HISTORY • by Gerard Lyons

Survival depends on political union

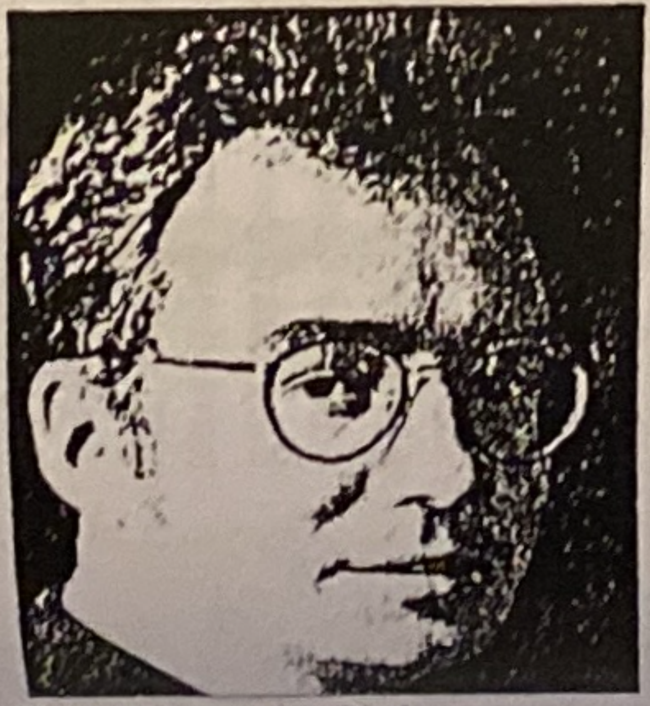
The lessons of history suggest that the success of Emu is far from guaranteed

The European economic and monetary union (Emu) may need to become a political union to survive. This is one lesson from a historical analysis of monetary unions in the 19th and 20th centuries. Monetary unions of large sovereign nations which do not have political union eventually fail, sometimes after a long time.

Politics has been the driving force behind Emu. Since the Luxembourg prime minister presided over the Werner Report in October 1970, the irreversible fixing of exchange rates has been a central objective in European economic policy. Yet, even in 1970 it was not a new idea. A century ago Europe was also dominated by the desire for currency stability and the experience then suggests Emu's success is far from guaranteed.

Monetary unions can be divided into four categories, as shown in the table.

The first category is where political union has ensured the monetary union's success. Many examples fit this category.



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nomic and political stability and common policy objectives. The suspension of the gold standard at the outbreak of the first world war led to volatility in real exchange rates and provided the trigger for the gradual col-

bank in 1871 and the introduction of the mark in 1876. The collapse came at the outbreak of the first world war.

The fourth category is a temporary monetary union that survives for a long time without political union but eventually collapses. The Latin and Scandinavian monetary unions from last century are examples.

The Latin monetary union was formed in 1865 between France and the closely linked economies of Belgium, Italy and Switzerland. Greece joined in 1868. It was a bimetallic union, initially based on silver and then on gold. The precious metal standard, common in old unions, reflected a commitment to fiscal conservatism and small balanced budgets. This union ran alongside Germany's monetary union until the first world war.

Denmark and Sweden almost joined the Latin monetary union but did not, because of the Franco-Prussian War. Instead, they formed the Scandinavian currency union, which Norway joined in 1875. This was the most stable of all the unions, benefiting from economic and political stability and common policy objectives.

Recent monetary unions

Still surviving but with political union	
British monetary union between England and Scotland	From 1707
Italian monetary union	From 1861
US Federal Reserve system	From 1913
German unification	From 1990
Still surviving without political union	
Belgium-Luxembourg union	From 1923
West African CFA franc zone	From 1948
Failed once political system collapsed	
German monetary union	1857-WW1 (First World War)
The Soviet system	1917-1993
Temporary monetary unions	
Latin monetary union	1865-WW1*
Scandinavian currency union	1873-1920
Other currency pegs	
Gold standard	1870-1931/36
Bretton Woods	1944-1973
ERM	From 1979
Asian currency crisis	1997

* Link changed from silver to gold in 1878

example is German unification. Longer lasting is last century's Italian monetary union, which followed political unification in 1861. The example Emu may try and emulate is the US Federal Reserve, established in 1913 as a decentralised system. The setting of twin policy mandates for the Federal Open Market Committee, as well as accountability to Congress, have ensured a credible yet flexible monetary policy. This has been supported by flexibility in the labour market and in fiscal policy, helping to create the conditions for employment growth that Europe has been unable to match.

Second, monetary unions of small countries can survive without political union, provided there has been economic convergence. Two examples are the 1923 Union between Belgium and Luxembourg and the CFA franc zone in west Africa, which has survived from 1948, helped by a substantial devaluation in 1994 following disappointing economic performance.

The third category is where the survival of the monetary union is dependent on the political system. Once the political system binding it together collapses the monetary union fails. One example is the collapse of the Soviet system, another is the failure of the 19th century German monetary union. This was one of three monetary unions which coexisted across Europe a century ago, the other two without political union. All three survived for some time.

There is a common perception that political union preceded German monetary union in the 19th century. Yet, many elements of monetary union were in place following the creation of the Zollverein in 1834, which removed all internal tariffs and created a single market, prior to German political union in 1871. Then followed the formation of the Reichs-Union in 1920.

The lesson is monetary unions of politically independent, large sovereign nations can fail, particularly when there is an external shock, causing the economic environment to change. It is easier for unions to survive when the economic cycle is favourable. The long time during which both the Latin and Scandinavian unions survived demonstrates the importance to withhold judgment on the success of a union, until its performance can be judged in an economic downswing or when there is a deflationary shock.

There is also a fifth relevant category for Emu. This is the lesson from currency pegs or other systems. The lesson from the gold standard, Bretton Woods or even the exchange rate mechanism (ERM) is the need for flexibility, particularly when currency systems are attempting to bind together economies whose cycles and structures are different. The ERM worked well in its first phase, from 1979-87 because the system was flexible, with 11 frequent realignments. The second phase between 1987-92 appeared to work well. There was only one realignment, when the lira moved to a narrow band. Yet all that happened was that problems built up below the surface. Nominal exchange rates did not change, but real rates moved badly out of line, providing the catalyst for the system's near collapse in September 1992. Flexibility is important for any currency system.

Last year's Asian currency crisis was the latest example of the clash between domestic and external needs. Previous experience of monetary unions in Europe is that they can last for some time, but ultimately, Emu must become a political union to survive.