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Discipline or international balance: the choice of monetary systems in Europe

Jonas Ljungberg\textsuperscript{a} and Anders Ögren\textsuperscript{b}

\textsuperscript{a}Economic History, Lund University, Lund, Sweden; \textsuperscript{b}Economic History, Uppsala University, Uppsala, Sweden

\textbf{ABSTRACT}

In retrospect and erroneously the nineteenth century international gold standard was interpreted as a quest for monetary discipline. The discipline argument was introduced after WWI in support for a restoration of the gold standard. The interwar failure led to an emphasis on international balances, the argument which came to the fore in the preparations for the Bretton Woods system. The balance argument was central in the early discussions of monetary union in Europe, but with the criticism of Keynesianism the discipline argument became determinant in the design of the Economic and Monetary Union.

\textbf{KEYWORDS}

Bretton Woods; EMU; Exchange rates; Gold standard; International monetary regimes

\textbf{JEL CODE}

B17; B27; F31; N13; N14

1. Introduction

The purpose of this paper is to disentangle the economic arguments for choosing specific monetary arrangements at certain historical junctures in Europe since the nineteenth century, with more specific focus on understanding the reasons for the design of the Economic and Monetary Union (EMU). There is a large literature on the creation of the EMU but it primarily deals with the political economy or negotiations, while allocating a secondary role at best to the economic ideas (e.g., Dyson 1994; Dyson and Featherstone 1999; McNamara 1998; James 2012). Our argument is that paradigmatic shifts in economic thinking have been decisive in shaping different monetary arrangements.

In retrospect, it seems as if a pendulum has swung between two major lines of argument. One argument is that the choice to adhere to an international fixed exchange rate system in itself not only signals, but also fosters, monetary discipline to the extent that international long term imbalances can be avoided. The other view argues that such long term imbalances may indeed arise under any international fixed exchange rate system. Unless the market, through capital flows, corrects such imbalances between surplus and deficit countries, an institutionalised lender of last resort is
required. Such imbalances are caused by divergences in price and cost trends, which typically arise due to structural differences between countries at different income levels. If not adjusted by exchange rate changes, imbalances will remain and put the fixed exchange rate under stress.

The implications of the arguments are quite different. The “discipline argument” views exchange rates as a nominal phenomenon. Accordingly the “discipline argument” favours rule-based monetary policy under a fixed exchange rate, and requires that nations adjust with the help of their domestic policies, which usually force countries with a deficit in their current account into “internal devaluation”. In short, adhering to “monetary discipline” will solve the issue of long term imbalances. The argument about the problem of imbalances, the “balance argument,” sees the nominal exchange rate as a tool for adjustment, either by floating and more continuous adjustment, or by “pegged but adjustable exchange rates”. Lacking the possibility to adjust the exchange rate in an international monetary system implies the need for an international lender of last resort to overcome the problem of imbalances. Cooperation between central banks provided such a function at critical moments under the classical gold standard (Eichengreen 2019). Efforts to provide an international lender of last resort largely failed during the interwar periods (Kindleberger 1973), but in the post-war period the International Monetary Fund has taken the lead in that function.

We critically discuss the economic arguments for the choice of the monetary regime at four different junctures of an international or European context. The first was during the formation of the gold standard. The second was in the interwar period. The third was in the formation of the Bretton Woods system. The fourth was during the road to the EMU. We stop at Maastricht because at this point the blueprint for the new system was completed. Our emphasis is on the first and fourth junctures, where crucial voids pertain to received views.

A retrospective interpretation shows that the pendulum between the “discipline argument” and the “balance argument” can be traced at least since the implementation of the classical international gold standard in the late nineteenth century. But whereas the classical gold standard in retrospect has been interpreted along the lines of the “rules of the game” thus signalling a disciplinary regime, the argument about “discipline” did not guide contemporaries in the implementation of the international gold standard—on the contrary, other considerations led to the choice of gold. But in the 1920s the discipline of fiscal prudence had echoed through the international conferences making its mark on how the classical gold standard was interpreted. The interwar restoration of the gold standard was based on this interpretation of the monetary regime as a disciplinary force solving the issue of international imbalances. This again changed in the preparations for the Bretton Woods system. Instead of fiscal discipline the problem of international imbalances and the aim of full employment were major concerns. This awareness of the balance problem – a lesson from the inter-war period – fades away in the theoretical and political discourse in the 1970s and 1980s. Again the idea of a disciplining rule-based monetary policy came to dominate preparations for the economic and monetary union in Europe.

1 Central banks and governments may act as lenders of last resort within the national economies, but considered here is the international scene.
Broadly, the contribution of this paper is fourfold: first, to highlight the paradigmatic differences underpinning international monetary arrangements; second, noting that the argument of the gold standard as a disciplinary device came in retrospect and served purposefully in other junctures; third, showing that the balance argument evolved in the wake of the break-up of the interwar gold standard; and fourth, while a huge literature describes the process towards EMU (e.g., Moravcsik 1998; Dyson and Featherstone 1999; James 2012), including its dependence on neoliberal policies (McNamara 1998; Magnusson and Stråth 2001), we trace its roots in the theoretical critique of Keynesianism and the “monetary approach to the balance of payments.” In particular, we trace the paradigmatic shift in various reports published by the European Commission and uncover the key role of the Optica Reports, not noticed in previous literature. The long-term scope highlights the interplay between ideas and monetary arrangements.

The sources employed for this paper include contemporary literature and official documents, the latter in particular pertaining to post-war European integration.

2. The classical international gold standard

In retrospect the nineteenth century was the century of the gold standard, although most economies were not on gold for most of the century. Conventional wisdom today often refers to the disciplining characteristics for the success of the gold standard as well as why it was instigated (see Bordo 1984). One important line of argument is that countries that joined the gold standard received “a good housekeeping seal of approval” for economic conduct and public debt management which would provide them with access to cheaper international capital. This in turn would be due to the credibility which was inherent in adopting the gold standard (the quote from Bordo and Rockoff 1996; see also e.g., Bordo and Capie 1993, 7–12; Bordo and Kydland 1992; Eichengreen 1989; Giovannini 1995; Meissner 2003).

It is true that the discipline argument for adopting the gold standard was present in the domestic British debate after Britain had suspended convertibility during the Napoleonic wars (see e.g., Moggridge [1972] 1992; Thornton ([1802] 1939) but as we show below this was not the case on the international level half a century later. The focus on Great Britain in research on the gold standards is natural as it was not only the first European country to adopt the gold standard,2 it was also the world’s most important economy during the heyday of the international classical gold standard. But these facts also underline that the British experience of the classical gold standard was far from that of most countries (Ögren and Øksendal 2012a). Britain’s economic position as capital exporter and producer of the world’s high-powered money made it an outlier. Thus we argue that the “internal” domestic arguments in Britain for adopting the gold standard have overshadowed the rationale in the international discussion for adopting gold as an international standard. We thus ask if the establishment of the

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2 Moggridge in his work on the re-adoption of the gold standard in interwar Britain pointed out the fact that Britain de jure and de facto had been on gold since Newton had set a fixed price on gold in 1717. The exception was during the Napoleonic wars, why the Acts in 1819 and 1821 on the return to the gold standard were not debated but seen as the return to ‘normality’. A similar view on the return to the gold standard was held in the aftermath of WWI (Moggridge [1972] 1992, 3).
international gold standard that tookpaste from the 1870s was based on similar ideas concerning monetary discipline that was put forward earlier in the British case.

