

The Theory of Political Monetary (Dis)Integration; A Minority Report from the Perspective of Austrian Economics

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Abstract:** *The issue of monetary disintegration gains an increasing place in the interest of political economists and policy makers alike. Until recently, the process through which two states that previously shared a common currency decide to abandon it and choose national currencies instead was a marginal and accidental event in history. It was met in the case of political disintegration of state constructions such as Czechoslovakia, Soviet Union or Yugoslavia, typically built through military aggression and experiencing widespread economic planning. Today, world may experience another type of monetary disintegration. In this case, it is the result of a deep economic crisis affecting the democratic process of integration in Western Europe. The difficulties experienced by some of the member states of the Euro-zone as well as the debate around the correct path towards solving them has raised the scenario that at least some of these countries will abandon their membership of the European Monetary System. The hallmark characteristic of these states is their open and predominantly market-oriented economies. Their return to a planned economy as well as complete autarchy from the rest of the global and regional economy is highly improbable. But they have also a monetary system based on political money and massive wealth redistribution is possible through the monetary mechanism.*

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The debate on the nature of money is one of the most challenging and controversial issues in political economy. According to Ludwig von Mises, the core issue in monetary economics lies in the explanation of the formation and dynamics of the purchasing power of the monetary unit: *“the central element in the economic problem of money is the objective exchange value of money, popularly called its purchasing power. This is the necessary starting point of all discussion”* (Mises, 1981, p. 117). All other issues are derivative or formalistic.

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The fundamental controversy in this field of study is determined by the fact that monetary economists are divided between what could be called realists and nominalists. The first category considers that money is a market phenomenon which was appropriated and manipulated by the state. They do not ignore the legal dimension of state regulations but argue that the reality of the economic processes is a result of independent laws that shape them. The state cannot fix by decree the purchasing power of the monetary unit as this is a result of the interplay between demand and supply for money of all the users of that currency in a society. The second category considers that money is a state phenomenon, established and defined exclusively by political authority. The state could manipulate the money supply as it sees fit. According to Mises, however, *“the nominalistic monetary theories of the present day are, characterized by their inability to contribute a single word toward the solution of the chief problem of monetary theory ... namely, that of explaining the exchange ratios between money and other economic goods. For their authors, the economic problem of value and prices simply does not exist”* (Mises, 1981, p. 77).

In this paper, we opt for a realistic perspective on the monetary phenomenon and employ principles advanced by Austrian economics to scrutinize the challenging processes of monetary integration and disintegration. We differentiate between *market monetary integration* and *political monetary integration*. In the first case, we consider a realistic and economic process of monetary integration, undergone in a free market. In the second case, we identify political monetary integration as a political process designed by states.

We define the political monetary integration as a process through which two or more states decide to adopt the same currency as a legal tender. By contrary, monetary disintegration is a process through which one or more states decide to abandon a previously common currency and adopt different currencies from that moment on. Monetary disintegration is a process that could take different forms, such as the scenario that only one of the societies establishes a new currency and the other keeps the old one or each one of them adopts a new currency. Each of these scenarios has its own challenges and details. But a paramount theory of monetary disintegration should not only attempt to explain the dynamics of the purchasing power of the new currencies but also the transfer of wealth between the two societies in the moment of disintegration.

What is money? The monetary integration on a free market

According to Austrian economists, money is an economic good that performs the function of a medium of exchange. Whenever there are more than two individual who want to engage in market exchanges and there are more than two goods that are consumed in society, the possibility of the so-called indirect exchange arises. That is, at least one individual will engage in market exchanges in order to buy goods not for direct and immediate consumption but for paying later for other (anticipated to be more desired at that moment) goods. As an economy develops and the range of goods and the involvement of individuals composing that particular society increase, the need for media of exchange grows.

The choice by market participants of a good as a medium of exchange derives from its inner physical qualities. Several economists in the history of economic thought have noted that these qualities should satisfy the condition of the so-called *„marketability”*: high value per unit of quantity, divisibility, physical durability, homogeneity, easiness of transport and conservation

and so on. Societies have experienced different forms of money until they discovered and choose the qualities of precious metals like gold and silver.

