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The History of Previous Currency Unions

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I. The History of Monetary Unions

"Before long, all Europe, save England, will have one money". This was written by William Bagehot, the Editor of "The Economist", the renowned British magazine, 120 years ago when Britain, even then, was heatedly debating whether to adopt a single European Currency or not.

A century later, the euro is finally here (though without British participation). Having braved numerous doomsayers and Cassandras, the currency - though much depreciated against the dollar and reviled in certain quarters (especially in Britain) - is now in use in both the eurozone and in eastern and southeastern Europe (the Balkan). In most countries in transition, it has already replaced its much sought-after predecessor, the Deutschmark. The euro still feels like a novelty - but it is not. It was preceded by quite a few monetary unions in both Europe and outside it.

What lessons does history teach us? What pitfalls should we avoid and what features should we embrace?

People felt the need to create a uniform medium of exchange as early as in Ancient Greece and Medieval Europe. Those proto-unions did not have a central monetary authority or monetary policy, yet they functioned surprisingly well in the uncomplicated economies of the time.

The first truly modern example would be the monetary union of Colonial New

England.

The four kinds of paper money printed by the New England colonies (Connecticut, Massachusetts Bay, New Hampshire and Rhode Island) were legal tender in all four until 1750. The governments of the colonies even accepted them for tax payments. Massachusetts - by far the dominant economy of the quartet - sustained this arrangement for almost a century. The other colonies became so envious that they began to print additional notes outside the union. Massachusetts - facing a threat of devaluation and inflation - redeemed for silver its share of the paper money in 1751. It then retired from the union, instituted its own, silver-standard (mono-metallic), currency and never looked back.

A far more important attempt was the Latin Monetary Union (LMU). It was dreamt up by the French, obsessed, as usual, by their declining geopolitical fortunes and monetary prowess. Belgium already adopted the French franc when it became independent in 1830. The LMU was a natural extension of this franc zone and, as the two teamed up with Switzerland in 1848, they encouraged others to join them. Italy followed suit in 1861. When Greece and Bulgaria acceded in 1867, the members established a currency union based on a bimetallic (silver and gold) standard.

The LMU was considered sufficiently serious to be able to flirt with Austria and Spain when its Foundation Treaty was officially signed in 1865 in Paris. This despite the fact that its French-inspired rules seemed often to sacrifice the economic to the politically expedient, or to the grandiose.

The LMU was an official subset of an unofficial "franc area" (monetary union based on the French franc). This is similar to the use of the US dollar or the euro in many countries today. At its peak, eighteen countries adopted the Gold franc as their legal tender (or peg). Four of them (the founding members of the LMU: France, Belgium, Italy and Switzerland) agreed on a gold to silver conversion rate and minted gold and silver coins which were legal tender in all of them. They voluntarily limited their money supply by adopting a rule which forbade them to print more than 6 franc coins per capita.

Europe (especially Germany and the United Kingdom) was gradually switching at the time to the gold standard. But the members of the Latin Monetary Union paid no attention to its emergence. They printed ever increasing quantities of gold and silver coins, which constituted legal tender across the Union. Smaller denomination (token) silver coins, minted in limited quantity, were legal tender only in the issuing country (because they had a lower silver content than the Union coins).

The LMU had no single currency (akin to the euro). The national currencies of its member countries were at parity with each other. The cost of conversion was limited to an exchange commission of 1.25%.

Government offices and municipalities were obliged to accept up to 100 Francs of non-convertible and low intrinsic value tokens per transaction. People lined to convert low metal content silver coins (100 Francs per transaction each time) to buy higher metal content ones.

With the exception of the above-mentioned per capita coinage restriction, the LMU had no uniform money supply policies or management. The amount of money in circulation was determined by the markets. The central banks of the member countries pledged to freely convert gold and silver to coins and, thus, were forced to maintain a fixed exchange rate between the two metals (15 to 1) ignoring fluctuating market prices.

Even at its apex, the LMU was unable to move the world prices of these metals. When silver became overvalued, it was exported (at times smuggled) within the Union, in violation of its rules. The Union had to suspend silver convertibility and thus accept a humiliating de facto gold standard. Silver coins and tokens remained legal tender, though. The unprecedented financing needs of the Union members - a result of the First World War - delivered the coup de grace. The LMU was officially dismantled in 1926 - but expired long before that.

The LMU had a common currency but this did not guarantee its survival. It lacked a common monetary policy monitored and enforced by a common Central Bank - and these deficiencies proved fatal.

