A History of Monetary Unions

John Chown

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A History of Monetary Unions

EMU may well be trumpeted as the great economic experiment in monetary union, but as John Chown shows in this superb book, there have been many other examples of monetary unions over the years – some successful, others not so.

In this comprehensive historical overview, the author writes about monetary unions with an admirable completeness and covers such themes as:

- the gold standard and the drama of bimetallism
- nineteenth-century monetary unions in Europe and the world
- EMU and its policy ramifications
- the collapse of the rouble zone and of Yugoslavia
- the sterling area as an accidental monetary union: the contrasting experience of the former French colonies

Written in a readable and often enjoyable prose, *A History of Monetary Unions* combines historical analysis with present-day context. The book will be of great interest to students and academics involved in the study of money, banking and finance. Moreover, it is essential reading for anyone working in the financial sector.

John Chown is a partner in Chown Dewhurst LLP, an independent UK and international tax adviser. Another of his books, *A History of Money*, is also available from Routledge.

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1 General introduction

Introduction

The main theme of this book is monetary unions, how they are created, and how they fall apart. The first six chapters set out the main principles of various types of international monetary arrangements, briefly citing examples which are to be discussed in more detail. There is a range of economic literature discussing the principles in great depth. I have not attempted to compete with this, but rather to illustrate the great range of examples.

There are two main types of monetary union. 'Type 1' monetary unions are between countries on a gold (or silver) standard, with each currency defined in terms of gold (*or* silver) meaning that exchange rates are already fixed. The collapse of bimetallism, an early 'monetary disunion', confirms that even metallic currencies have their 'exchange rate' problems.

'Type 2' unions are more interesting, where the countries would otherwise have independent monetary policies based on inconvertible fiat currencies: these can be subdivided according to whether or not exchange controls restrict the free flow of capital.

Many 'monetary unions' were simply a reaction to political change, as countries were linked by marriage or conquest, or achieved independence. There are also many examples of countries adopting the trusted currency of a neighbour: what we would now call 'dollarisation'.

Monetary union after the Napoleonic Wars

The concept of 'monetary union' becomes much more interesting when coins (or banknotes convertible into metal) of a particular value are precisely defined by a given weight and fineness of gold or silver.

After the Napoleonic Wars (which themselves included some of the more important early experiments with inconvertible paper currency) there were major type 1 monetary unions within Europe. There were also disunions, such as when the former Spanish empire in Latin America fell apart, and where other newly independent countries followed a wide variety of monetary policies.

By this time monetary arrangements had become more formalised with the concept of 'free minting', when anyone could take gold or silver, in the form of bullion or foreign coins, to be minted into domestic coins without charge, the cost being borne by the state. Given a gold standard *or* silver standard, the value of each currency was defined in terms of a weight of metal, exchange rates were fixed and there was, in general, no question of exchange risk. The traveller from, say, England armed with gold guineas or sovereigns suffered no 'exchange risk' when he travelled to France, but would simply suffer 'transaction costs' of changing his English coins into gold louis (or later 20 franc napoleons). Reminting, though typically by then free of charge, took time and trouble and it was more practical to exchange them with a money changer.

Although the percentage transaction costs were much lower than those imposed by late twentieth-century banks (when the electronic revolution might have been expected to reduce them) they were still worth avoiding. All that was needed was for nations to agree to standardise the weight and fineness of their coinage: there were none of the technical economic problems involved in type 2 unions between countries with fiat currencies, but as in the twentieth century, national politics made the process fearsomely difficult.

The Latin Monetary Union

The classic example of a type 1 monetary union was the Latin Monetary Union, under which a number of countries agreed effectively to bring the weight and standard of their coins into line with those of France. There were at about the same time other unions: what is now Germany began to rationalise a number of regional coinages in 1837; considerable progress was made, but full monetary union was only really achieved in 1892 after Bismarck had imposed political union. Switzerland, a loose confederation, had long arguments about what national currency unit to adopt eventually resolved by joining the Latin Monetary Union. The various coinages in what is now Italy were again only united following political union.

