Lessons for the Euro from History

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The makers of the Euro, and almost every analyst and commentator, assume that the creation of the single European currency was a major and novel experiment in building a non-national money, and thus that there were few if any lessons to be derived from any more remote historical experience.[1] That deduction is not really valid, and there are some important lessons that may be drawn from the vast laboratory of historical experience, especially in regard to the need for rules, but also of flexibility in the implementation of monetary policy.

EMU, as discussed in the 1970s and 1980s, stood for Economic and Monetary Union. But the technical aspects went ahead of the political initiatives on European integration, with the result that there was imperfect agreement on crucial aspects of the monetary union, in particular fiscal rules and banking supervision and regulation. Both these issue areas raised political concerns about loss of national sovereignty and about the redistributional consequences of Europeanizing a fundamental part of economic policy-making. In consequence, the makers of the settlement looked back on a task that was only half accomplished. As former EU Commission President Jacques Delors put it

[1] There are some exceptions, drawing on the history of monetary unions: Michael D. Bordo and Lars Jonung, The Future of EMU: What Does the History of Monetary Unions Tell Us? NBER Working Paper No. 7365, September 1999; Michael D. Bordo and Harold James, A Long Term Perspective on the Euro, NBER Working Paper No. 13815, February 2008.

in a recent interview, "the finance ministers did not want to see anything disagreeable which they would be forced to deal with."[2]

The institutional framework for the single European currency was designed by central bankers, who tried to isolate themselves from political pressures. They gave a great deal of attention to central bank design, but other elements that would have been needed for the successful and enduring operation of a durable monetary union were neglected. In the first draft of the European Central Bank statute produced by the central bankers, Article 2 on the objectives of the European System of Central Banks stated that it should "support the general economic policy of the Community." But on the grounds that there was a multiplicity of national economic policies, at a late stage in the Intergovernmental Conference that culminated in the Treaty of Maastricht, the Dutch presidency of the Community substituted the phrase "support the general economic policies in the Community." In other words, there was to be no mechanism for making an economic policy to go alongside the new monetary regime. The verbal problem of "policy" in the singular or plural is reminiscent of the dilemma of early Americans, who as often referred to the United States in the plural ("the United States are…") as in the singular.

There are two parallel reasons for concern about the Euro: one is the imperfect realization of the fiscal concomitants (including the fiscal implications of bank resolution) attached to monetary union; the second, however, is excessive trust in the integration of the capital market and as a consequence inadequate flexibility in monetary policy. For both cases, history offers a rich laboratory of potential solutions.

[2] http://www.telegraph.co.uk/finance/financialcrisis/8932640/Jacques-Delors-interview-Euro-would-still-be-strong-if-it-had-been-built-to-my-plan.html (December 2, 2011)

European interest in American precedents for federal finance has been whetted in the aftermath of Europe's debt crisis. In particular, Alexander Hamilton has become the hero of contemporary Europe. Maybe one day his face should appear on a new version of the Euro note.

Specifically Alexander Hamilton's 1790 negotiation of a federal assumption of the high levels of state debt in the aftermath of the War of Independence looks like a tempting model for European states groaning under unbearable debt burdens. It has been cited as a precedent in Thomas Sargent's Nobel Prize Acceptance speech. [3] The states had not been responsible for the poor fiscal performance: that was a consequence of the external circumstances of the war of independence. At least it might be argued that some of the European debt problems are also not the consequence of bad policies but of a global financial crisis.

Hamilton argued – against James Madison and Thomas Jefferson - that the war debt accumulated by the states in the War of Independence should be assumed by the federation. There were two sides to his case, one practical, the other philosophical. Initially the most appealing argument was that this was an exercise in providing greater security and thus reducing interest rates, from the 6 percent at which the states funded their debt to 4 percent. The historical case looks like an attractive precedent for the Europeans of today. Hamilton emphasized the importance of a commitment to sound finance as a prerequisite to public economy. "When the credit of a country is in any degree questionable, it never fails to give an extravagant premium upon all the loans it

