European Monetary Union in Historical Perspective

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Introduction

Economic historians are well used to writing essays on historical parallels with current economic problems, and drawing lessons from the past. In the case of European Monetary Union (EMU), however, there are no historical precedents. To be sure, we have examples of currency unions that have broken up, but these unions typically existed in the context of multinational empires, such as the Soviet Union. When the empires collapsed, so did the currency unions, and it is not surprising that they did so in circumstances of conflict and economic chaos. To ascribe these conditions to the collapse of the currency unions involved, rather than to the breakup of the empires themselves, as some banking analysts have recently done, is clearly unconvincing.[1]

The nineteenth century Scandinavian Monetary Union, and Latin Monetary Union, were 'currency unions', or 'monetary unions' which, like EMU, involved independent countries. However, both were in reality little more than fixed exchange rate arrangements between countries, linking the value of their currencies to gold or silver. These arrangements did not involve a common, multinational central bank like the European Central Bank. And while the US Federal Reserve does operate in a union of states, that union also has a federal government with a federal tax policy.

European Monetary Union, then, was a completely unprecedented economic experiment.

Nonetheless, economic history has a lot to tell us about both the economics and the politics underlying this experiment. To anticipate the argument: the design of European Monetary Union very much reflects German concerns, as is well known, but EMU is also a creature of the 1980s, reflecting the intellectual fashions and policy preoccupations of that decade. Those fashions and preoccupations were at odds with the post-war political traditions of Western European democracies, which had informed the move towards European integration in the 1950s. They were also at odds with the economic lessons of the 1930s, which had been largely forgotten a half-century later, but which are frighteningly relevant today. Europe needs to relearn those lessons, and re-engage with its social democratic past, if it is to survive this crisis unscathed.

In the Beginning: The Origins of the European Union

On 9 August 1941, the *Prince of Wales* sailed into Placentia Bay on the coast of Newfoundland, after a risky journey from Scapa Flow. It was bringing Winston Churchill to a meeting with Franklin D. Roosevelt, a meeting which culminated in the agreement of the Atlantic Charter. This was an eight-point statement outlining the principles that the British, and later the Americans, were fighting for. Most of the points were a familiar restatement of Wilsonian internationalism – a rejection of military aggression, the principle of self-determination, a commitment to international trade. The fifth point, however, was different. It stated that the two leaders desired 'to bring about the fullest collaboration between all nations in the economic field with the object of securing, for all, improved labor standards, economic advancement, and social security'.

Whatever else may be said of Winston Churchill, he was not one of history's instinctive social democrats. What was he doing including a reference to improved labour standards and social security, in what amounted to a statement of British war aims?

To someone who had lived through the 1930s, this would not have seemed at all strange. The 1920s had seen a gradual reconstruction of the international economy and, with it, signs that Germany was being successfully reintegrated into the international community: the signing of the Locarno Treaties in 1925, Germany's admission to the League of Nations in 1926, the agreement of the Young Plan in August 1929. Moderates had reasons to be optimistic. The Nazis obtained just 2.6 per cent of the vote in 1928.

Then, in late 1929, the Great Depression hit and everything fell apart. Thanks to Brüning's deflationary economic policies, which emphasised austerity, Germany's national income fell by more than a quarter, and official unemployment rose to almost a third of the labour force. Optimism was replaced by a profound sense of insecurity. Inevitably, the extremist parties benefitted. In 1930, the Nazis increased their share of the vote to 18.3 per cent; in July 1932, they scored 37.8 per cent. By this stage, Brüning was gone, his successor had adopted some modestly stimulative policies, and there were signs of a partial recovery. Not coincidentally, in November 1932 the Nazi share dipped to 33.1 per cent; but by then it was too late, and the Weimar Republic was doomed.

The lesson was clear: states needed to provide their citizens with the security which the gold standard and the market system, left to their own devices, had so conspicuously failed to do. The alternative was nationalism in all its guises: economic nationalism at best, but potentially something much uglier and far more dangerous.