On a free market, the social drive towards a single medium of exchange should be unstoppable as the benefits of choosing the same good as money are significant. Ludwig von Mises called it "*monetary unification*": "*the simultaneous use of several kinds of money involves so many disadvantages and so complicates the technique of exchange that the endeavor to unify the monetary system would certainly have been made in any case*" (Mises, 1981, p. 46). Even if individuals do not value directly a particular medium of exchange in the condition of a monetary competition, they will choose to hold in their cash balances the most frequently used such medium. They will accept and value more such a medium of exchange that allows them the most value from their participation in the market.

In consequence, as the political barriers between societies fall, the market participants will most probably choose a single medium of exchange that allows them the participation in the entire market that is open to them, be it local, regional or global. On a free market, the monetary competition will most probably lead to the choice for a single medium of exchange: "*Economic history is the story of the gradual extension of the economic community beyond its original limits of the single household to embrace the nation and then the world ... It would not be possible for the final verdict to be pronounced until all the chief parts of the inhabited earth formed a single commercial area, for not until then would it be impossible for other nations with different monetary systems to join in and modify the international organization*" (Mises, 1981, p. 46).

On the other hand, individuals will always prefer not to risk holding all their cash in a single economic good. It is highly probable that, besides the good which will be the winner of the competition among media of exchanges, market participants will also hold at least a part of their cash holdings in another medium of exchange. They will attempt to diversify the risk of holding their savings. Historical experience has proven that even if gold could be qualified as the winner of the free market competition among the media of exchange, silver has always played a second but important role. So the existence of multiple media of exchange is also a manifest phenomenon of a free and competitive market.

Monetary disintegration on a free market

The concept of monetary disintegration on a free market has a particular meaning. It cannot describe a process through which market participants decide to give up the use of a particular medium of exchange. The goods that play the function of media of exchange are not politically – and centrally – chosen by any political authority but by individuals concluding market contract (so in a "*politically*" decentralized way). Such a process could emerge as a result of the loss of characteristics of the good in question (such as, for example, a dramatic change in the physical supply – the good becomes too abundant and individuals do not perceive it any longer to be scarce), of the loss of its use in direct consumption (the invention of other methods of production that dramatically reduce the demand for its direct use) or the emergence of other economic goods that better perform the function of a medium of exchange.

But the process of monetary disintegration on a free market would less probably have a particular location or definite borders. Most probably, it wouldn't mean the physical disappearance of the good in question. As long as it keeps a value of use in direct or indirect

consumption (even if greatly reduced), any such good will remain in the value scales of the members of society and will be transacted on the market. Modification in the market context could lead to a revival of the interests of the market participants in its qualities.

Political money

Austrian school of economics argues that the present-day monetary system is a result of a historical process of abuse by the state of the monetary phenomenon. Even from ancient times, the sovereigns have attempted to monopolize the production of money due to the obvious benefits of controlling the quality and quantity of its supply. The process of monopolization most probably started as a certification of the content of gold in coins and later implied also coin production. The first signs and symbols on coins were most probably forms of branding by money producers. The monopoly of production allowed however the first forms of manipulation such as debasement (the reduction of the gold content of the monetary unit). Later on, the emergence of banknotes (as certificates of deposits of gold in banks) and of the financial depository institutions allowed them, through a strict control of the banking system, the manipulation of the money supply.

The complete nationalization of money by the state occurred through the process of cutting the relation between the issuance of banknotes and the quantity of gold in bank coffers. Today, the world witnesses a monetary system where the money supply is fundamentally a political decision. It is called "*fiat*" money. It doesn't have any connection with the reality of scarcity. A central bank could decide to inflate the money supply almost to infinite, as modern experiences such as Interwar Germany and contemporary Zimbabwe (before 2008) witness.

The monopoly of money production is paired with the interdiction of the use of other media of exchange. It is the legislation of "*legal tender*" which prevents monetary competition from other media of exchange that could emerge by private contracts. The state imposes to its subjects the use of a single legally recognized medium of exchange not only in their relations with state authorities but also in their private dealings.