Among the stylised facts of the gold standard is that it emerged spontaneously as countries joined (Eichengreen 2019; Ögren and Øksendal 2012b). That is only partly true since it was prepared by a whole series of international conferences. The first was in connection with the Great Exhibition in London in 1851, which was followed up at the statistical congresses in Brussels in 1853 and Paris in 1855. The idea was to harmonise money as a unit of account, as a standard of measure. To overcome difficulties in calculating values between full coins and token coins of different currencies, the metric system was pushed by the French delegates and adopted by many countries in the following decades with some notable exceptions, such as the UK. To harmonise measures of money, however, it was also a prerequisite that the content, weight and denominations of coins were aligned between currencies. The 1855 statistical meeting in Paris did not lead to any common plan, but delegates from all countries signed a declaration recommending their respective governments aim for coin conformity. Behind all this was clearly the idea of money as a measure of value that could and should be harmonised in order to remove unnecessary transaction costs in relation to trade.

Discussions and committees continued to investigate the issue and the same claim was again made at the statistical congresses in Vienna 1859 and in Berlin 1863. At the latter, delegates unanimously voted that a common monetary system (metallic content, relationship between silver and gold coins, weights etc.) should be investigated at the national level by each government. From these statistical congresses originated more specific meetings on a common European monetary system. The focus on harmonising measures and weights turned into a quest for universal coinage, not only for European countries but also for the US. A British proposal was launched in Berlin in 1863, suggesting adoption of the metric system, and with four national currencies based on both silver and gold as reference units. Paradoxically the American delegates objected and the proposal fell because of its bimetallism, since “the sentiment for a single gold standard had gained too much headway, especially among the nominally bimetallic states” (Russell 1898, 22).

From today’s perspective, countries might have recognised an advantage in the increased discipline implied by the supposedly narrower gold points compared to silver, but that was not the reason. The context in the 1850s and 1860s was the opposite. In the late 1850s the classical economist John Ramsay McCulloch indeed predicted what would come:

The great increase in the supplies of gold from California and Australia, coupled with the extraordinary demand for silver in India and China, having raised the value of the latter, as compared with that of the former, gold has come into very extensive use as money in France. There seems, indeed, to be little doubt that it will very speedily be as generally used there as in England. Large amounts of French silver currency have been exported; and it will, most likely, become subsidiary to gold, and be employed only in making small payments. (McCulloch 1858, 430)

McCulloch noted that most classical economists had preferred either gold or silver but that favour was divided between the two. One might presume that the gold points
would be narrower than silver points and that the disciplinary effect should have been greater for gold, but in the mid-nineteenth century freight rates for bullion were mostly based on value and not weight, why “the points” should have been similar.

As noted in the quote from McCulloch 1858, gold discoveries in the US had dampened gold prices compared to silver, and silver coins began to be taken out of circulation as agents could make arbitrage profits from the difference in the silver to gold ratio (see also Russell 1898, 47; Flandreau 1996, 879). The step from a silver to a gold standard was less costly than ever, especially as this was one solution to the problem of the outflow of silver coins. Thus, the choice of gold as the international anchor was not a question of increasing monetary discipline as the single focus on the British debate in the early nineteenth century suggest. Discipline was a question of convertibility to any specie, as clarified by J.S. Mill ([1848] 1965, 558) and unbacked paper money was not the alternative to gold.

The formation of the Latin Monetary Union (LMU) was also a result of the inconvenience of silver coins being taken out of circulation due to falling gold prices, plus the problems caused by the different silver content of the coins in the neighbouring countries of Belgium, France, Italy and Switzerland. Clearly France was the driving force behind the union, to which the Vatican and Greece joined in 1867 and Romania in 1868 (Einaudi 2000, 2010). France reached a preliminary agreement with Austria to adapt to the LMU (Royal Commission 1868). France further extended the invitation to join the LMU to Prussia and the US, keeping the latter especially closely informed of the development of the LMU. The USA was also represented by delegates at all meetings that took place, such as in connection with the world exhibition in Paris 1865 where the first session was entitled: “Preparatory Conference Relative to the Establishment of an International System of Measures, Weights and Coins”. This directly aimed at a universal monetary system through the unification of coinage for large parts of Europe and the US.

Again the bimetallic standard, on which the LMU rested with France as the major guarantor of the system, was unwanted in the context of falling gold prices in relation to silver with the disappearance of silver coins as a consequence. In preparation for the 1867 meeting, the French envoy wrote to the delegate of the US that the treaty of the union: “had a sole object, that of putting an end to the abnormal disappearance of fractional silver money.” (Russell 1898, 38–39). However, the wish to apply a pure gold standard to solve this problem raised new problems, most notably what became known as “the silver question”.

The “silver question” was the recognised problem of how the choice of an international reserve metal affected its price. To go from silver and/or bimetallism to gold would mean a precipitous decrease in the silver price when candidate countries jointly began to sell out their silver in a scramble for gold. The problem emulated the features of a “pyramid scheme”, wherein the first movers would gain at the expense of the late movers, and consequently it was deemed that international coordination was needed. Despite its advanced plan for international monetary cooperation, including the switch to gold, the meeting in 1867 did not succeed in a general agreement.

The delegates from Prussia, satisfied with the economic benefits of the progressing integration of the German states, which were operating on a silver standard, hesitated
to take part in the LMU and wanted to be sure they were able to carry out the switch to a gold standard. The delegates from the Scandinavian countries, which were dependent on their trade with the German states and still on a silver standard, awaited the decision of Prussia. Germany itself was in need of standardisation of the currency, still after the currency reform of 1857 there were seven different systems and Alfred Soetbeer, a leading proponent of gold, characterised the German situation as “Münzzerren” (Soetbeer 1869). Also Spain, despite not formally joining the LMU, took part in the negotiations and with a plethora of coins and 8 different monetary systems strived for a standardisation (Sardá 1948; Gaceta de Madrid 1869). However, most importantly Great Britain, the only country except Portugal at the time on a gold standard, now declared they neither had intention of adapting to the LMU system in weights and measures, nor of adopting the metric system (Russell 1898, 73–74).

Even if the meeting in Paris in 1867 did not lead to the instigation of a common currency or currency standard it led countries to change their legislation in order to promote the change to a gold standard; Norway passed a law allowing for gold reserves and in 1869 the Bank of Norway became the first central bank to massively substitute gold for silver. The Swedish parliament, which controlled Riksbanken, the Swedish central bank, also in 1869 decided to allow gold to be recognised as legal part of its reserves (Ögren 2006, 72). Special committees in Sweden and Denmark, set up as a result of the meeting, laid the foundations for the switch to the gold standard and the formation of a Scandinavian Currency Union (SCU) in 1873, which Norway joined in 1875 (Ögren 2019; Russell 1898, 103; Talia 2004).

In reality the switch to the gold standard was not particularly dramatic, because most countries were already on some kind of specie standard, if not gold either a silver standard or a bimetallic standard. In the same way as there is a tendency to explain the emergence of the international gold standard with the British dominance, there is a general idea that a single specie standard was the preferred solution because it was economically superior to a bimetallic standard (Bordo 1984). The fact that the aforementioned gold findings, which McCollough referred to, had led to decreased gold prices in relation to silver, and thus hoarding of silver coins that disappeared from circulation was seen as an illustration of the problems inherent in the bimetallic standard. There were, however, influential economists who argued for the advantages of the bimetallic system. One of those was the French scholar Louis François Wolowski.

