Book Reviews

European Monetary Unification: Theory, Practice and Analysis. Barry Eichengreen. Cambridge, Mass.: MIT Press, 1997.

Barry Eichengreen has long been considered by the academic profession as one of the most prominent scholars of the European Economic and Monetary Union process. His work has contributed considerably to shedding light on the most relevant economic aspects of this process which will probably change the economic structure of Europe dramatically, as it will likely that of the rest of the world.

This book draws together several pieces on issues related to the EMU that have been published as articles or chapters in various journals or books. The book, therefore, does not offer any original material, beyond the introductory and concluding chapters, but this by no means makes it redundant; quite the contrary. Notably this collection of reprints of essays written by a single author (with different coauthors) provides the reader with a very compact and informative overview of an important part of the most relevant empirical literature on EMU issues.

The book is structured in nine core chapters plus the introduction and the concluding chapter. The author has chosen to present them in an approximate chronological order according to the date they were written (from 1989 to 1997), a crucial period of the monetary union process. This structure is probably not that which best permits the author's contributions and views on the different issues to be identified. I will review the contents of the book along the lines of the answers to three questions: Is Europe an optimum currency area (OCA)? What can be done to make a workable monetary union in Europe? How could the transition to the single currency best be organized?

The OCA issues are primarily dealt with in chapters 3–6. They provide evidence on the fulfillment of the two Mundell (1961) conditions: (i) symmetry of macroeconomic shocks, and (ii) factor and, in particular, labor mobility. The U.S. monetary union and, occasionally, Canada are used as a benchmark for comparison throughout the analysis. Chapter 3 provides an initial approximation to the degree of asymmetry of macroeconomic shocks affecting EU economies. The approach is based on the cross-correlations of real exchange rates and real securities prices. Results show that correlations are much lower across European states than across their North American counterparts. However, the methodology employed is subject to the criticism that relative prices are the result of both shocks and adjustments.[1]

[1] In the case of the stock market this problem can severely bias the results. A high correlation of the stock prices of two different countries is compatible with those countries being subject to unrelated shocks to the extent that national stock markets are sufficiently integrated, in the sense that prices are formed in

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In Chapter 4 this problem of separating shocks from responses is properly solved. The author uses a Blanchard–Quah structural VAR approach to identify supply and demand shocks for EU countries and U.S. states. The statistical analysis of those shocks confirms the results obtained in Chapter 3 as supply shocks tend to be larger and less correlated across states in Europe than in the United States. This analysis also shows that the adjustment to shocks is faster in the United States. However, the difference is less significant if core EU countries are compared to the United States, suggesting that the rejection of the OCA condition in the EU is essentially due to the heterogeneity produced by peripheral countries.

The second Mundell condition is analyzed in Chapters 3 and 6. Chapter 3 compares migration flows between U.S. states and EU nations, confirming the results of previous studies in which labor mobility was found to be much weaker and less sensitive to regional disparities in Europe than in the United States. This chapter also provides an interesting illustration, based on the experience in the postslavery period in the United States, of how supply and demand factors interact to explain a particular degree of labor mobility. The analysis conducted in Chapter 6 is probably more refined. In order to isolate the effect of remaining barriers to labor mobility across EU states, data on interregional migrations within some EU countries is analyzed and compared with those between U.S. regions. Results show that despite the fact that shocks to the labor market are not more asymmetrical in the United States than in Europe, migration responds much more rapidly in the former area to income and unemployment differentials. Surprisingly enough, however, no evidence is found of deviations of regional unemployment from the national average being more persistent in Europe than in the United States. Eichengreen concludes from this result that there should be other mechanisms, such as capital mobility or real wage flexibility, which substitutes for labor mobility in keeping regional figures in line with the national averages.

The evidence presented on both Mundell conditions supports the view that Europe is far from being an OCA. Chapter 5 presents a simple metric to assess the distance between Europe's economic structure and that which would be compatible with the OCA definition. The metric is based on cross-section regressions of the exchange rate variability on "fundamental" variables such as GDP differentials, productive specialization, trade volume, and size. An OCA index would then result from the implicit value of exchange rate variability associated with the projected future value of the regressors. The results are depressing in most cases, including a possible monetary union between Germany and France, although some slight improvement in the OCA index is predicted in the medium term.

