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A Historical Perspective on the Euro: the Latin Monetary Union (1865–1926)

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INTRODUCTION

Out of the many experiments in international monetary unification that took place in Europe before the creation of the Euro, the Latin Monetary Union (LMU, 1865-1926) is probably the most interesting and long-lasting experiment. Yet, despite its obvious appeal as a subject of study to assess the complex interaction between sovereign states in managing common forms of money despite different financial conditions and political preferences, it is not entirely fitting as a comparison with today's European Monetary Union. The LMU should be correctly defined as a coinage union, rather than a full monetary union, it lacked the most basic common institutions and operated in a world where monetary policy was not really comparable with that of the twenty-first century. Yet its long history provides examples of how apparently major differences in policy and interests could somehow be bridged to maintain mutually beneficial arrangements, while limiting its scope and impact to prevent larger effects on the different member economies.

THE BIRTH OF THE LATIN MONETARY UNION

The Monetary Convention agreed on 23 December 1865 between France, Italy, Belgium and Switzerland was an effort to resolve relatively minor problems of monetary circulation of silver coinage in the area of the former Empire of Napoleon I. The first French Empire (1804-1815) had left an inheritance of homogenous standards for silver and gold coins expressed in francs in France, Belgium and Switzerland or lire in Italy, whose shape, weight, metallic content were identical, even if the images and symbols were different for every country. In fact in the early 1860's those four countries had the same bimetallic coinage and their coins moved across borders and were informally accepted at a one to one exchange rate.

This equilibrium was challenged by the persistently low price of gold after the California gold discoveries of 1848. The latter caused a relative appreciation of silver bullion in comparison to gold bullion, above the fixed official mint price of 15.5 grams of silver for every gram of gold, which had formed the basis of the French and Italian bimetallic system since 1803 (the creation of the franc germinal). In this system every individual had the right to bring unlimited amounts of silver or gold bullion to the mint and have it coined, creating a free market for monetary issue of the most depreciated of the two metals. In the early 1860's gold was the depreciated metal and it was minted in far larger quantities, while silver was progressively driven out of monetary circulation to be transformed into bullion given its higher market value in comparison to its value as coinage. According to Gresham's law the bad depreciated currency (gold) replaced the good appreciated currency (silver).

The problem faced at the time by the governments of bimetallic nations was how to keep a sufficient amount of small change silver coin in circulation despite market forces, in order to prevent difficulties in small-sized daily transactions. Each government started independently seeking a solution by reducing the percentage of silver content in its coinage in order to cancel out any profit for speculators who would demonetize and melt silver coins to sell them as bullion. From a common initial 90% of silver purity, diversity was emerging. Switzerland was the first to take an initiative, reducing the silver purity of some coins to 80% in 1860, Italy chose 83.5% purity and France selected the same level as Italy, but for a different set of coins. Those decisions disrupted the informal free movement of silver coinage in the four countries.

Belgium took the initiative to suggest an agreement between the various nations involved and France called for an International Monetary Conference at the end of 1865. An agreement was achieved by the four participant countries to reestablish a free flow of silver and gold coinage, reducing all silver coins below the écus of five francs/five lire to a common silver content of 83.5%, while the silver écu kept its original 90% silver content, similarly to all gold coins. Public cashiers of the four countries linked by this monetary convention would accept the gold and silver coinage of other nations in the union at par. It was therefore a coinage union with a one to one fixed exchange rate based on the intrinsic gold and silver content (De Cecco 1992). A limit on the issue of depreciated silver coins at 83.5% was fixed at six francs/lire per inhabitant, to prevent over-issue by some countries and loss of seignorage by others. No limits were placed on the issue of gold coins and silver coins with 90% silver. Copper coins and banknotes were not included in the agreement and therefore were not regulated by the Monetary Convention. It was a monetary union with multiple currencies linked by specie money (gold and silver), leaving out fiat money (paper money and bank deposits, which had not yet acquired a dominant role in Continental Europe). In other words, it was a very incomplete union.

The modest official name adopted ("Monetary Convention of 23 December 1865") and the absence of a clear coordination mechanism (no common institution or central bank was created and national banks of issue were not involved in the negotiations) reflected the initial limited purposes set by finance ministries of solving a technical problem of divisionary coinage.

Such modesty was, however, swiftly surpassed by new developments because the involvement in the preparatory negotiations of the French foreign affairs ministry and of the Vice President of the French Council of State, Felix Esquirou de Parieu, as chief French negotiator, gave a far larger international dimension to the negotiations. It also became an attempt to create a European or a Universal currency, in line with the ideas of free trade, simplification and scientific standardization of the time, from the Anglo-French free trade treaty of 1860, negotiated by Cobden and Chevalier, to agreements concerning post, transportation, or units of measure. Parieu progressively injected European federalist ideas into the debate. Accordingly, the Convention included a mechanism inviting the applications by candidates for membership and an intergovernmental mechanism for decision-making through monetary conferences conveyed when necessary. It also became the fighting ground for several decades of debate between the bimetallic view of the monetary system, which had emerged out of the French revolution and the supporters of the gold standard (Willis 1901). Parieu became the chief supporter of the Gold standard in France, a system adopted only in England and Portugal at the time.

