

The Agony and the Ecstasy: European Common Currency (1865-2010)

Luca Einaudi

*Joint Center for History and Economics
Harvard University*

April 7, 2010

(text updated on 28 April)

Robinson Hall

Basement Seminar Room

4:15pm



Coin projects, from the Latin Monetary Union to the Euro

This presentation is about the long history of monetary unification in Europe. It recalls the 19th- and 20th-century history of ideas proceeding in that direction, and some of the main experiences of international monetary unification preceding the Euro, distinguishing them from the process of inevitable monetary unification that accompanies national political unification. The history of the Latin Monetary Union of 1865-1926 is the main precedent used to draw parallels with the experience of the Euro. It shows that both in the LMU and EMU the rules conceived initially to guarantee the stability of the union proved insufficient and that they had to be changed while the game was being played, encountering substantial difficulties.

The intellectual case for European monetary unification

1582	Gaspare Scaruffi	Harmonise the intrinsic content of gold and silver coins and rules of issue to achieve a universal standard. (Treatise on the Italian mints)
1866-70	Felix Esquirou de Parieu,	International Monetary Conference of Paris in 1867. A ‘Europa’ coin based on the gold standard and fixed irrevocable exchange rates. £1=\$5=10 florins=25 francs, lire, pesetas, drachme, etc.
1928	Louis Archer	Proposed Federation of European States, issuing "Europa“ currency.
1930	Briand and Stresemann	Briand’s speech to the League of Nations for a European political entity. Included a customs union and monetary union.
1932	Richard Coudenhove Kalergi	Pan European League proposals for a European Federation included a European currency and Central Bank
1944	Luigi Einaudi	Proposed a single European currency and a single European bank of issue
1969-70	Raymond Barre and Pierre Werner	Barre Memorandum and Werner report suggested Economic and monetary integration in three steps after ten years, concluded by a single currency, monetary and fiscal policy coordination, a federal system of European central banks and a European Monetary Cooperation Fund.
1989	Jacques Delors and others	Single currency after ten years, process in three stages, with a partial centralisation of budgetary policies and a total centralisation of monetary policies. Independent European System of Central Banks aiming at domestic price stability.

See: Einaudi Luca, “‘The generous Utopia of yesterday can become the practical achievement of tomorrow’”: 1000 Years of Monetary Union in Europe’, *National Institute Economic Review*, n.172, April 2000, pp.90-104.

Why a Monetary Union?

Proponents of Monetary Unions expected the following advantages:

1. reduce transaction costs, increase competition, facilitate trade, prosperity and progress
2. resist monetary instability and devaluations, fight currency arbitrage and speculation, [later, anti-inflationary advantage of removing monetary policy from politicians' control]
3. favour peace in Europe
4. be part of a process of creation of a Federal Europe

The arguments of opponents of monetary union

1. Loss of political independence
2. Later fear of the loss monetary stability and of independence in interest rate and exchange rate setting as policy instruments for readjustment against asymmetric shocks.
3. In Northern Europe reluctance to associate with states with dubious public finances
4. In the UK concerns about the role of the London financial center in a monetary union

Supranational Monetary Unions in Europe

1808-14	French Empire and satellites	No central bank nor paper money.	Based on the bimetallic franc, one to one exchange rate with lira and frank.
1838-71	Münzverein, Germanic Monetary Union	No central bank, decentralised issue of paper currency not in the convention.	Common thaler of the north, with a 1 to 1,75 fixed exchange rate with the southern gulden. Silver standard.
1865-1926	Latin Monetary Union	Bank notes not included. Central role of the Bank of France remains informal and not neutral.	Multiple currencies with a fixed 1 to 1 exchange rate.. Initially bimetallic, evolved towards gold.
1872-1931	Scandinavian Monetary Union	No common central bank but intense cooperation. Bank notes in the union from 1901.	Single currency (crown) minted nationally, gold standard but with a dominant paper circulation.
1999-?	European Monetary Union	European Central Bank controls monetary policy and all monetary issue.	Common and single currency. Coordination of fiscal policies (stability and growth pact).

National monetary unifications following political unification

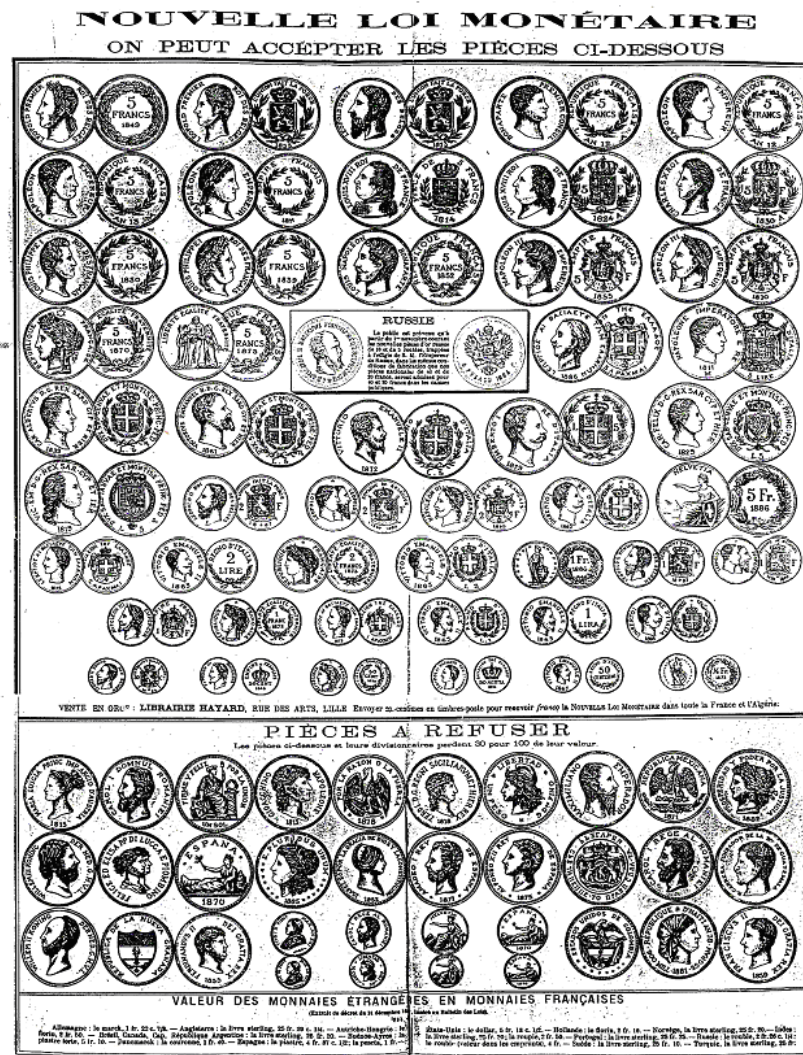
	Country	Central banks, paper currency and other characters
1850	Switzerland (after a civil war)	Introduction of a single common currency but with several banks of issue and no central bank until 1907.
1862	Italy (after unification)	Banca Nazionale nel Regno d'Italia in 1861, transformed into Bank of Italy in 1893. Bank notes issued by six different private banks of issue.
1871	German Empire (after Unification)	The Prussian Bank became the Reichsbank in 1876 and centralised bank notes issue. German states within the Empire retained the right to issue coinage.
1919	Kingdom of Yugoslavia (after creation)	In 1920 the National Bank of Serbia became the National Bank of Yugoslavia, using the Serbian dinar as common currency. Entirely unified currency and coinage.
1919	Poland (after independence)	The new Polish mark, linked to the German mark was destroyed by hyperinflation in 1924, while francs and dollars constituted the real currency. The Bank of Poland was created in 1924 together with the zloty, equal to a French gold franc.
1990	Germany (after reunification)	The Bundesbank extended its functions as central bank to the new Länders. One to one exchange rate decided at political level.

The Latin Monetary Union

Formed in 1865 between France, Italy, Belgium and Switzerland, to resolve problems of monetary circulation of silver coinage between neighboring countries in a bimetallic system (gold and silver). Include a limit of issue for depreciated silver coinage to 6 francs per inhabitant. It was a Coinage union with maintained existing national coins with different names (francs, lire and drachme) and a 1 to 1 fixed exchange rate, based on the intrinsic gold and silver content of the coins, recoining all those not in lie with the new common system.

Became also an attempt to create a European or a Universal currency through the injection of federalist ideas by the chief French negotiator and of French political ambition.

Clash between supporters of the gold standard and bimetallism hampered the LMU.



French poster of the 1880,s depicting which coins could be accepted in France as part of the LMU.

Enlarging the Monetary Union

The French attempted to enlarge the Monetary Union by inviting all European countries and some other world powers to the 1867 International Monetary Conference of Paris, inviting candidacies on the basis of an international gold standard and the LMU-franc type of coinage.

Felix Esquirou de Parieu's project for a "Europa" currency, a European federation, a European Union and a European parliament.

British reluctance and the conversion to Union of Gladstone's Chancellor of the Exchequer in 1869, caused a heated debate.