The Latin Monetary Union could easily have become the basis of what would have amounted to a world money. The gold sovereign was worth 25.2 French francs and could, by a trivial debasement, be reduced to the same gold content as 25 francs. If the French had then replaced their standard 20 franc gold coin with one of 25 francs the two national coins would change hands at par. The Americans, who were returning to a metallic standard after the Civil War, would have been very willing to adjust their own standard so that a 5 dollar gold coin would have exactly the same value as one British pound and 25 French francs. The coinages would have been interchangeable and many other countries would surely have come into line. Why did this not happen? The answer of course is that, then as now, politics and national pride took precedence over economic common sense.

Bimetallism

There was also another and more subtle factor which led to an interesting and complex form of monetary disunion. Although the British were on a gold standard, the French, and therefore the Latin Monetary Union, were on a bimetallic standard which assumed a fixed ratio between the price of gold and silver. Up to a point this ratio had been self-sustaining, but when it collapsed there were widespread repercussions, both in Europe and more specifically in the United States where the 'silver lobby' was strong, and in the Far East and Latin America, which were also wedded to silver. I have never been able to find the quote, but recall that someone once said that 'there are three roads to madness: love, ambition and the study of bimetallism'. It was Hegel who said that 'we learn from history only that men do not learn from history', and this obscure nineteenth-century topic is proving surprisingly relevant to the early twenty-first century.

Inconvertible paper money

The 'golden age of the gold standard' was very short indeed, and even before 1914 there were many examples of countries abandoning gold and silver for inconvertible paper money. In the twentieth century this was to become the norm: during and after the two world wars, many countries abandoned convertibility into gold or silver, and apart from a brief return to gold in the 1920s, each country would have its own paper currency, which it could in principle print at will. Each could, or thought it could, control its own money supply and monetary policy, and exchange rates between such countries could not be fixed.

Paper money creates an obvious inflationary bias and although this temptation was often resisted by monetary authorities, there were many examples of currencies being totally wiped out by hyper-inflation. Many attempts were made to civilise international monetary arrangements, one key debate being between 'fixed' and 'floating' exchange rates, while hybrid versions such as 'crawling pegs', 'managed floats' and others were and are widely discussed.

We need to distinguish between independent inconvertible paper currencies which are partly insulated from each other by exchange controls (much of the world for much of the period from 1914), and those freely traded in free markets (the industrial world in the late twentieth century). The latter are often referred to as 'convertible' in the sense that there are no restrictions on exchanging them into other currencies, but they are 'inconvertible' in the more classic sense that they are not exchangeable into gold or silver at a fixed parity.

There are many examples of smaller countries voluntarily surrendering monetary sovereignty, accepting the policy of a 'big brother', pegging a currency to that of a larger country (the Caribbean islands are interesting examples, having switched their allegiance from the pound sterling to the US dollar). The most formal and convincing type of link involves a currency board, or simply ‘dollarising’, permitting the dollar (or another currency) to circulate either as legal tender or at least as the *de facto* currency of the country.

Bretton Woods

The Bretton Woods system was effectively a type of monetary arrangement attempting fixed rates but leaving sovereign states to manage their domestic economies; and with the ultimate, if in principle restricted, right to change parities. During its heyday, when it worked well, most countries were (fairly) successful in protecting their currencies by exchange controls, of which a little more later. The Exchange Rate Mechanism and other earlier experiments with monetary union in the European Common Market had similar characteristics.

European Monetary Union

European Monetary Union itself is arguably a unique experiment: the only near-precedent for independent countries pooling their control of monetary policy and their right to issue fiat money without first creating a political union is Austria-Hungary.

Monetary disunion

One of the lessons of this book is that monetary unions can and do fall apart: both supporters and opponents of European Monetary Union will find it well worth studying why and how ‘monetary disunions’ happen.

Monetary disunion often follows the break-up of a political union, and history offers plenty of examples, painful to the participants but instructive for historians and policy makers alike. The three most instructive examples are the end of the Austro-Hungarian Empire in 1921, the collapse of the Soviet Union and the break-up of former Yugoslavia. In all these cases there was a remarkable variety of monetary experience amongst the successor states.