[3] Thomas J. Sargent, "United States Then, Europe Now," December 8, 2011 Nobel Prize speech: http://www.nobelprize.org/nobel_prizes/economics/laureates/2011/sargent-lecture.html.

has occasion to make." Hamilton also insisted on a stronger reason for following good principles than merely the pursuit of expediency. There existed, he stated, "an intimate connection between public virtue and public happiness." That virtue considered in honoring commitments. Extended in a political body, it would build solidarity. Those principles made the fiscal union what he called "the powerful cement of our union."[4]

The condition for success in the American case was that the Union raised its own revenue, initially mostly through federally administered customs houses. The logic of a need for specific revenue applies also in modern Europe, where a reformed fiscal system might include a common administration of customs or of value added tax (with the additional benefit in both cases of eliminating a great deal of cross-border fraud).

In the American case, however, the Union was bought at a price. The exposure to the common liability of Virginia, the most politically powerful state in the union, was limited with a ceiling. Only this inducement moved Madison to drop his opposition and agree to the proposal. (The compromise, which also led to the capital being moved to the new site of Washington, on the border of Virginia and Maryland, may be a precedent for limiting German liabilities in the case of the creation of a common European bond or Eurobond.) And some states, such as Georgia, opted out of the assumption.

The U.S. experiment in federalized finance was not immediately successful. Two important parts of Hamilton's financial architecture were not realized, or only realized imperfectly. He proposed a model of joint stock banking on a national scale, which ran into immediate opposition, and which curiously was much more influential in Canada than in the U.S. Secondly, the proposal for a national central bank was eventually blocked by political opposition. The charter of the First Bank of the United States was

[4] Alexander Hamilton, Report on Public Credit, January 9, 1790; available as: http://press-pubs.uchicago.edu/founders/documents/a1_8_2s5.html.

allowed to lapse in 1811; then, one generation later, the charter of the Second Bank of the United States was successfully opposed by Andrew Jackson in 1836.

Neither did the Hamiltonian scheme of federal finance guarantee a peaceful commonwealth. In fact the fiscal union proved to be explosive rather than cement. As international capital markets developed in the early nineteenth century, American states used their new reputation to borrow on a large scale, and promptly ruined their creditor status. In the late 1830s there was a wave of state defaults. In this case, as in that of for instance contemporary Greece, the problems stemmed from misguided policies, and cannot be blamed on external circumstance, war or global crisis. One generation later, in the 1860s, the country was torn by Civil War as a result of what was in large part a dispute about states' rights and about the character of financial burdens. In attempting to end the immoral practice of slavery, Abraham Lincoln originally proposed that the slaveowners should be compensated by the public purse. But that was unacceptably expensive. So in the end, the Virginians (and the rest of the South) were expropriated by the Union – at least that is the way they saw things.

The Hamiltonian assumption was not and could not be on its own a guarantor of political order. The perspective that debt required a common foundation of morality was central to Hamilton's approach; but it foundered on the differences between the different states' conception of morality.

Europeans today have caught onto the practical side of the argument, that this might be a means to cheaper credit; but they have not worked out the political institutions that would be needed to give reality to the union. The consequences of the extended and politicized debate about debt restructuring – what is termed kicking the can down the road – have been harmful, and have made a Hamiltonian solution more difficult. The fact is that the credit of the countries has become questionable.

An obvious starting point for a Hamiltonian Europe would be to set some standard limit up to which national debt would be federalized – perhaps the notorious 60 per cent of GDP from the Maastricht convergence criteria, perhaps a lower limit. Debt exceeding that amount would be left to the responsibility of the national states. What can the Europe of tomorrow learn from the American past? A collective European burden-sharing responsibility is in the long run the only non-catastrophic way out of the current crisis. Such generalized European burden-sharing requires a substantially greater dimension of political accountability and control on a European level.

Monetary Flexibility

A common criticism of monetary union is that it requires a single monetary policy, that thus becomes "one size fits all" and deprives policy-makers of a policy tool in responding to particular national or regional circumstances. When the EC Committee of Central Bank Governors began to draft the ECB statute, it took two principles as given: price stability as the primary objective of the central bank; and the indivisibility and centralization of monetary policy. This would not be "in contradiction with the principles of federalism and subsidiarity." But in fact the second assumption was not really justified either historically or in terms of economic fundamentals.

