The Economics of European Integration

McGraw Hill Education

Chapter 13

A Monetary History of Europe

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Why Studying History?

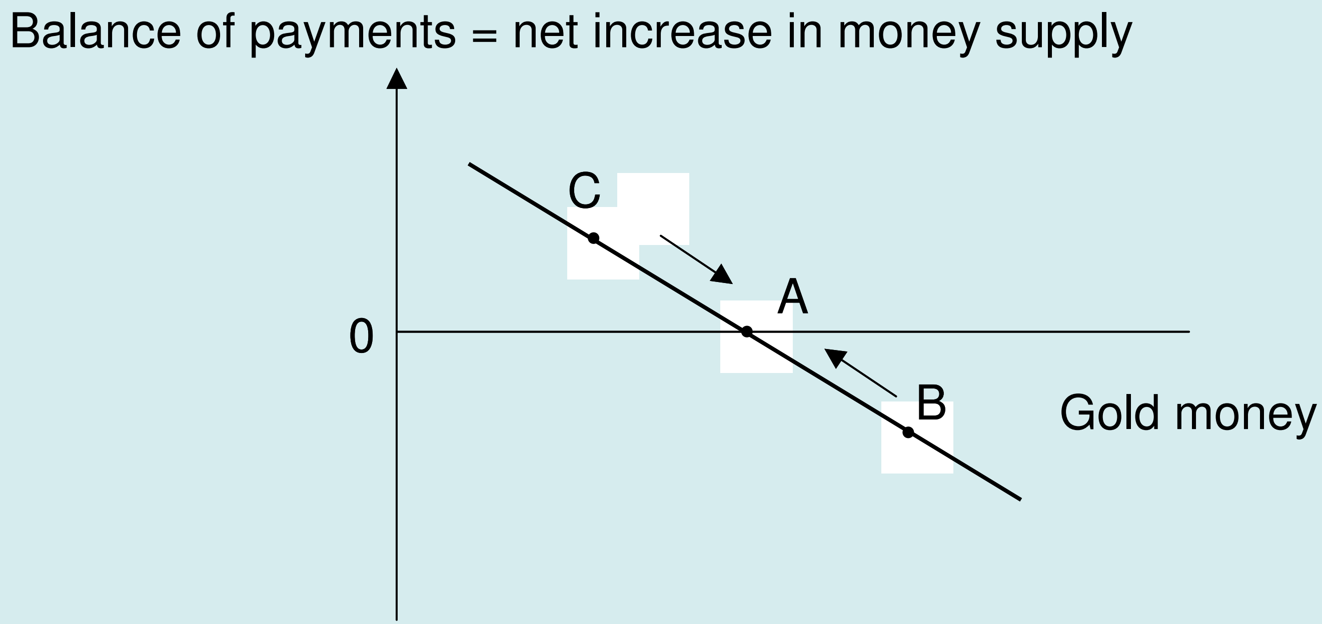
- Monetary union is the controversial end of a long process. History helps understand.
- Since paper money was invented, Europe’s monetary history has been agitated. Each bad episode carries important lessons.
- Before paper money, Europe was a *de facto* monetary union. Understand how it worked helps understand how the new union works.

Metallic Money

- Under metallic money (overlooking the difference between gold and silver) the whole world was really a monetary union.
- Previous explicit unions only agreed on the metal content of coins to simplify everyday trading.