Wolowski argued that it was in fact the bimetallic standard that had made the adoption of the large gold quantities into monetary circulation possible without causing too aggravated disturbance in general prices. The reason for this was that with a bimetallic system, as long as both silver and gold were legal tender at a fixed price ratio, the one metal not falling in value would act as a “parachute” for the other (Wolowski 1870, 72, 100). Thus, bimetallism had the advantage of being more stable than a single specie standard, or in the words of Wolowski:

I would not like to impinge on a question that has been submitted to another commission, the issue of the two metals gold or silver, but in passing I will emit the opinion very firm, very clear, that the stability of prices has meant that many countries,

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3 This is the stylized fact, but according to the Royal Commission (1868, ix) also Turkey and Brazil were on a single gold standard.
and France in the lead, have maintained the two metals to fulfil the role of [monetary] circulation. The coexistence of silver and gold used as intermediaries in trade have prevented the violent [price] variations that necessarily would have occurred in one way or another, if one of the two metals exclusively had served all over the world as intermediary for transactions in trade. One metal has served as the parachute to the other.4 (Wolowski 1870, 100 – translated by the authors)

To his mind the idea was not about a bimetallic monetary standard, which he viewed as impossible to implement as the double standard already was “condemned everywhere”, it was instead about a “double legal standard” (Wolowski 1870, 73). The problem with bimetallism was not because a single standard was easier to manage, but because there was no internationally uniform legal fixed exchange rate between silver and gold. If there had been, the problems of the leakage of silver coins would not have occurred (Wolowksi1870, 77).

Reviving Wolowski’s “parachute theory”, Flandreau (1996, 866) – although with no mention of Wolowski – showed that France’s bimetallic standard indeed did work as an inbuilt stabiliser in accordance with Wolowski’s idea. This was why France had been able to successfully keep the bimetallic standard for 65 years. So even if Germany sold silver, it was only when France, as a way of getting back at Germany, stopped buying silver in 1873 that silver prices fell and French bimetallism ended (Flandreau 1996; Oppers 1996). Contemporary discussions referring to Wolowski’s “parachute theory” in relation to the emergence of the international gold standard underlines that these monetary mechanisms were indeed observed and understood by economists and policy makers also at the birth of the international gold standard. Wolowski’s theory was for instance discussed in depth by the the Swedish parliament’s preparatory committee for the switch to the gold standard (Betänkande 1870). Even in Great Britain bimetallism was debated in the 1870s and 1880s (Moggridge [1972] 1992, 4 footnote 1). Jevons the marginalist wrote in a letter to Wolowski that he found arguments for silver or bimetallism strong: “in theory… But in the practical aspect the subject looks very different, and I am inclined to hope for the extension of the single gold standard” (Jevons [1868] 1884, 306).

Unlike the claim found in the British debate on the re-adoption of the gold standard in the aftermath of the Napoleonic wars in the 1820s, which has been promoted in more recent influential work on the emergence of the international gold standard (Bordo 1984), gold was not seen as a superior anchor due to its disciplinary effect in the contemporary international debate. Neither bimetallism, nor gold or silver were seen as having specific features that meant that any metal served better as an anchor than the others. Most international transactions were carried out without specie transfers, and this had been the case since long before the international gold standard (see for instance Michie 1998; Ögren 2016).

4 “Je ne voudrais pas empiéter ici sur une question qui est soumise à l’examen d’une autre commission, la question des deux métaux de l’or et de l’argent mais en passant j’émettrai l’opinion très ferme, très nette, que la stabilité des prix a tenu à ce que beaucoup de pays, et la France en tête, ont maintenu les deux métaux pour remplir l’office de la circulation. La coexistence de l’argent et de l’or employés comme intermédiaires des échanges a empêché les variations violentes qui se seraient produites nécessairement dans un sens ou dans l’autre, si l’un des deux métaux avait exclusivement servi dans le monde entier d’intermédiaire aux transactions aux échanges Un métal a servi de parachute à l’autre.”
Another advantage was related to the quest for an international monetary standard, a bimetallic standard would make it easier to incorporate different economies whether on silver or on gold. In Wolowski’s opinion an international money would be accepted successively, as was already the case with the LMU, while the cost of radically changing monetary regime would be higher than the advantages (Wolowski 1870, 74). In his analysis the key to an international money was not lying in the British decision to join or not, it was instead the decision of the German states that was crucial. Since the Northern German states were connected to Northern Europe and Scandinavia, while the Eastern and Southern region was closely linked to Austria, whatever standard that would be chosen by the German states – be it silver, gold or bimetallism – would be adopted by these countries orbiting Germany. Wolowski was right about the importance of Germany for the choice of an international monetary standard. While he made his analysis in 1865, the choice made by Germany in 1871 to adopt the gold standard spawned the movement towards gold in Europe (and elsewhere), which is demonstrated by the fact that when Germany decided to go on gold, countries with important economic ties to Germany followed suit within a few years. The importance of the German decision illustrates what has been shown by Meissner (2005) that the single most important reason for countries to join the gold standard was the choice of their trading partners measured by GDP, meaning that if an important country joined others followed suit. This suggests that the argument for joining the gold standard first and foremost was about avoiding exchange rate related risks and transaction costs in trade. Nevertheless, the idea of the classical gold standard as implemented for its disciplinary role has been prevalent in descriptions of the classical gold standard in retrospective.

The adoption of the international gold standard was thus a result of historical events and political decisions, not of any quest for its disciplinary role. The theoretical idea about gold as the superior anchor in terms of monetary policy and international adjustment, put forward by Wicksell’s (1898) thesis from 1898 Geldzins und Güterpreise, emanated after the international gold standard had been established.

3. Monetary arrangements in the interwar period

One of the most influential accounts of the working of the classical gold standard is the intermediate report in 1918 by the British Cunliffe committee. The task of this committee was to investigate the way to organise the monetary system in its transfer to normality after WWI. Clearly the committee did not consider any other possible regimes than a return to the gold standard as it was perceived to have worked before from a British perspective, or to quote Moggridge:

Throughout its discussions, the Committee assumed that Britain would return to the gold standard at pre-war par, and members of the Committee and witnesses did not question this assumption by either considering alternative gold standard rates or alternative currency policies. (Moggridge [1972] 1992, 18)

Thus the focus of the report was the re-adopted of the gold standard, as it was believed to have worked in the pre-WWI period. The report established what became the conventional wisdom on how the gold standard worked: it was guaranteed by the currency’s fixed exchange rate into gold and managed by the Bank of England’s
discount changes to steer gold flows in accordance with the price specie flow mechanism, whereby trade imbalances were settled by shipments of gold and currencies (Eichengreen 2019, 24). The report also noted the problem of a “permanently adverse trade balance” but argued that this would also be taken care of by alterations in the Bank’s discount rates as this “led to a general rise of interest rates and a restriction of credit.” This rise in the interest rates would in the end cause an internal devaluation by making domestic prices fall and correct the deficit in the current account (Cunliffe Committee 1918, 2–7). Thus, the Cunliffe Committee clearly advocated a strategy of internal devaluation, which in turn was a consequence of the discipline argument. This, in essence, is what Eichengreen and Temin (2000) have coined as the gold standard mentality, which gained hegemony in economic policy thinking not only in Britain but on the Continent as well.

The Cunliffe Committee reports (the preliminary in August 1918 and the final in December 1919) read like a blueprint of the theoretical construction of how the gold standard worked from the British perspective. The reports, naturally, also concerned British interests. They were meant to facilitate trade and exchanges and, more importantly, to preserve London’s position as a financial centre. They even included a step to centralise gold reserves in the Bank of England, first nationally but also internationally. The gold standard was a necessity as it would guarantee a stable currency that was instrumental for trade and financial markets:

We have found nothing in the experiences of the war to falsify the lessons of previous experience that the adoption of a currency not convertible at will into gold or other exportable coin is likely in practice to lead to overissue and so to destroy the measure of exchangeable value and cause a general rise in all prices and an adverse movement in the foreign exchange. (Chancellor of the Exchequer, Mr Chamberlain, on presentation of the Final Cunliffe Report, as quoted in Federal Reserve Bulletin 1920, 142)

The focus on the gold standard as a force for monetary discipline to curb over-issuance of notes and the concomitant volatility of exchange rates was clearly a response to inflation with an un-backed currency during the war. To make the gold standard work as before, countries should again allow free gold flows, fix their currency to gold, put a limit on fiduciary issue and reduce government spending. The aim to return to the pre-war gold parity complicated the task, however, and caused a delay in return. Complications were raised by issues related to war debts and reparations, and the differences in price levels compared to 1914.