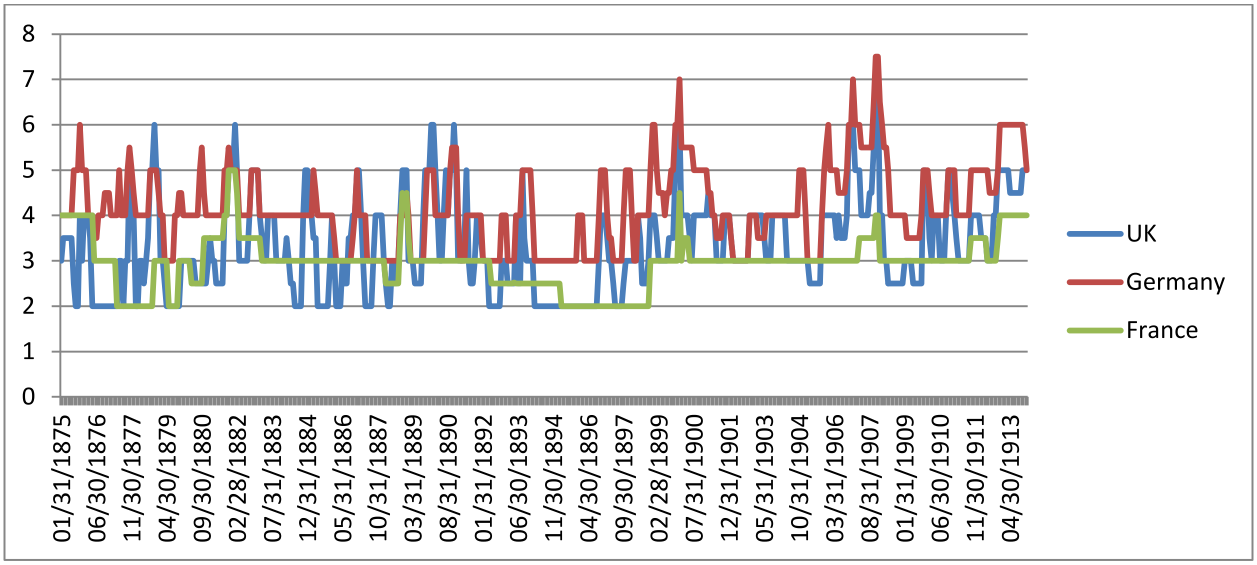
Think first of the gold standard. Many critics of EMU maintain that looks a lot like the pre-1913 gold standard, which imposed fixed exchange rates on extremely diverse economies. But is that resemblance as bad as it sounds, or as the euro's critics insist? The critics should take the gold-standard analogy more seriously. Like any system in the real world, it was more complex, more interesting, and also filled with more real policy possibilities than textbook caricatures suggest.

First, there was no automatic deflationary pressure following from some alleged peculiarity of the adjustment mechanism. The question of overall deflationary – or inflationary – impact depended (and still depends) on the total quantity of money. Thus, in periods after large new gold discoveries – for example, following the California Gold Rush of 1849, and again in the 1890's, when new mining techniques opened up South African, Alaskan, and Australian reserves – the classical gold standard had a mild inflationary bias. In an era of paper money, however, the link to a physical stock of some precious metal – or, indeed, some other commodity – does not exist, and there should be no reason why a central bank cannot aim at an overall inflation rate. In fact, almost all modern central banks, including the European Central Bank, do precisely that.