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each country applying a single stochastic discount factor (a single pricing kernel) to aggregate national dividends.

The results in this part of the book have inspired a vigorous debate in the literature. Without being exhaustive, Fatás (1997) shows that departures from the OCA paradigm may come from regional disparities even within currently existing nations. Thus, while the Euro area may be less suitable as a monetary union than the United States, it may well be closer to an OCA than most current monetary unions in Europe. In a different vein, while the book documents how exchange rates move in response to output differentials, it is not obvious that exchange variability has sufficiently contributed to reducing them. Canzoneri, Vallés, and Viñals (1996) have shown that historically exchange rate flexibility has not been a powerful tool to mitigate real imbalances across European countries arising from asymmetric real shocks. Finally, it is extremely hard to make inferences on costs associated with EMU based on historical data. The introduction of the single currency and the consolidation of the single market for goods, services, and production factors would normally change the nature of all relevant statistical relationships, even if they are structural. The interesting comparison between Puerto Rico (within the U.S. monetary union) and Portugal (within the EMU) in Chapter 2 clearly illustrates this issue. According to this chapter it is not unlikely that the degree of factor mobility between Portugal and the rest of the EMU could become relatively close to that of Puerto Rico with the mainland United States once the monetary union is fully functioning. Unfortunately those "reverse causality effects," while acknowledged in some chapters of the book (e.g., the concluding section of Chapter 5), might not have always been taken sufficiently into account when drawing general policy conclusions in the book.

On the question regarding the procedures to build a workable monetary union, Eichengreen offers two clear answers: first, increase the EU budget to permit a much higher degree of transfers between regions; and second, permit sufficient autonomy for domestic fiscal policies.

The case for a larger degree of fiscal federalism is convincingly presented in Chapters 2 and 3. If, compared to the United States, Europe is far from satisfying the OCA conditions, it needs mechanisms of interregional redistribution, at least as strong as, if not stronger than, those of the United States. Since private mechanisms do not work properly, governments have to agree on establishing fiscal transfer arrangements that could prevent strong real imbalances across countries. This would amount to a substantial increase in the EU budget. Chapter 3 also provides a very illuminating discussion on how a system of fiscal transfers could work with limited risk of generating moral hazard problems or providing perverse incentives for factor mobility.

The arguments against excessive constraints for domestic fiscal policies are spelled out in Chapters 2, 8, and 9. First, available empirical evidence shows that the market generates incentives for disciplined policies and low public indebtedness. The excessive deficit procedure of the EU treaty is, therefore, at best redundant. Second, in the absence of a strong federal budget, Maastricht rules might imply too few stabilization possibilities for national budgets. Third, if national states are subject to borrowing constraints, they would be inclined to request transfers from the EU budget when facing adverse cyclical conditions. To the extent that, unlike national governments, the EU might not have the possibility of collecting taxes directly in the near future, the risk of a monetary bailout of EU financial obligations by the ECB could then become larger. Therefore, before a fully fledged federal tax system is put in place, borrowing constraints may reduce and not increase the credibility of the ECB. The first two ideas are at the core of the literature on fiscal binding rules and have been subject to keen debate [see, e.g., Lamfalussy (1989), Bishop (1991), Restoy, (1996), and Goodhart (1997)]. The third argument is more sophisticated as it criticizes borrowing constraints despite favoring ultimately what the author considers the first best solution (complete fiscal federalism) on the grounds that those constraints are likely to promote centralization of expenditures before centralization of tax revenues. It could be argued that this possibility depends crucially on the questionable assumption whereby either the EU balanced budget rule is removed, and/or the size and the scope of the activities of the European Investment Bank are enlarged.