Southern German favour for monetary union as a part of a strategy to resist Prussian expansionism.

Private Bankers and National banks of Issue opposed monetary unification.

The refusal of the French Treasury and Banks to abandon bimetallism destroys the opportunity to involve the UK. The Franco-Prussian war on 1870-71 leads to the creation of the German mark and to the collapse of possible extensions of monetary union.

See Einaudi Luca, 'From the Franc to the "Europe": Great Britain, Germany and the Attempted Transformation of the Latin Monetary Union into a European Monetary Union (1865-73)', *Economic History Review*, May 2000.

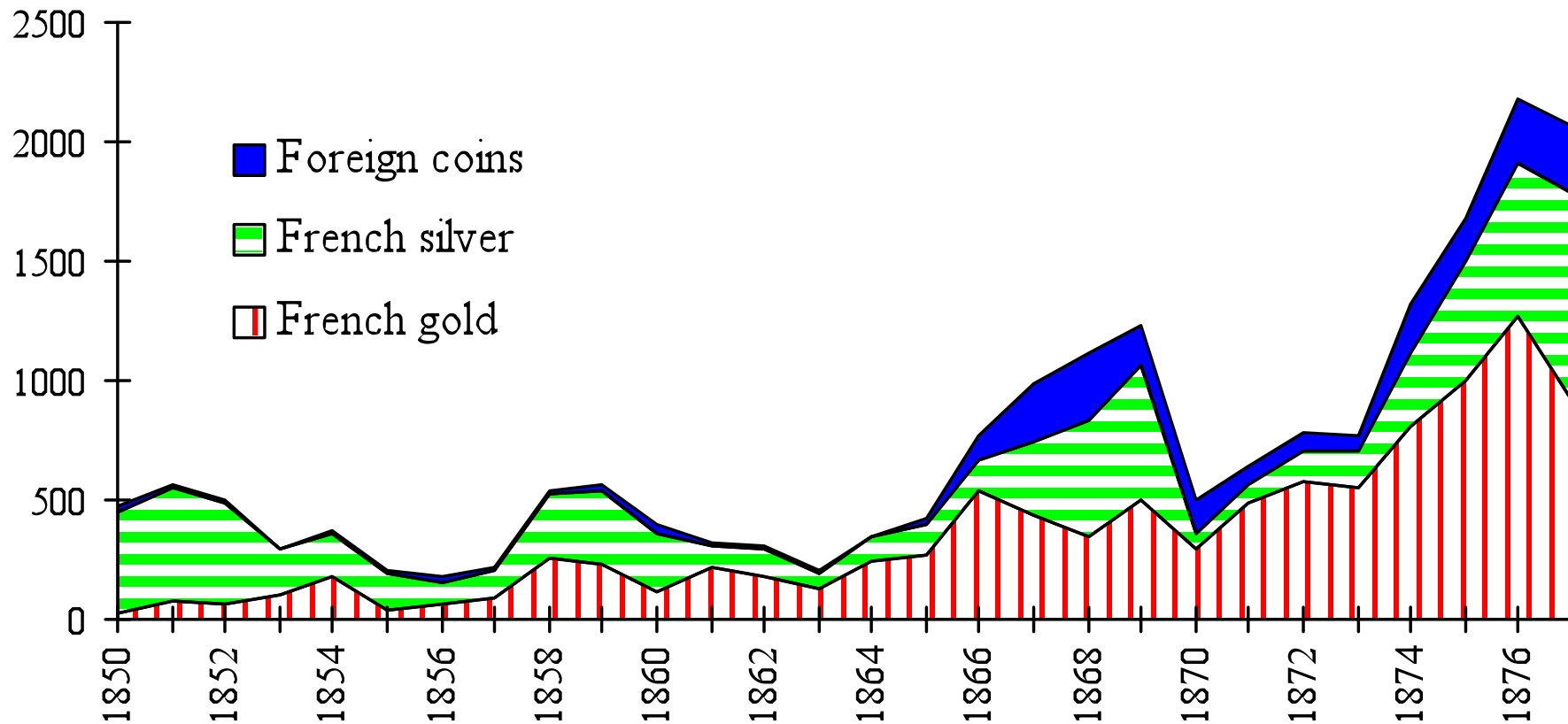
The Italians, the Pope and the Greeks

- Italian budget deficit and inconvertible paper currency from 1866 (because of a war with Austria) was followed by new forms of monetary issue not included in the Monetary Convention (paper, bronze coinage). Caused flight of Italian currency to France and Switzerland, preventing them from minting their full share of coinage. Generated tension in the LMU, but was ultimately resolved reinforcing the rules on new issues.
- Papal monetary scams: The Papal State applied to join, obtained temporary authorization to issue coinage accepted in France and then over-issued by 10 to 1, ultimately declining to join and to take back its currency which had migrated to France. The Papal State was pushed out of the LMU system.
- Greek wars for national unification and financial weaknesses led to inconvertible paper currency in 1869 and from 1877 to 1910 and debt default in 1893. This, together with sale of Greek coins at a discount in Paris (by private bankers), determined foreign control of part of Greek monetary issue from 1869, and to limitations to Greek membership of LMU.
- The problems encountered in managing the LMU convinced the strongest members of the Union to block further enlargements (refusing all other applications for membership, coming mainly from southern or central Europe and the Balkans and from Latin America) and to restrict the field of action of the LMU for the future, not extending it to paper money, as the Scandinavian Monetary Union did instead.



See Einaudi Luca, 'Monetary Unions and Free Riders: The Case of the Latin Monetary Union (1865-78)', *Rivista di Storia Economica*, n.3, 1997, pp.327-61.

The effect of the union on the reserves of the informal central bank of the LMU: Composition of the metallic reserves of the Bank of France 1850-77, (millions of francs)



Source: Willis, *History of the Latin Monetary Union*, 90.

Managing the Union: how to change the rules during the game

The initial rules proved insufficient:

- 1) Limits of issue of debased coinage and exchange of information on annual monetary issue to control the respect of limits;
- 2) The rules were incomplete, the transmission of information not credible and political/ military disruption created financial instability

New rules emerged through an iterative process of pressure by the strongest economies on the weakest

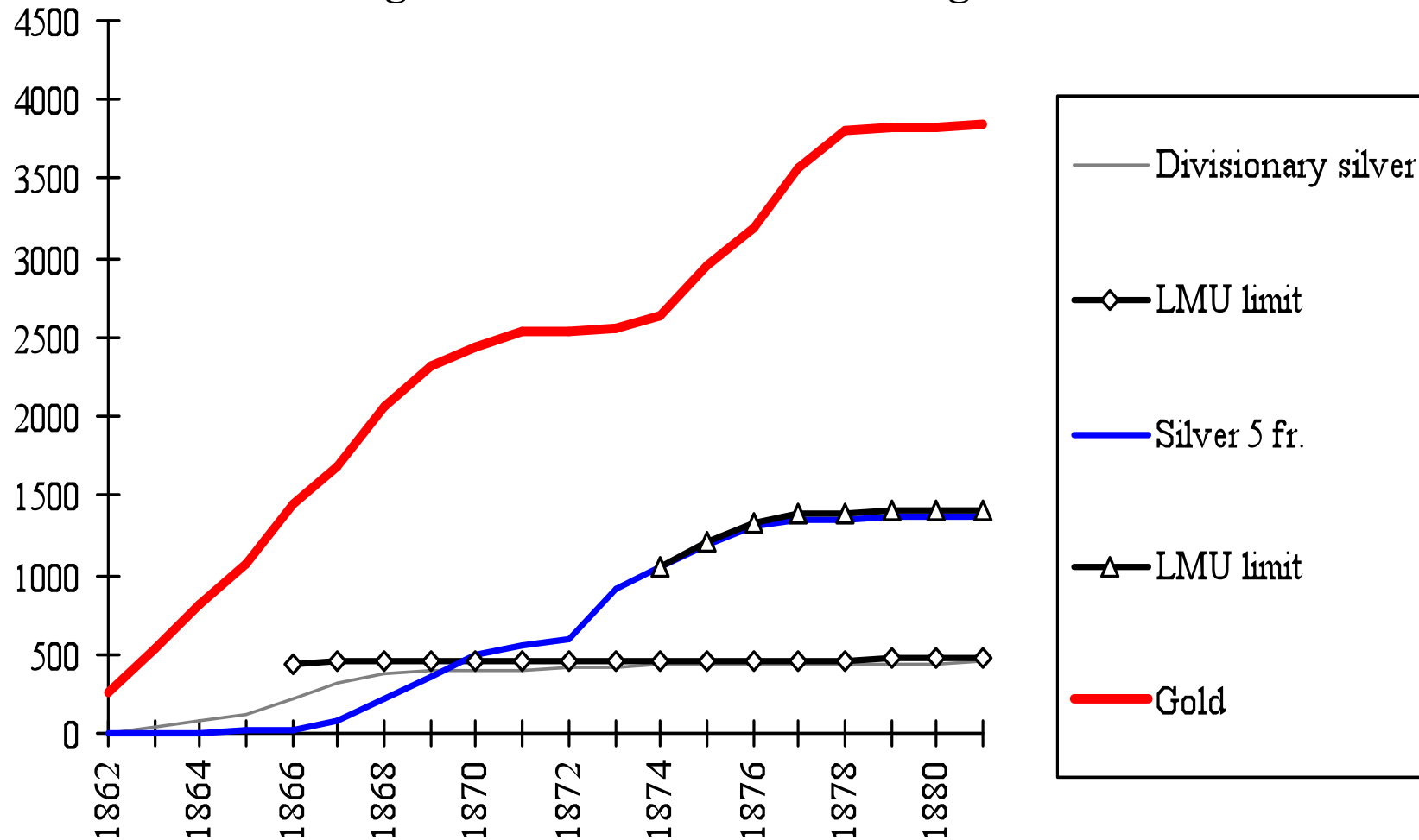
- 1) Extend limits of issue to other forms of fiduciary money (small change paper money from late 1860's and silver écus from 1874)
- 2) Attributing to the strongest government (France) an absolute control over the issue of coinage in new weak members (Greece);
- 3) Threatening to return divisionary coinage to issuers of non convertible paper money (Italy and Greece) in exchange for gold, threatening a financial penalty;
- 4) Neutralizing/expelling the free riders from the Union (non completion of accession process of the Pontifical State, freezing of Greek currency);
- 5) Refusing membership to the states which did not guarantee sound financial conditions (Spain, Austria-Hungary, Romania, San Marino and later others).

