at the national central banks. The rules of the Maastricht Conversion Criteria and the Stability and Growth Pact (SGP) aim to protect against inflation as well as prevent inflationary bailouts and excessive deficits by focusing on price stability as a primary objective of macroeconomic policy. Although, the debate on the SGP raises concerns about inconsistencies, the rule does have certain flexibility which can be applied in "special circumstances."

The problem seems to be that due to the need for keeping flexibility, the enforcement of the SGP can become politicized raising doubts about its credibility. The SGP 3 per cent deficit rule and medium-term balance rule are not self-enforcing and the conditions under which warnings and sanctions will be issued can be intensely political. This makes the operations of the EMU less transparent and more confusing. To remain

fiscally sustainable, what the EMU needs is not only fiscal rules and procedures but also a system of coordination of sound monetary and fiscal policies. Without the credible enforcement of the policies, the system will continue to face pressure for inconsistencies which can cause problems of inflation temptation, possible bank bailouts, labor market crises, or budgetary constraints slowing down individual economies.

The positive effects of the SGP center around its focus on maintaining price stability which is crucial for the long-term good of the Union. However, the preoccupation with price stability also seems to interfere with the efficacy of automatic stabilizers and the ability to address important structural reforms including problems of labor markets, bank regulations, integration of capital markets, budget constraints, and tax harmonization. For the efficacy of automatic stabilizers, many economists hold that the EU fiscal rules seem to be too binding to allow for pro-cyclical stability measures to be effective. The free operation of automatic stabilizers is especially important for maintaining structural reforms to address the macroeconomic stability of the region. In this regard, the study reveals that the present system of EU fiscal and monetary policy-making does not seem to adequately address the differences in economic structures and initial conditions of the EU countries.

Furthermore, the SGP seems to mostly enforce rule compliance rather than positive incentives of good fiscal behavior.

Overall, it can be concluded that the endurance of the EMU and the Euro will evolve over time. The methods and procedures of EU fiscal and monetary policies will need to be fine-tuned in light of the concerns noted above. As long as the political will is there for the Union to make this endeavor work, there will be a way to maintain fiscal sustainability in the region. For macroeconomic stability, the EMU must take into account economic priorities other than price stability as these will undoubtedly emerge in a soon to be enlarged European Union. Especially important in EU policy-making will be to provide for adequate level of responsiveness to macroeconomic structural reforms including addressing asymmetric shocks, economic disturbances, and differences in economic conditions of individual EU nations.

The success of the EU is crucial for a stable world economy as events of the EU will be felt globally through economic interdependence. The confidence of international investors about the value of the Euro, the Euro's purchasing power, its exchange value against the U.S. \$ and other international currencies, the volume of Euro trade are all factors that will greatly influence the economies of the EU and the world in the future.

### Figure 1 - Stability and Growth Pact (SGP)

Obliges participating member states to achieve **budgetary positions close to balance or in surplus sustainability** to minimize the risk of breaching the 3 per cent budget deficit criteria in the course of a business cycle. **“early warning system”** in order to detect problematic developments in time. A system

of **economic recommendations** by the Ministers of Finance of the EU (ECOFIN) and the European Commission (EC)

**Fines** if the 3 per cent criteria is breached. During unusually deep recessions or at time of natural disasters, deficits above 3 per cent might be allowed temporarily.

Fines amount to 0.2-0.5 per cent of GDP, depending on the size of the budget deficit (in the first year these “fines” are un-remunerated deposits).

### Figure 2 - Maastricht Convergence Criteria

- **Price Stability:** annual inflation rate that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States.
- Sustainability of the **government financial position:**
  - a) **deficit to GDP ratio  $\leq$  3 per cent**
  - b) **debt to GDP ratio  $\leq$  60 per cent**, unless diminishing and approaching 60%.
- **Exchange rate stability:** Observance of **normal ERM fluctuation margins** for at least two years, **without devaluation.**
- **10y government benchmark bond yield** not exceed by more than 2 pp that of, at most, the three most price-stable Member States.
- **Legal convergence:** central bank independence, legal compatibility.

### Figure 3 – Alternatives and Policy Recommendations for EMU

- I. Stability and Growth Pact
  - ensure credibility of SGP
  - revise SGP to address concerns and inconsistencies
  - on-going adjustment of EMU Policy
  - balancing flexibility while ensuring adherence to the rules



- II. Paradigm Shift away from Price Stability
  - structural reforms
  - labor market adjustments
  - bank regulations
  - integration of capital markets
  
- III. Macroeconomic Stabilizing Policies
  - pro-cyclical automatic stabilizers
  - flexible macroeconomic policy measures
  
- IV Fiscal Federalism in EU
  - not likely to compensate for problems anticipated (Fatas, 1998)
  - discourage factor mobility and create socially inefficient unemployment
  - comparison of US and EU reveal many differences that make the two systems quite different (Eichengreen, 1997a)

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