ENLARGING THE LATIN MONETARY UNION

At the beginning of 1866 the British press nicknamed the Monetary Convention as the "Latin Monetary Union" (LMU), to highlight how this continental experiment could not possibly involve the United Kingdom. The name stuck even if the French government attempted instead to enlarge the monetary union by inviting all European countries to the International Monetary Conference of Paris in 1867, "to facilitate the establishment of a uniform monetary circulation between all civilized states" (Einaudi 2001). The surprising outcome of the Conference, which was in fact lead by Parieu and attended by representatives of 20 states, including LMU members, the UK, most German states, the USA, Russia, Japan and the Ottoman Empire, was unanimously in favour of the adoption of an international gold standard, and an LMU-style system based on a fixed exchange rate for gold coins with one pound equal to five US dollars, ten Austrian florins and 25 francs/lire/pesetas/drachme. Participant countries had to mint the 25 franc coin, which functioned as a pivot for the system. Following this apparent success, Parieu also developed a project for a "Europa" currency, a European federation, a European Union and a European Parliament (Parieu 1870). Government delegates expressed a growing desire for a gold standard without having necessarily always the authority to commit their governments, which was particularly true of the UK, the US and Prussia.

In the following years a large number of countries applied for full membership of the LMU, or at least with regard to the gold standard (Greece, Papal State, Austria-Hungary, Spain, Sweden, Serbia, Romania, Bulgaria, Finland, plus several Latin American countries). The southern German states, which were still independent at the time, gave their support to the idea of monetary union, at least in their diplomatic correspondence with France. This was part of a strategy to resist Prussian expansionism between their defeat in the Prussian – Austrian war of 1866 and before the creation of the German Empire in 1870. The German and British chambers of commerce strongly campaigned in favour of monetary unification, while bankers opposed it.

The enlargement of the LMU proved far more limited than expected because the Great powers refused to adopt a French-based system; and the refusal by the French Treasury and its banks to abandon bimetallism made it impossible to involve the UK.

Under the Conservative government of Disraeli the UK flatly refused any involvement in 1867, but, after the liberals returned to power under Gladstone the following year, a brief window of opportunity opened. Robert Lowe, then liberal Chancellor of the Exchequer and his adviser, the economist William Stanley Jevons, were convinced that the proposal was bound to unite Europe and that the UK risked remaining isolated if it did not sign up. In 1869 Lowe informally presented his proposal to reduce the value of the pound by 0.8% - making it equivalent to the proposed 25 francs international coin - in exchange for the end of bimetallism in France to Parliament, where it gave rise to heated debate. Gladstone was "astonished", free traders and chambers of commerce lined up to support Lowe, while Conservatives, the Bank of England, the City and most of the press opposed it in an intense debate (Einaudi 2000). After a few months Lowe declared that the proposal could not move forward because France was not willing to abandon bimetallism, which was defended by agricultural and financial interests and by part of the French public administration.

Ultimately Prussia and the USA did not join the project of universal coinage, but instead individually adopted the gold standard in 1872-73. Prussia unified the various German currencies in the process of national unification with a new currency, the mark, equivalent to a third of the old German thaler and unrelated to the franc. The outlook moved from cooperative to antagonistic, with a war occurring between France and the German states in 1870-71, followed by a war indemnity levied on France, protectionist tendencies and competition in the colonial field.

MANAGING A DIFFICULT UNION: THE ITALIANS, THE POPE AND THE GREEKS

The LMU did not expand to become a European monetary union, but it survived - despite conflicts - for over 60 years, until 1926. This was largely due to the introduction of new rules to solve the conflicts and malfunctions of the Union, even at the cost of limiting its expansion in geographic terms. This, however, also prevented its evolution into a full monetary union.

An early problem arose with Italy due to the high budget deficits in the first few years after national unification in 1861 and the inconvertibility of Italian paper currency into gold and silver, caused by a war with Austria in 1866. Inconvertibility was followed by new forms of monetary issue not included in the Monetary Convention (especially paper money), causing the flight of Italian currency to France and Switzerland. Tensions were ultimately resolved, reinforcing the rules on new issues.

The Papal State applied to join the LMU in 1866, but, while negotiating, it over-issued coinage with reduced silver content by ten to one, ultimately declining to join and to take back its depreciated currency which had migrated to France. The Papal State was ultimately pushed out of the LMU system.