The third question addressed in the book is the analysis of the transition to EMU. In particular, Chapter 7 analyzes the role of the ERM in bringing about a smooth transition to EMU. This article, written shortly after the 1992–1993 ERM crisis, analyzes with great insight the causes of the crisis. Eichengreen studies three possible explanations of the crisis: (i) balance of payments difficulties caused by overt or hidden real exchange rate misalignments; (ii) expected policy shifts; and (iii) self-fulfilling speculation. The author offers very convincing arguments and empirical evidence that makes option (i) unsuitable as a general explanation of the crisis. Options (ii) and (iii) are much more appealing. Explanation (ii) argues that a speculative attack occurs whenever the market considers that the balance between the benefits (qualification for EMU) and the costs (low growth or high unemployment), as perceived by authorities, points in the direction of relaxing monetary policy and accepting a devaluation. Explanation (iii) is similar except that the attack is not caused by an expected policy shift; rather the latter is produced because of the success of the attack. According to model (iii), if there were no attack, policy would remain consistent with the exchange rate peg, thus generating multiple equilibria. Although explanations (ii) and (iii) are conceptually different, I suspect that, in practice, the difference is not that great. If one considers that the probability of success of the attack is not only related to the amount of foreign reserves available, but also to the authorities' aversion to raise interest rates under adverse employment conditions, both (ii) and (iii) generate reduced-form equations in which real fundamental disequilibria explaining exchange rate instability. This idea is missing in Chapter 4, in which model (iii) is presented in a way in which fundamentals play no obvious role. Fortunately the introductory chapter of the book (Chapter 1) clarifies this issue in a satisfactory manner.

The most controversial aspect of Chapter 7 is the proposal to introduce a Tobin-type tax to prevent speculation as the only possible way to guarantee the degree of exchange rate stability required for a smooth transition to EMU. The recent history of the ERM has proven that this was not actually required. Indeed, the combination of a widening of the bands that eliminated the destabilizing effects of the narrow bands [Bertola and Caballero (1992), divorce effects] plus enhanced political support for EMU did the trick. But it would be unfair to blame the authors for not being able to forecast developments which, at the time the article was first written, were simply impossible to predict.

Chapter 9 summarizes Eichengreen's views also present in Chapter 12 on the complementarity between the Economic, Monetary, and Political Unions. In a particularly convincing essay, the author claims that when analyzing these issues one should adopt a political economy perspective rather than a microeconomic efficiency approach. It is important to see the extent to which economic integration may be accepted by the public without a single currency, and the extent to which ECB accountability may be properly achieved without additional steps in the direction of political integration. But these ideas suggest that the old Mundell OCA world — the framework used for much of the literature on the topic — is only partially relevant for studying the implications of monetary integration in Europe. EMU will be much more than a solid fixed-exchange rate mechanism.

The book also contains an interesting essay (Chapter 9) on international policy coordination in which it is found that the optimal degree of coordination depends on the degree and output effects of fiscal discipline. I find, however, that the topic and the methodology of this chapter do not fully blend in with the rest of the book and therefore could have been excluded from the collection.

In sum, *European Monetary Unification: Theory, Practice, and Analysis* is an excellent collection of essays that combine sound economics with relevant policy analysis. Although, given the nature of the book, one cannot expect these essays to span exhaustively all the relevant issues, it provides very useful material for scholars in this field and the economics profession at large. I strongly recommend it.

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A Primer on Securitization. Leon T. Kendall and Michael J. Fishman, eds. Cambridge, Mass.: MIT Press, 1996.

The prospect of introducing securitization to a novice — whether it be a newly minted graduate of business or law school, or a seasoned CFO of a corporation that is considering its first securitization — is daunting. The elegance of the theoretical concept becomes quickly mired in the interdependent demands of accounting, taxation, bankruptcy and securities laws, and the ever-changing contours of the investor marketplace as soon as the novice begins to ask questions. Successful completion of real-world securitization transactions requires not only cooperation among professionals in a variety of disciplines, but an intimate understanding of the parameters of those disciplines. The prospect of a primer that would provide a first glimpse of the contours of this terrain would be a welcome addition to the library of many a law firm, accounting firm, or investment bank.