The difficulties were reflected by the international financial committee of the League of Nations in Brussels 1920. Although the financial committee shared the aim of a return to gold, it did not suggest a quick fix. It was recognised that the debt problem had to be solved, and that this was the responsibility of each participating nation. The lack of an anchor, such as gold, was part of the problem. The different needs of the participating nations made the resolutions adopted inconsistent in monetary and financial issues. Readopting the gold standard was stated in paragraph VIII of the “Resolutions proposed by the commission on currency and exchange” and adopted unanimously by the conference: “It is highly desirable that the countries which have lapsed from an effective gold standard should return thereto.” (League of Nations 1922, 225). There was a general fear that monetary issuance and credit creation would
continue to increase and feed an inflationary spiral without the gold standard. Further, it was agreed that inflation prevented recovery and the achievement of price stability.

Where this additional currency was procured by further ‘inflation’ [i.e., by printing more paper money or creating fresh credit] there arose what has been called a vicious spiral of constantly rising prices and wages and constantly increasing inflation, with the resulting disorganization of all business, dislocation of the exchange, a progressive increase in the cost of living, and consequent labour unrest. (League of Nations 1922, 223)

On the other hand, the following paragraphs IX to XII all concerned the difficulties of returning to gold, stating:

It is useless to attempt to fix the ratio of existing fiduciary currencies to their nominal gold value, ... The reversion to, or establishment of an effective gold standard would in many cases demand enormous deflation ... Deflation, if and when undertaken, must be carried out gradually, and with great caution; otherwise the disturbance to trade and credit might prove disastrous ... We cannot recommend any attempt to stabilize the value of gold and we gravely doubt whether such attempts could succeed ... We believe that neither an International Currency nor an International Unit of Account would serve any useful purpose or remove any of the difficulties from which international exchange suffers to-day. (League of Nations 1922, 225)

These points show a serious concern about the ability to return to gold in the prevailing circumstances, and this was stated by the conference in 1920, before the deflationary crisis in 1921–22 - a severe crisis which can largely be attributed to some countries’ attempts to reinstate the gold standard. It was particularly the deflationary strategy of the Cunliffe Committee that evoked criticism among contemporaries. The Swedish economist Gustav Cassel was maybe the most persistent and in a series of publications (e.g., 1918, 1920, 1923) warned for the effects of deflation and suggested an international arrangement around a “centre of stability” based on the existing dollar-pound exchange rate (Cassel 1923, 260). Keynes held similar critical views, although he advocated a drastic rise of the discount rate in early 1920 and first with A Tract on Monetary Reform (1923) presented a more comprehensive criticism (Howson 1973, 463 n; Moggridge and Howson 1974). Like Cassel, Keynes saw the stability of the internal price level, as opposed to the external exchange, as the prime aim:

Of all the omissions from the Cunliffe Report the most noteworthy is the complete absence of any mention of the stability of the price level; and it cheerfully explains how the pre-war system, which it aims at restoring, operated to bring back equilibrium by deliberately causing a “consequent slacking of unemployment.” The Cunliffe Report belongs to an extinct and almost forgotten order of ideas. Few think on these lines now; yet the Report remains the authorised declaration of our policy, and the Bank of England and the Treasury are said still to regard it as their marching orders. (Keynes [1923] 2017, 107)

The debate on restoration of the gold standard concerned domestic issues rather than problems of international balance. Internal versus external stability was indeed the issue of the debate, but it meant price stability versus exchange rate stability, for the individual nations. Only in a passage of A Tract Keynes favoured a “managed currency” in a way that anticipated later views on the balance problem:

A fluctuating exchange means that relative prices can be knocked about by the most fleeting influences of politics and sentiment and by the periodic pressure of seasonal
trades. But it also means that this method is the most rapid and powerful corrective of real dis-equilibria in the balance of international payments arising from whatever causes, and a wonderful preventive in the way of countries which are inclined to spend abroad beyond their resources. (Keynes [1923] 2017, 89)

The Cunliffe report had plead for a return “without delay” but to restore exchange rates was not a swift affair and the difficulties prepared for compromises in the resolutions of the Genoa conference 1922. Thus, the aim to bring down the value of gold to the old parity was avoided for the aim to restore the exchange rates between major currencies and peg others at depreciated rates. This meant a gold exchange standard with not all currencies directly convertible to gold and limited the need for gold. However, not even the Genoa resolutions could provide the basis for concerted action. Strangely, countries facing the largest obstacles for a return were the most dogged to the old order. Ralph Hawtrey, of the British treasury, complained in *Economic Journal*: “Some countries, whose currencies are at less than half their pre-war gold parities, are nevertheless extremely unwilling to give up the prospect of restoring them. France, Belgium and Italy all took this attitude at Genoa.” (Hawtrey 1922, 303). The French debate is in detail reviewed by Mouré (2002). There were dissenting critics against the hard-line official policy, but what finally drove France back on gold with the franc at only 20 per cent of its pre-war value was the failure of the government to pay back the debt, accumulated during the war, to *Banque de France*. Inflation continued and the stabilisation, *de facto* in 1926 and *de jure* in 1928, meant a radical devaluation of the franc. Hawtrey and Genoa might seem as a gold standard soft, but the common denominator of the gold standard mentality was nevertheless intact in his indictment of the currency disorder in 1922: “These disorders are due, one and all, to budget deficits. This is true without qualification.” (Hawtrey 1922, 302). Or, as portrayed by Carole Fink (1984, 238) in her account of the Genoa conference: “Both the experts and the Financial Commission discussed the links between smoothly functioning exchanges and the need to settle debts, reparations, and the problems of European peace. Again, the call was for ‘discipline’.”

It is not necessary to repeat the well known story of the breakdown of the gold standard. For Britain and other countries that abandoned gold early in the Great Depression, it was obvious that the solution to the problems of indebtedness and diminishing trade was not a return to the gold standard. Countries that had experienced various degrees of inflation in the early 1920s, such as France and Germany, were more reluctant to leave the gold standard. France had moreover amassed, without monetising, massive gold reserves, and initiated the gold bloc. Germany continued with the fixed exchange rate but implemented controls on both capital and current accounts. In the end the gold standard had to be abandoned as the cost of keeping it was too high (Eichengreen 1992).

The interwar period began with dreams about the resurrection of the nostalgic years before 1914 with the help of the gold standard. The focus was the disciplinary effects of the gold standard, and of fixed exchange rates, but the dreams ended with the nightmare of the Great Depression.
4. Bretton woods and international balance

From an economic point of view it is possible to see the implementation of the Tripartite Agreement in 1936, when France, the UK and the US agreed to help each other to stabilise their respective currencies, as an awakening of insights into the balance problem and hence an anticipation of the discussions that prepared for the Bretton Woods system (Clarke 1977).

Yet, those discussions had already begun. The new international economic regime, as realised with the post-war Bretton Woods system, was outlined in the 1930s. For example, Arthur Salter (1935) suggested that the BIS should handle an international equalisation fund, not very different from what later became assigned to IMF as an international lender of last resort. Salter further addressed the balance problem: “In that case no country would be expected to make the ratio right by deflation... Where the alternative is an increase of Bank rate or depreciation, the latter must be chosen.”  

