

## History of Previous European Currency Unions

By Sam Vaknin, Ph.D.

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The Euro feels like a novelty - but it is not. It was preceded by quite a few Monetary Unions in Europe and outside it.

To start with, countries such as the USA and the USSR are (or were in the latter's case) monetary unions. A single currency was or is used over enormous land masses incorporating previously distinct political, social and economic entities. The American constitution, for instance, did not provide for the existence of a central bank. Founding fathers, the likes of Madison and Jefferson, objected to its existence. A central monetary institution was established only in 1791 (modelled after the Bank of England). But Madison (as President) let its concession expire in 1811. It was revived in 1816 - only to die again. It took a civil war to lead to a budding monetary union. Bank regulation and supervision were instituted only in 1863 and a distinction was made between national and state-level banks.

By that time, 1562 private banks were printing and issuing notes, some of them not a legal tender. In 1800 there were only 25. The same thing happened in the principalities which were later to constitute Germany: 25 private banks were established only between 1847 and 1857 with the express intention of printing banknotes to circulate as legal tender. In 1816 - 70 different types of currency (mostly foreign) were being used in the Rhineland alone.

A tidal wave of banking crises in 1908 led to the formation of the Federal Reserve System and 52 years were to elapse until the full monopoly of money issuance was retained by it.

What is a monetary union? Is it sufficient to have a single currency with free and guaranteed convertibility?

Two additional conditions apply: that the exchange rate be effective (realistic and, thus, not susceptible to speculative attacks) and that the members of the union adhere to one monetary policy.

Actually, history shows that the condition of a single currency, though preferable, is not a sine qua non. A union could incorporate "several currencies, fully and permanently convertible into one another at irrevocably fixed exchange rates" which is really like having a single currency with various denominations, each printed by another member

of the Union. What seems to be more important is the relationship (as expressed through the exchange rate) between the Union and other economic players. The currency of the Union must be convertible to other currencies at a given (could be fluctuating - but always one) exchange rate determined by a uniform exchange rate policy. This must apply all over the territory of the single currency - otherwise, arbitrageurs will buy it in one place and sell it in another and exchange controls would have to be imposed, eliminating free convertibility and inducing panic.

This is not a theoretical - and thus unnecessary - debate. ALL monetary unions in the past failed because they allowed their currency or currencies to be exchanged (against outside currencies) at varying rates, depending on where it was converted (in which part of the monetary union).

“Before long, all Europe, save England, will have one money”. This was written by William Bagehot, the Editor of The Economist, the renowned British magazine. Yet, it was written 120 years ago when Britain, even then, was debating whether to adopt a single European Currency.

Joining a monetary union means giving up independent monetary policy and, with it, a sizeable slice of national sovereignty. The member country can no longer control its the money supply, its inflation or interest rates, or its foreign exchange rates. Monetary policy is transferred to a central monetary authority (European Central Bank). A common currency is a transmission mechanism of economic signals (information) and expectations, often through the monetary policy. In a monetary union, fiscal profligacy of a few members, for example, often leads to the need to raise interest rates in order to pre-empt inflationary pressures. This need arises precisely because these countries share a common currency. In other words, the effects of one member's fiscal decisions are communicated to other members (through the monetary policy) because they share one currency. The currency is the medium of exchange of information regarding the present and future health of the economies involved.

Monetary unions which did not follow this course are no longer with us.

Monetary unions, as we said, are no novelty. People felt the need to create a uniform medium of exchange as early as the times of Ancient Greece and Medieval Europe. However, those early monetary unions did not bear the hallmarks of modern day unions: they did not have a central monetary authority or monetary policy, for instance.

The first truly modern example would be the monetary union of Colonial New England.

The New England colonies (Connecticut, Massachusetts Bay, New Hampshire and Rhode Island) accepted each other's paper money as legal tender until 1750. These notes were even accepted as tax payments by the governments of the colonies. Massachusetts was a dominant economy and sustained this arrangement for almost a century. It was envy that ended this very successful arrangement: the other colonies began to print their own notes outside the realm of the union. Massachusetts bought back (redeemed) all its paper money in 1751, paying for it in silver. It instituted a mono-metallic (silver) standard and ceased to accept the paper money of the other three colonies.

The second, more important, experiment was the Latin Monetary Union. It was a purely French contraption, intended to further, cement, and augment its political prowess and monetary clout. Belgium adopted the French Franc when it attained independence in 1830. It was only natural that France and Belgium (together with Switzerland) should encourage others to join them in 1848. Italy followed in 1861 and the last ones were Greece and Bulgaria (!) in 1867. Together they formed the bimetallic currency union known as the Latin Monetary Union (LMU).

The LMU seriously flirted with Austria and Spain. The Foundation Treaty was officially signed only on 23/12/1865 in Paris.

The rules of this Union were somewhat peculiar and, in some respects, seemed to defy conventional economic wisdom.

