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Brussels and Ahnatal-Weimar in November 2006

Lars Jonung

Jürgen Nautz

Introduction

Lars Jonung

The recent birth of the euro as the common European currency has created an interest in the history of monetary unions, successful ones as well as failing ones. Here, we bring together a number of contributions that focus on political aspects of monetary unification and international monetary and financial cooperation. Adopting such a perspective, the conflicting views in society concerning monetary arrangement are brought into the forefront, hence the title *Conflict Potentials in Monetary Unions*.

The evidence is taken from many countries and from different episodes in time; from the foundation of the US monetary union in the 18th century to the euro referendum in Sweden in the first years of the 21st century. We focus on the process of monetary unification to bring out the turns and twist of monetary unification. As revealed here, monetary unification is not always a smooth process. We first summarize the contributions and then draw conclusions from them.

1. The constitutional creation of a common currency in the U.S. Monetary stabilization versus merchant rent seeking

The US monetary union is commonly regarded as a successful monetary union. Still its creation and development over time is a subject of contention. Two chapters deal with this issue. First, Farley Grubb examines the creation of a common currency for the United States, covering the period 1748-1811. His analysis starts from a description of the monetary system that emerged in the thirteen colonies prior to the American Revolution. Initially the colonies were prevented by the British from setting up banks, minting coins and even importing coins from England. Consequently, foreign monies were imported from other countries than England through the trade surplus of the colonies.

Starting with Massachusetts in 1690, the monetary systems of the North American colonies gradually became based on the issuance of bills of credit denominated in pound units – a form of local paper money – that circulated at flexible exchange rates to specie and to the each other. These notes were accepted in the payment of taxes to the colonies. Competition in the market for currencies, that is for bills of credit issued by different colonies, contributed as a rule to monetary discipline. Through the emission of bills of credit, a colony could carry out an active monetary policy by adjusting the supply of paper money to prevailing macroeconomic conditions. Properly managed, the supply and demand for bills of credit functioned as an automatic stabilizer of the economies of the colonies.

In 1775, during the revolutionary war against the British, the first US government issued its own fiat paper money, denominated in Continental dollars: a currency that depreciated rapidly and soon was taken out of circulation. In 1782 the Continental Congress established the Bank of North America as a first step towards a bank-based federal monetary system. The decisive step was taken after the American Revolution in 1787 when the monetary system of many competing paper currencies was eliminated by the new US Constitution which prohibited the individual states from issuing new bills of credit and established one currency, the US dollar, as the sole currency of the new federal state. The new monetary system was based on fractional reserve banking where the US congress determined the specie contents of a US dollar in the Mint Act of 1792. By these decisions, the room for active monetary policy measures was severely limited.

After these steps, several monetary units were used in parallel, the new dollar and the old monies of the states. How long time did it take for the dollar to become the sole unit of account and medium of exchange? By examining a unique data base, the market for immigrant servant contracts in Philadelphia, at that time the largest city in the U.S., Grubb concludes that the process was time-consuming. The new currency was not immediately accepted by market participants. Rather, trust was high in the old currency of the state of Pennsylvania as long as it was circulating as demonstrated in a number of statistical tests. Grubb explains this by the prudent management of the monies of the colonies/states before and after the Revolution. The mismanagement of the federal money supply during the Revolution reinforced this sentiment.

Why was state-issued paper money eliminated by the US constitution when it performed so well? Grubb suggests a political economy (rent seeking) approach, arguing that a group of influential merchant-bankers managed to ban the monies of their major competitors, the states, during the Constitutional Convention. Through their clever manipulation, the US was initially equipped with a less efficient monetary system than otherwise. Finally, Grubb speculates about lessons from the forming of the US currency union for present day monetary unification.