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And so the democracies of the post-war period became social democracies – although British voters in 1945 judged that Churchill was not the man best suited to bringing this about. His defeat, and the election of a Labour government, symbolised the desire of ordinary Europeans, who had suffered so greatly during the war, to see their lives improve in its wake. Given the experience of the Great Depression, they were hardly going to be willing to leave it to the market: 'embedded liberalism' in which the market was 'embedded' within a broader social and political context, and made to serve wider social aims, was a logical consequence.[2]

According to Alan Milward, the three crucial constituencies which post-war governments had to placate were: agricultural voters, whose disillusionment had led them to support extremist parties during the interwar period in many countries; workers; and those dependent on the welfare state.[3] The solution was to provide workers with rising wages and full employment, to ensure rising living standards for the agricultural sector, and to establish modern welfare states.

Accomplishing all three goals required an extension of government intervention in the economy. The welfare state reduced economic insecurity, while Keynesian macroeconomic policies helped stabilise economic fluctuations. As regards agriculture, after World War II all European countries experienced severe food shortages, at a time when governments wished to achieve food self-sufficiency for strategic reasons. The result was widespread agricultural intervention across Europe.

Another crucial component of post-war economic strategy in Europe was the dismantling of trade barriers between European countries, and between Europe and North America. This was essential to achieving the economic growth without which governments could not attain their other objectives. But how could this be reconciled with widespread government intervention as described above?

Governments of the time were deeply conscious of the need to reconcile domestic with international policy objectives, and of taking steps to ensure that the achievement of the latter did not undermine the former. For example, in the case of agriculture the answer was to replicate national agricultural policies at the European level, by setting up a Common Agricultural Policy.

Governments also feared that free trade would mean that their industries would be placed at a competitive disadvantage *vis-à-vis* industries in other countries whose social welfare systems were less well developed. It was politically essential that the domestic social welfare systems – which not only underpinned governments' political legitimacy, but their economic growth strategies as well[4]– not be undermined by the development of Europe-wide free trade. As Milward puts it:

The problem genuinely was how to construct a commercial framework which would not endanger the levels of social welfare which had been reached ... The Treaties of Rome had to be also an external buttress to the welfare state.[5]

The Treaty of Rome thus called for the (not yet realised) harmonisation of social policies. The EU has since developed a range of other policies designed to deepen economic integration between members, while allowing governments to collectively retain the regulatory control they deem necessary. European integration has therefore traditionally combined deeper economic ties among Member States with political structures allowing those Member States to retain the control over markets which their voters deem necessary. It has traditionally allowed governments to collectively achieve goals which would have been difficult for them to achieve on their own – in Millward's words, the post-war period saw the 'European rescue of the nation state'.

The Trilemma and EMU

In recent decades, however, Europe has been seen more and more as a constraint on national governments' ability to act, rather than as an enabler. The change came in the 1980s, with the Single European Act and the development of the Single Market. Logically, a single market required a single competition policy, while constraints on national procurement policies and other similar measures were also introduced. Increasingly, politicians were able to argue, or forced to explain to local populations, that particular policies were illegal under EU law, no matter how popular they might be domestically. And, of even greater relevance for today's economic problems, the abolition of capital controls between Member States placed great limitations on their ability to conduct independent monetary policies.

In order to understand the latter point, it is helpful to turn to the famous economic trilemma which generations of economists have taught their students, and which, as Obstfeld and Taylor have shown, is essential in understanding the broad contours of international monetary history over the past century and a half. In their words:

> *... the chosen macroeconomic policy regime can include at most two elements of the 'inconsistent trinity' of three policy goals:*
>
> - *full freedom of cross-border capital movements;*
> - *a fixed exchange rate; and*
> - *an independent monetary policy oriented towards domestic objectives.*[6]

The proof of this proposition is fairly straightforward. If capital is free to flow internationally, then it will search out the highest available returns, which will as a consequence be forced into equality internationally. To investors contemplating investing in different currencies, the returns they can expect will depend not only on interest rates, but on anticipated exchange rate movements. However, if exchange rates are credibly fixed against each other, returns will depend on interest rates alone. In this case, capital mobility will, by equalising the returns on investing in different countries, lead to interest rates being equalised as well. If a smaller country adopts a fixed exchange rate *vis-à-vis* a larger economy, and allows capital to flow freely between them, it will as a consequence be forced to accept whatever interest rates are decided in its partner country. In other words, it will lose the ability to choose interest rates appropriate to its own economic circumstances: if it sets them lower than abroad, capital will flee the country, the central bank's reserves will be depleted, and the country will as a result be forced to exit the fixed exchange rate arrangement.[7]

Confronted with this economic trilemma, governments have made very different choices at different moments in history. Under the classical (pre-1914) gold standard, open capital markets and fixed exchange rates meant that central banks subordinated interest rate policy to the goal of maintaining gold reserves and staying on gold. Faced with a drain, a country would in principle raise interest rates, thus inducing capital to stay, while the resulting deflation (an internal devaluation, we would say today) would restore its competitiveness in the longer run.