Social redistribution through inflation

The purchasing power of the monetary unit is given by the mechanism of supply and demand for money. Anytime when an individual wants to sell a good on the market, he is demanding money. Anytime he buys a good on the market, he supplies money. So the monetary unit has its own "price", expressed in the physical units of all other goods in society that could buy such a monetary unit. While any unit of a non-monetary good has a money price, a monetary unit has a price in almost infinite number of non-monetary goods.

As monetary economists have argued, any quantity of money allows the performance of the function of medium of exchange. But it does not mean that the manipulation of the quantity of money in society (the money supply) does not have consequences. By contrary, it is one of the most distorting economic phenomena. As opposed to other forms of state intervention, monetary intervention affects all individuals in society who use the legal medium of exchange. In fact, any increase in the money supply will determine an unequal rise in prices of at least certain goods. This is the phenomenon of inflation, that is, the decrease in the purchasing power of the monetary unit determined by an increase in the aggregate money supply.

Inflation could also occur on a free market when, for example, the physical supply of the commodity previously chosen by market participants led to an increase in its available stock. But in the case of commodity money, such an increase in supply is fundamentally restricted at least by the costs of production, not to speak of the natural limitation of the deposits of the physical resource in question.

In the case of political money however, there is no restriction in the possible increase of their supply. Because money as defined under the contemporary systems does not have a physical existence (the largest part of the contemporary money supply consists in “electronic” deposits), the increase in their supply may be potentially unlimited. So the purchasing power of the monetary units could reach, in practical terms, zero. In this scenario, any money will cease to perform any function.

Such a discussion of the dynamics of the purchasing power of the monetary unit also has a social dimension. As several economists have noted, any increase in money supply in society (the “new” stock of money) does not enter the society in a “neutral” way. Individuals value the monetary unit according to their personal assessment related to the previous purchasing power of the monetary unit. Mises calls this the “*regression theorem*” and states that the purchasing power of the monetary unit today is a result of the purchasing power of the monetary unit yesterday, adjusted to the dynamics of the supply and demand mechanism of today. Each time that a new supply of money enters the monetary system, those who get it first will use it based largely on the expectations of the rest of society regarding the past purchasing power of the monetary unit. In accordance, the “new” stocks of money (especially of those that does not have a cost of production so they are not scarce) will be valued according to the purchasing power of the “old” stock of monetary units. Individuals cannot differentiate between “old” and “new” stocks of money.

In conclusion, the expansion of the money supply in a system based on political money has a significant redistributive impact. All those who hold positive cash balances of “old” stock of money will experience a reduction in the purchasing power of their hoards as the “new” stock of money enters the economic system. The same impact is on the “*money at maturity*”, that is, on the purchasing power of nominally fixed rights and obligations. Monetary expansion will reduce the value of all claims denominated in the currency in question (the creditors will be poorer) while also reducing the value of all debts denominated in the same currency (the debtors will be richer because they will pay less).

Monetary integration under a system of political money

While the drive towards a single currency is a manifest phenomenon of the free market (under a commodity money system), a similar drive can be noticed also in the case of a monetary system based on political money. However, several economists (Hulsmann, 1997, p. 81) have argued that such a trend is caused by fundamentally different factors. Under a system with at least two states, each with its own political money, a process of monetary competition emerges which resembles – but it is not similar in nature – with the monetary competition on a free market. What is common however is that individuals in both societies will look for the currency which is most frequently used and which they anticipate will keep (or increase) its purchasing power in the foreseeable future. In fact, the outcome of the process

of monetary competition under a system of political money will be fundamentally determined by the difference between the inflation rates and their foreseeability in the near future.

For two states that enforce a system of complete autarchy, the members of their societies do not have the option to choose among the two currencies. But the fact that individuals, under a system of relative freedom of trade and foreign exchange, will choose to hold their cash balances in the most stable and less prone to inflation currency will act somehow as a restriction in the path of a government that wants to inflate the money supply. This is what the classical “*Gresham Law*” states.

Monetary competition can have a dramatic impact on the more inflationary state. The choice of even its own citizens for holding their cash balances as well as contract money in other currencies will deprive this state of its monopoly of money production. The state that ignores the reaction of market participants in what regards the manipulation of its own money will end up in bankruptcy.