2. From monetary union to financial union in the United States

How long time does it take for a monetary union to become financially fully integrated – that is to become a financial union? John Landon-Lane and Hugh Rockoff provide an answer to this question by examining the monetary and financial record of the United States. The United States was established as a currency union in 1788, see here the account by Farley Grubb above. The authors suggest that we should expect financial markets to become integrated faster than labor markets, product markets and markets for physical capital as transaction costs in these markets are typically larger than in financial markets.

The issue is an old one. US economists and economic historians have debated the financial integration of the US economy for a long time. Landon-Lane and Rockoff first review a large number of earlier contributions on financial integration, stressing that these focused on long-run adjustment processes as economists in the past were primarily interested in the determinants of economic growth. However, from a monetary union perspective the speed and uniformity by which monetary disturbances are communicated from financial centers to the rest of the country should be examined. Thus the transmission of monetary shocks takes the center stage, reflecting the policy question to what extent the central bank of the monetary union is capable of affecting all parts of the union in the short run. This is an important issue as the US banking system has had a very fragmented structure across individual states.

Next, the authors examine when the impact of central bank actions become identical or close to identical across the regions/member states of the US monetary union. Here they adopt changes in interest rates as their measure of monetary policy. They examine first financial integration during financial crisis, concluding that financial unification was incomplete, in particular during the depression of the 1930s. They split their sample into three periods: 1880-1905, 1906-1945 and 1945-1960. A set of statistical tests are performed, running from simple correlations to VAR:s and impulse-response calculations. The basic conclusion emerging is that it took at least 100 years for the US to be financially fully integrated in the sense that the central bank was able to communicate its policy in a uniform manner across the financial markets in the union. The integration process was slowed down by various political obstacles, not least the US civil war.

The issue examined by Landon-Lane and Rockoff is of current interest for the group of European countries that recently formed the euro area. Barriers to financial integration remain within the euro area and policies are being put into place to remove them. Still, it is unclear how fast the financial markets of the members of the monetary union will be integrated. National differences in regulation, in financial technologies, in financial governance and in banking systems may be long-lasting.

3. Ethnic conflicts and monetary unification in Austria-Hungary

The history of the monetary union between Austria and Hungary prior to World War I illustrates the problems facing a common currency in a political entity with large tensions between various language groups as demonstrated by the account of Jürgen Nautz. He starts with the Compromise of 1867 (the *Ausgleich*), an arrangement determining the relationship between Austria and Hungary with a term of 10 years. The *Ausgleich* replaced the centralism of the Austrian Empire with the dualism of the Austro-Hungarian monarchy. Imperial Austria and Imperial Hungary where established as two largely independent states under Franz-Joseph, the Emperor of Austria and the King of Hungary. Most political issues became the responsibility of the separate halves of the empire. In particular, economic policy framing as well as financial and monetary policy were the autonomous preserve of Austria and Hungary. Thus, joint action in these areas required bilateral agreements and corresponding legislation.

The Compromise of 1867 laid the constitutional basis for a monetary union between the Austrian and the Hungarian half of the Habsburg Empire. Shortly after signing the *Ausgleich*, the two governments agreed that the Austrian National Bank should remain the common central bank as a privileged corporation. Nevertheless, the future of the Bank remained controversial.

The Hungarians demanded that the national bank should set up a closer network of branches in Hungary and that Hungarian credit needs should be taken into account more strongly. Hungary reached full parity with the Germans in the central bank only on the evening before the introduction of the gold crown following several intermediate steps.

The temporary compromises and their equivalence in monetary policy, the Privileges, provided a framework for achieving periodically negotiated arrangements between the opposing interests of the Magyars and the Germans. However, more dangerous challenges emerged from the multi-ethnic structures *within* the Austrian and the Hungarian half. Nationalistic organizations tried to influence monetary policy which resulted in conflicts about the organizational and personnel structure of the central bank, ranging from questions pertaining to currency reforms, the role of the central bank within the political system, the appropriate foreign exchange policy, the Bank's operational business, the scope and regional distribution of its branches to the design of the notes. There were also severe, ethnically colored attacks against the introduction of the gold standard in 1891 and 1892, brought forward by Slavs, protesting against the supremacy of the Magyars and the Germans in the political, cultural, and economic life of the monarchy. In short, the Austro-Hungarian central bank became a popular target for criticism by a number of social and ethnic groups.