This approach to economic policy sat well with the liberal philosophy of the time, but was gradually undermined by the growing rigidity of product and labour markets. Internal devaluations became more difficult to achieve, and since wages were now less easy to cut than before, deflationary policies increasingly led to unemployment (by lowering the price of economic output, relative to the cost of the labour required to produce it).

Not only did the unemployment costs of such policies rise, but the political costs rose as well, since the extension of the franchise means that those most affected by unemployment were now in a position to express their objections at the ballot box. Democracy and the gold standard were, in the end, mutually incompatible.[8] Since markets could observe all this, governments' protestations that they would stick with gold, no matter what the economic and political consequences, gradually came to seem less and less credible.

Matters came to a head after 1928, when the gold standard transmitted higher US interest rates worldwide, turning a national contraction into a global one. Worse, gold standard membership made it impossible for national governments to fight the recession once it had begun. As long as countries stayed on gold, they could not, by definition, engage in expansionary monetary policy, and indeed they were also reluctant to engage in expansionary fiscal policy, since they feared that it would lead to a drain in reserves, by sucking in imports. Worse, governments very often adopted pro-cyclical, 'austerian' fiscal policies – notably in Germany, as we have seen – and in some cases perversely raised interest rates rather than lowering them.[9] The net result was that a severe recession became a depression, with the social and political consequences that we know.

In the long run, these attempts to save the gold standard by destroying the economy came to naught, and countries were forced to abandon gold anyway as the economic situation spiralled out of control. And as they did so, one after the other, their economies started to recover. Those that left gold earliest, like the United Kingdom, recovered earlier than those, such as the French, who stuck to gold right to the bitter end, which came in 1936.

After the interwar disaster, a new regime was instituted at Bretton Woods, which prioritised domestic monetary policy autonomy and fixed exchange rates. The result, in accordance with the logic of the trilemma, was capital controls, which persisted for many years, but were eventually undermined by the markets. In 1973, fixed exchange rates were thus abandoned, and the world entered the era of capital mobility and floating rates which persists to this day.

While capital mobility has proved troublesome on many occasions – especially when market participants have persuaded themselves that they did not need to concern themselves with exchange rate risk – there is no doubt that the floating rate environment was one reason that the policy response to the crisis of 2008–9 was so much more successful than the policy response of 1929–32.[10] Nor is it a coincidence that the current global economic black spot is the euro zone, which of course embodies the polar opposite of floating exchange rates.

Within Europe, the move to floating in the 1970s was seen as a serious challenge because of the threat it was feared sharp exchange rate movements might pose to the Common (and later Single) Market, and for technical reasons having to do, for example, with green exchange rates. Attempts to limit exchange rate fluctuations soon got underway, culminating in the creation of the European Monetary System in 1979. Initially, the system functioned fairly well, due to residual capital controls, and frequent exchange rate realignments. However, after 1987 the system became far more rigid, while capital controls were abolished as a result of the Single Market programme. Countries were thus, in accordance with the trilemma, increasingly obliged to follow German interest policy, which became more restrictive in the wake of unification.

In retrospect, the collapse of 1992–93 can be seen as inevitable, since (as George Soros correctly foresaw) there was a limit to the extent to which national governments were prepared to subordinate national monetary policy to the requirements of a fixed exchange rate regime, or tolerate higher interest rates and growing unemployment in order to stay pegged to the Deutsche mark.

The Single Market, and capital mobility, thus posed a problem for European governments: it made it much more difficult for them to credibly adopt a fixed exchange rate system. A radical solution to this problem was to abolish national exchange rates altogether: EMU can thus be seen as a logical technical response to free capital mobility. Unfortunately, the institutional design of EMU left a lot to be desired. The European Central Bank – uniquely among the major central banks of the world – is supposed to focus on limiting inflation, to the exclusion of all other goals, such as limiting unemployment. This in part reflects the German preoccupation with inflation, which is odd, since as we have seen Hitler came to power as a result of austerity, deflation and depression, not as a result of the much earlier hyperinflation.