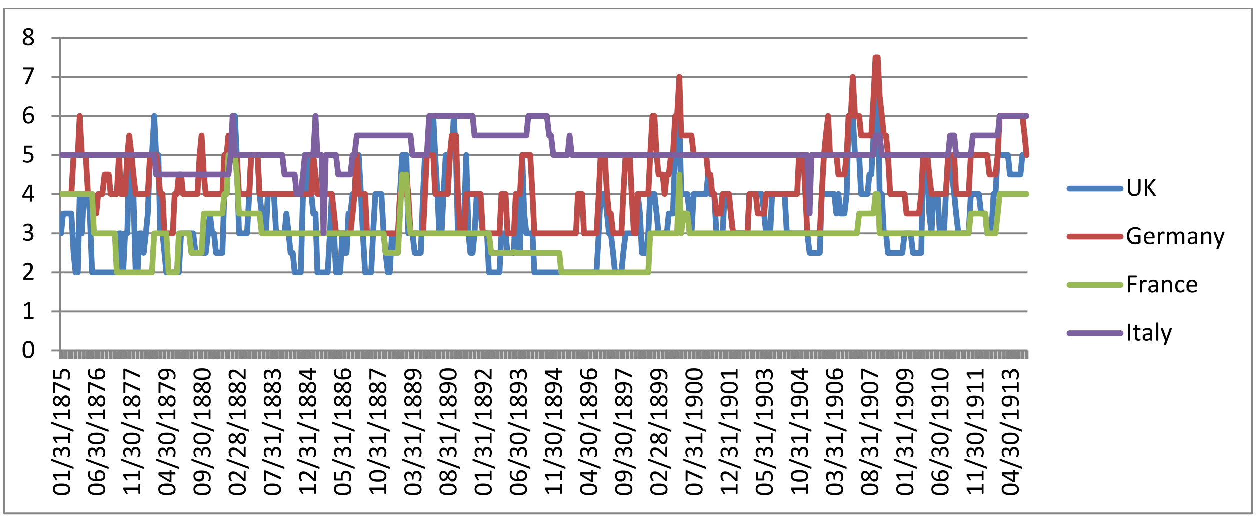
The second lesson to be learned from the gold standard concerns the extent and limits of capital-market integration. In the early 1990's, policymakers, market participants, and economists alike simply assumed that the European Community's "1992 program" – the legislative framework for the single market, and thus for a single capital market – would create a new reality, within which the single currency would work its magic. From this followed an official obligation to treat all types of risk in the monetary union – bank risk or government risk – as identical.

But the history of the gold standard, and of other large common-currency areas, was more complex. Despite the theoretical possibility of capital being sent over vast distances to other parts of the world, much capital remained local. Creditors and banks often preferred to do business with known borrowers, and where local jurisdictions could settle any disputes.

Discount Rates under Gold Standard, France, Germany, UK (Global Financial Data)