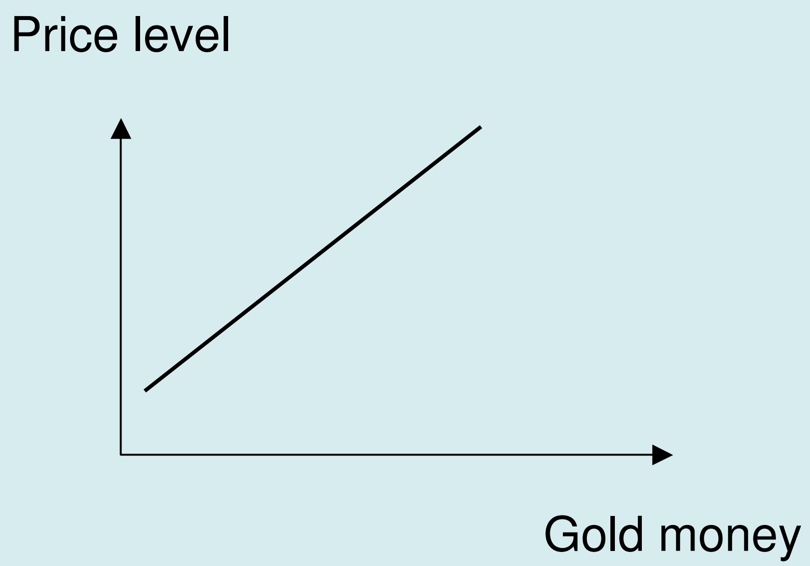
The Gold Standard and Hume's Mechanism

- Hume's mechanism implies an automatic change in the money stock to achieve balance of payments equilibrium.



The Gold Standard and Hume's Mechanism: The Trade Account

- Money determines the price level (in the long run).

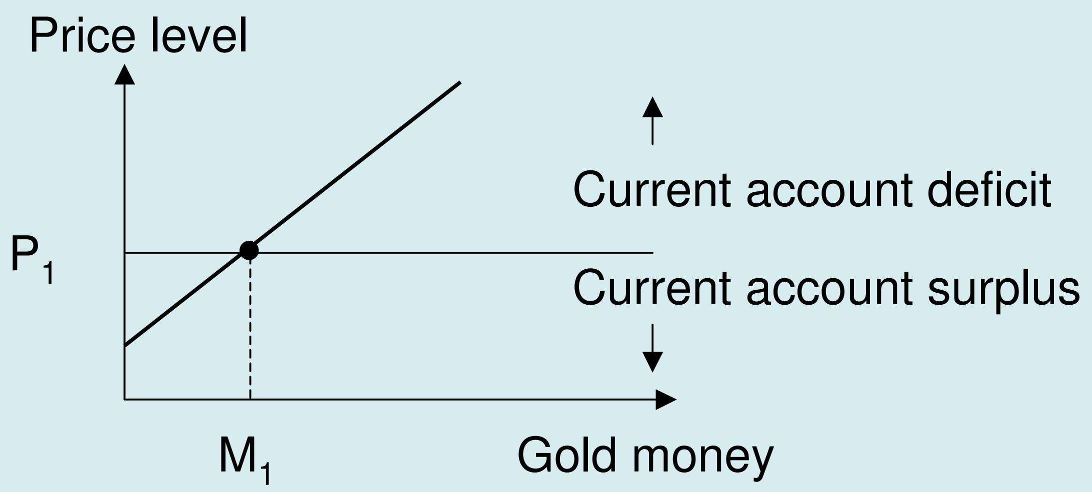


The Gold Standard and Hume's Mechanism: The Trade Account

- The price level affects the trade balance:
  - if domestic prices are high relative to foreign prices, we have a deficit
  - conversely, relatively low domestic prices lead to a trade surplus.

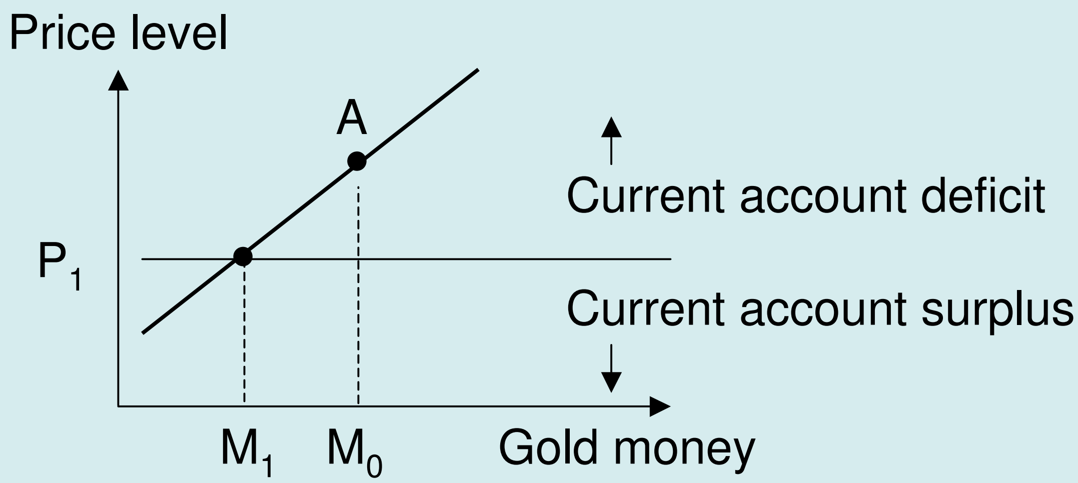
The Gold Standard and Hume's Mechanism: The Trade Account

