The future of EMU - what does history tell us?

The collapse of the European Exchange Rate Mechanism (ERM) underlined the long term fragility of fixed exchange rate regimes. Second generation models of currency crisis highlight that speculative pressure may increase on a certain currency if a government faces a strong incentive to abandon the fixed peg in order to set policy in tune with domestic objectives.

Full monetary union is one solution to the fallibility of fixed exchange rate systems. This entails greater commitment, and it is harder to leave a system when the domestic currency must be reinstated and a central bank or monetary institutions need to be rebuilt and gain credibility. However, just because the costs of abandoning membership of a single currency are higher than leaving a fixed exchange rate system, they might not be insurmountable. If a particular country is subject to an idiosyncratic shock requiring an independent policy remedy then commitment to the single currency can still be tested.

Bordo and Jonung (*The Future of EMU: What does the history of monetary unions tell us?*, NBER working paper 7365, September 1999) assesses the sustainability of the European single currency from the perspective of monetary unions formed and dissolved in the past. In doing so an important distinction is made between monetary unions that are formed nationally (between the regions of the same nation) compared to those formed multinationally (between different nations).

Table 1: The creation and dissolution of monetary unions

Monetary union	Time of creation	Time of dissolution	Causes of dissolution
National monetary unions			
USA	1789-92	-	-
Italy	1861	-	-
Germany	1875	-	-
Austria	-	1919-27	Defeat at war, creation of several new nation states
Russia	-	1918-20	Creation of several new nation states
Soviet Union	-	1992-94	Political unrest, creation of several new nation states
Yugoslavia	-	1991-94	Political unrest, civil war, rise of new states
Czechoslovakia	-	1993	Political divergence, rise of new nation states
Multinational monetary unions			
Latin monetary union	1865	1914-27	Divergent monetary policies
Scandinavian monetary union	1873-75	1914-24	Divergent monetary policies

Source: Bordo and Jonung (1999)

Monetary unions at the national level tend to follow as the process of political reunification (USA, Germany, Italy). However, economic considerations are also important, including the reduction in transaction costs, gains from trade, access to wider markets and harmonisation of prices. Multinational monetary unions have tended to arise between countries which share a common history, language, culture and religion. The Latin monetary union consisted of France, Belgium and Switzerland, and the Scandinavian monetary union between Norway, Denmark and Sweden.

Break-ups have also tended to be politically driven, although it is noted that many political tensions are driven by economic differences. Bordo and Jonung argue that currency unions which evolve along national lines tend to have higher chances of survival than those formed multinationally. This is because nation states are better at developing institutions and mechanisms to resolve economic and political conflicts. Many of the successful monetary unions (USA and Germany) have arisen through a federal structure. This enables transfer payments to ameliorate inequalities, and also for cultural tensions to be moderated by allowing regional sovereignty.

A number of potential fault lines are identified for EMU, and most notably the authors do not believe the Euro area to constitute an optimal currency area. However, they view EMU as being developed along national lines. Harmonisation in taxes and spending and the development of social institutions and laws are seen as important steps in building a political union. Also, unlike previous examples of monetary unions, a single central bank (European Central Bank) has been established which makes it harder to jettison the single currency once adopted than if national central banks remain in existence. The Maastrict treaty does not allow the provision to re-establish national currencies.

Political will though is important. National sovereignty will override the Maastrict treaty if push came to shove. Bordo and Jonung accept that sometime along the line an idiosyncratic shock will hit the Euro area, and in such a case the break up of the union is a possibility if the political will to remain in the monetary union evaporates as a result of economic or political tension.