In consequence, several observers noticed that there is a strong incentive for such a state to politically pressure the other state to engage in a coordinated increase in money supply. Hulsmann points that “*This is the mechanism at work that incites political unification in modern democracies. The driving force is the necessity and the will of governments to extend their power, and to survive in times of crisis. This force leads to political unification, because bankrupt and not-yet-bankrupt governments have a common interest in bargaining financial assistance against political influence*” (Hulsmann, 1997, p. 92). In this sense, monetary cooperation is a mechanism that fundamentally prevents the system of monetary competition and, indirectly, political competition. Such a monetary cooperation could take several forms, from an agreement of holding a fixed exchange rate system to the adoption of a common currency.

A common currency adopted by two states under a system of political money does not generate the same incentives as a single currency adopted by the free markets under a system of commodity money. The wrong incentives in the first case materialize in the scenario that the two states will engage in a dramatic process of inflation of the money supply. In this scenario, the members of the two societies will lose their ability to arbitrate and choose another, sounder, currency.

Fundamentally, a monetary system of two currencies with a fixed rate of exchange allows a coordinated expansion of money supply. However, as long as the two governments will remain autonomous, there is also the possibility of cheating. In this case, the government will inflate more the money supply (A) will determine costs for the government which inflates less (B). On the one hand, the Gresham Law confirm us that individuals will begin to hold their cash balances in the sounder currency (B) so the prices in that particular society – denominated in the sounder currency – will experience a deflationary process and the currency will be artificially “*in shortage*”. While deflation is not a problem by itself, the fixed foreign exchange rate will cause a widespread export of goods from society B to society A. In consequence, we will witness a process of welfare redistribution from society B (whose goods are artificially undervalued) to society A (where goods are artificially overvalued). In the end, the government B will be obliged to inflate at the same rate the money supply as government A. The loser under such a system is the government that inflates less and later.

The single currency under a system of political money: case 1 (the adoption of an existing currency)

Two countries could adopt a single currency in fundamentally two ways. They may decide, on the one hand, to adopt the currency of one of them as a common currency (see the political unification of Western and Eastern Germany and the adoption of the Deutsche mark as a common currency) or, on the other hand, exchange their currencies for a new, common currency (the case of the adoption of the euro by 11 members of the European Union).

In the first case, the state that supplies the common currency has to accommodate the new demand for money either from the existing stock (in this case, it will have to “buy” the necessary money stock for the conversion and determine a deflationary pressure on its domestic prices) or from the issuance of a new stock of money. In this second case, it will inflate through one shot the existing money supply to accommodate the demand for money of the citizens of the other state. Such a process is somehow unacceptable for the political elite of the second state as it will gain nothing from and could not control the redistribution of such a process.

In the case of German reunification, as a result of the existence of a planned economy in the German Democratic Republic (GDR) as well as the lack of any kind of market for foreign exchange between the two currencies, the Federal Republic of Germany (FRG) decided to quantitatively limit the quantity of money that GDR citizens could exchange: „A 1M:1DM rate was applied to East German wages, salaries, rents, leases and pensions. Savings accounts of GDR citizens were converted at a 1M:1DM rate up to a limit of M 4,000 for persons between 15 and 59 years of age. The corresponding limit was M 6,000 for older persons and M 2,000 for younger persons. A 2M:1DM rate was used to convert all other financial assets and liabilities of GDR residents. Mark assets held by individuals who live outside the GDR were converted at a 3M:1DM rate” (Bofinger, 1990, p. 17). The statement of Peter Bofinger that „it is not easy to assess the relative per capita incomes of the two Germanys. The GDR’s administratively set domestic prices and exchange rates do not accurately reflect its economic conditions; consequently, official data, when available, must be treated with skepticism” is obviously a big understatement of the reality that there were no possible comparisons of the absolute and relative prices between the two economies. GDR was a planned economy while FRG was a predominantly market economy.

German monetary integration was purely and simply a gift of the FRG (in fact, of its citizens) towards the GDR’s citizens. As Mises stated elsewhere, „in a socialist commonwealth which, whilst it need not of necessity dispense with money altogether, yet finds it impossible to use money as an expression of the price of the factors of production (including labor), money can play no role in economic calculation” (Mises, 1990, p. 15). It is practically impossible to ascertain a real exchange rate between the two marks so any rate adopted was a political decision of FRG in order to win the support of GDR citizens for the reunification.