- Trade balance is achieved when the stock of money is $M_{1.}$



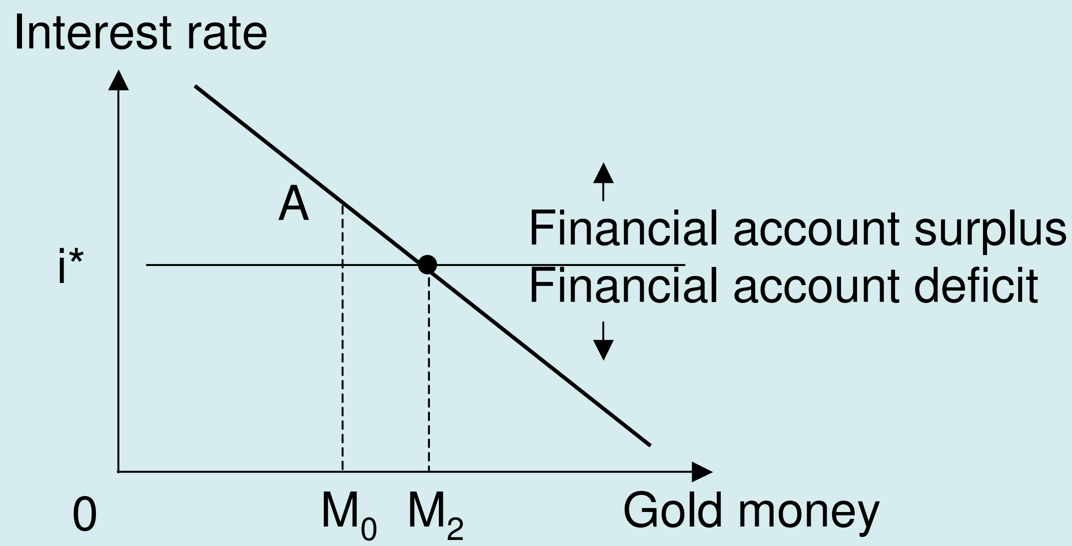
The Gold Standard and Hume's Mechanism: The Trade Account

- Hume's mechanism: return to balance is automatic:
  - if we start with deficit (point A, high money stock M_0), money flows out until we get back to balance.