**Continuous bargaining on new monetary issues in the Union:
LMU limits to silver mintage, in millions of francs, lire and drachmae (1865-1908)**

	Years	France	Italy	Belgium	Switzerland	Greece	Total
Silver	1865	239	141	32	17	-	429
divisionary	1867	239	156	32	17	-	444
coinage	1870	239	156	32	17	9	453
(total	1878	240	170	33	18	10.5	471.5
limit to	1885	256+8	182.4+20	35.8+5	19+6	15	551.2
issue)	1897	394	234.4	46.8	28	15	718.2
	1908	628,8	540,8	116,8	57,6	42,4	1386,4
Silver Écus	1874	60	40+20	12	8	0	140
(yearly	1875	75	50	15	10	5	155
limit to	1876	54	36	10.8	7.2	3.6+8.4	120
issue)	1877	27	18	5.4	3.6	0	54
	1878	0	10	0	0	0	10
	1879	0	20	0	0	0	20
	From 1880	0	0	0	0	0	0
Total Écus	1874-80	216	194	43.2	28.8	17	499

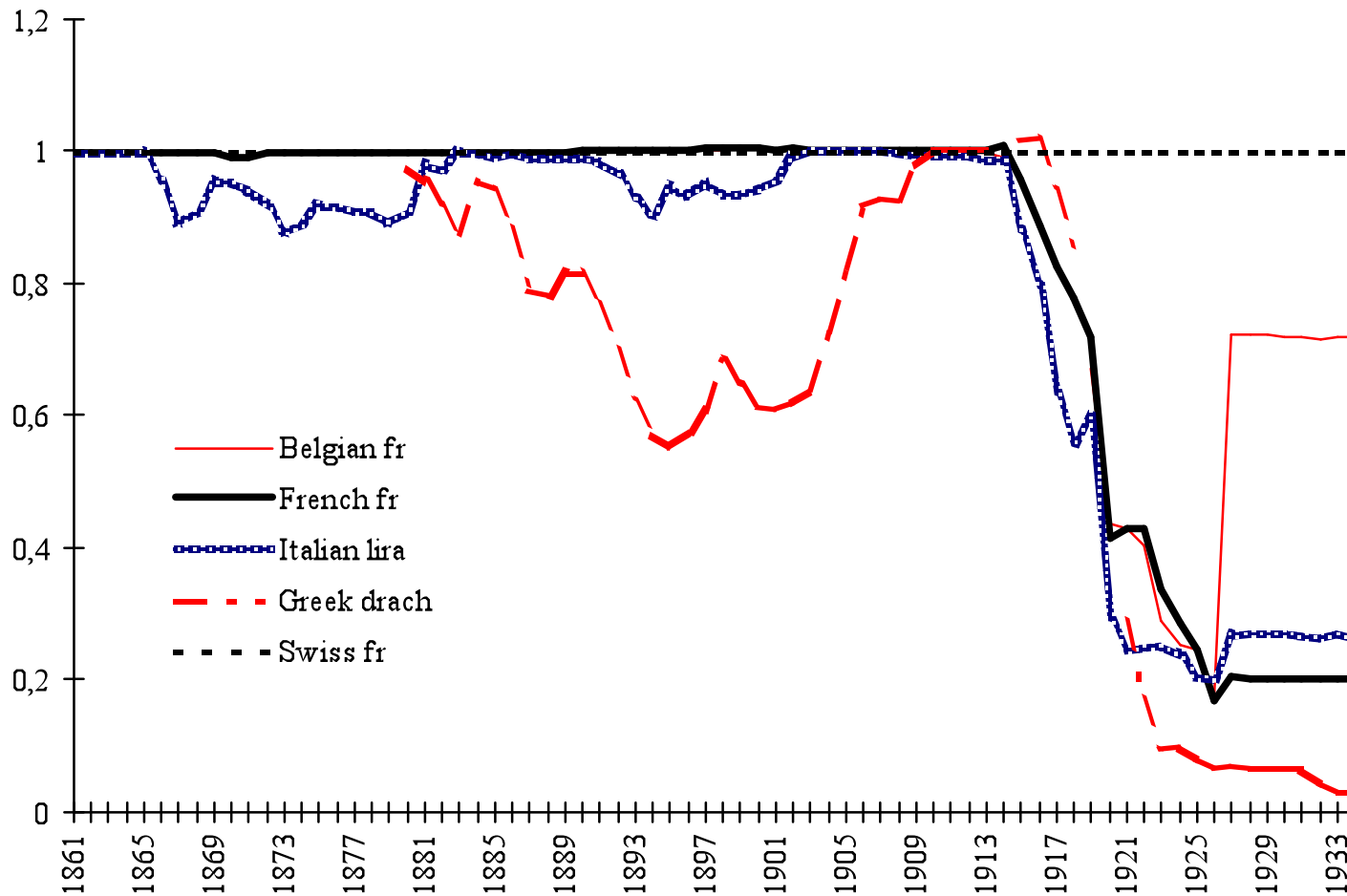
Sources: Data from the Archives of the Ministère des Affaires Étrangères, Archives de la Monnaie de Paris and reports attached to the *Minutes of Evidence of the Gold and Silver Commission* (London, 1879).

How new rules managed to curb new issues of undesired depreciated silver currency: cumulated issue of the Latin Monetary Union coinage since 1862, leading to the establishment of the gold standard



Source: elaboration on mint figures in Leconte, *Bréviaires des monnaies de l'Union Latine*.
 Figures are in millions of francs and include French, Italian, Belgian, Swiss and Greek issues.

The exchange rates of the LMU paper currencies, in Swiss francs, showing the devaluation of Italian lire and Greek drachme during periods of inconvertibility of their paper money and the collapse of the all system through the shock of WWI and the different stabilization levels in the 1920's.



Source: Einaudi Luca, *Money and Politics: European Monetary Unification and the International Gold Standard (1865-1873)*. Oxford, Oxford University Press, 2001.

What causes monetary unions to break or to consolidate?

Breaking political unity destroys the political conditions for union

1. through **war**: Ottoman Empire (1831-1919), Russian Empire (1918), Austro-Hungarian Empire (1919), Yugoslavia (1991-1999)
2. through **peaceful dissolution of the federal pact**: USSR (1991), **Czechoslovakia** (1993), New Yugoslavia (2008)