It also reflects the policy preoccupations of the 1980s, a decade when governments and central banks were largely concerned with squeezing the last remnants of the 1970s inflation out of the system. Intellectually, the decade saw the widespread acceptance of the principle that rigid rules were to be preferred to macroeconomic policy-making discretion, since in the long run, it was claimed, activist policy did nothing to lower unemployment, and only served to make inflation worse. And politically, of course, this was the decade that saw the post-war social democratic consensus shatter under the onslaught of the radical pro-market views of Ronald Reagan and Margaret Thatcher, who sought to 'disembed' liberalism, and the market, from the social and political constraints of earlier decades. The result was that the most conservative major central bank in the world was grafted on to the old social democracies of Western Europe. The political consequences of that decision are there for all to see today.

Saltwater economists never abandoned the view that in certain circumstances – not always! – labour markets could fail to clear as a result of a lack of aggregate demand, and that as a consequence Keynesian countercyclical policies might be needed from time to time. Furthermore, since the business cycle might vary across European countries, some countries might need monetary policies which dampened demand at the same time as others needed expansionary policies. One monetary policy, therefore, might not suit all countries simultaneously. This was one reason for Keynesians to oppose EMU, on purely technical grounds, while the hard-line monetarist design of the ECB was another. Such a stance did not, however, come easily to many, since on political grounds they were anything but Eurosceptic.

The Current Crisis

I have argued that on balance floating exchange rates have been good for the world since the breakdown of the Bretton Woods regime in the 1970s. The other component of today's global financial system, international capital mobility, has been far more problematic, however. Of particular concern has been the way in which there have been periodic bouts of excessive lending to rapidly growing economies, fuelled largely by the assumption that the lending was riskless, and channelled through the books of banks and other financial intermediaries. The result has been property bubbles, wage and cost inflation, the loss of competitiveness, and eventual crises associated with the rediscovery of risk, the reversal of capital flows, the pricking of bubbles, and the insolvency of the banks through which these capital flows had been channelled.

Such was the story of Thailand during the Asian financial crisis of 1997, for example, and the symptoms I have described will be familiar to an Irish audience as well. It is Ireland's great misfortune, however, that unlike Thailand it does not have its own currency to devalue in order to regain competitiveness. By a process of elimination, the only available policy to restore competitiveness – as long as EMU membership is unquestioned, and no matter how objectively lousy the policy may be – is the 'internal devaluation' strategy that successive Irish governments have been pursuing since 2008, after a fashion.[11] But for such a strategy to have any chance of working, everything else has to go right. In particular, foreign economies have to remain buoyant, since export markets become vital when domestic ones are being squeezed. The generalised rush towards European austerity in 2010, egged on by conservatives who saw this as the great opportunity to shrink the state, and by Irish politicians who liked to be seen as poster boys for the new orthodoxy, was therefore an unmitigated disaster for Ireland. And in order for such a strategy to work, debt burdens also need to be reduced, which is one reason among many why saddling Irish taxpayers with the debts of defunct banks was so unconscionable.[12]

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The drive towards generalised austerity is bad not only for Ireland, but for the entire euro zone economy. That it is economically harmful is obvious, but the political costs could be even higher in the long run. If this drive were to become constitutionalised, via the proposed fiscal austerity pact, it would do untold damage to the European project. As French voters pointed out in 2005, when they rejected the European constitutional treaty, it is inappropriate for constitutions or treaties to rule out policies which are properly the subject of normal domestic political debate in modern democracies. Doing so will in the long run only serve to heighten disaffection with the European project, which for all its many flaws has been the great political success story of post-1945 Europe.

We are slowly and painfully relearning the economic lessons of the 1930s: it is difficult to lower nominal wages across the board in a modern economy, and being able to devalue your currency is thus an economic policy tool whose loss is extremely costly. Contractionary fiscal policy is indeed contractionary, especially when exchange rates are fixed, and even more so when everyone is doing the same thing simultaneously. Central banks have to care about much more than inflation. And so on.