The Gold Standard and Hume's Mechanism: The Trade Account

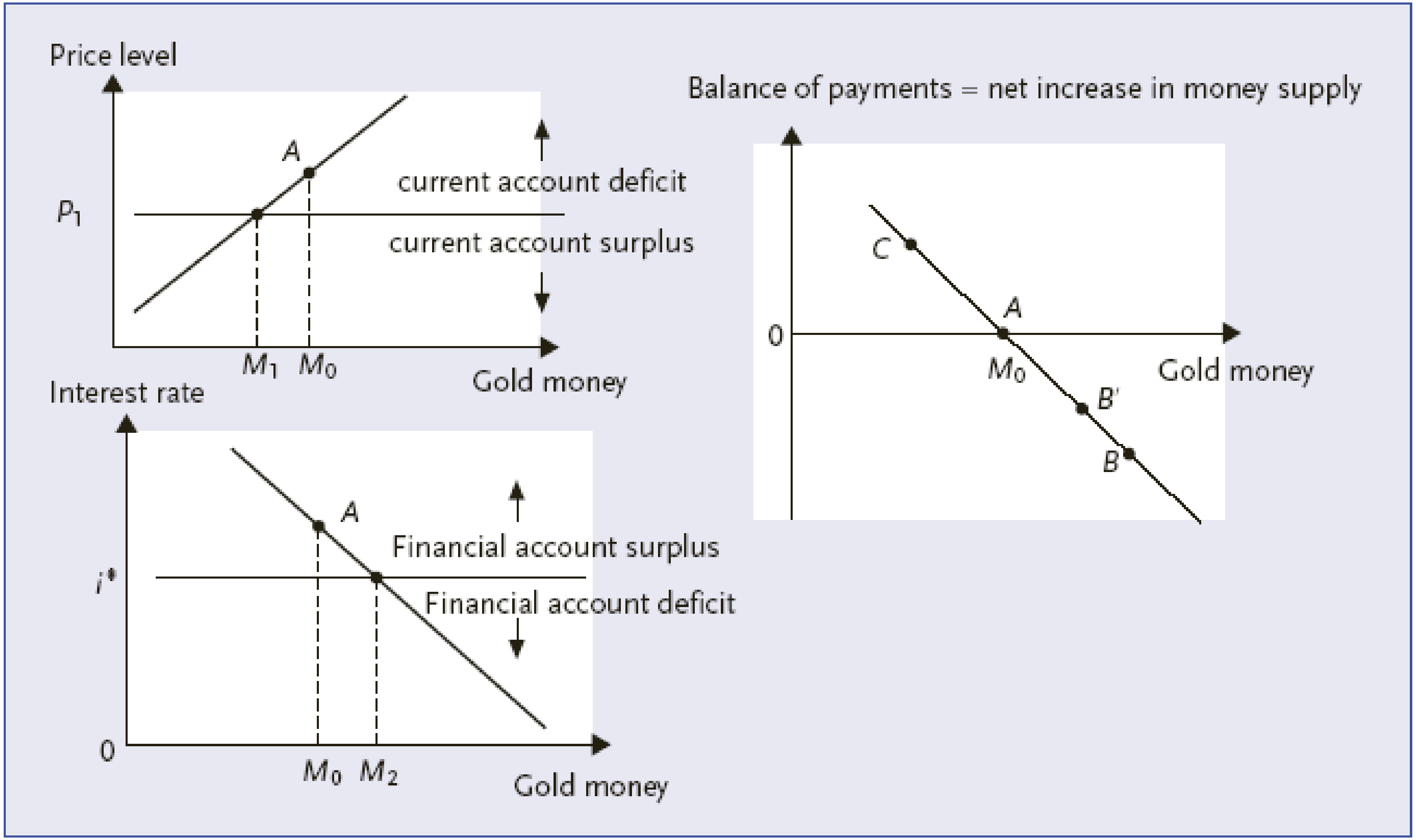
- Much the same story applies to the financial account: if the domestic interest rate is high (low), capital flows in (out) and the return to balance is automatic.



The Gold Standard and Hume's Mechanism: The Trade Account

- The balance payments adds the current and financial accounts.

Hume's Price-Specie Mechanism



The Interwar Period: The Worst Of All Worlds

- Paper money starts circulating widely.
- Yet the authorities attempt to carry on with the gold standard but:
  - no agreement on how to set exchange rates between paper monies
  - an imbalanced starting point with war legacies
    - high inflation
    - high public debts.

The Interwar Period: Three Case Studies

- The British case: a refusal to devalue an overvalued currency breeds economic decline.
- The French case: devaluation, under-valuation and beggar-thy-neighbour policies, until others retaliate and the currency becomes overvalued.
- The German case: hyperinflation, devaluation and, finally, evading the choice of an appropriate exchange rate by resorting to ever-widening non-market controls.

