The Economics of European Integration

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Chapter 13

A Monetary History of Europe
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.

Balance of payments = net increase in money supply
The Gold Standard and Hume’s Mechanism: The Trade Account

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

\[\text{Price level} \quad \uparrow\]

\[\text{Gold money} \quad \rightarrow\]
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 $M_1$. 

![Diagram showing the relationship between price level, current account deficit, current account surplus, and gold money.](image-url)
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.

![Diagram of Interest Rate and Gold Money](image-url)
The Gold Standard and Hume’s Mechanism: The Trade Account

- The balance payments adds the current and financial accounts.
Hume’s Price-Specie Mechanism

Price level

current account deficit

current account surplus

Interest rate

Gold money

Balance of payments = net increase in money supply

Financial account surplus

Financial account deficit

Gold money

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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

1. Without the Snake

2. The Snake in the tunnel

Source: IMF.

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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

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Gold Standard</th>
<th>Inter-war</th>
<th>Bretton Woods</th>
<th>EMS</th>
<th>EMU</th>
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