Unofficially, the French influence extended to 18 countries which adopted the Gold Franc as their monetary basis. Four of them agreed on a gold to silver conversion rate and minted gold coins which were legal tender in all of them. They voluntarily accepted a money supply limitation which forbade them to print more than 6 Franc coins per capita (the four were: France, Belgium, Italy and Switzerland).

Officially (and really) a gold standard developed throughout Europe and included coin issuers such as Germany and the United Kingdom). Still, in the Latin Monetary Union, the quantities of gold and silver Union coins that member countries could mint was unlimited. Regardless of the quantities minted, the coins were legal tender across the Union. Smaller denomination (token) silver coins, minted in limited quantity, were legal tender only in the issuing country.

There was no single currency like the Euro. Countries maintained their national currencies (coins), but these were at parity with each other. An exchange commission of 1.25 % was charged to convert them. The tokens had a lower silver content than the Union coins.

Governmental and municipal offices were required to accept up to 100 Francs of tokens (even though they were not convertible and had a lower intrinsic value) in a single transaction. This loophole led to mass arbitrage: converting low metal content coins to buy high metal content ones.

The Union had no money supply policy or management. It was left to the market to determine how much money will be in circulation. The central banks pledged the free conversion of gold and silver to coins. But, this pledge meant that the Central Banks of the participating countries were forced to maintain a fixed ratio of exchange between the two metals (15 to 1, at the time) ignoring the prices fixed daily in the world markets.

The LMU was too negligible to influence the world prices of these two metals. The result was overvalued silver, export of silver from one member to another using ingenious and ever more devious ways of circumventing the rules of the Union. There was no choice but to suspend silver convertibility and thus acknowledge a de facto gold standard. Silver coins and tokens remained legal tender.

This became a major problem for the Union and the coup de grace was delivered by the unprecedented financing needs brought on by the First World War. The LMU was officially dismantled in 1926 - but died long before that. The lesson: a common currency is not enough - a common monetary policy monitored and enforced by a common Central Bank is required in order to sustain a monetary union.

As the LMU was being formed, in 1867, an International Monetary Conference was convened. Twenty countries participated and discussed the introduction of a global currency. They decided to adopt the gold (British, USA) standard and to allow for a transition period. They agreed to use three major "hard" currencies but to equate their gold content so as to render them completely interchangeable. Nothing came out of it - but this plan was a lot more sensible than the LMU.

One wrong path seemed to have been the Scandinavian Monetary Union.

Sweden (1873), Denmark (1873) and Norway (1875) formed the Scandinavian Monetary Union (SMU). The pattern was familiar: they accepted each others' gold coins as legal tender in their territories. Token coins were also cross-boundary legal tender as were banknotes (1900) recognized by the banks of the member countries. It worked so perfectly that no one wanted to convert the currencies and exchange rates were not available from 1905 to 1924, when Sweden dismantled the Union following Norway's independence. Actually, the countries involved created (though not officially) what amounted to a unified central bank with unified reserves - which extended monetary credit lines to each of the member countries.

The Scandinavian Kronor held well as long as gold supply was limited. World War I changed this situation as governments dumped gold and inflated their currencies, engaging in competitive devaluations. Central Banks used the depreciated currencies to buy gold at official (cheap) rates. Sweden saw through this ploy and refused to sell its gold in the officially fixed price. The other members began to sell large quantities of the token coins to Sweden and use the proceeds to buy the much Stronger Swedish "economy" (=currency) at an ever cheaper price (as the price of gold collapsed). Sweden reacted by prohibiting the import of other members' tokens. Without a fixed price of gold and without coin convertibility, there was no Union to talk of.

The last big (and recent) experiment in monetary union was the East African Currency Area. An equivalent experiment is still going on in the Francophile part of Africa involving the CFA currency.

The parts of East Africa ruled by the British (Kenya, Uganda and Tanganyika and, in 1936, Zanzibar) adopted in 1922 a single common currency, the East African shilling. Independence in East Africa had no monetary aspect because it remained part of the Sterling Area. This guaranteed the convertibility of the local currencies into British Pounds. Regarding this a matter of national pride (and strategic importance) the British poured inordinate amounts of money into these emerging economies. This monetary union was not disturbed by the introduction (1966) of local currencies in Kenya, Uganda and Tanzania. The three currencies were legal tender in each of these countries and were all convertible to Pounds.

It was the Pound which gave way by strongly depreciating in the late 60s and early 70s. The Sterling Area was dismantled in 1972 and with it the strict monetary discipline which it imposed - explicitly and through the free convertibility - on its members. A divergence in the value of the currencies (due to different inflation targets and resulting interest rates) was inevitable. In 1977 the East African Currency Area ended.

Not all monetary unions met the same gloomy end, however. Arguably, the most famous of the successful ones is the Zollverein (German Customs Union).