In 1867, twenty countries debated the introduction of a global currency in the International Monetary Conference. They decided to adopt the gold standard (already used by Britain and the USA) following a period of transition. They came up with an ingenious scheme. They selected three "hard" currencies, with equal gold content so as to render them interchangeable, as their legal tender. Regrettably for students of the dismal science, the plan came to naught.

Another failed experiment was the Scandinavian Monetary Union (SMU), formed by Sweden (1873), Denmark (1873) and Norway (1875). It was a by-now familiar scheme. All three recognized each others' gold coinage as well as token coins as legal tender. The daring innovation was to accept the members' banknotes (1900) as well.

As Scandinavian schemes go, this one worked too perfectly. No one wanted to convert one currency to another. Between 1905 and 1924, no exchange rates among the three currencies were available. When Norway became independent, the irate

Swedes dismantled the moribund Union in an act of monetary tit-for-tat.

The SMU had an unofficial central bank with pooled reserves. It extended credit lines to each of the three member countries. As long as gold supply was limited, the Scandinavian Kronor held its ground. Then governments started to finance their deficits by dumping gold during World War I (and thus erode their debts by fostering inflation through a string of inane devaluations). In an unparalleled act of arbitrage, central banks then turned around and used the depreciated currencies to scoop up gold at official (cheap) rates.

When Sweden refused to continue to sell its gold at the officially fixed price - the other members declared effective economic war. They forced Sweden to purchase enormous quantities of their token coins. The proceeds were used to buy the much stronger Swedish currency at an ever cheaper price (as the price of gold collapsed). Sweden found itself subsidizing an arbitrage against its own economy. It inevitably reacted by ending the import of other members' tokens. The Union thus ended. The price of gold was no longer fixed and token coins were no more convertible.

The East African Currency Area is a fairly recent debacle. An equivalent experiment, involving the CFA franc, is still going on in the Francophile part of Africa.

The parts of East Africa ruled by the British (Kenya, Uganda and Tanganyika and, in 1936, Zanzibar) adopted in 1922 a single common currency, the East African shilling. The newly independent countries of East Africa remained part of the Sterling Area (i.e., the local currencies were fully and freely convertible into British Pounds). Misplaced imperial pride coupled with outmoded strategic thinking led the British to infuse these emerging economies with inordinate amounts of money. Despite all this, the resulting monetary union was surprisingly resilient. It easily absorbed the new currencies of Kenya, Uganda and Tanzania in 1966, making them legal tender in all three and convertible to Pounds.

Ironically, it was the Pound which gave way. Its relentless depreciation in the late 60s and early 70s, led to the disintegration of the Sterling Area in 1972. The strict monetary discipline which characterized the union - evaporated. The currencies diverged - a result of a divergence of inflation targets and interest rates. The East African Currency Area was formally ended in 1977.

Not all monetary unions ended so tragically. Arguably, the most famous of the successful ones is the Zollverein (German Customs Union).

The nascent German Federation was composed, at the beginning of the 19th century, of 39 independent political units. They all busily minted coins (gold, silver) and had their own - distinct - standard weights and measures. The decisions of the much lauded Congress of Vienna (1815) did wonders for labour mobility in Europe but not so for trade. The baffling number of (mostly non-convertible) different currencies did not help.

The German principalities formed a customs union as early as 1818. The three regional groupings (the Northern, Central and Southern) were united in 1833. In 1828, Prussia harmonized its customs tariffs with the other members of the Federation, making it possible to pay duties in gold or silver. Some members hesitantly experimented with new fixed exchange rate convertible currencies. But, in practice, the union already had a single currency: the Vereinsmunze.

The Zollverein (Customs Union) was established in 1834 to facilitate trade by reducing its costs. This was done by compelling most of the members to choose between two monetary standards (the Thaler and the Gulden) in 1838. Much as the Bundesbank was to Europe in the second half of the twentieth century, the Prussian central bank became the effective Central Bank of the Federation from 1847 on. Prussia was by far the dominant member of the union, as it comprised 70% of the population and land mass of the future Germany.

The North German Thaler was fixed at 1.75 to the South German Gulden and, in 1856 (when Austria became informally associated with the Union), at 1.5 Austrian Florins. This last collaboration was to be a short lived affair, Prussia and Austria having declared war on each other in 1866.

Bismarck (Prussia) united Germany (Bavarian objections notwithstanding) in 1871. He founded the Reichsbank in 1875 and charged it with issuing the crisp new Reichsmark. Bismarck forced the Germans to accept the new currency as the only legal tender throughout the first German Reich. Germany's new single currency was in effect a monetary union. It survived two World Wars, a devastating bout of inflation in 1923, and a monetary meltdown after the Second World War. The stolid and trustworthy Bundesbank succeeded the Reichsmark and the Union was finally vanquished only by the bureaucracy in Brussels and its euro.