But we also need to remember the political lessons of the 1930s. A colleague of mine recently opined that only an economist would be stupid enough to think that having foreigners impose austerity and 'internal devaluations' on the euro zone's southern periphery would work. I know what he meant but, in fairness, saltwater economists, like Keynes himself, have always had an instinctive understanding that you need to take the predictable political consequences of your actions into account when designing economic policies. This is why, aside altogether from any moral considerations, fairness and democratic legitimacy are so important. It is why the social democrats of the post-war period advocated not only regulation (in particular of the financial sector), and reflation (when necessary), but redistribution as well. These 3 Rs are as relevant today as they were in the 1950s, and if Europe is to survive and prosper politically it has to rediscover them.

Are there any signs of hope on the horizon? Paradoxically, the fact that current economic policies are so clearly failing may be Europe's best hope of salvaging something from this mess. The French Socialists have said that they will renegotiate the fiscal austerity pact, should they be elected to the Presidency in 2012. Mario Monti, appointed Italian Prime Minister in November 2011, may become the spokesman that the periphery needs: Italy is a large country which will probably not accept the 1930s-style contractions in income which have been experienced in smaller countries such as Ireland or Latvia.

It is crucial that the centre and centre-left seize the initiative now, and show voters that their opinions matter, that their votes can fundamentally change the direction of policy, and that we are not going to ditch the European social model in the name of European Monetary Union. Otherwise Europe's many extremist political parties will make hay. As Tony Judt put it: 'Why have we been in such a hurry to tear down the dikes laboriously set in place by our predecessors? Are we so sure that there are no floods to come?'.[13]

Notes

1. '… almost no modern fiat currency unions have broken up without some form of authoritarian or military government, or civil war'. UBS Investment Research, 'Euro break-up: the consequences', *Global Economic Perspectives*, 6 September 2011.
2. John G. Ruggie, 'International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order', *International Organization*, Vol. 36, Issue 2, March 1982, pp. 379–415.
3. Alan S. Milward, *The European Rescue of the Nation-State* (second edition), London: Routledge, 2000.
4. Barry Eichengreen, *The European Economy since 1945: Coordinated Capitalism and Beyond*, Princeton NJ: Princeton University Press, 2007.
5. Alan S. Milward, *op. cit.*, p. 216.
6. Maurice Obstfeld and Alan M. Taylor, *Global Capital Markets: Integration, Crisis, and Growth*, Cambridge: Cambridge University Press, 2004, p. 30.
7. A fixed exchange rate implies a commitment by the central bank to buy and sell foreign currencies at a fixed price, which in turn implies that it needs adequate reserves of foreign exchange so that it can sell these if the demand arises.
8. Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression 1919–1939*, Oxford: Oxford University Press,1992.
9. The phrase 'austerian' has come into vogue since 2010. It is a play on words, since economists who self-identify as 'Austrian' tend to support the pro-austerity policies which swept across Europe in that year. See http://www.ritholtz.com/blog/2010/06/word-origins-austerians/
10. Barry Eichengreen and Kevin H. O'Rourke, *A Tale of Two Depressions*, 2009 (http://www.voxeu.org/index.php?q=node/3421); Miguel Almunia, Agustín S. Bénétrix, Barry Eichengreen, Kevin H. O'Rourke and Gisela Rua, 'From Great Depression to Great Credit Crisis: Similarities, Differences, and Lessons', *Economic Policy*, Vol. 25, Issue 62, April 2010, pp. 219–65.
11. In principle, Ireland's social partnership institutions might have been deployed in 2009 to ensure that wages and costs were reduced across the board in as fair and comprehensive a manner as possible. Instead, that year saw the emergence of a divisive and distracting split between the public and private sectors, fuelled by the right-wing media. Ireland thus offers the latest proof of Milton Friedman's skepticism regarding the ability of modern societies to successfully 'internally devalue' to the extent that would be required to maintain full employment. It is important to note that Friedman, just like mainstream Keynesians, felt that being able to really devalue was important at times for an economy's health. Ireland's unemployment rate suggests that he was right.
12. http://www.irisheconomy.ie/index.php/2010/12/01/barry-eichengreen-on-the-irish-bailout/
13. Tony Judt, *Ill Fares the Land*, London: Penguin, 2010, p. 224.

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