Lessons So Far

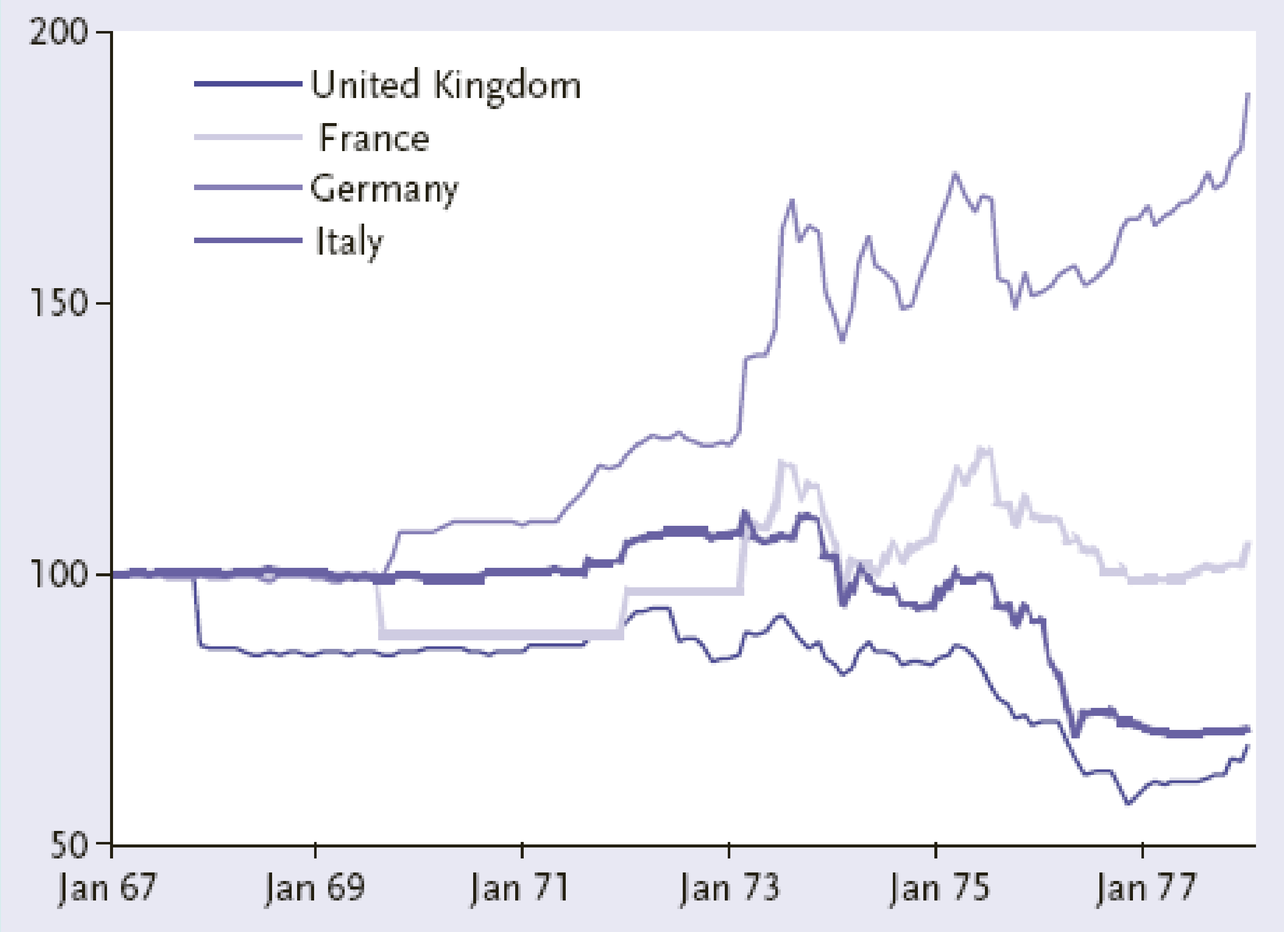
- We need a system, one way or another.
- The gold standard – monetary unions – delivers automatic return to equilibrium, but at the cost of booms and recessions.
- No agreement leads to misalignments, competitive devaluations and trade wars.
- Agreements require ‘rules of the game’, including a conductor.

European Postwar Arrangements

- An overriding desire for exchange rate stability:
  - initially provided by the Bretton Woods system
  - the US dollar as anchor and the IMF as conductor.
- Once Bretton Woods collapsed, the Europeans were left on their own:
  - the timid Snake arrangement
  - the European Monetary System
  - the monetary union.