This is the only case in history of a successful monetary union not preceded by a political one. But it is hardly representative. Prussia was the regional bully and never shied away from enforcing strict compliance on the other members of the Federation. It understood the paramount importance of a stable currency and sought to preserve it by introducing various consistent metallic standards. Politically motivated inflation and devaluation were ruled out, for the first time. Modern monetary management was born.

Another, perhaps equally successful, and still on-going union - is the CFA franc

Zone.

The CFA (stands for French African Community in French) franc has been in use in the French colonies of West and Central Africa (and, curiously, in one formerly Spanish colony) since 1945. It is pegged to the French franc. The French Treasury explicitly guarantees its conversion to the French franc (65% of the reserves of the member states are kept in the safes of the French Central Bank). France often openly imposes monetary discipline (that it sometimes lacks at home!) directly and through its generous financial assistance. Foreign reserves must always equal 20% of short term deposits in commercial banks. All this made the CFA an attractive option in the colonies even after they attained independence.

The CFA franc zone is remarkably diverse ethnically, lingually, culturally, politically, and economically. The currency survived devaluations (as large as 100% vis a vis the French Franc), changes of regimes (from colonial to independent), the existence of two groups of members, each with its own central bank (the West African Economic and Monetary Union and the Central African Economic and Monetary Community), controls of trade and capital flows - not to mention a host of natural and man made catastrophes.

The euro has indirectly affected the CFA as well. "The Economist" reported recently a shortage of small denomination CFA franc notes. "Recently the printer (of CFA francs) has been too busy producing euros for the market back home" - complained the West African central bank in Dakar. But this is the minor problem. The CFA franc is at risk due to internal imbalances among the economies of the zone. Their growth rates differ markedly. There are mounting pressures by some members to devalue the common currency. Others sternly resist it.

"The Economist" reports that the Economic Community of West African States (ECOWAS) - eight CFA countries plus Nigeria, Ghana, Guinea, the Gambia, Cape Verde, Sierra Leone, and Liberia - is considering its own monetary union. Many of the prospective members of this union fancy the CFA franc even less than the EU fancies their capricious and graft-ridden economies. But an ECOWAS monetary union could constitute a serious - and more economically coherent - alternative to the CFA franc zone.

A neglected monetary union is the one between Belgium and Luxembourg. Both maintain their idiosyncratic currencies - but these are at parity and serve as legal tender in both countries since 1921. The monetary policy of both countries is dictated by the Belgian Central Bank and exchange regulations are overseen by a joint agency. The two were close to dismantling the union at least twice (in 1982 and 1993) - but relented.

II. The Lessons

Europe has had more than its share of botched and of successful currency unions. The Snake, the EMS, the ERM, on the one hand - and the British Pound, the Deutschmark, and the ECU, on the other.

The currency unions which made it have all survived because they relied on a single monetary authority for managing the currency.

Counter-intuitively, single currencies are often associated with complex political entities which occupy vast swathes of land and incorporate previously distinct -and often politically, socially, and economically disparate - units. The USA is a monetary union, as was the late USSR.

All single currencies encountered opposition on both ideological and pragmatic grounds when they were first introduced.

The American constitution, for instance, did not provide for a central bank. Many of the Founding Fathers (e.g., Madison and Jefferson) refused to countenance one. It took the nascent USA two decades to come up with a semblance of a central monetary institution in 1791. It was modeled after the successful Bank of England. When Madison became President, he purposefully let its concession expire in 1811. In the forthcoming half century, it revived (for instance, in 1816) and expired a few times.

The United States became a monetary union only following its traumatic Civil War. Similarly, Europe's monetary union is a belated outcome of two European civil wars (the two World Wars). America instituted bank regulation and supervision only in 1863 and, for the first time, banks were classified as either national or state-level.

This classification was necessary because by the end of the Civil War, notes - legal and illegal tender - were being issued by no less than 1562 private banks - up from only 25 in 1800. A similar process occurred in the principalities which were later to constitute Germany. In the decade between 1847 and 1857, twenty five private banks were established there for the express purpose of printing banknotes to circulate as legal tender. Seventy (!) different types of currency (mostly foreign) were being used in the Rhineland alone in 1816.

The Federal Reserve System was founded only following a tidal wave of banking crises in 1908. Not until 1960 did it gain a full monopoly of nation-wide money printing. The monetary union in the USA - the US dollar as a single legal tender printed exclusively by a central monetary authority - is, therefore, a fairly recent thing, not much older than the euro.