Alas, *A Primer on Securitization*, edited by Leon T. Kendall and Michael J. Fishman, is not that book. The primer is instead is a collection of essays by some of the pivotal players in the development of securitization over the last quarter century, drawn from an eight-week colloquium held in 1994 at the Kellogg Graduate School of Management at Northwestern University. Each has a vantage point. Each has war stories. Each brings the vocabulary of its author's discipline to the attention of the novice. The essays function as introductory material in the sense that they expose the novice reader to a number of perspectives and, in so doing, to the terms, phrases, and trains of thought inherent in each.

The old saw about the blind men and the elephant forms an apt parallel to the primer. What we have here is not a book about how to do, or even how to think about doing, a securitization transaction, but rather a compendium of historical perspectives looking back from the mid-1990s to the early development of securitization techniques.

Fortunately, the primer is an easy read. The individual essays are for the most part engagingly written and thought-provoking. The centerpiece, by investment banker Lew Ranieri, the most luminary of the primer's star-studded cast, is also the liveliest essay. Mr. Ranieri has already written extensively about his role at Salomon Brothers in creating mortgage securitization. The names dropped in this essay — and there are many — give his stories life. He takes special pleasure in recounting the stumbles of the developmental process. He frankly acknowledges the investment banking industry's failure to foresee a fundamental risk in securitizing cash-out second mortgages: a rash of prepayments when cash-strapped homeowners connected with overaggressive appraisers. Even when recounting the stumbles, Mr. Ranieri displays a certain smugness in his and the industry's success in finding the analytical flaw and correcting it after the fact. That patties may have suffered losses as a result of the earlier miscalculation is less important to Mr. Ranieri than the challenge of inventing an ever-better mouse trap. But we enjoy reading about this because we, too, are in the business of inventing mouse traps.

Neil Baron's essay, from the rating agency perspective, has the most ordered presentation of its subject matter in the primer. Like several other offerings in the book, his is the well-rehearsed stump speech of an apologist for his industry. This may be forgiven in view of the critical role of rating agencies in the day-to-day business of putting securitizations together. Moreover, because the rating agencies' role is often slighted in business and law schools, this clear presentation of their perspective is helpful. Mr. Baron explains the role of rating agencies, their methodology, and their analytical tools. Unfortunately, like the rest of the primer, this is the view from 30,000 feet, and Mr. Baron does not explain how the agencies really go about their business, nor how other parties relate to them in practice. Like so many conference presentations, the essay presents just enough information to tweak the imagination but keeps the real tricks of the trade in strictest confidence.

And so it goes, each little essay a well-crafted jewel from a mover and shaker who was there. Each is designed around two or three salient points, adducing selective facts and anecdotes to support those points. It is not necessarily a bad way to get a dose of education, although it is not systematic.

Dennis Cantwell of Chrysler gives us an insider's view of how securitization is used as a tool of balance sheet management, and how its value, as compared to other funding sources, varies with the changing characteristics of both the issuing company and the external market. He then demonstrates how cash flows of particular receivables drive the structure, comparing the structure Chrysler uses to securitize its wholesale receivables (dealer credit) to that which it uses to securitize retail receivables (consumer credit).

Steve Baum of PaineWebber covers commercial mortgage-backed securities (CMBS). He makes two key points, illustrated from a historical perspective: first, that securitization emerges in particular markets as a response to a funding vacuum rather than merely to improve pricing; and second, that tranching is used in CMBS to differentiate credit quality, as compared to the residential MBS environment, where tranching is used to achieve call protection.

The essay by Michael Jungman, now at J. P. Morgan, but more importantly the architect of the CMBS program undertaken by the RTC several years ago, seems the most disingenuous essay in the primer. Mr. Jungman tells how CMBS enabled the RTC to “unload” its enormous loan inventory, albeit with high levels of credit support. He understates, however, the extent to which the RTC retained the ultimate exposure on the loans, and, in this author’s view, overstates the role of the RTC in the development of the CMBS market.

Marcia Myerberg, who led Salomon Brothers’ efforts to establish a mortgage-backed securities industry in the United Kingdom, provides an interesting chronicle of that process. She describes how England and France reacted differently to the introduction of securitization. When Ms. Myerberg tries to draw generalizations that might apply in other international markets, however, they appear to be based more on speculation than on anything else.