All demands by the non-German peoples for stronger participation in the central bank were fended off at the political level within Austria. Due to this, Czech organizations called their members for stock purchases to improve their weight in the shareholders' meetings of the central bank. This strategy provoked corresponding counterstrategies among German organizations.

The central bank nevertheless managed to operate a successful financial policy and to support the economic modernization of the monarchy. In particular, the central bank combined its interest rate policy with an exchange rate policy to avoid major movements in the discount rate. The background was that the lending policy of the Austro-Hungarian Bank was a major source for continuous complaints. The practical solution of this problem was to stabilize the currency from 1896 onwards within an informal currency band whose exact size the authorities never specified. This was achieved through discretionary foreign exchange intervention when the exchange rate departed from the central parity. This strategy was successfully implemented by the Austro-Hungarian Bank in the period between 1896 and the outbreak of the First World War in 1914.

4. The escudo zone – a failed attempt at colonial monetary union

Which are the conditions necessary for creating a well-functioning monetary union? The history of Portugal provides us with an example of a fascinating but little known experiment to set up a monetary union combined with free trade area in the 1960s. At that time Portugal was an empire with colonies spread out in Africa and Asia far from the home country. Trade and finance between Portugal and its colonies were regulated through a system of trade preferences and different currencies, although they were all named escudo after the currency of the home land. The system was thus not based on a common currency, nor on free trade.

The European integration process emerging at the end of the 1950s, with the rise of the European Communities (EC) and the European Free Trade Association (EFTA) as two competing trade blocs, inspired Portugal to apply for membership in EFTA. Membership, which was eventually granted to Portugal, required the quick abolishment of the colonial restrictions on trade. A clearing scheme and a monetary fund for the escudo zone were set up. The Bank of Portugal was designed the central bank for the new monetary union.

The new monetary union lasted for a very short time. It immediately run into problems due to imbalances in trade and financial flows within the escudo zone. It faced major challenges, first of all the ongoing colonial war in Angola and Mozambique causing capital flight. In short, the fixed exchange rate implicit in the monetary union could not be maintained. Various trade and exchange controls were soon introduced, ending the attempt to create a free trade area and a monetary union in less than ten years.

As pointed out by Nuno Valério, the preconditions for a successful monetary union based on the escudo were simply not at hand. The Portuguese colonies were located extremely far from the home land, trade and financial links between the various colonies were basically non-existent, the size of the colonies varied considerably, they were at different stages of development. Cultural and, most important, political differences were wide. Portugal, the home land, did not hold the economic and monetary powers necessary to keep the colonial empire together. The monetary union was doomed to fail. The disintegration of the escudo union was accompanied by a process of decolonization, effectively eliminating the empire in the early 1970s.

5. Trade, money and institutions for conflict resolution in monetary unions. The gold standard and European integration compared

Why has the institutional design of international cooperation in money and trade in the 19th and 20th century varied over time? This is the question considered by Céderic Dupont and Carsten Hefeker. They compare the characteristics of international cooperation during two periods: the classical gold standard in the 19th century up to the outbreak of World War I and the post World War II period. In short, they describe the evolution of the international system of trade and monetary cooperation during the past 150 years.

The basic difference between the two periods is the following one. During the gold standard cooperation and coordination was a spontaneous and decentralized process. Great Britain and France took the initiative of a free trade agreement with most favored nation (MFN) clauses in a treaty in 1860. Other countries joined and eventually the world turned into a regime of free trade. The agreements were temporary. The system was put under strain due to the arrival of new producers on the world market. Several countries introduced tariffs. Thus international cooperation did not manage to maintain free trade.