At the beginning of the 19th century, there were 39 independent political units which made up the German Federation in what is today's Germany. They all minted coins (gold, silver) and had their own standards for weights and measures. Labour mobility in Europe was greatly enhanced by the decisions of the Congress of Vienna in 1815 but trade was still ineffective because of the number of different currencies.

The German statelets formed a customs union as early as 1818. This was followed by the formation of three regional groupings (the Northern, Central and Southern) which were united in 1833. In 1828, Prussia harmonized and unified its tariffs with the other members of the Federation. Debts related to customs could be paid in gold or silver. Several currencies were developed and linked to each other through fixed exchange rates. There was an over-riding single currency: the Vereinsmunze. The Zollverein (Customs Union) was established in 1834 to facilitate trade and reduce its costs. Most of the political units agreed to choose between one of two monetary standards (the Thaler and the Gulden) in 1838 and nine years later, the central bank of Prussia (which comprised 70% of the population and land mass of the future Germany) became the effective Central Bank of the Federation. The North German Thaler was fixed at 1.75 to the South German Gulden and, in 1856 (when Austria became associated with the Union), at 1.5 Austrian Florins (this was to be a short lived affair, because Prussia and Austria declared war on each other in 1866).

Germany was united by Bismarck in 1871 and a Reichsbank was founded 4 years later. It issued the Reichsmark which became the legal and only tender of the whole German Reich. The currency Union survived two world wars, a devastating bout of inflation in 1923 and a collapse of the currency after the Second World War. The Reichsmark became the solid and reliable Bundesbank. The Union still survives in the Deutschmark.

This is the only case of a monetary union which succeeded without being preceded by a political arrangement. It survived because Prussia was sizeable and had enough real power and perceived clout to enforce compliance on the other members of the Federation. Prussia wanted to have a stable currency and introduced consistent metallic standards. The other states could not deprive their currencies of their intrinsic values. For the first time in history, coinage became a professional economic decision, totally depoliticized.

In this context, we must mention another successful (on-going) union - the CFA Franc Zone.

The CFA (French African Community) is a currency used in the former French colonies

of West and Central Africa (and, curiously, in one formerly Spanish colony). The currency zone has been in existence for well over three decades and comprises diverse ethnic, lingual, cultural, political and economic units. The currency withstood devaluations (the latest one of 100% vis a vis the French Franc), changes of regimes (from colonial to independent), the existence of two groups of members, each with its own central bank, controls of trade and capital flows - not to mention a host of natural and man made catastrophes. What makes it so successful is maybe the fact that the reserves of the member states are hoarded in the safes of the French Central Bank and that the currency is almost absolutely convertible to the French Franc. Convertibility is guaranteed by the French Treasury itself.

France imposes monetary discipline (that it sometimes lacks at home!) directly and through its generous financial assistance.

Europe has had more than its share of botched (the Snake, the EMS, the ERM) and of successful (ECU, the United Kingdom and Ireland) currency unifications.

A neglected one is between Belgium and Luxembourg (BENELUX is the political alignment which includes the Netherlands).

There is no real currency union here. Both maintain separate currencies. But their currencies are at parity and serve as legal tender in both countries since 1921. The Belgian Central Bank controls the monetary policies of both countries, with the exception of exchange regulations which are overseen by a joint agency. In both 1982 and 1993 the two countries considered dismantling the union - but this was not serious talk, the advantages being so numerous (especially to the smaller partner).

These three currency unions have all survived due mainly to the fact that one monetary authority has been responsible, at least de facto, for managing the currency.

What can we learn from all this (not insubstantial) cumulative experience?

(A) A dominant country is required for a Union to succeed. It must have a strong geopolitical drive and maintain political solidarity with some of the other members. It must be big, influential, and its economy must be intermeshed with the economies of the others.

(B) Central institutions must be set up to monitor and enforce fiscal and other policies, to coordinate activities of the member states, to implement political and technical decisions, to control the money aggregates and seigniorage (=money printing), to determine the legal tender and the rules governing the issuance of money.

(C) It is better if a monetary union is preceded by a political one. Even so, it might prove tricky (consider the examples of the USA and of Germany).

(D) Wage and price flexibility are sine qua non. Their absence is a threat to the continued existence of any union. Fiscal policy (money transfers from rich areas to poor) are a partial remedy. They can mitigate and ameliorate problems - but not solve them. Transfers also call for a clear and consistent fiscal policy regarding taxation and

expenditures. Problems like unemployment plague a rigid, sedimented union. The works of Mundell and McKinnon (optimal currency areas) prove it decisively (and separately).

(E) The last prerequisite is clear convergence criteria and monetary convergence targets.

Judging by these requirements, the current European monetary union did not sufficiently assimilate the lessons of its ill begotten predecessors. It is set in a Europe more rigid in its labour and pricing practices than 150 years ago, it was not preceded by serious political amalgamation, it relies too heavily on transfers without having in place either a coherent monetary or a consistent fiscal policy.

This monetary union is, therefore, likely to join its forefathers and remain a footnote in the annals of economic history.

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