Comment on: "Money and the Sovereignty of the State", by R. Mundell

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The paper by Mundell offers a broad and very illuminating discussion of the historical and logical links between monetary and political institutions. These comments will address only some aspects of the issues raised by the paper.

The first section of Mundell's article contains an interesting overview of monetary arrangements in the context of the evolution (over a long period of time) of the concept and practice of political sovereignty. The author stresses that the right to legislate on monetary affairs has often been considered an essential element of the powers of the ruling authority[1]. And, indeed, the historical references in the paper illustrate the proposition that the consolidation of political power has typically led (although not necessarily without delay) to the establishment by the government of an exclusive right to issue money and to rule about its use in private transactions. Now, the history vividly discussed by Mundell suggests that the motivations to act in that way were often related, either to the incentives to define a monetary system that would facilitate internal trade, to an urge to appropriate seigniorage revenues, or to the intention of modifying the outcomes of contracts in periods of "crisis". This poses the question of how the analysis would change in cases where such considerations have less importance.

The EMU seems to have unique characteristics in terms of the decision process that led to its design. The EMU does propose a profound change in monetary institutions, and it implies a significant reduction in the set of policy tools available to individual governments. However, unlike other instances of monetary unification, this is not dictated by a single actor: joining the union is a "sovereign choice" of countries, guided by their own judgments of costs and benefits. European governments have already made strong commitments to policies agreed among themselves, touching a wide range of instruments. Also, as Mundell notes, a country in the EMU trades the possibility of deciding about its own monetary matters for a share of the authority over the policies in the larger area. One may ask to what extent the collective decisions leading to actions by the new Central Bank would satisfy the objectives of the parties, but the monetary integration is not equivalent to a unilateral cession of powers by the member countries to an outside agent. The right to secede from the union allows (obviously in extreme circumstances) monetary sovereignty to re-assert itself.

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[1]It may be noted, as an aside, that in some languages a single word (e.g. divisa in Spanish) may denote at the same time "currency" and "banner", suggesting an implicit analogy between money and a "national symbol" like a flag. However, it is not clear whether the national attachment to local currencies (emphasized by Mundell with reference to a statement of J.S. Mill) is focused on the symbolic aspects of the currency (i.e. the "denomination" that is used to "speak" about prices and, say, the images printed on bills) or it relates to the substantive powers of the government to run an autonomous monetary policy.

It seems hard to imagine a monetary regime without a (possibly implicit) "escape clause". But, clearly, systems of rules differ with regard to the tightness with which the authorities are bound to act according to them (or, put differently, the costs they would face if they decided to abandon the regime). Mundell distingushes sharply between the properties of "true" and "pseudo" currency areas, in the sense that the former would not be subject to de-stabilizing speculation and would be characterized by the convergence of interest rates. Indeed, a tight convertibility system (almost by definition) will seldom (and, in the limit of a truly irrevocable currency union, never) generate devaluation expectations[2], and thus nominal interest rates would not incorporate a premium in anticipation of changes in the parity. However, there is no reason for interest rates not to differ within a true currency area, for "real causes" (e.g. perceptions of a different "country risk"). And the situation of the national financial systems may be widely different even though exchange rates are firmly fixed.

The paper quickly dismisses in a brief footnote any concern about the lender of last resort function of Central Banks in true currency areas. But it would seem that a strict monetary system and low budget deficits are not sufficient guarantees against the emergence of financial troubles. No doubt, the discussion about the origins of financial crises is not likely to be resolved soon, but recent episodes strongly suggest that the possibility of failures in the coordination of intertemporal decisions of private agents (due, for example, to miscalculations of the rate of return on investments) cannot be ruled out. In any case, these episodes in Latin America and Asia have provoked large sacale operations, involving domestic authorities and also international agencies. Whatever the opinion one may have about these actions and, more generally, about the financial policies that should be applied to reduce the likelihood of disturbances and those that should be used if disturbances do happen, the evidence seems to indicate that lender of last resort interventions will continue to take place (on occasion) in the future.

One of the aims of the EMU is to promote the integration of the financial systems of the member countries. Despite the high degree of commercial integration, European financial systems seem to be characterized by "home country bias" and "home currency bias", in the sense that the asset holdings of residents of a given country are to a large extent liabilities of other residents, and these instruments are mostly denominated in the local currency. If financial integration proceeds fast enough, it is clear that the supervision of intermediaries and, if the need may arise, the powers to act as lender of last resort would naturally be assigned to an area-wide entity. But, even though integration goes more slowly, monetary unification would provide incentives for a movement in the same direction. That is so because, if at some moment the banks of a certain country run into difficulties, it is very probable that the common Central Bank would assume at least part of the

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[2]However, the statement that, say, a currency board will always induce stabilizing speculation seems too strong. For example, the Argentine peso came under attack in 1995, and the Hong Kong dollar in 1997 (however, in neither of these cases did the attacks force devaluations). In more general terms, no system (short of a full currency union with no option to withdraw from it) is likely to be "completely credible" at all times: even a more than 100% reserve backing of the monetary base does not provide full insurance, because there might be cases in which the public may be uncertain about whether the authorities would use reserves to help out the banks in the event of a run on deposits.

burden of a potential rescue operation (among other reasons, to prevent "contagion effects" from developing). Now, if this possibility cannot be excluded, it is also to be expected that the attributions to supervise banks and to regulate their activities would be trusted to a "central authority" (in order to avoid the well-known malincentives of having a lender of last resort without appropriate supervision). Monetary unification would then lead to centralized bank supervision, which is certainly a non-trivial transfer of policy-making capacity away from local authorities.

Mundell discusses the substitution of local currencies for the area-wide money as a unit of account of prices. The need to "recompute" prices indeed forces individuals to engage in some arithmetical computations. But monetary unification would also promote a change in the denominator of credit contracts, with effects extending beyond the moment when individuals have "got used" to the new unit of account. When Argentina pegged its currency to the US dollar, in 1991, strong legal restrictions were placed on the discretion of the Central Bank, and it was established that the exchange rate could only be modified through a law. While these provisions were meant to reinforce expectations of the effectiveness and durability of the new monetary system (and they did contribute much to abate short-run inflationary anticipations), there probably remained much uncertainty about how long the policies would be sustained, and about their resilience to shocks: the relevance of implicit escape clauses remained to be discovered. Disinflation promoted a sharp expansion in credit; even though the exchange rate was fixed, a good number of contracts (particularly those extending over more than a few months) were written in dollars. The growth of a large mass of dollar contracts strengthened the incentives to maintain the exchange rate regime, by making a large class of individuals with debts in foreign currencies definitely averse to a devaluation. And the probable disruption in the system of contracts (with the hazard of provoking an "implosion" in credit) has served to deter proposals to revise the exchange rate regime, even in periods of extremely high unemployment. Of course, the conditions in Europe are different from those of Argentina. But it remains the case that the historical experience of the effects of devaluations in European countries cannot be extrapolated to a situation where contracts are not denominated anymore in the national currency. It would seem that the change in the standard of contracts would generate a "lock-in" effect of a monetary unification, independently of the existence of legal provisions about the irrevocability of the union.

Mundell ends his paper with a question: will the big bang approach work? Clearly, an experiment on the scale of the European monetary unification is bound to generate numerous queries. Beyond its obvious significance for European economies, the actual performance of the EMU will be a crucial reference for the choice of monetary institutions in other areas of the world.