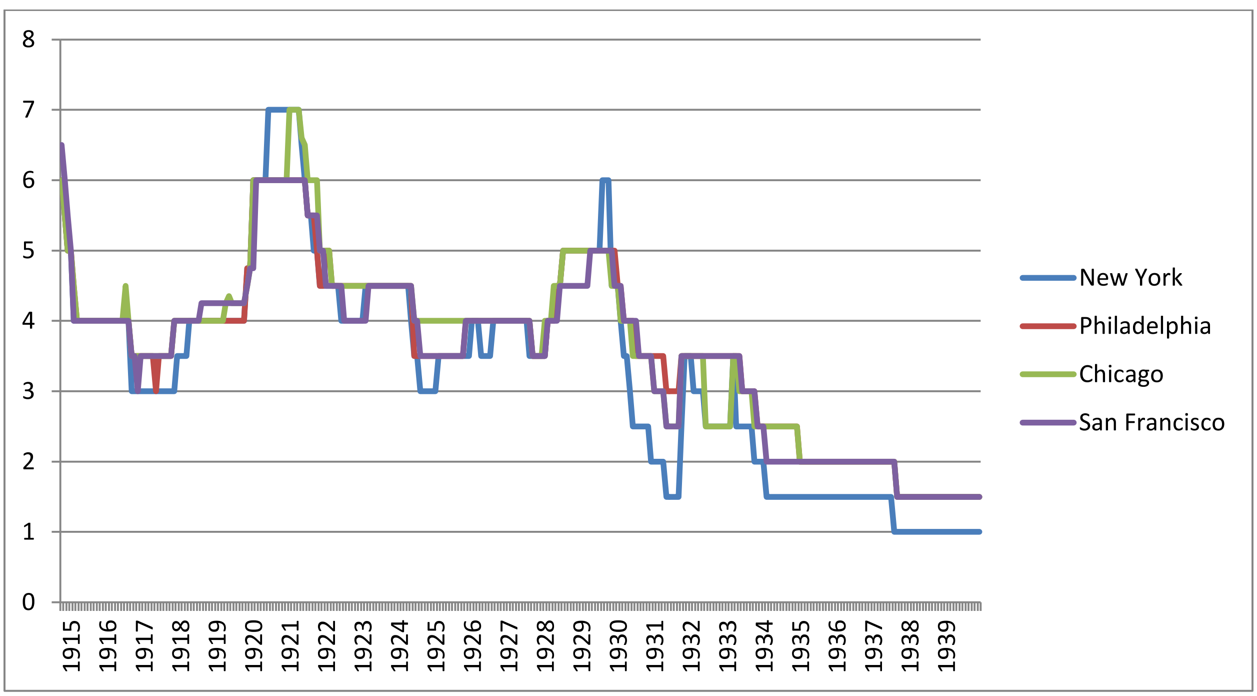


Discount Rates under Gold Standard with Italy (Global Financial Data)



In particular, a critical part of the gold standard was that individual national central banks set their own interest rates, with the aim of influencing the direction of capital movements. This became the central feature of the gold-standard world: a country that was losing gold reserves would tighten interest rates in order to attract money. Central bank discount rates (the policy rate) in France and Great Britain, major capital exporters, were constantly lower than in Germany, which had no major current account surplus, even though there was never any market expectation of a parity alteration. France and Britain in practice placed a floor under rates, and their choices affected other countries because of the possibility of arbitrage. Italy, where there were expectations of parity changes in the 1870s and 1880s, needed much higher rates. The gold-standard rules look very different from the modern practice of monetary union, which relies on a single uniform interest rate. That one-size-fits-all approach meant that interest rates in southern European countries were too low before 2009, and too high in northern Europe. A gold-standard rule would have produced higher rates for the southern European borrowers, which would have attracted funds to where capital might be productively used, and at the same time acted as a deterrent against purely speculative capital flows.

Federal Reserve Discount Rates 1914-1939



We can see the same differentiation of interest rates in the early history of the Federal Reserve System. Individual Reserve Banks set their own discount rates. Under Section 14(b) of the 1913 Federal Reserve Act, these rates were "subject to review and determination of the Federal Reserve Board." The Board also (section 13) had the "the right to determine or define the character of the paper thus eligible for discount." The individual Reserve Banks had different collateral requirements and accepted differing kinds of securities. In smooth or normal times, the rates tended to converge. But in times of shocks, they could move apart. In the summer of 1929, at the height of the credit boom, New York tightened, while the other banks left rates unchanged; in 1932, New York went much faster and further in lowering rates than other banks. There was thus a space for big policy conflicts. In 1919 the Attorney General ruled that the Board could change rates for a Bank; and in 1929 there was an acute conflict when the Board voted 4:3 to impose a reduction on the Chicago Bank.[5] By the late 1930s, the rate differences were disappearing, but they only vanished completely during the Second World War, for the simple reason that operating with Federal bills (a single instrument) rather than a multiplicity of differently valued private securities became the primary tool of U.S. monetary policy. The makers of the ECB took the practice of the postwar Federal Reserve, and simply assumed that the debt instruments of different member states could fill the monetary policy role of Federal debt in the case of the Federal Reserve's open market policy.

Is modern Europe a single capital market in a deeper sense than that of the nineteenth century, when there were also no formal capital controls between European countries? One guide is the extent to which securities markets are primarily national. Many countries in the nineteenth century issued bonds that were mostly held abroad. Since the 2008 financial crisis erupted, there has been something of a renationalization of financial behavior in Europe. Up to the late 1990's and the advent of monetary union,

[5] See Lester Chandler, *Benjamin Strong, Central Banker*, Washington D.C.: Brookings, 1958, p. 444; Allan H. Meltzer, *A History of the Federal Reserve I: 1913-1951*, Chicago: University of Chicago Press, 2003, pp. 221-223.

most European Union sovereign debt was domestically held: in 1998, the overall ratio of foreign-held debt was only one-fifth. That ratio climbed rapidly in the aftermath of the euro's introduction.