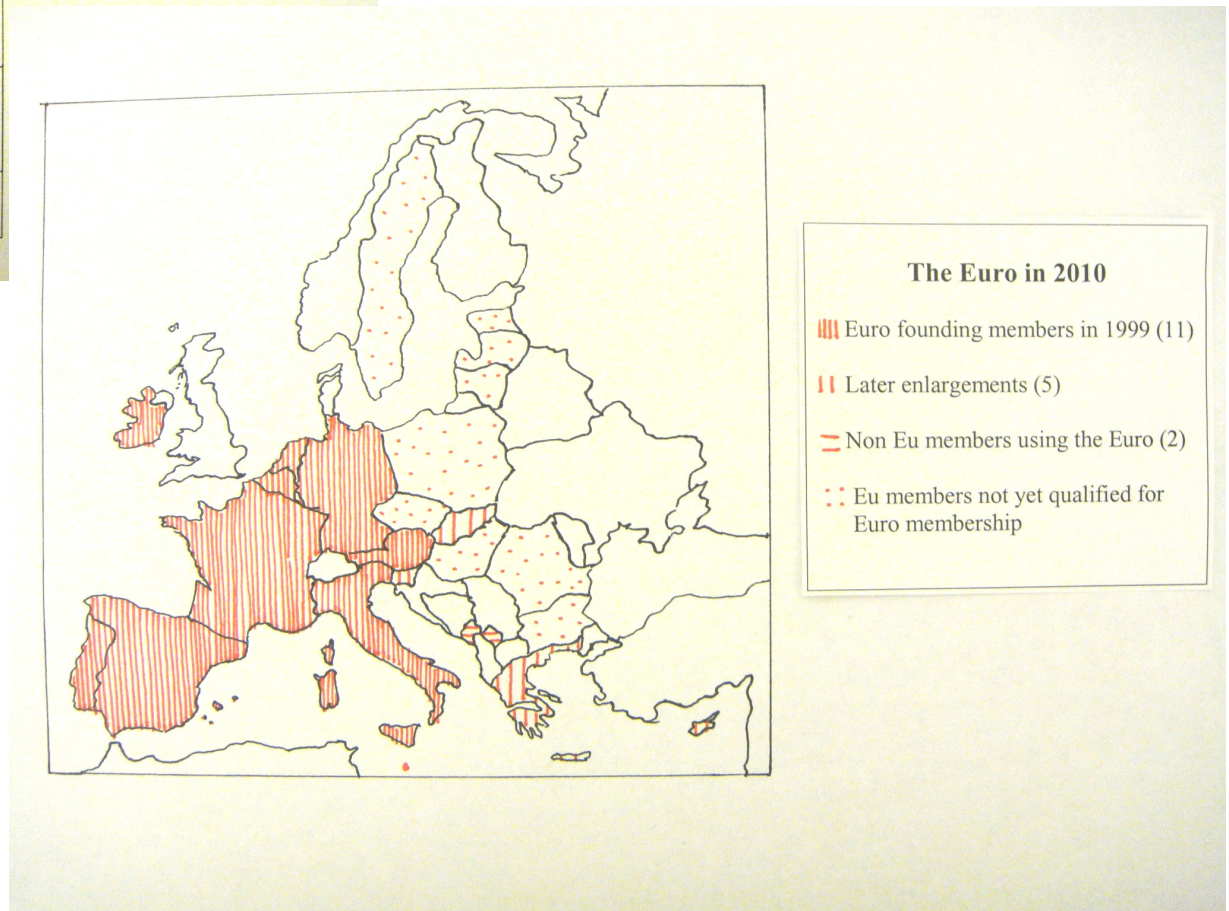
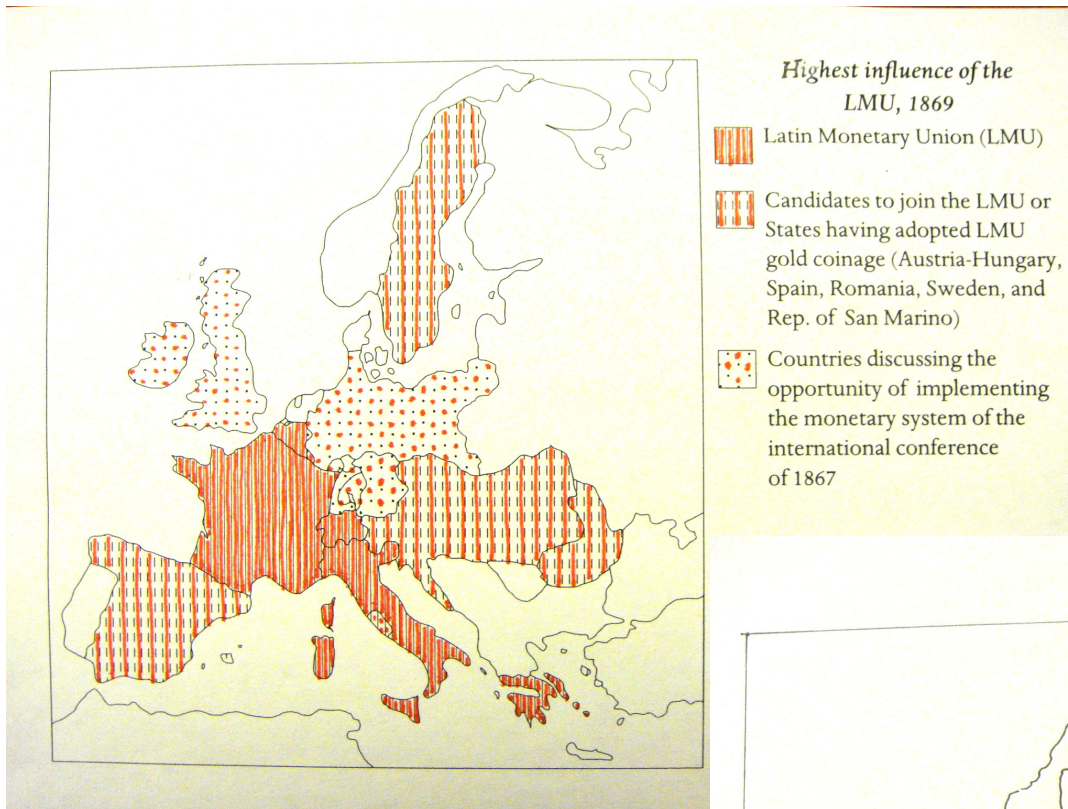
Major economic shocks can destroy economic conditions for union

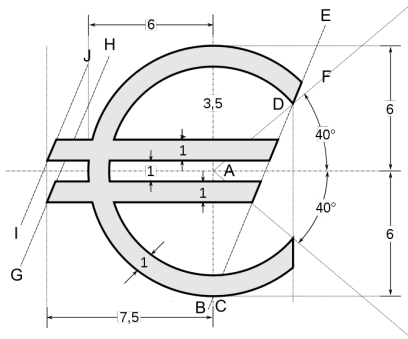
1. **Economic divergence** caused by WWI: Latin Monetary Union
2. **Great Depression**: Scandinavian Monetary Union

Successful Monetary Unions consolidate in a full political unification:

1. The Münzverein becomes the German Monetary Unification (mark) after the creation of the German Empire in 1871

The comparative geography of the Latin Monetary Union (LMU) in 1869 and of the European Monetary Union (EMU) in 2010. Some patterns are persistent (British and Norwegian refusal, interest in southern Europe). The main difference is the German conversion to monetary union, thanks to Helmut Kohl in the 1990's.





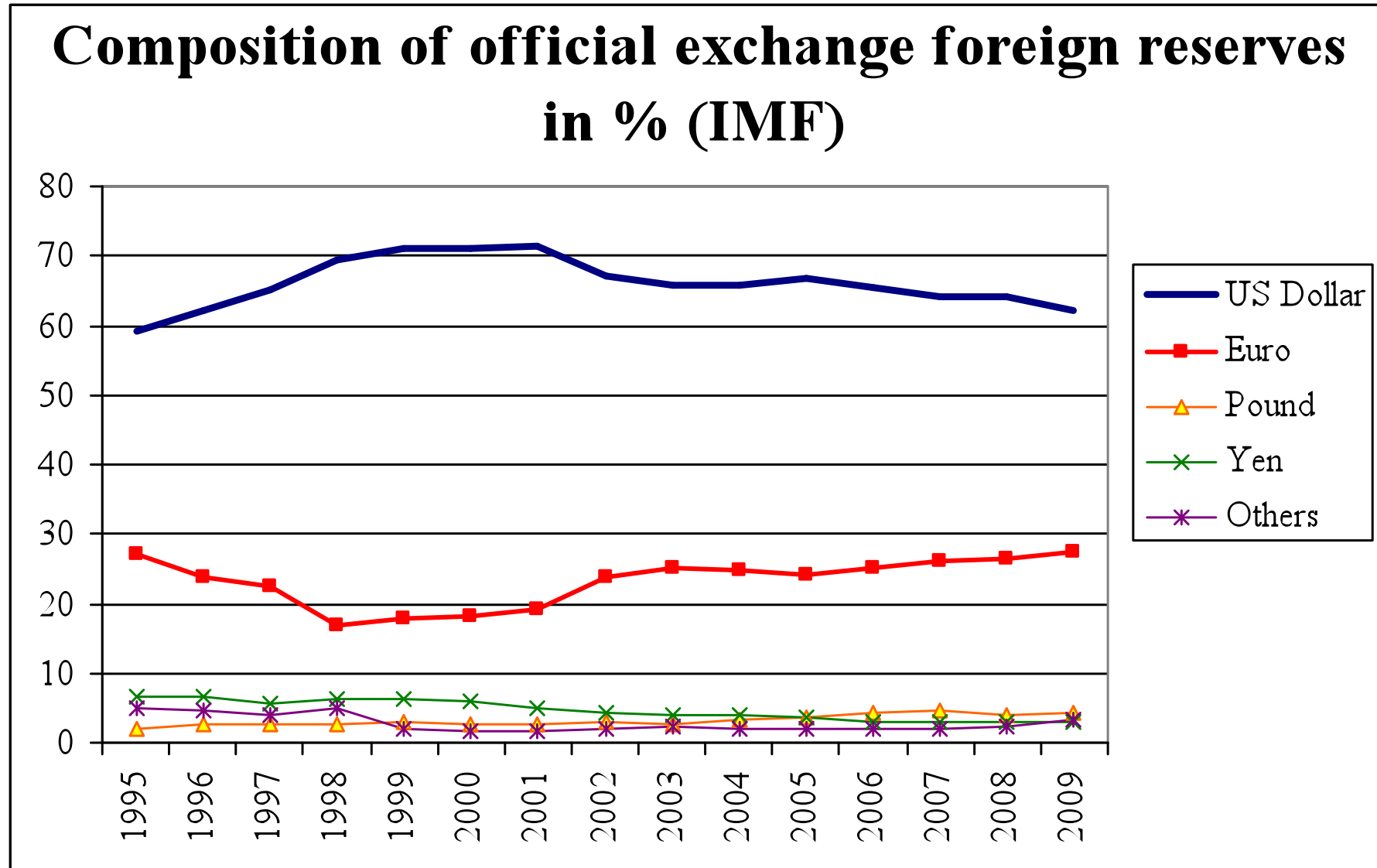
The ambition of the Euro



The euro was launched as a political and economic project:

- 1) Advance the economic integration of Europe, completing the single market, reducing transaction costs and securing fair competition, by eliminating the possibility of devaluations in the area and reducing exchange fluctuations risks.
- 2) Reinforce the international role of Europe creating a common currency capable of competing with the dollar.
- 3) For southern Europeans challenge to end model of trade competitiveness based on higher inflation compensated through devaluations and to converge towards more sustainable public finances.
- 4) Push political integration following economic integration.
- 5) Link Germany to the European project while it was reuniting after the fall of the Berlin wall.

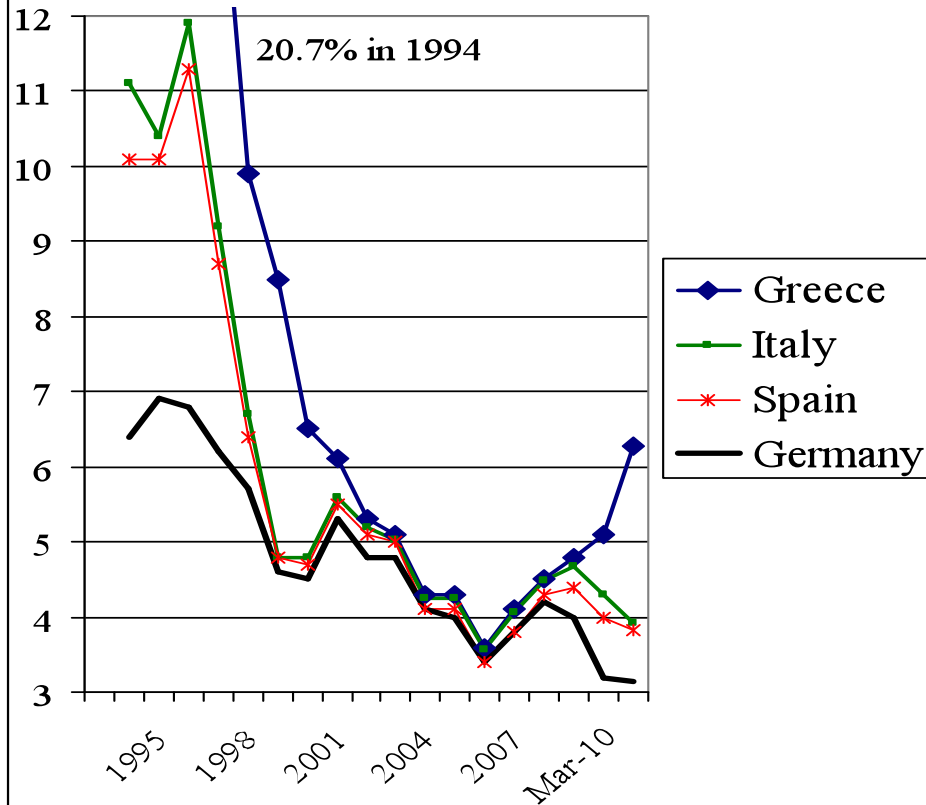
The Euro has increased its role as an international reserve currency, but only recovered the losses occurred in the run-up to the creation of the Euro.



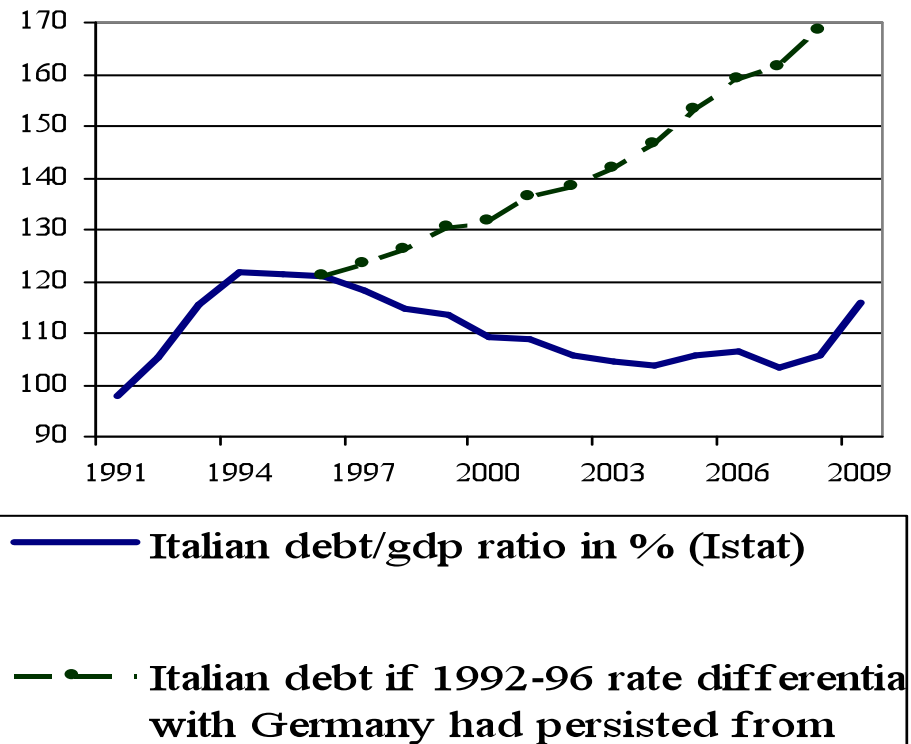
Interest rates did converge thanks to the Euro and were very important in reducing government deficits and preventing an explosive path of debt in several countries.

In the case of Italy, the cancellation of an interest rate differential with Germany (over 4% in the five years preceding EMU) facilitated a reduction of debt which would otherwise have grown to nearly 170% of GDP by 2008.

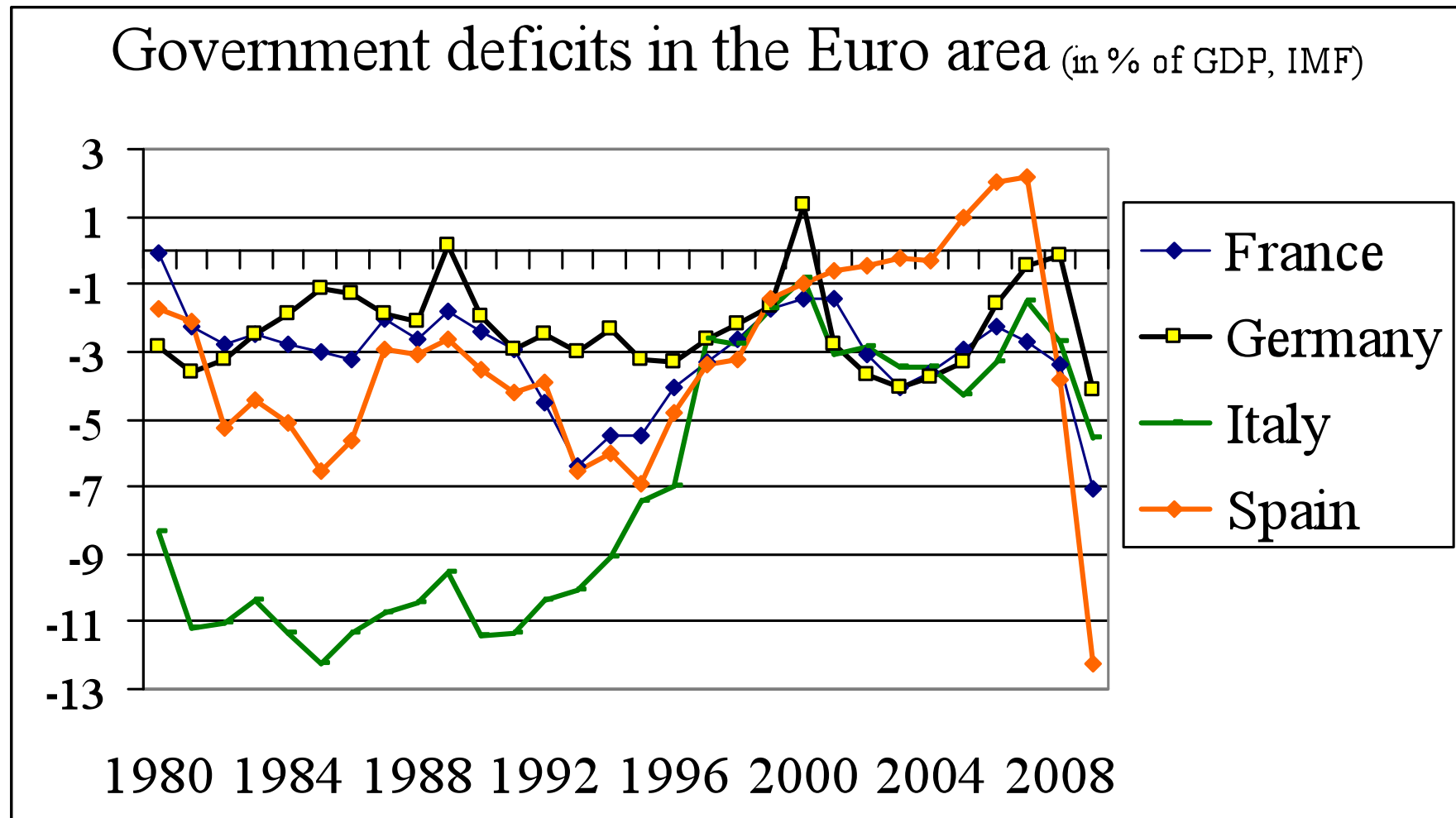
Long term interest rates: convergence through the Euro, divergence through the global crisis (1993-2010)