The American Civil War was caused by the federal government (its powers deliberately limited by the Founding Fathers, but certainly including the sole right to coin money) seeking to impose a social chapter on certain states which were very attached to labour practices to which others (in that case rightly – the parallel is imperfect) took exception. The Confederate states introduced their own currency, which subsequently collapsed (Chown 1994, ch. 27).[1] Post-Napoleon Latin America combined the end of empire and the widespread use of paper money, while the later gradual break-up of the British empire and the sterling area is a fascinating, if undramatic, example of the break-up of a monetary union.

The collapse of bimetallism as a 'monetary disunion'

The Latin Monetary Union was based on a bimetallic standard, assuming a fixed ratio (15.5:1) between the price of gold and silver, and it broke apart (perhaps unnecessarily, but politics so often overrides economics) when the price of silver collapsed. This event also had its repercussions in the East and Latin America. Nordic Monetary Union began as a 'type 1' union, based on gold, continued formally after currencies became inconvertible in 1914, but again ultimately collapsed.

The special case of Germany, 1990

German political reunification in 1990 is particularly interesting, being followed by a monetary union on inappropriate terms (the Bundesbank said disparagingly that 'it was a political decision') which had to be corrected by a very tight monetary policy in Germany. This policy being quite inappropriate for the European Monetary System partners who were shadowing the deutschmark, the event created an 'asymmetric shock' leading to the partial collapse of that experiment in monetary union – an example of a union producing a disunion, and a classic case of 'how not to' achieve monetary union!

2 The gold standard

An instructive example of a system of fixed exchange rates, and indeed arguably of a monetary union, is the classical gold standard. This had its heyday after the partial collapse of attempts to extend the Latin Monetary Union, and had a surprisingly short life. However, the principles underlying it also apply to fixed exchange rates and monetary unions in an age of paper money, and the analysis in this chapter leads naturally into the arguments about the relative merits of 'fixed' and 'floating' exchange rates, 'optimum currency areas' and monetary unions generally. The collapse of the gold standard is an important example of a 'disunion'.

As explained in Chown 1994, ch. 7,[1] the UK had officially been on a silver standard since Newton's recoinage of 1696, but with the growth of trade, gold became the more important circulating medium. A Committee on Coin, one of many during the century, was set up in 1787, but before it reached any conclusion, the Napoleonic Wars intervened, and the British adopted an inconvertible paper currency: reform of the coinage had to wait.

Action was taken in advance of the 1821 Resumption of Payments, and the UK introduced a formal gold standard in 1816. The sovereign was defined as 123.27447 grains of standard 22 carat (11 ounces or 91.67 per cent fine) gold, i.e. 113.0016 grains of fine gold: silver was given a subservient status. Silver coins, legal tender for no more than £2, were deliberately struck underweight. At market prices a pound of silver was worth 61 shillings (a ratio of 15.46) but was struck into coins worth 66 shillings, a deliberate action to prevent silver coinage leaving the country. This gave some margin against a *fall* in the ratio which was, in the event, enough, but only just, to survive a period of rising silver prices which lasted until about 1870.

Portugal adopted a gold standard in 1854 and Canada in 1867, but the international gold standard only really came into being when Germany adopted gold in 1873, incidentally sealing the fate of bimetallism, and bringing in other countries such as the USA (1879), Austria-Hungary (1892), Russia and Japan (1897). Many large countries were never members. The system broke down in 1914, with a short-lived revival between the wars.

Gold and silver currencies had of course a much longer history, but the history included many debasements, and it was only with the fairly general introduction of free minting in the nineteenth century that travellers and traders could safely assume fixed parities. Under the classic gold standard, each participating country's coinage was defined as a specific weight of gold, banknotes were convertible into gold, and there were no restrictions (and low, if any, costs) on converting bullion into coins and vice-versa. A sovereign, or a US gold eagle, was just a denomination of gold as, in 1999, the deutschmark and the French franc were technically denominations of the euro.