Less difficult seems to be the integration of two countries with relatively open economies where there is some degree of freedom on the foreign exchange market. Political authorities of the two states may take the rate of exchange between their currencies from the money market and used it for conversion. In consequence, the authorities from the state that supplies the common currency will issue a new money stock that will cover the existing stock of the “disappearing” currency and denominate the prices of the two economies in the single common currency. However, this process does raise its own challenges.

There is always a limit in the relevance of market prices for the value of economic goods in a society. However free a foreign exchange market could be, it does not capture but the demand and supply for one currency denominated in the other currency at one moment, under the prevailing market circumstances. In consequence, such foreign exchange markets cannot capture the demand and supply of the populations for non-monetary economic goods as well as the demand and supply for other currencies (and, in consequence, for non-monetary goods denominated in such foreign currencies). If, for example, we use such a principle for the monetary integration between two open economies (A and B) where A is a relatively a less monetary economy (barter and autarchic production are still widespread) or/and its international economic relations are oriented towards other countries than B, the relatively free exchange rate between the currencies of A and B could significantly misrepresent the value of the domestic currency (its purchasing power) of such a state.

The money price of corn in a particular local market is relevant only for those who engage in market transactions with corn in that particular market. For those who hold stocks of corn or want to participate in other local markets (or engage in market transactions denominated in other currencies), such a local money price is somehow irrelevant. Obviously, there is the possibility of arbitration but without some clues related to the future, there would be no speculation. The forced conversion of their stocks of goods at that particular market price may generate a massive wealth transfer (most probably negative).

The single currency under a system of political money: case 2 (the issuance of a new common currency)

The process through which two countries decide to abandon their existing currencies in favour of the adoption of a new currency seems to be just similar to the above-mentioned case. In other words, taking the existing market exchange ratio between the two currencies, we take the resulting single currency and redenominate it under a new name. If, for example, the market exchange ratio between currencies A and B is 1:2 (2 units of B equal 1 unit of A), we may exchange one unit of currency A for 2 unit of currency C and one unit of currency B for 1 units of currency C.

But a further problem could arise, a problem derived from the moral hazard. Suppose that B is an industrial developed economy while A is a pastoral underdeveloped economy. If the two countries decide to adopt a new single currency, each one of them will be exposed to the risk that the other will bring from nowhere (newly issued) stocks of its own currency in order to exchange it at the then already fixed exchange ratio. That is, such a government could use the moment of monetary integration as an opportunity to inflate and use the adopted fixed conversion rate in order to extract wealth from the other country.

In order to avoid such a scenario, the governments of the countries that adopt a monetary union may decide also how much money supply to exchange from each of the two or more currencies. This was, for example, the case of the adoption of the euro. Euro was preceded by ECU, the European Currency of Account. The value of ECU was calculated as a basket of currencies, weighted by what has been called their role in the economy of the European Common Market. Such an explicit weighting system (based on the size of the Gross Domestic Product, the size of the intra-community trade and so on) seems to be only a mechanism to prevent the moral hazard described above and not of a real economic significance. At the

moment of the adoption of the new currency, the weights would have been implicitly taken into consideration.

Monetary disintegration under a system of political money

The monetary disintegration would seem at first sight a simple process of reversal to the pre-integration stage. The challenges to such a process may prove however extraordinary. Monetary disintegration could be "*the equivalent of unscrambling an omelette*" (Bootle, 2012, p. 6).

In the first instance, the two states may allow all of their citizens to freely exchange their cash holdings into the new currencies. Under the assumption of a monetary system based on political money, individuals will most probably choose to hold the largest part of their cash holdings into the currency they will anticipate will keep its purchasing power more stable. In that case, in the currency of the state that will inflate less.