Concerning monetary cooperation, Great Britain was initially the major country on gold while the rest of the world was either on silver on a bimetallic standard. In the 1870s, a number of countries moved onto the gold standard. The process was driven by domestic policies. The result was that almost the whole world was on the gold standard when World War I broke out, thus forming a global monetary union.

After World War II, international cooperation has been characterized by multinational planning and centralization as well as by a process of evolving institutional solutions. The Bretton Woods system tried to set up a system of fixed but adjustable exchange rates combined with institutions like the IMF, the World Bank and the GATT. After the break-down of the Bretton Woods system, European countries deepened their economic cooperation. This has led to the creation of a common European market and a common European currency headed by a number of common centralized institutions with legal powers over the member states.

Dupont and Hefeker explain the emergence of these two different regimes, the decentralized one and the centralized, by bringing in political economy considerations. Every country has a choice between commitment to an international agreement (enforcement) and to domestic flexibility. The benefits and costs of international commitment and of domestic flexibility vary over time, depending on inter alia the type of chocks hitting the domestic economy, the openness of the economy and other characteristics of the national economy, the behavior of the other members of the international agreement, etc. Ultimately, the choice of institutions for international cooperation reflects domestic political considerations, in particular distributional issues.

Ending their survey of international cooperation in Europe in the past 50 years, Dupont and Hefeker conclude that rising economic integration in Europe has contributed to a system of centralized solutions and institutions to enforce the rules of integration. They stress that benefits of integration have increased significantly. This type of deep international cooperation is concentrated to Europe. It is more difficult to extend it to the rest of the world than was the case with the gold standard in the 19th century.

6. Managing a common currency. Political and cultural preferences

The theory of optimum currency areas – the OCA-approach in short – is the standard tool used by economists to analyze issues of monetary unification. In the traditional OCA-framework, originating from the work of Robert Mundell, policy-makers are faced with a trade-off between the microeconomic efficiency gains from a common currency (or a fixed exchange rate) and the macroeconomic benefits of having a national or domestic currency to use for stabilization policy purposes. However, the OCA-approach has turned out to be of little value when explaining monetary unification and predicting the success of monetary unions or exchange rate arrangements. The establishment of the EMU and the euro is a prime example of this. The history of the creation and destruction of monetary unions also illustrates the shortcomings of the traditional OCA-approach. Monetary unification is thus a more complicated process than assumed by this theory.

This is the starting point for Tal Sadeh. Adopting a political science perspective, he sets out to discuss the many and different services that money has performed and is performing in various societies. His basic view is that the OCA-theory builds upon a limited number of these services. Once we broaden the perspective, we arrive at a richer historical and political perspective on the role of money. Now social, political and cultural variables are brought into the picture alongside the traditional economic ones.

Using frequent examples from history, some going back to Mesopotamia and the Roman Empire, Sadeh surveys the role of money as a medium of account, a medium of exchange, as a store of value, as a precautionary device, as a taxing device, and as a macroeconomic tool. The first part of this survey considers the services that money renders private individuals and firms. The second part, that is the discussion of the role of money in taxation and in macroeconomic policy-making, examines the services that money offers to the government. Here the focus is on recent developments in the theory of money and macroeconomics. Sadeh gives a very concise summary of various theories and models of the effects of money emerging from the monetarist and Keynesian schools of thought.

The basic conclusion of Sadeh is that money performs many services and that the public holds preferences concerning these services. The preferred type of service will influence the design of monetary policy and monetary arrangements. When there is a change in the monetary preferences, this may contribute to a change in monetary policy. Technological and financial inventions or innovations may also change the composition and character of the services offered by money. This broad approach suggests that we should go beyond the standard OCA-framework when we study the evolution of monetary unions.

7. The political economy of monetary unification. The Swedish euro referendum of 2003

The Swedish referendum in September 2003 on adopting the euro or keeping the domestic currency, the *krona*, represents a unique event to examine the public's perceptions of the benefits and costs of monetary unification. The voters chose between the two polar cases of exchange rate regimes: either a freely floating exchange rate or membership in a monetary union. This is the first and so far the only case where the voters in a democratic society has been faced with such a choice. Although other European countries have held referendums on the Maastricht Treaty and on EU membership, these elections have not involved a clear-cut choice between exchange rate systems.