It is common to confuse the logistics of a monetary union with its underpinnings. European bigwigs gloated over the smooth introduction of the physical notes and coins of their new currency. But having a single currency with free and guaranteed convertibility is only the manifestation of a monetary union - not one of its economic pillars.

History teaches us that for a monetary union to succeed, the exchange rate of the single currency must be realistic (for instance, reflect the purchasing power parity) and, thus, not susceptible to speculative attacks. Additionally, the members of the union must adhere to one monetary policy.

Surprisingly, history demonstrates that a monetary union is not necessarily predicated on the existence of a single currency. A monetary union could incorporate "several currencies, fully and permanently convertible into one another at irrevocably fixed exchange rates". This would be like having a single currency with various denominations, each printed by another member of the Union.

What really matters are the economic inter-relationships and power plays among union members and between the union and other currency zones and currencies (as expressed through the exchange rate).

Usually the single currency of the Union is convertible at given (though floating) exchange rates subject to a uniform exchange rate policy. This applies to all the territory of the single currency. It is intended to prevent arbitrage (buying the single currency in one place and selling it in another). Rampant arbitrage - ask anyone in Asia - often leads to the need to impose exchange controls, thus eliminating convertibility and inducing panic.

Monetary unions in the past failed because they allowed variable exchange rates, (often depending on where - in which part of the monetary union - the conversion took place).

A uniform exchange rate policy is only one of the concessions members of a monetary union must make. Joining always means giving up independent monetary policy and, with it, a sizeable slice of national sovereignty. Members relegate the regulation of their money supply, inflation, interest rates, and foreign exchange rates to a central monetary authority (e.g., the European Central Bank in the eurozone).

The need for central monetary management arises because, in economic theory, a currency is never just a currency. It is thought of as a transmission mechanism of economic signals (information) and expectations (often through monetary policy and its outcomes).

It is often argued that a single fiscal policy is not only unnecessary, but potentially harmful. A monetary union means the surrender of sovereign monetary policy instruments. It may be advisable to let the members of the union apply fiscal policy instruments autonomously in order to counter the business cycle, or cope with asymmetric shocks, goes the argument. As long as there is no implicit or explicit guarantee of the whole union for the indebtedness of its members - profligate individual states are likely to be punished by the market, discriminately.

But, in a monetary union with mutual guarantees among the members (even if it is only implicit as is the case in the eurozone), fiscal profligacy, even of one or two large players, may force the central monetary authority to raise interest rates in order to pre-empt inflationary pressures.

Interest rates have to be raised because the effects of one member's fiscal decisions are communicated to other members through the common currency. The currency is the medium of exchange of information regarding the present and future health of the economies involved. Hence the notorious "EU Stability Pact", recently so flagrantly abandoned in the face of German budget deficits.

Monetary unions which did not follow the path of fiscal rectitude are no longer with us.

In an article I published in 1997 ("The History of Previous European Currency Unions"), I identified five paramount lessons from the short and brutish life of previous - now invariably defunct - monetary unions:

To prevail, a monetary union must be founded by one or two economically dominant countries ("economic locomotives"). Such driving forces must be geopolitically important, maintain political solidarity with other members, be willing to exercise their clout, and be economically involved in (or even dependent on) the economies of the other members.
Central institutions must be set up to monitor and enforce monetary, fiscal, and other economic policies, to coordinate activities of the member states, to implement political and technical decisions, to control the money aggregates and seigniorage (i.e., rents accruing due to money printing), to determine the legal tender and the rules governing the issuance of money.
It is better if a monetary union is preceded by a political one (consider the examples of the USA, the USSR, the UK, and Germany).

Wage and price flexibility are sine qua non. Their absence is a threat to the continued existence of any union. Unilateral transfers from rich areas to poor are a partial and short-lived remedy. Transfers also call for a clear and consistent fiscal policy regarding taxation and expenditures. Problems like unemployment and collapses in demand often plague rigid monetary unions. The works of Mundell and McKinnon (optimal currency areas) prove it decisively (and separately).

Clear convergence criteria and monetary convergence targets.

The current European Monetary Union is far from heeding the lessons of its ill fated predecessors. Europe's labour and capital markets, though recently marginally liberalized, are still more rigid than 150 years ago. The euro was not preceded by an "ever closer (political or constitutional) union". It relies too heavily on fiscal redistribution without the benefit of either a coherent monetary or a consistent fiscal area-wide policy. The euro is not built to cope either with asymmetrical economic shocks (affecting only some members, but not others), or with the vicissitudes of the business cycle.

This does not bode well. This union might well become yet another footnote in the annals of economic history.