Indeed, an editorial in *The Economist* had anticipated what became the signum of Bretton Woods, “pegged but adjustable exchange rates”: “A limited power to vary parities may, indeed, be a permanent feature of the new regime.” (*The Economist* 1934)

In the preparations for the post-war Bretton Woods system, the balance problem came into focus. Keynes tried to avoid deflationary traps and at the same time reduce the need for exchange rate changes by making surplus and deficit countries obliged to share the responsibility for achieving international balance. In summary, the argument runs: the less financing the surplus countries were willing to provide and/or willingness to expand, the more flexibility was needed in the exchange rates. Otherwise the outcome would be deflationary and that, in the words of Keynes, would result in the return to “the evils of the old automatic gold standard” (Keynes 1980, 143). Crucial in the British (Keynes) plan, which aimed to guarantee liquidity for international trade, was an international clearing union and a new reserve currency, Bancor, against which the USA (White) proposed a more restrictive plan with a unit of account, Unitas, though in practice with the dollar as the reserve currency (Robinson 1943; Solomon 1982). The final Bretton Woods agreement became, as is well known, a compromise with no clearing union and the US dollar as the reserve currency. Controls on capital accounts should, on the other hand, give more room for national monetary policies under “pegged but adjustable exchange rates.”

Bretton Woods might have looked like a sustainable arrangement in view of American economic superiority and the European “dollar gap” after World War II, and with the need for a European Payments Union (EPU) to get the system fully implemented in the late 1950s. However, the catching-up of Western Europe and Japan in the post-war period meant that the positions as regards the international monetary system were strikingly reversed around 1970 – as predicted by Robert Triffin (1960). While concerns about international imbalances in the 1940s were voiced by the

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5 Similar views were expressed by R.F. Harrod (1937): “The choice is then clear. Does the country prefer to have its balance revaluated in the last resort by controlled and well-ordered movements in its foreign exchange rates or by doses of inflation or deflation having no relation to its internal needs? It can make its choice freely without any arrière-pensée with regard to its effect on the value and status of gold.” Keynes himself, although shortly after Salter (in Lloyd’s Bank Monthly Review, October 1935) also suggesting an international Equalisation Fund to be handled by BIS, was still less explicit yet in favour of a managed currency (Keynes 1982, 364).
Europeans (as represented by the British and Keynes) and talked down by the Americans, it was the latter who proposed a symmetrical arrangement (penalising large surpluses) in the early 1970s, and the Europeans who resisted (Solomon 1982, 242 ff). Reflecting the restoration of the international economy there had appeared, in the post-war period, a new and huge literature on the balance of payments (for example Meade 1951; Fellner, Machlup, and Triffin 1966; Frenkel and Johnson 1976).

The EPU involved all the OEEC countries and was established in 1950 to overcome bilateral trade as long as the European currencies were not convertible, and dissolved when convertibility was achieved by end of 1958 (Kaplan and Schleiminger 1989; Eichengreen 1993). It was thus not aiming for monetary integration, although its “catalyst” or “architect” (so labelled by Carli 1982 and Eichengreen 1993, respectively) Robert Triffin envisioned it as a springboard to monetary unification (Triffin 1953; see also Maes and Bussière 2016; Maes and Pasotti 2018). Triffin saw the European Monetary Agreement of 1955, activated at the close of EPU and aiming to “bolster up the convertibility of European currencies” (Triffin 1957, 220), as a further step for monetary integration, in particular through the creation of the European Fund for balance of payments rescue operations. As will be shown below, this institutionalisation of a lender of last resort leapt as a common thread on one side of the controversies surrounding European monetary integration right up to the Treaty of Maastricht.6

In the early 1970s it was continental countries and not Britain that spoke for Europe. At this time European integration within the EEC, including the vision of a monetary union, was on the agenda. This was reflected in the relations between the USA and Europe as the” Snake in the tunnel“, which should limit intra-European exchange rate fluctuations to half those of the Smithsonian agreement of G10 in December 1971. For global monetary arrangements, these years of the break-up of the Bretton Woods system (finally in early 1973) was a prelude to the easing of exchange rates that has followed – but in Europe it was the beginning of a realisation of old ideas about a common currency that, as seen above, had been debated in the nineteenth century (Giavazzi and Giovannini 1989).

On the initiative of the German Chancellor, Willy Brandt, the EEC Hague summit in 1969 had committed the Werner Report, which was delivered in 1970 as the “Report to the Council and the Commission on the Realization by Stages of Economic and Monetary Union in the Community” (European Commission 1970). The idea of a common currency for the European Community was in the air and it was no coincidence that a proposal came from Willy Brandt. Tensions between the lax monetary policy of the US during the Vietnam war, and the European Community, in particular Germany, were intensifying. The Germans were no longer comfortable with the Bretton Woods pegged exchange rates and were in favour of floating (Emminger 1977;

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6 Maes and Bussière (2016) characterize Triffin as too “utopian” to become really influential in the European monetary integration. This “utopism” can be seen in his inconsistent positions as regards the balance problem. On the one hand, echoing the critics of the interwar gold standard: "Exchange rate adjustments, however, are one of the least damaging forms of adaptation to the disequilibria arising from a divergent evolution of national monetary policies and national price and cost levels. As long as such divergencies persist, exchange rate flexibility should be encouraged rather than discouraged" (1957, 290). But also expounding the discipline argument as a prerequisite for monetary unification: "The participating regions or countries must, in either case, subordinate their internal money and credit expansion to the maintenance of equilibrium in their balance of payments" (1957, 289).
Tsoukalis 1977, 55). Brandt had shortly before the Hague summit been approached, and impressed, by Jean Monnet, the founding father of European integration, who at this time worked closely with Robert Triffin for the promotion of monetary integration, in which they, notably, saw a reserve fund as crucial (James 2012, 70 ff). A first version of the Werner Report was presented in spring 1970 with the goal of achieving economic and monetary union in 1980. “Economic” was primarily motivated by budgetary policy, “the harmonized administration of which is fundamental to the cohesion of the union” (European Commission 1970, 8). Exactly what was meant by a “harmonised” budgetary policy was not made clear but its priority contrasts with the role budgetary or fiscal policy was assigned in the realisation of the EMU through the Maastricht treaty.

The Werner Report was somewhat sketchy, and a more comprehensive analysis was entrusted, by the European Commission in 1972, to a “Study Group on Economic and Monetary Union” which delivered its report in October 1973 (European Commission 1973). The Study Group consisted of 11 distinguished professors, among them James Meade, Robert Mundell, and Herbert Giersch. Irrespective of the variety of the individual views among its members, the report of the Study Group clearly reflected a Keynesian paradigm and it stated that the balance problem was “the central issue in the process of creating a monetary union” (European Commission 1973, 4). Interestingly, the group saw divergence in price and cost trends, which are at the root of the balance problem, not only as caused by different economic policies but also as a consequence of countries being at different levels of income and development. A wide-ranging discretionary economic policy was thus advocated, at the Community level, and should include regional policy, since monetary unification was predicted to exert heavier pressure on economically weak regions.

More controversial was an issue first raised explicitly in the concluding section, namely a quest for “a new concept of parallelism” (p. 60). More concretely this can be seen as connected to the proposal for a prompt issuance of a European parallel currency: “What the Europeans need, and they need it now, is the creation of a substitute for the dollar” (p. 13, italics added). Without addressing the ongoing controversy within the Community between “monetarists” and “economists”, where the former demanded instant reform and the latter economic integration before monetary union (see e.g., Tsoukalis 1977, 90 ff; Dyson and Maes 2016), the Study Group ingeniously tried to find a short cut to monetary unification. “Parallelism” was the compromise, making co-habitation between “monetarists” and “economists” possible by stating that economic integration and monetary unifications should proceed together (see e.g., James 2012, 93). One should notice that “monetarists” represented by the French had little in common with the monetarism of Milton Friedman, for example; they favoured discretionary economic policy, whilst the “economists” as represented by the Germans were strongly leaning towards a rule-based economic policy. The short cut of a parallel currency was also elaborated elsewhere by two members of the Study Group, although with slightly different blueprints (Magnifico 1971, 1973; Mundell 1973). According to Maes ([1998] 2002, 37), “ministry of finance officials and central bankers turned ‘wild’ at these proposals.” Not all did, though. None less than Guido Carli, governor of Banca d’Italia and former president of the European Payments Union, wrote the endorsing foreword to Magnifico’s (1973) plea for a European currency.
The prospects of a European monetary union came to look rather gloomy in the 1970s, however. In 1975 another “Study Group” (15 experts headed by the former vice-president of the European Commission Robert Marjolin) on “Economic and Monetary Union 1980” summarised the situation:

Europe is no nearer to E.M.U. than in 1969. In fact if there has been any movement it has been backward. The Europe of the Sixties represented a relatively harmonious economic and monetary entity which was undone in the course of recent years: national economic and monetary policies have never in 25 years been more discordant, more divergent, than they are today. (European Commission 1975, 1)

The Marjolin Report saw “inflation, unemployment, and balance of payments deficits” (p. 7) as the origin of the menace for the European integration. It is notable that in the outline of proposed measures the Marjolin Report included “action to strengthen the Community element in international financial solidarity” (p. 20) with an Exchange Stabilisation Fund, and a widened role for the European Monetary Cooperation Fund. Such measures, intending to create balance between deficit and surplus countries and to fill a lender of last resort function, were ruled out in the further development of monetary unification. Before delving further into these matters, however, we need to go back in time to sort out the elements and origins of European monetary integration after WWII. It is enlightening to compare the Marjolin Report of 1975 with the Marjolin Memorandum of 1962, which was initiated by the European Commission in order to keep the momentum of early European integration.

5. European integration and the attraction of fixed exchange rates

While Robert Mundell (1961) discussed optimum currency areas in general terms, Tibor Scitovsky (1957) had addressed the problems facing a European common currency before the ink had dried on the Treaty of Rome. Similar to Mundell (1961), he highlighted the balance problems and concluded “that a common all-European capital market and a common European employment policy would be prime requisites of a common currency”. Scitovsky pointed to the economic advantages of larger capital and labour markets but went on, “…quite apart from their being desirable in themselves, these may well be necessary conditions of a common Western European currency, because they would provide the main forces equilibrating balances of payments among members of the currency union” (Scitovsky 1957, 32).

The Treaty of Rome provided a plan for a customs union, but apart from the imperative about “an ever closer union”, the aspects of an economic, monetary and political integration were only described in very general terms. In order to assess the achievements so far and outline a “second step” of the integration, the European Commission (1962) presented the “Marjolin Memorandum” and raised the aim of both an economic and monetary union. The argument of the Commission concerning monetary integration was somewhat similar to the “inconsistent quartet” as later formulated by Padoa-Schioppa ([1982] 1994) – the “inconsistent quartet” in turn is an extended version of the” open economy trilemma”, which says it is only possible to combine two of the three: fixed exchange rates, open capital markets, and independent monetary policy. To these three the “inconsistent quartet” adds free trade. The ultimate
reason for the “trilemma” and the” inconsistent quartet” is the balance of payments, which under a fixed exchange rate require either controls on capital account or a relinquishment of monetary independence. The argument of the Commission was thus that progress towards a customs union, which had already proceeded half-way to its realisation, was a challenge for monetary integration:

Every significant change of exchange rates would thus cause profound turbulence in the commodity trade of the countries that were no longer protected by tariffs, and due to the common guarantee of prices for grains and other agricultural products, also trigger so sudden changes in the price levels of agricultural products and consequently of farmers’ incomes, that the Common Market as such might be questioned. (European Commission 1962, 87 – translated from the German version by the authors)

The argument was, firstly, that member countries could be tempted to resort to devaluations when their industries faced competition from other members in the customs union. The second part of the argument, referring to the Common Agricultural Policy (CAP) which still was under development, did not fully anticipate the CAP’s intricate construction. In want of a common currency, a system with double exchange rates was later introduced with administered “green exchange rates” for products within the domain of CAP. These were, however, complemented with compensatory payments between the member states to make up for the exchange rate turbulence in the 1970s (Morris 1980). Even if there was some resemblance with the” open economy trilemma” in the argument of the Marjolin Memorandum, the balance problem which makes out the basis of the” trilemma” was not addressed. The emphasis was instead on transaction costs and concern about unfair competition within the customs union. There were also political considerations rooted in rivalry with the USA and Britain:

The six countries of the EEC belong finally to a world monetary system built on gold and two important reserve currencies…The creation of a European reserve currency would significantly enhance the contemporary international monetary cooperation. (European Commission 1962, 88 – translated from the German version by the authors)

The Memorandum rested on the progress of the customs union and outlined visions for further integration with a rather technical approach, without much consideration of economic or political complications.

The Marjolin Report in 1975 came in a period of economic crisis and difficulties for the integration process and was the output of a broader “study group.” While taking the visions of economic and monetary integration as given, the outlook of the Report was also much broader, and it tried to identify current and emerging problems and

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7 The dependence of the Common Agricultural Policy on stable exchange rates was also emphasised a few years later in an expert report on “The Development of a European Capital Market”: “With the progressive dismantling of the various impediments to intra-Community trade, in particular customs barriers, economic integration is tending to standardize the price structure within the Community. The decisions connected with the common agricultural policy signify a decisive step in this direction. Because common agricultural prices have been fixed and are expressed in units of account, any modification of exchange-rate relationships between the member countries would have such a heavy impact on the Community’s farming sector that it now seems a very unlikely eventuality.” (European Commission 1966, 285-6)

8 The role of the CAP in the predilection for fixed exchange rates or even a common currency is highlighted by a press conference of the then president of the European Commission, Walter Hallstein, who explained the decision by the Council to fix a common price for cereals, on the night of 22 December 1964, “simply by declaring that the European currency had been born” (Etienne and Ciavarini-Azzi 1979, 441).
ways to proceed. The Report reflected a Keynesian approach, with concerns about imbalances and proposals for an Exchange Stabilisation Fund as well as the empowering of the European Monetary Cooperation Fund. In line with Scitovsky (1957), the Report put much emphasis on regional policy, not only because of existing disparities but also because of expected imbalances in a monetary union. “Supply-side policy” had not made its way into the Report, on the contrary, “a common demand-management policy” was called for (p. 33) and the whole was packed as a federalist project with national governments handing over, not only monetary policy, but also economic, that is fiscal, policy and social policy, to the Community (p. 4, 29), thus further pressing these aspects from the Werner Report.

As regards the economic approach came, however, other winds to dominate in the journey to EMU. The integration process as a whole continued to meet hard headwinds in the late 1970s, until a German-French initiative suggested the reform of the much reduced” snake” into the European Monetary System (EMS). The idea of the Exchange Stabilisation Fund was an element in the proposal but was quietly buried after objections from Bundesbank (Gros and Thygesen 1992, 55ff; Kenen 1995, 6; Eichengreen 2019, 150)9. The EMS aimed to stabilise intra-European exchange rates, but during its first eight years eleven “realignments” were undertaken, in effect collective devaluations against the Deutsche mark (Gros and Thygesen 1992, 68). This was the soft EMS, followed from 1987 by the hard EMS, with almost no realignments. The success of the hard EMS turned into the EMS crisis in the autumn 1992, however, which could only be eased, in the summer of 1993, by a loosening of the fluctuations allowed in the Exchange Rate Mechanism (ERM) (BIS 1994, 168; Gillingham 2003, 292; Eichengreen 2019, 163).10

It is remarkable that there is a large body of literature assessing EMS performance up to 1990, but rarely any connection between the EMS and the ensuing EMS crisis.11 Even de Grauwe (1994), who outlines the fragility of fixed exchange rate regimes, finds the credibility of EMS increasing after 1987 when realignments entered a phase of standstill. Although inflation rates had converged, there was sufficient asymmetry in trends for substantial losses in competitiveness to accumulate among countries that were catching-up within EMS, which also was admitted by the Committee of Governors of Central Banks (1993). As a consequence, the hard EMS became a pressure cooker and more so as several new and associated countries entered the exchange rate mechanism of EMS in 1989–91. The lack of awareness of these tensions reflects a lack of concern for the balance problem: speculative attacks would be avoided through the credibility of a fixed exchange rate, eventually a common currency.