The referendum was preceded by a long campaign and debate about the advantages and disadvantages of membership in the euro area. The public was well informed by the issues involved. Actually, the referendum attracted more than 80 per cent of the eligible voters. The no-vote attracted the majority of the votes, close to 56 per cent. However, the referendum outcome revealed large differences in voting behavior across regions, socio-economic groups in society and party affiliations. In short, the Swedish public was split on the euro.

How should these differences in voting behavior be explained? Lars Jonung examines them starting from an approach inspired by the theory of optimum currency areas (OCA), using data compiled through an exit poll conducted on the day of the referendum by the Swedish Television – a public service company. He assumes that voters act in their self-interest and that they are informed about the consequences of their votes. Within a country like Sweden, distributional issues must take centre stage when we try to explain differences in voting patterns across groups in society. Some gain or loose more than others from a common currency.

For this reason, Jonung uses the OCA-approach to derive the expected behavior of different voters by focusing on distributional effects implied by this body of theory. In short, voters benefiting from the efficiency gains from monetary unification should tend to vote yes to the euro. We should expect to find them primarily in the open sector of the economy. High income and well-educated voters are also more likely to benefit from monetary unification. On the other hand, low income and poorly educated voters are more likely to benefit from a domestic currency as they will obtain more insurance through national policy autonomy. Insurance in this context means protection from the public sector in the face of adverse macroeconomic shocks.

Examining the exit poll data, Jonung finds supports for this interpretation. The optimum currency area theory proves to be a constructive framework to predict voting behavior across socio-economic groups and regions. The distribution of the expected benefits and costs across groups stands out as a major determinant of their voting behavior. As predicted by theory, the yes-vote was strongest among voters employed in the tradable sector, in high growth regions as well as among high-income earners and well educated. The no-vote was strongest among voters employed in the non-tradable sector, in particular in the public sector, and among low-income earners, the unemployed and the less educated – in short, among groups dependent on public-sector transfers to maintain their living standards in the event of adverse economic shocks. Finally, political attitudes towards the European integration process heavily influenced the views of the voters towards the euro.

Summing up the results, it is clear that the decision of the voters was influenced by a large number of factors, economic as well as political ones. Economic factors played a dominant role in this context. To win a country for a common currency, the evidence suggests that the majority of the voters should be convinced about the beneficial effects of monetary unification.

8. Conclusions

This volume covers the monetary experience of several countries. Three major messages emerge. First of all, monetary unification and monetary cooperation is a time-consuming process. A monetary union is usually not created in a short period. Monetary unions, once established, evolve over time as well. The period for adjustment and adaptation can be very long – as the case of the United States proves. Here financial unification followed long after monetary unification. A number of techniques can be used to make the monetary union more flexible and adaptable as the case of the Austro-Hungarian monetary union demonstrates. Attempts to create a monetary union may be ill-conceived from the start as the case of the monetary union between Portugal and its colonies shows.

Second, monetary unification involves both economic and political issues. Political issues are strongly influencing the process. Often they are difficult to separate from economic ones. Politics is commonly driving monetary marriages as well as monetary divorces. In short, money is an inherent political matter. This message emerges from every chapter of the book.

Third, as politics is important, this implies that distributional issues are important when a country decides to adopt a common currency or not or want to change its monetary constitution. The Swedish euro-referendum brings out this message strongly for modern times. Here the evidence shows that income, education and attitudes towards international cooperation were major determinants of the choice of currency arrangement.

We may see a process of monetary unification in Asia, Africa and Latin America inspired by the rise of the euro in Europe. This volume identifies a number of factors that those interested in future monetary unions and in future international monetary and financial cooperation should pay attention to.