In 2008, on the eve of the crisis, three-quarters of Portuguese debt, one-half of Spanish and Greek debt, and more than two-fifths of Italian debt was held by foreigners, with foreign banks holding a significant proportion, especially in the case of Greece, Portugal, and Italy. One consequence of the ECB's large-scale long-term refinancing operation (LTRO) has been that Italian banks are once again buying Italian government bonds, and Spanish banks are buying Spanish bonds.

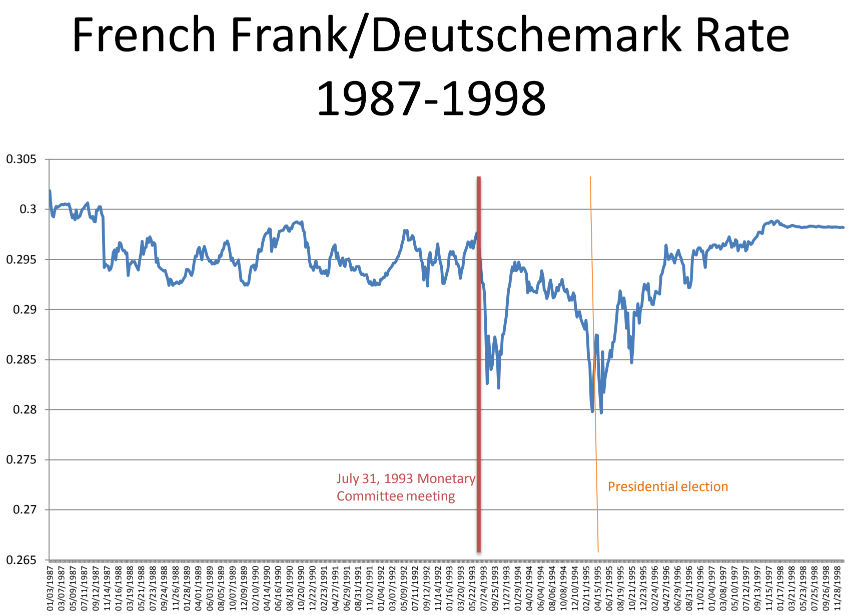
German Economics Minister Philipp Rösler has made the fascinating suggestion that members of the European System of Central Banks should set their own interest rates (though, interestingly, he made this suggestion explicitly as a party politician, not as a government minister). Autonomous interest-rate determination would penalize banks that have borrowed in southern Europe from their national central banks. Meanwhile, the German Bundesbank would have lower rates, but southern European banks would be unlikely to have access to that credit for use in their own markets. There are also signs that individual central banks are using the leeway that they have within the existing framework in order to carry out important policy shifts. The Bundesbank has stated that it will no longer accept bank securities as collateral from banks that have undergone a government recapitalization.

The new collateral requirements, together with tentative talk of autonomous interest rates, represents a remarkable incipient innovation. In the aftermath of the crisis, some policymakers are beginning to see that a monetary union is not necessarily identical with unfettered capital mobility. Recognition of diverse credit quality is a step back into the nineteenth-century world, and at the same time forward to a more market-oriented and less distorting currency policy. Different interest rates in different countries might open the door to a more stable eurozone.

Even greater monetary flexibility

Europeans can also look to other past episodes, when previous crises produced innovative solutions. The history of the immediate aftermath of the Maastricht Treaty holds out some lessons. The European Monetary System (EMS) crises between September 1992 and July 1993 looked as if they would blow up the whole course of European integration. What was at first seen as a one country problem (then it was Italy) toppled other currency regimes like dominos: Britain, Spain, Portugal, and by July 1993 even France was vulnerable. Then as now the future of Europe was at stake.