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9 Bundesbank desisted to be obliged to be the creditor of EMS and preferred to take the power and set the tune for monetary policy. This is why EMS became an asymmetric system as described by the “n-1 problem” (Giavazzi and Giovannini 1985; Claassen 1989).

10 In the ECB Festschrift to the euro (Buti et al. 2010, p. 127 n.12) Mongelli erroneously dates the loosening of ERM to March 1993.

11 The crisis seems to have come as a surprise even for those who knew the system in detail: “Overall there is therefore little reason to believe that the EMS would be destabilized by random self-fulfilling attacks in the early 1990s. There is therefore no need to construct special safeguards against turbulences in financial markets” (Gros and Thygesen 1992, 166; the Introduction to the book is dated in March 1992). Still a week before the outbreak of an attack on the Finnish markka in September 1992, the IMF did not see any warning in the sky (Eichengreen 2003, 229). For a survey of the early literature on “the Crises of 1992–93”, see Cobham 2008.
Nevertheless, even if the EMS crisis surprised actors, Giovannini and De Cecco (1989, 2) had warned that with the then-forthcoming liberalisation of foreign capital controls in 1992, as prescribed by the Single European Act, financial markets would be seriously destabilised. Their recipe was to speed up the implementation of the EMU and avert speculative attacks by demonstrating a commitment that in turn should generate *credibility*, a concept that had become fundamental with rational expectations. This was part of a criticism of the gradualism in the Delors report, but that kind of shock therapy was not politically feasible in the EC context, primarily due to the resistance of the German Bundesbank.

It is clear that the worries raised in the Marjolin Report, about the management of imbalances in a monetary union, were no longer seen as relevant in the late 1980s. The disciplinary effect of a fixed exchange rate had instead become the main concern. This line of argument in the discussion about the European monetary affairs can be traced back to the *Optica Reports* (Basevi et al. 1976, 1977; see also Thygesen 1978). Interestingly, these reports were again assigned by the European Commission to a group of external experts, professors in economics, almost in parallel to the larger and more mixed “study group” which delivered the Marjolin Report. The analysis and proposals of the *Optica Reports* were guided by the “monetary approach” to the balance of payments (Basevi et al. 1976, 9) This meant a conviction that the purchasing power parity theorem holds, that is, that exchange rates reflect movements in price levels, at least over a somewhat longer term. Consequently, “…the problem of the exchange regime affects, on the whole, merely the nominal values of the economic union, and this in such a way that the arguments for and against a monetary union are, in a nutshell, reduced to the arguments for and against a common rate of inflation” (Basevi et al 1976, 40). Structural differences between countries would not matter and the common rate of inflation was a question of monetary policy.

Armed with the new theory of rational expectations, this provided strong arguments for a rule-based economic policy, which were ultimately elaborated in an article by Giavazzi and Pagano (1988). The title of that article is very telling, “The advantage of tying one’s hands: EMS discipline and Central Bank credibility” and the message was that higher-inflation countries could borrow credibility and reduce inflation by pegging their currencies to the Deutsche Mark. The mechanism should work even better in a monetary union. A theoretical foundation for fixed exchange rates, ideally a gold standard, as part of a rule based economic policy was provided by Barro and Gordon (1983) and McKinnon (1988), and it was also embraced by the free banking school (White 1985). The theoretical approach for the eventual design of EMU, with no particular

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12 The only member of both groups was Niels Thygesen, Professor in Economics at the University of Copenhagen, who later also was appointed to the Delors Committee which prepared the Maastricht Treaty with the final plan for the EMU. Co-authors in the second *Optica report*, with “the main task… to verify and complete” the first report, also included two PhDs. Remarkably Thygesen is neglected by Dyson and Maes (2016) in their dubbing of “architects” of the euro. The role of Thygesen in the shaping of the euro can scarcely be overestimated, and his influence was not only “ideational.” While the Delors Committee often was ridden by frustration, among its members Thygesen was “the only figure who consistently came across as an enthusiast for monetary unification” (James 2012, 243). Arguably, to exclude Thygesen from the architects of the euro is like playing Hamlet without the prince of Denmark.

13 The new paradigm of rational expectations implied a change of the foundation of the discipline argument. Whereas the Quantity Theory of Money had been at its roots in the old days, a more elaborate thinking evolving around neutrality of money and credibility now underpinned the discipline argument.
concerns for the balance problem, but based on the idea of the monetary system as a disciplinary device, can however be traced to the *Optica Reports*.

This interpretation is further supported by the appearance in *The Economist* on November 1, 1975, of “The All Saint’s Day manifesto for European Monetary Union”, with a plea for a European Parallel Currency (EPC) that should compete with the national currencies and let “the market decide” its validity. The manifesto was undersigned by “nine prominent European economists”, of which five were involved in the *Optica Reports*. Only Niels Thygesen was also in the Delors Committee and did not then retain the idea of a parallel currency. A parallel currency was however part of the critique against the “gradualism”, which since the early 1970s had been part of the official EC strategy. The critics of “gradualism” had won a lot, however, with the Maastricht design of the EMU: a common currency, an independent Central Bank, and no lender of last resort.

The *Optica Reports* and the manifesto of 1975 provided a theoretical platform for rational expectations and a rule based strategy for a monetary union as realised by Maastricht. The German-French proposal in 1978 for a replacement of the crumbling “Snake” with the EMS still contained many of the Keynesian concerns about a symmetry between deficit and surplus countries, manifest in the Exchange Stabilisation Fund, and so did the report by “three wise men”, one of whom was Robert Marjolin (Council of the European Communities 1980). The latter report was about the overall prospects of the European integration project and took the opportunity to make a plea for “the two unwritten rules of Community solidarity” which they saw as fundamental for the whole project and which reflected concerns about the balance problem. These rules suffered a defeat in the realisation of the EMS, when the mutual support mechanism of the Exchange Stabilisation Fund was vetoed by the Bundesbank, and again with the Maastricht plan for the EMU, where the no-bail-out clause simply prohibited that kind of solidarity (Article 104 in the original Maastricht Treaty, reprint in Gros and Thygesen 1992, 431 ff). The no-bail-out clause prohibited supportive actions for member countries in financial difficulties. The rationale of the clause was of course to avoid moral hazard due to indebted members in the EMU, who should not be tempted to exploit the higher credibility and lower interest rates to borrow more and let all members share the risks.

14 The fifth, although not among the Optica co-authors in the bibliography below, was Michele Fratianni, involved as an assistant for *Optica* 1976. The suggested name of the parallel currency was ‘Europa’. Several proposals for the issue of a parallel currency, just as a century before also named ‘Europa’, were made in the early 1970s. In 1974 a book was written in four languages, by five independent European intellectuals, “sufficiently well-known” to make an imprint, so they presented themselves in the preface (Cairncross et al. 1974). One of the co-authors of the book also signed the Manifesto, namely Herbert Giersch (Basevi et al. 1975). An important difference between the book and the Manifesto, however, was the former’s emphasis of the balance problems, which were less of a concern in the Manifesto and could be solved by a “vigorous regional policy.”

15 The first was the “rule of active solidarity” calling for assistance “by all means” for a member state “in serious difficulty, whether as a result of circumstances, or of the application of certain Community rules, or of its own mistakes…” The second was the “rule of passive solidarity” which carefully warned for “financial discipline… which causes problems for its associates in the Community” (Council of the European Communities 1980, 74–75). Clearly, the concerns were about balance problems caused by an asymmetric monetary system.

