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I. INTRODUCTION

The incompatibility of pegged exchange rates, international capital mobility and national monetary autonomy is a basic postulate of open economy macroeconomics. Prior to the breakdown of the Bretton Woods System, economic analyses commonly held that nations seeking to maintain exchange rate stability would have to compromise their monetary independence. Subsequent experience suggests that these conclusions, formed as they were in a period when many countries retained controls on capital movements, if anything understated the dilemma. In today's world of high capital mobility, even the minor exercise of policy autonomy can produce major exchange market pressures. Modest uncertainty about whether national monetary authorities are inclined to make use of their theoretical independence can lead to significant financial market volatility. If currencies are floating, they can fluctuate widely.[1] If the authorities attempt to peg them, the costs of doing so, measured by reserve losses or interest-rate increases, can be extremely high. Even a government otherwise prepared to maintain a pegged exchange rate may be unwilling or unable to do so when attacked by the markets and forced to raise interest rates to astronomical heights. Attempts to peg the exchange rate can be defeated, in other words, by rational and self-fulfilling attacks.[2]

This leaves two possibilities. One is to make exchange rates inflexible and unadjustable – irrevocably fixed, as is true within the United States, Canada, and other federations. The only means of credibly doing so is monetary unification. By eliminating the exchange rate, monetary unification eliminates exchange rate fluctuations. This is the path that the European Union has opted to follow. But as the slow and rocky road from Maastricht has shown, there remains ample scope for exchange rate instability during the transition – instability so severe that it threatens to prevent the EU from reaching its goal.

Another option is to live with floating exchange rates. In a sense this is inevitable: even if a core of EU countries forms an early monetary union, the

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