Actual Italian Debt to GDP ratio and hypothetical effect of higher interest rates



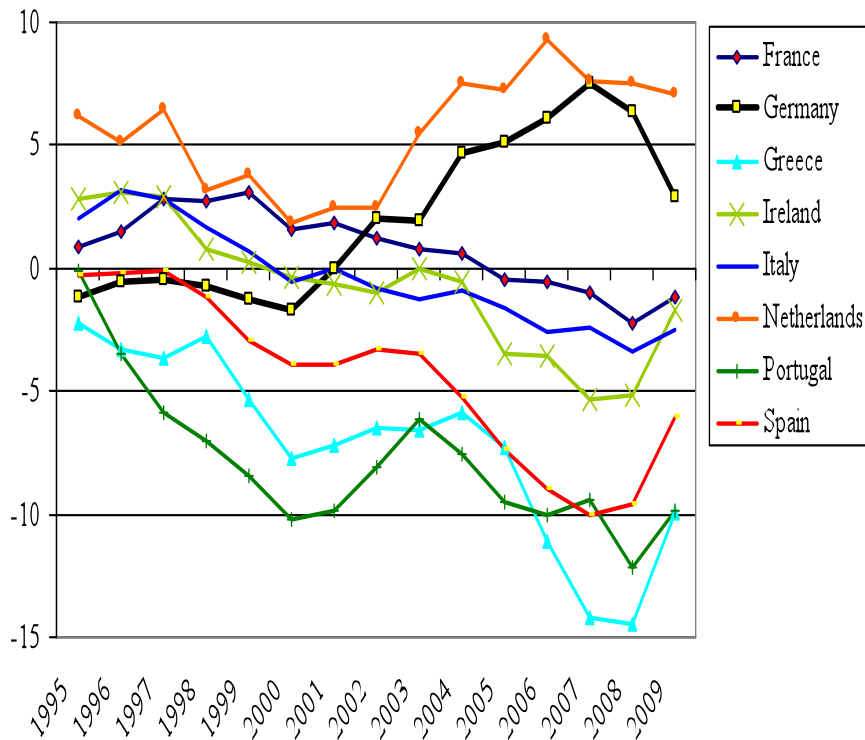
The Euro has produced greater convergence in public finances and in GDP growth, but has not totally cancelled such differences, also because it did not impact on preexisting levels of government debt. Spain and Italy improved radically their public finances in comparison to the situation preceding 1997 and to Germany and France.



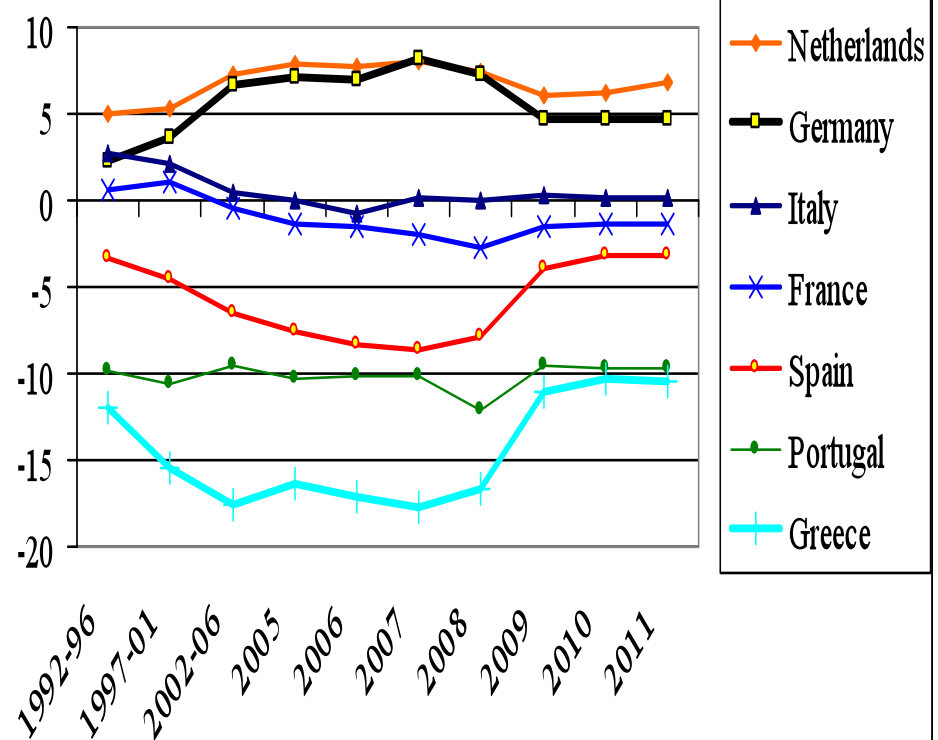
Competitiveness, unbalances and absence of devaluations inside the EMU

The effect of fixed exchange rate was to raise external imbalances (trade balance and current account imbalances) until 2007, because of persistent differentials in productivity growth and inflation, without devaluations to compensate for them.

The widening of current account imbalances since the beginning of the Euro (in % of gdp, IMF)



Merchandise trade balance (in % of Gdp, Eu Com forecasts, Nov 2009)