Robert Graffam of the IFC takes this speculation one step further in his effort to project the possible utilization of securitization in developing countries. Mr. Graffam’s remarks suffer from their 1994 vantage point, as the market for cross-border future flows transactions has bloomed in the period since then. The most important lesson we take from the Myerberg and Graffam essays may be that the international securitization market is so tiny that it may not be worth the Herculean effort entailed in developing the legal, accounting, tax, and market structures needed to support it.

Susan Phillips, of the Federal Reserve Board, offers a perspective not often included in securitization conferences. She projects the effect that securitization may have on the Federal Reserve’s ability to control monetary policy. She suggests, more on theoretical than empirical grounds, that the monetization of housing-related assets will mean that Fed policy maneuvers will cease to have the disproportionate impact on the housing sector that they have had in the past. This, in turn, suggests that wider swings in Fed-controlled rates may be needed in order to steer the economy, and that the effects desired by the Fed may take longer to accomplish than was true in the past. It is an interesting and thoughtful analysis, but one whose social implications Ms. Phillips does not explore, at least not in this essay.

The book ends with an essay from Lowell Bryan of McKinsey & Company. Mr. Bryan is a futurist. If the other essays look at securitization from 30,000 feet, Mr. Bryan views securitization from outer space. He sees securitization as the final phase in the demise of the world's banking system as it has existed since the Middle Ages. In this grandest of overviews, Mr. Bryan does not limit himself to the receivables-based securitizations that normally go by that name. His analysis turns more on the globalization of capital markets as a whole than on anything about securitization. Though an interesting set of musings, his essay ends up being the least enlightening of the bunch.

Notwithstanding its somewhat disjointed nature, common to any group presentation, this book does have underlying themes that recur. One relates to the importance of prepayment analysis when structuring transactions, and the realization that prepayment concerns have begun to shape retail credit markets. An example of this is the increase in the use of prepayment charges in the retail mortgage market in the years since these essays were first presented.

A second recurring theme is that of model risk. Historically, Wall Street has done quite a good job of capturing and analyzing the interest-rate risks inherent in securitized products, and, through some harrowing lessons, has learned about credit risk as well. Belatedly, however, the same investment banking houses have come to realize that there are behavioral assumptions embedded in the models they have used. As a result, over time these models may prove to be incomplete. An example cited by several of the contributors is the failure of models to predict the introduction into the mortgage market of low-points and no-points home refinance loans. In the declining interest rate environment of the early 1990s, refinancings using these loans substantially accelerated prepayments. Wall Street's computer models failed to include a variable for the pricing practices of mortgage originators. With hindsight, these practices could have been anticipated, as mortgage loans were increasingly being originated by parties who did not hold portfolios of loans and would therefore not be adversely impacted by market conditions that encouraged refinancing. These nonportfolio originators ended up leading the market, including portfolio lenders, on a race to the bottom in regard to points and fees.

A third common thread among many of the commentators relates to the market's increasing demand for information about portfolio performance. The irony of this is not lost on the authors. Securitization was once touted as enabling investors to avoid delving into the underlying pool performance or the credit of participants. Twenty years of experience have demonstrated that pools of identically rated, identically characterized receivables do not necessarily behave the same way. The investing public is beginning to demand more information during the life of the transaction.

A final common theme in the essays is the importance of regulatory capital requirements in dictating the conduct of both originators and investors in securitized product. The 1992 Basle Accord for banks and the NAIC risk-based capital rules for insurance companies strongly motivated the issuance of and investment in mortgage- and asset-backed securities. An interesting case in point is Marcia Myerberg's observation that a short-lived misinterpretation of the Basle Accord's impact in the United Kingdom caused leading banks to misconstrue the capital required for mortgage-backed securities, causing the volume of mortgage securitizations in the United Kingdom to plummet.

Taken together, the essays provide an accurate and reasonably diverse view of the securitization business as it existed in 1994. The primer is weakest in its effort to predict the future. Its strength and its interest to practitioners, both novice and experienced, is as a historical explanation of 20-odd years of product development. In that role, the book works well.

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