16 Here the architects of Maastricht cheated themselves. In rational expectations markets are always right but following the introduction of the euro, capital markets stood too generously at the disposal of private business in, e.g., Ireland and Spain (Pisany-Ferry 2014, 55).
While the whole project of European integration continued to face difficulties until the mid-1980s, two factors paved the way for the Maastricht plan for the EMU: one was the convergence of inflation rates, which was a wider international phenomenon and not limited to the EMS; the other was the decision, in 1986, by the European Council to advance from the customs union to the Single Market. The convergence of inflation rates seemingly made it possible to de facto fix exchange rates within the EMS, and the Single European Act (SEA) signified the political turn-around of the European Community. Before the SEA an interventionist paradigm had guided the Community’s economic policy, as demonstrated, for example, by the steel cartel (Eurofer), initiated by the Commission as a response to the steel crisis in the late 1970s, and which was combined with an acceptance of national governments’ massive subsidies to ailing industries (Mény and Wright 1987; Ljungberg 1995). The Community became unequivocally oriented for competition with the SEA, and a rule-based economic policy as signalled in the Optica Reports.

In this new climate the Delors Committee was assigned, by the European Council at the meeting in Hannover 1988, the task of designing the plan for the EMU.\(^{17}\) The Delors Report did not devote much concern to the balance problem but thought that the reform and expansion of the structural funds, decided by the European Council in February 1988, would be a relief (Committee for the Study of Economic and Monetary Union, 1989, 10–11). The underlying idea was that imbalances should not be allowed to arise, due to the constraints of a rule-based economic policy, which had gained primacy in the economics profession. To the extent that politicians were still worried about imbalances, they were pleased by the illusory argument that national current accounts would be merged into one (European Commission, 1990, 11)\(^ {18}\).

The Delors Report was accompanied by a set of papers by committee members, which either underlined positions taken by the Report, or exposed dissenting views. To the former belonged, for example, the paper by Maurice Doyle (1989) of the Central Bank of Ireland, on regional policy, and the paper by Wim Duisenberg (1989) of the Dutch Central Bank, on the maladies of a parallel currency. To the latter belonged the plea of Jacques de Larosière (1989), of the Banque de France, for a European Reserve Fund, as a reform and extension of the European Monetary Cooperation Fund which had been implemented in the early 1970s. This was a reappearance of the constant French request for institutionalised mutual support which, as noted above in connection with the making of the EMS, had been disavowed by the German Bundesbank. Although the Report itself reprinted both views (§§53 and 54), the symmetry argument, with its demand for a Reserve Fund, was clearly at odds with the rule-based stance that became definitely formalised in the no-bail-out clause of the Maastricht Treaty.

\(^{17}\) In addition to the President of the European Commission Jacques Delors, and the Commissioner for Agriculture Frans Andriessen, the committee consisted of the 12 central bank governors, and additionally three “personalities”, one of which was economist Niels Thygesen. The British Treasury and the Bundesbank were very disappointed about Delors being chairman of the committee and the President of Bundesbank, Karl Otto Pöhl, reacted and acted when Delors, rather imperiously, appointed two of his protégés as rapporteurs of the committee. Tommaso Padoa-Schioppa, probably the most influential, remained, but the other was replaced by someone with a background in the German Ministry of Finance (James 2012, 235).

\(^{18}\) James (2012, 12) emphasises the importance of this argument in the making of EMU, but without any hint that it makes no real economic difference whether the balance of payments is constructed on the union level or on the national level. The balance problem is simply redefined to a regional problem.
De Larosière’s paper can be seen as the last stance of the Keynesian approach to the balance problem, although the preceding intellectual defeat of Keynesianism had undermined its prospects for success.

Also dissenting was, notably, Karl Otto Pöhl of the Bundesbank who demonstratively “assumed that the goal of monetary union cannot be reached in a quantum jump” (p. 132, italics added). This was contrary to what was stated in the Report (p. 12 §14) and reflected the old contradiction between “monetarists” and “economists”, with a more recent terminology rather described as protagonists of the so-called endogenous and the traditional OCA theory, respectively (Mongelli 2002, 2010; James 2012, 215). The Bundesbank view had been that the monetary union could only be reached along with economic integration, which included fiscal policy harmonisation, thus retaining views from abandoned theory. In the 1970s and in the Werner Report, fiscal policy harmonisation had been a sine qua non, but this was now reduced to fiscal discipline. This is particularly clear if the Marjolin Report (1975) with its quest for a “common demand-management policy” is compared to the rule-based Maastricht convergence criteria.

The compromise of the Delors Report was that the EMU should be reached gradually and in stages, even if Pöhl feared that these would be passed through prematurely. His consent was acquired with help of the design of the European System of Central Banks (later to become ECB and copy-pasted from the Bundesbank), where practitioners’ discipline found a perfect fit with rule-based theory. For the more orthodox advocates of the monetary union the gradualism of the Delors Report was distasteful and a threat to the whole project (Giovannini 1990). Although the final plan for the path to EMU did not precisely follow the contemporary orthodoxy, but merged parts of old opposite positions, the eventual edifice was based on the new paradigm.19

6. Conclusions

Historically, different arguments figure in the support for international exchange rate arrangements. From the mid-nineteenth century, the quest for standardisation of weights and measures came to include the international monetary system. In the view of economic theory, this quest can be traced to the transaction cost argument, a desire to facilitate trade. Britain had long stood on gold but until 1870 a bimetallic standard dominated in continental Europe. A circumstance that pushed for gold instead of silver or a bimetallic standard was the scarcity of silver. When the unified Germany switched to gold after the Franco-Prussian war, other countries followed suit. Ironically, with economic growth and more countries joining the gold standard, gold also became scarce until new mines were opened in the 1890s. A second argument concerns the disciplinary effect of a fixed exchange rate. In retrospect this argument has been ascribed to the nineteenth century context of the gold standard, but there seems to be little, if any, contemporary evidence for the disciplinary argument as regards the choice between gold, silver or a double standard. Instead the disciplinary argument was

19 In a political economy account Bundesbank was forced by the government to comply, and Pöhl resigned before Maastricht (Moravcsik 1998, Ch. 6).
conceived ex-post, most notably by the British Cunliffe committee by the end of WWI, and came to guide the efforts to restore the gold standard in the interwar period.

With the Depression and the fragmentation of international economic cooperation in the 1930s, focus began to shift to the problem of imbalances in current accounts and how to solve them. The Bretton Woods system implemented after WWII was designed to take into account the problem of those imbalances, however, the Bretton Woods system built too much on American supremacy and when other countries caught up, the system was not sustainable.

European integration evolved alongside the catching-up, and there were soon also ideas about European monetary unification. Of course, at the bottom of these ideas were concerns about transaction costs but the dividing issues were about other impacts of monetary arrangements. In its early phase, the balance problem had a central role in the discussions but was, from the mid-1970s, superseded by the disciplinary argument which was summarised in the 1980s as the “advantage of tying one’s hands” (Giavazzi and Pagano 1988). This change of argument was underpinned by the critique of Keynesianism in the wake of the stagflation in the 1970s. In came the new theories of rational expectations and the monetary approach to the balance of payments, from which followed a strong preference for rule-based economic policy. Again, stylised arguments about the classical gold standard came to the fore in discussions of monetary reform. It is notable, however, that opposing political and theoretical positions could become complementary on the way to EMU, at the price of compromise on seemingly subordinate matters. French “monetarists” achieved their goal of a monetary union but had to give up their discretionary quest for a European Reserve Fund. German “economists” got a European rule-based monetary policy but had to accept that the harmonisation of economy and policy might still hobble when the common currency would be launched. Eventually, the new orthodoxy had won the set: an independent Central Bank and no lender of last resort with a common currency provided for a disciplinary system. How well and how far it worked is another matter.

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