The 'automatic' mechanism was simple in concept, and had indeed been described by David Hume in 1752. Assume a participating country suffers an 'asymmetric shock' (often, in those days, a bad harvest) and for that, or any other reason, internal prices rise. Given that the exchange rate (gold specie parity) is fixed, the change in relative prices means that its exports fall, and its imports rise, causing a balance of trade deficit which results in an export of gold, which (given that gold is the monetary base) means that there is a decline in the quantity of money in circulation. Domestic demand falls, forcing down prices and (through unemployment) wages, until a new equilibrium is reached, albeit at a lower level to take account of the real economic loss from the shock.

This might seem brutal (and often was) but balance of trade deficits could also be financed, again automatically, by capital movements. In the above circumstances tight money would, as part of the process of reducing demand, force up interest rates, and these higher rates would attract capital from other, unaffected, countries – provided that market participants assumed that exchange rates would remain stable, and that the deficit country would not default. Short-term fluctuations could be financed in this way, but countries with deficits resulting from unsound or profligate internal policies would (in principle) be left to meet the problem by a sharp and salutory internal deflation.

There are plenty of examples to show that it did not always work like that (see for instance Panic 1992)[2] but in principle the effect of the gold standard was to maintain equilibrium, and purchasing power parity, by forcing internal prices down or up in response to changing circumstances.

The gold standard mechanism and fiat currencies

In the more modern world fixed exchange rates, with inconvertible fiat money, can only be maintained if governments (or independent Central Banks) take deliberate action to stimulate or restrain internal demand in response to balance of payments surpluses or deficits. As this history shows, sometimes they did, and sometimes they didn't, but the key difference between the nineteenth and twentieth centuries is that, for whatever reason, it became very difficult actually to reduce money wages. An event which would in earlier times have caused a mild recession and a reduction in wage levels would, in the changed circumstances, cause massive unemployment and a depression on the 1930s scale. The old adjustment process had ceased to work efficiently, and a more flexible exchange rate regime began to look attractive. More of this in the next chapter, but it is first worth noting another feature of the gold standard.

A gold standard, or indeed any other commodity standard, does not, as its more enthusiastic advocates sometimes claim, guarantee stable prices. For prices to be stable, the effective money supply needs to grow in line with the size of the economy, neither more nor less. The stock of gold grows every year as new gold is mined, but the rate of growth depends on gold discoveries. The gold brought home from South America by the conquistadores sparked off an inflation in Spain, with grave long-term damage to that country's economy. During the last couple of centuries, the world's economy has been expanding, and if gold had remained the only available money, there would have been a strict and intolerable limit to economic expansion: a deflationary bias. During the nineteenth century there were important gold discoveries, but more significantly the growing use of banknotes and bank deposits meant that money, broadly defined, became a high and rising multiple of the gold stock.

On this point, Panic (1992, quoting Triffin 1964)[3] says that in 1815 gold and silver accounted for two thirds of the total money supply in the UK, US and France, but by 1913 the figure was down to 10 per cent – but what definition of 'money' was used? Similarly, Davis Dewey (quoted by Kemmerer[4]) says:

> Before the passage of the Sherman Act nine-tenths or more of the customs receipts at the New York custom house were paid in gold or gold certificates; in the summer of 1891 the proportion of gold and gold certificates fell as low as 12 per cent; and in September 1892, to less than 4 per cent. The use of United States notes and treasury notes of 1890 correspondingly increased.

It could be argued that only by a lucky accident did the effective supply of money grow more or less in line with the needs of trade, and there were many, from John Law on, who argued for some 'new form of money' (Chown 1994, chs 22, 23).

The gold standard therefore did not provide the perfect solution, either to the problem of stable prices or that of how trading nations adjust their economies to changing conditions, but had, in the eyes of many, one great advantage. It kept one set of economic decisions out of the hands of politicians.

Indeed, one of the great debates on money over the years has been 'rules versus discretion': a government which has the power to influence monetary conditions and to keep money supply adjusted to the changing needs of trade and commerce can achieve much, if it uses that power wisely. It can also cause great damage if it does not understand that power, or uses it merely to achieve short-term political advantage or to patch up an urgent problem, and history, including very recent history, has too many examples of both to give us much comfort. Even a benevolent and wise government (possibly only an abstract concept) may well find that the issues are too subtle, and the data needed too unreliable, for them to be sure of doing more good than harm.

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