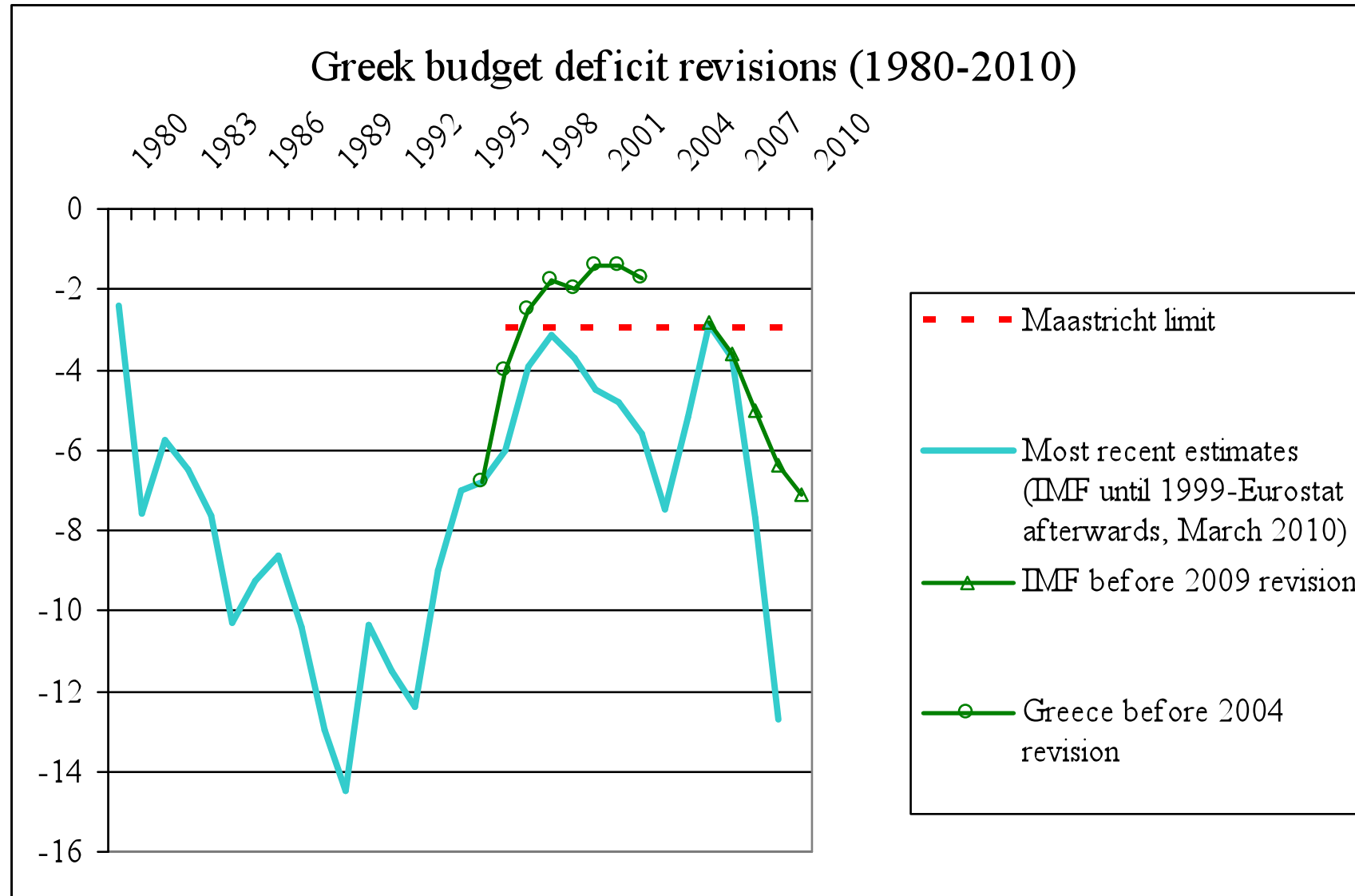


The Greek crisis in 2009-2010

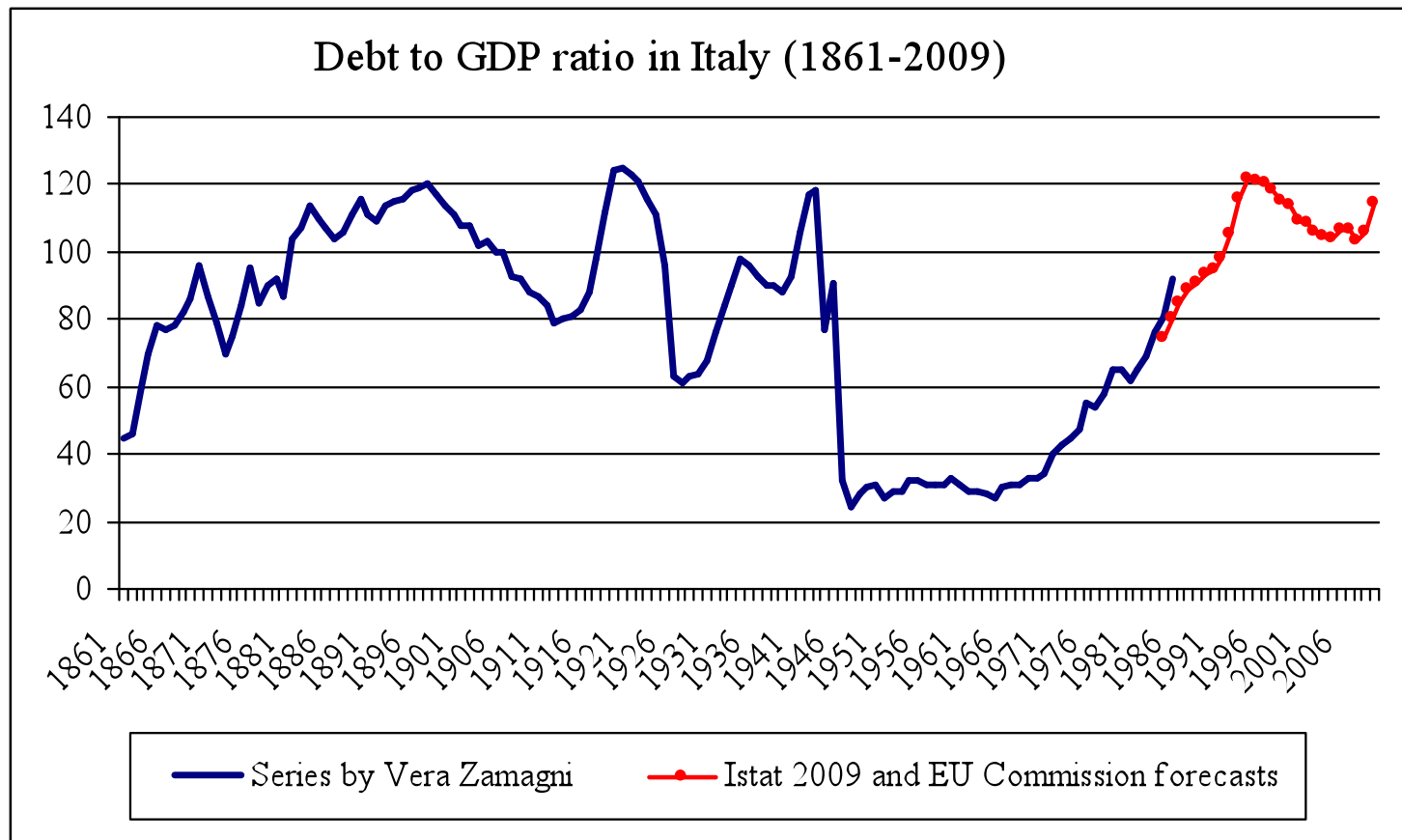
The revelation of the real extent of the Greek deficit in late 2009 (12,7% of GDP) after the newly elected Papandreou government decided to revise the fraudulent data previously provided, coupled with the high and rapidly growing debt, caused fears of default and attacks on the sustainability of monetary union. Germany requested severe punishment and austerity measures to rebalance the Greek budget, also because of the breach of trust. The Greek government cut public sector pay, froze spending, increased retirement age, in three phases by February 2010. The Euro area governments then committed to help Greece, with loans if necessary. Various European support programs were announced with the intention to stabilize the situation, but initially with the clear hope and intent not to provide actual financing. Positive announcements were however followed repeatedly by the German refusal to provide help, destabilizing expectations further, increasing the risk of default and facilitating financial speculation against Greek debt. Markets took it as an indication that no real support was coming. Interest rates rose as a consequence, from an average of 5% in 2009, to over 7% at the end of March 2010. On 11 April, Euro area governments agreed to make available loans for 30 billion euro at approx 5%, still high compared to other countries with similar conditions, but bearable. The IMF would complement with another 15 billion. Continued German reluctance to support Greece and further downgrading of Greek public debt by rating agencies pushed rates to 13% at the end of April. While no default is likely if interest rates return rapidly to a normal level, persisting high rates would cancel the benefits of austerity measures adopted by the Papandreou government, increasing interest spending on public debt pushing the country further in recession and delaying recovery.



Greek Governments manipulated official debt and deficit statistics from 1997 to 2003 in order to join the Euro area and again in 2008 and 2009.