But neither government will easily accept the re-emergence of the monetary competition among its domestic and other foreign currencies. In fact, the political decision to disintegrate was most probable taken because political authorities didn't accept the lack of the tool of the monetary inflation. So we could speculate that even from the start the rates of inflation would be different. All governments under a system of political money will prefer the imposition of their own currency onto their citizens. Otherwise, the arbitrage among market participants will deprive it of the tool of inflationary monetary policy. Most probable, governments will impose its own new currency unto its citizens and residents through "*legal tender*" legislation. In practical terms, any cash balance held in a domestic financial depository institution will be exchanged against the new currency and the use of the old currency strictly forbidden.

Obviously, the government that adopts a new currency will have to provide an exchange ratio of the old currency against the new. Due to existence of political money both before and after the monetary secession in both the monetary union and the state who abandons it, there is no criterion to decide which should be such a ratio. In the case of a gold standard, such a decision would have been related to the content of gold. The case of a country that decides to adopt the gold standard is not the object of the present paper.

The transfer of cash deposits in both currencies in both directions (in and out the country) should be no problem for any government as economic theory argues, as we have already mentioned, that any stock of money can perform the function of media of exchange. The flight of cash abroad cannot but induce a deflationary trend in the domestic economy that, ultimately, cannot but stimulate foreign trade and direct investments. In this discussion, we ignore the problem of the stock of capital and the impact of the flight of savings abroad. From the narrower perspective of the purchasing power of money, any government should allow such a rapid adjustment to the new monetary reality. Moreover, such an exodus of cash deposits abroad, depending on the relative size of the two countries, will put a pressure on the general level of prices in the country that keeps the old currency.

If the two states decide to keep their economies open to flows of trade in consumer goods and factors of production as well as a free foreign exchange market, the market participants will adapt to the new economic environment. No wealth transfers could be anticipated. As the stock of money under a system of political money does not bring wealth by itself, the challenge derives from the dynamics of the purchasing power of the two currencies from that

moment on. And we may witness two situations: the state that abandons the monetary union is expected to engage in massive inflationist policies (the so-called “Greek-exit”) or, by contrary, is expected to engage in strictly conservative policies (the so-called “German-exit”). Obviously, the metaphors are just contextual and speculative.

Any government that engages in inflationary monetary policies has, at some moment, to introduce further regulations that will attempt to prevent some of the manifest negative effects of such policies. The most probable are those related to the foreign exchange market or/and capital controls. As a higher inflation would lead to a fall in the purchasing power of the domestic monetary unit and the depreciation of the foreign exchange rate, governments usually attempt to hide it from the population through foreign exchange controls (that will obviously overvalue the domestic currency) or capital controls (that will prevent the flight of domestic capital abroad but also the “speculative” investments). At such a moment, such a government engages on the path of ruin as the entire economic calculation in the domestic economy will be cut off from the rest of the world. It is precisely the route to the system of the German Democratic Republic.

Moreover, the so-called “impossible trinity” may again be put into motion. Independent budgetary policies (and deficits), together with free capital flows and fixed exchange rate ratios are impossible and unsustainable to hold together. In fact, we may read it in other form: independent inflationary policies are incompatible with fixed exchange ratios. If a government allows market participants to arbitrate it, it will find ruin so the need for capital controls, from the perspective of such a government, is compulsory. But it should be obvious that the escape from the impossible trinity does not lie in capital controls (the preferred route for supporters of state intervention) but in controlling the budgetary equilibrium and the rate of inflation.

Historical experiences in the case of monetary disintegration are not too relevant. Either they occurred in the age of golden standard (before World War One) when the route to another commodity money was easy. If a government changes the golden content of the monetary unit, it apparently introduces other money while the real medium of exchange remains gold. Other cases such as Czechoslovakia, Soviet Union or Yugoslavia occurred in planned economies and neither is relevant for the present and the foreseeable future.

Conclusions

In this paper, we attempted to explore the potential routes for monetary disintegration or, in other words, the scenario when a state abandons a monetary union and adopts a new fiat currency. We attempted to demonstrate that monetary disintegration does not bring to such a government the “liberty” to inflate the new money supply. Monetary disintegration brings back the process of monetary competition which, under a system of relatively open market economies, could not be easily manipulated. A “successful” monetary disintegration, from the perspective of such a government, cannot result but in an introduction of a predominantly planned economy, cut off from the rest of the flows of trade and finance. It is the surest path towards poverty.

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