The Bretton Woods System Collapse

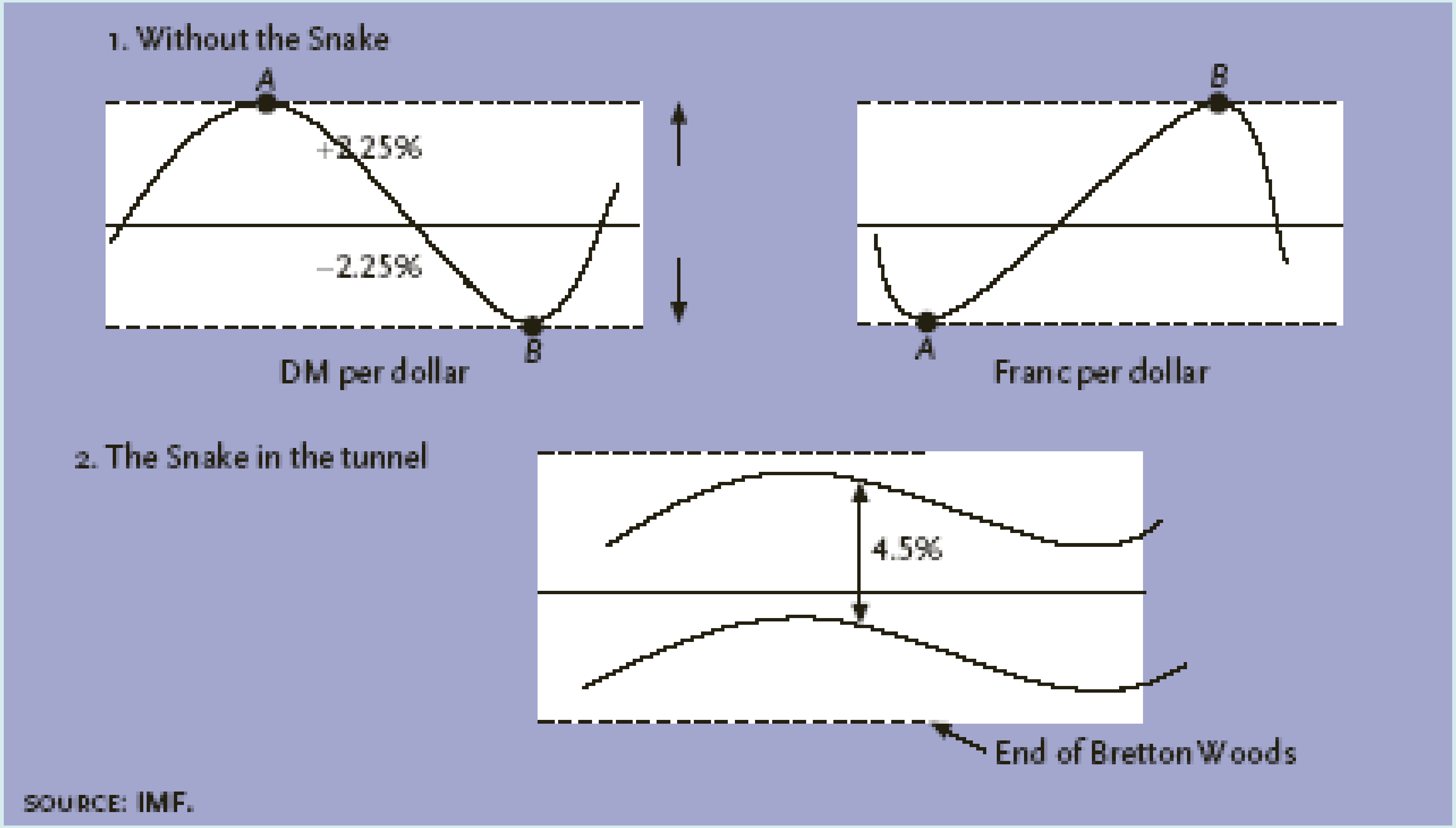
- Initial divergence.



The Snake Arrangement

- Agreeing on stabilizing intra-European bilateral parities.
- No enforcement mechanism: too fragile to survive.

The European Snake



The EMS: Super Snake

- Complements bilateral exchange rate commitments with a support mechanism.
- Allows for prompt realignments to avoid misalignments.
- Emergence of the Deutschemark as the system’s anchor.

Lessons From History

	Gold Standard	Inter-war	Bretton Woods	EMS	EMU
Long-lasting misalignments must be avoided	✓		✓	✓	
Systems need to be built coherently	✓		✓	✓	✓
Policy misbehaviour must be ruled out					✓
Systems must be robust				✓	✓
Any monetary system needs a conductor	✓		✓	✓	✓

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