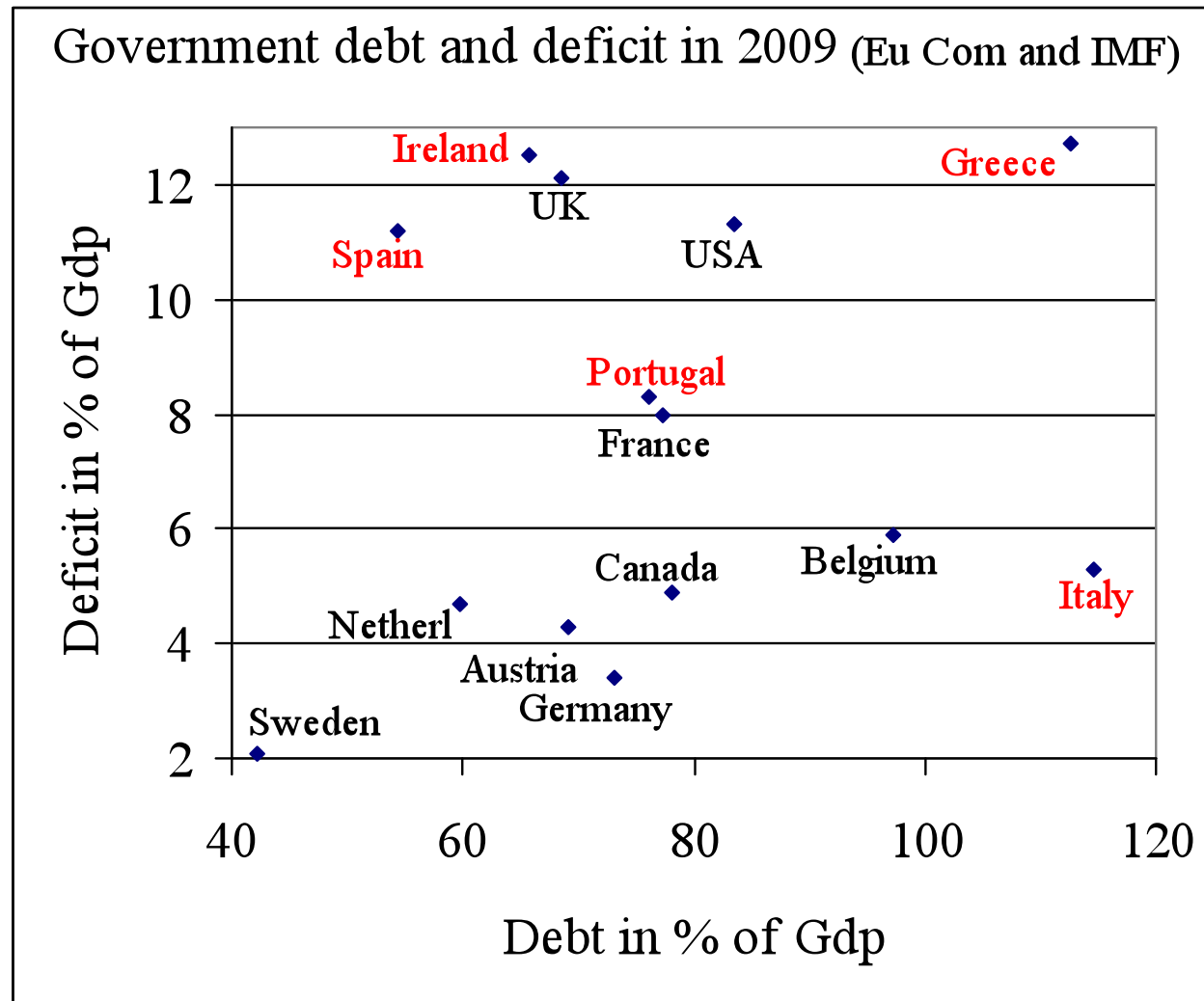


It is possible to sustain relatively high public debt for a long time without default. United Italy never defaulted on its public debt but recovered from high levels of debt either through strong economic growth or wartime inflation or through fiscal retrenchment, accompanied by lower interest rates produced by EMU in the 1990's. The latter episode highlights the fundamental importance of low interest rates for the success of a policy to stabilize public debt and deficit, essential for the recovery of Greece.



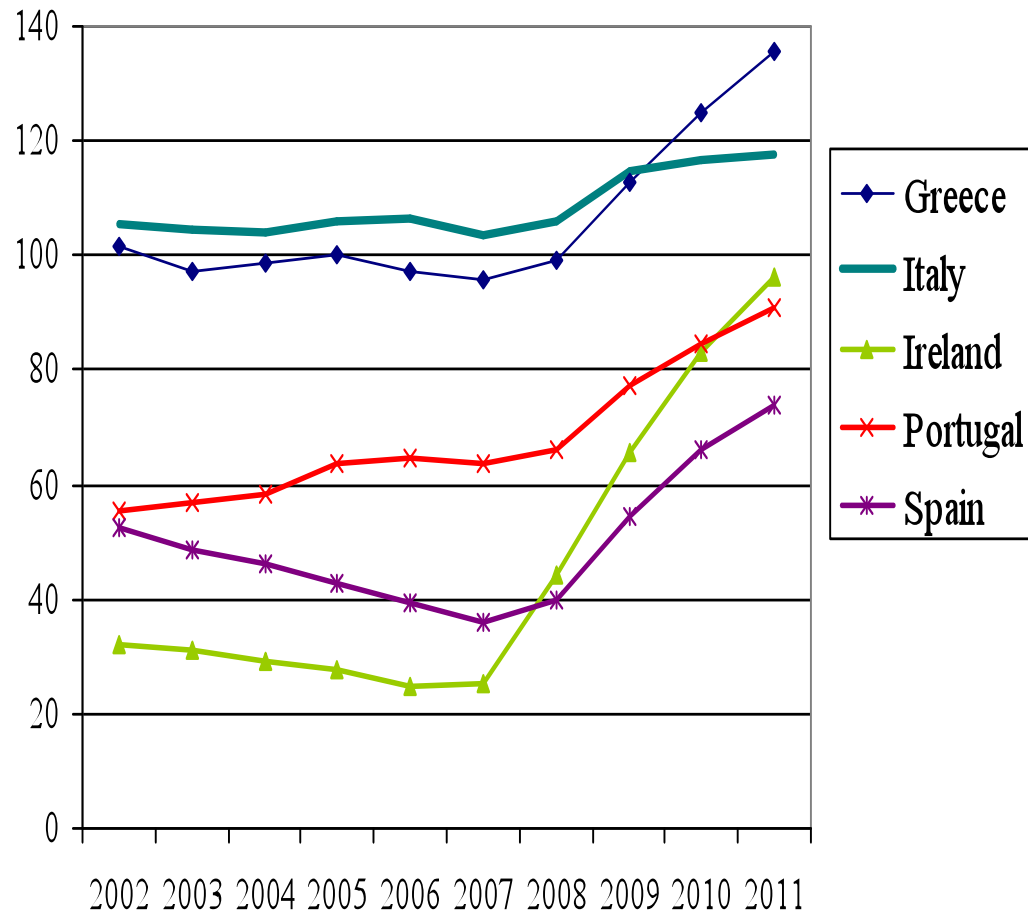
Are all PIIGS the same and are they worst than all others?

The use of the derogatory term PIGS (or PIIGS) has been used mistakenly to link Greece to Portugal, Spain, Ireland and Italy, as if they were all in a similar situation of near collapse of public finances. The combination of high debt and high deficit singles out the difficult situation of Greece, but also shows how different national circumstances are. US and UK are not in a better position than some so-called PIIGS countries.



PIIGS government debt

(Eu Commission forecast, Nov 2009)



The label PIIGS is meaningless

Debt is exploding in many countries, but it grows much faster in France and Germany than in Italy. The deficit is much higher in the US and UK than in Portugal. Ireland and Spain started the crisis with very low debt and had room. Only Greece has both very high debt and very high Government deficit.

Managing the Union: how to change the rules during the game

The Greek crisis highlights again the difficulty of:

- Harmonizing national economic policies, especially fiscal policies
- Monitoring effectively implementation of commitments inside the union
- Changing the rules while the game is being played
- Sharing the costs of intervention of support

The initial EMU rules were set to prevent inflation and unbalanced public finances:

1. Monetary policy, interest rate setting in the hand of an independent European Central Bank whose only objective is price stability. No possibility of monetization of fiscal deficits by Governments, no shared responsibility for other member countries' debt, no common fiscal policy.
2. Irreversible membership, no rules set to leave the Union, no expulsion mechanism.
3. Tough entry criteria: Maastricht Treaty criteria (1993) on deficit, debt, inflation, interest rates and exchange rate as prerequisite to become members.
4. "Stability pact" demanded by Germany (1997), "and growth", demanded by France. Excessive deficit procedure. Punishment in cash for countries exceeding 3% deficit over protracted time, never implemented.

Why change the rules?

The original stability pact “stupid”, inflexible, did not support growth.

The attempt to create new rules

1. First Revision of the Stability pact **to weaken it (2005)**, following German and French requests while they exceeded 3% deficit. Linked the decision to declare a country in excessive deficit on parameters: behavior of cyclically adjusted budget, level of debt, duration of slow growth period and possibility that deficit is related to productivity-enhancing procedures.
2. In fact there is a new process of revision of the Stability pact that Germany is pushing to **harden it (2010)**, as a reaction to the Greek crisis:
 1. The no bailout clause revised ad hoc: Greek support package (loans in case of emergency, as the last possible solution, at market rates, provided part by the Euro area, part by the IMF).
 2. German proposal for a European Monetary Fund as part of a structural European framework for crisis prevention, management, and resolution.
 3. German proposal to introduce the possibility to expel member countries (a strong threat which would impose devaluation and interest rates explosion, but also signals increasing risks to markets and has a destabilizing effect).
 4. Proposals for European economic government (or governance) or stronger policy coordination to avoid the creation of large imbalances.

The current situation recalls somehow the LMU problems (rather than Troy), even though great differences appear (the monetary system is not metallic anymore, financial markets now play a larger role, Greece is not at war, EMU today has more rules than the LMU in 1865 but is also more complex, including more countries and covering all types of monetary creation). The construction of additional new rules will take time but can succeed and keep EMU working well, but it must take place after the Greek crisis has been managed properly and it requires more willingness to extend economic and political cooperation.

The solution of the debt crisis requires lower interest rates, in order to prevent a snowball effect on Greek debt and to avoid cancelling the benefits of the Greek austerity package.



John Trever, New Mexico, *The Albuquerque Journal*, 10 March 2010