Greece was a very early applicant to join the LMU and was actually the only new member admitted (in 1867). Greek wars for national unification against the Ottoman Empire and financial weaknesses led to inconvertible paper currency in 1869 and again from 1877 to 1910, and to debt default in 1893. This, together with the sale of Greek coins at a discount in Paris (by private bankers), determined foreign control of part of Greek monetary issue from 1869, and to limitations to Greek membership of LMU afterwards.

The problems encountered in managing the LMU convinced the strongest members of the Union to block further enlargements (refusing all other applications for membership, coming mainly from southern or central Europe and the Balkans and from Latin America) and to restrict the field of action of the LMU for the future, not extending it to paper money, as the Scandinavian Monetary Union did instead.

After the adoption of the gold standard by Germany and the US in 1873, the price of gold started declining, the LMU suspended its new silver issues to prevent speculation and to avoid receiving demonetized German silver. New rules had to be set within the monetary union to manage the exit from bimetallism, initially on a provisional basis and then permanently.

HOW TO CHANGE THE RULES DURING THE GAME

The initial rules of the LMU proved insufficient and incomplete, as it became clear just a few months after the signature of the Monetary Convention. Essentially these rules amounted to limits on the issue of debased silver coinage and the exchange of information on annual monetary issue to control compliance with those limits. The transmission of information, however, was not credible and political/ military disruption created financial instability.

New rules emerged through an iterative process of pressure by the strongest economies on the weakest, sanctioned through new cycles of intergovernmental meetings. We can identify five set of measures or rules adopted throughout the history of the LMU to enforce monetary discipline and preserve the Union.

1. Limits of issue were extended to other forms of fiduciary money (small change paper money from late 1860's and silver écus from 1874 onwards)
2. The strongest government (France) was attributed absolute control over the issue of coinage in new weak members (Greece);
3. France and Switzerland threatened to return divisionary coinage to issuers of non convertible paper money (Italy and Greece) or to large quantities of silver écus (Belgium) in exchange for gold, a threat that effectively included a financial penalty;
4. Free riders were neutralized or expelled from the Union (non-completion of accession process of the Pontifical State, freezing of Greek currency);
5. Membership was refused to states that did not guarantee sound financial conditions (Spain, Austria-Hungary, Romania, San Marino and later others).

THE LONG PERSISTENCE OF THE LMU AFTER THE END OF ITS EUROPEAN AMBITIONS

The LMU appeared in difficulty, but managed progressively to renegotiate and tighten its rules, but at the cost of a more limited monetary issue and of a reduced role and meaning for the Union itself. The Union persisted, but declined in relevance due to the growth of other forms of monetary issue (banknotes, bank deposits). By 1914 only 5% of the monetary base was in gold and silver LMU coins in Italy, and this figure dropped sharply after World War I.

Despite the Union a trade war started between Italy and France in the late 1880's, military alliances diverged (Italy switched to an alliance with Germany, leaving the French zone of influence), and Greece defaulted. These tensions did not break the monetary union, because the cost of dissolution remained too high and trade advantages persisted. A level of flexibility was also allowed through what amounted to multiple currencies and dual exchange rate. The exchange rates of the LMU paper currencies fluctuated in terms of gold francs, during periods of temporary inconvertibility of national paper money. Italian paper lire and Greek paper drachme fluctuated at times. The paper lira lost up to 20% in comparison to the gold lira in the 1860's; while the drachma lost up to 40% in the 1890's. Both currencies, however, recovered and returned to parity, particularly in the decade before World War I. All members of the LMU devalued during WWI, ending in practice the substance of inter-circulation. The different stabilization levels of the LMU national currencies in the 1920s concluded the monetary union experiment and in 1926 it was decided to disband quietly the Union.

CONCLUSIONS

Rules can be changed and monetary unions can be resilient, but difficulties persist between countries with different levels of economic and financial strength. There is no clear limit to the process of reform and insti-

tutional expansion. On the contrary, it is a never-ending construction site, with alternate winners because the ultimate penalty, expulsion, has a substantial cost for both the weakest and the strongest member states. It is important to be able to tighten rules when the monetary situation changes and fiscal imbalances grow, but excessive austerity can constrain growth and increase poverty, and some forms of flexibility are necessary. The accidental system of dual currencies which emerged in the LMU was never agreed upon by other member sates at the time and does not seem be a solution to EMU's problems, as the rules are much tighter and the European Central Bank has exclusive control over the issue of currency. Expansionary policies are needed in surplus countries, to share the costs of readjustment between nations and not force all the adjustment on productivity, unemployment and wages. Abandoning the monetary union is no easy solution for weaker countries as it entails financial and trade costs; and nor is it advantageous for stronger countries either.

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