The solution adopted in frantic late night negotiations at a meeting of the EC Monetary Committee on July 31, 1993, in Brussels at first sight looked counterproductive. The massive widening of the EMS bands to 15 percent either way of the central rates initially made a single currency seem much further off. But it also took away the one way bet character of speculative attacks on the vulnerable currency, and thus removed the fundamental driver of instability. The French franc initially fell sharply against the Deutschemark (but within the new band), largely recovered by the beginning of 1994, had another bout of weakness around the contested and uncertain presidential election of 1995, and then rose to a stronger position than in 1992-3 on the eve of the introduction of the single currency.



The modern equivalent to the band widening of 1993 would be keeping the Euro for all members of the Eurozone but also allowing some of them (in principle all of them) to issue – if they needed it – national currencies. The countries that did that would find that their new currencies immediately trading at what would probably be a heavy discount. California recently adopted a similar approach, issuing IOUs when faced by the impossibility of access to funding. The success of stabilization efforts could then be read off from the price of the new currency. If the objectives were met, and fiscal stabilization occurred and growth resumed, the discount would disappear. In the same way, after 1993, in a good policy setting, the French franc initially diverged from its old level the band but then converged back within the band. Such a course would not require the redenomination of bank assets or liabilities, and hence would not be subject to the multiple legal challenges that a more radical alternative would encounter. There would also be the possibility that the convergence did not occur. The two parallel currencies could then coexist for a very much longer time period. This is not a novel thought. It was one of the possibilities that was raised in the discussions on monetary union in the early 1990s, that there might be a common currency but not necessarily a single currency.

Such a state of affairs is not just a theoretical construct in fringe debates in the early 1990s, but a real historical alternative. There is in fact a rather surprising parallel for such a stable coexistence of two currencies over a surprisingly long period of time. Before the victory of the gold standard in the 1870s, Europe operated with a bimetallic standard for centuries, not only gold but also silver. Each metal had its different coinage. One trick that made this regime so successful was that the coins were used for different purposes. High value gold coins were used as a reference for large value transactions and for international business. Low value silver coins were used for small day to day transactions, for the payment of modest wages and rents. Silver was what Shakespeare termed the "pale and common drudge 'tween man and man." A depreciation of silver relative to gold in this system would bring down real wages and improve competitiveness. Early modern Italian textile workers would find their pay in silver reduced, while their products still commanded a gold price on an international market for luxuries.[6] Larry Neal describes the operation of the Bank of Amsterdam in the seventeenth century as providing a flexible exchange rate its management between the bank guilder and the coin guilder, and thus offering a "shock absorber" for the domestic economy.[7] This is one of the reasons why theorists such as Milton Friedman considered a bimetallic standard inherently more stable than a mono-metallic (i. e. gold standard) regime.[8]

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[6] Richard A. Goldthwaite, *The economy of Renaissance Florence*, Baltimore : Johns Hopkins University Press, 2008; Tim Parks, *Medici money : banking, metaphysics, and art in fifteenth-century Florence* , New York : W. W. Norton & Co., 2005.

[7] Larry Neal, "How it all began: the monetary and financial architecture of Europe during the first global capital markets, 1648–1815," *Financial History Review* 7 (2000), pp. 117–140.

[8] Milton Friedman, *Money mischief : episodes in monetary history*, New York : Harcourt Brace Jovanovich, 1992.

In the modern setting, the equivalent of the adjustment mechanism in the early modern world of bimetallism would be a fall in Greek (or other crisis country) wage costs as the wages were paid in the national currency, as long as it was traded at a discount. These would be the equivalent of silver currencies. Meanwhile, the Euro would be the equivalent of the gold standard. It would be kept stable by the institutions which already exist today, the ECB and the ECSB of those national central banks who have no new alternative. In this sense the core countries would be the equivalent of eighteenth and early nineteenth century Britain, which also had no bimetallic standard but simply a gold standard regime. Now as then a choice of currencies in a national as well as an international setting seems odd and counterintuitive: but it can satisfy a demand for stability.