

**“Implementing a Regional Gold Standard. Lessons from European Monetary Integration”** by Antony Mueller

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RESUMO

“Instalando um padrão de ouro regional. Lições da Integração Monetária Européia”

Neste artigo se analisa a integração econômica e monetária Européia com o objetivo para ganhar pontos de referencia da institucionalização de acordos regionais baseado em ouro (regional gold standard). O exemplo da União Européia mostra que a institucionalização de acordos cambiais que estão aptos de promover taxas de câmbio estáveis é a conditio sine qua non para alcançar uma integração econômica mais profunda.

Diferente da teoria de “optimum currency areas”, a “seqüência Européia” não anda da integração econômica por a integração monetária, mas acordos cambiais comuns marcam o começo do processo da integração.

Não dá imitar o processo Europeu em América Latina, por causa de diferentes condições iniciais, mas também por falta de expertise suficiente de implantar sistemas do estilo Europeu (como o EMS I e EMS II). Por isso, se propõe tomar em consideração a alternativa de construir um sistema que está no mínimo parcialmente baseado em ouro e neste sentido institucionalizar um mecanismo que está fora da política mais de possível e que pode operar com um mínimo de intervenções.

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# **“Implementing a Regional Gold Standard. Lessons from European Monetary Integration”**

*Antony Mueller*

## **ABSTRACT**

This paper analyses the economic and monetary integration in Europe with the aim of deriving points of reference for the implementation of regional gold standard arrangements. At the example of European currency arrangements it is shown how the implementation of regional currency arrangements function as the necessary precondition for the deepening of economic integration and how stable exchange rate conditions provide the impulses not only towards financial convergence but also towards harmonization of economic policies. The sequence of European monetary and economic integration has not been from economic integration towards common monetary arrangements, but common currency arrangements have served as factual preconditions that helped to enforce economic convergence.

The study of the European sequence that runs from currency arrangements first towards deeper economic integration as its consequence reveals valuable insights how a regional gold standard might work as to its impact on deeper integration and the transformation of economic policies.

Due to insufficient technocratic expertise and due to political fragilities, as it is widely the case in large parts of Latin America, it seems problematic implementing common currency arrangements of the European kind. Instead, simpler methods should be considered and particularly such methods that are more remote from daily politics. It is mainly the gold standard in its appropriate concretization that is in accord with these demands.

## **Introduction**

For countries that want to form deeper economic integration, establishing currency arrangements outside of linkages to the US dollar becomes ever more urgent with the decline of the US dollar, the expansion of US government debt and the extreme extension of the balance sheet of the US central bank with the subsequent increase of money stocks.

In fact, the first phase to call for a move away from the US dollar occurred in 1971 when the United States severed the gold link of the US dollar and thus brought the Bretton Woods System to its end. At that time it was mainly only the Europeans who drew the necessary

consequences. As early as in 1969 plans were made to work towards the introduction of a common European currency. A series of proper European currency systems followed suit with each one of these steps moving closer towards a common currency that was finally introduced on January 1, 1999.

The establishment of currency arrangements is the *conditio sine qua non* for a region that wants to achieve a deeper economic integration. Countries, such as those which form the Mercosur, are confronted with the task to establish common currency arrangements before further steps towards a more profound economic integration can be successfully taken. Yet the establishment of effectively working currency arrangement requires a high level of technocratic bureaucracy that is still rarely found in Latin America. Thus what is needed for this region is a simpler path toward a common currency arrangement and a way by which trust in the new system can be automatically achieved.

In order to achieve this goal, the establishment of a regional gold standard should be considered.

It is rarely noted that there is still an unofficial linkage of the euro to gold, as gold's share of total foreign exchange reserves amounts to 61 % for the Eurozone. Gold accounts for 72 % of Germany's international reserves, 73 % of France's reserves and 67 % of Italy's reserves; the figure for the Netherlands is 62 % and for Portugal it is 91 %.

In contrast to the Eurozone countries, the gold position of Mercosur countries is extremely low: only 0.5 % of the foreign exchange reserves of Brazil are held in gold. The number is likewise low for Argentina with 3,4 %, for Paraguay with 0.6 % and for Uruguay with 0.1 %.<sup>1</sup> This extremely weak anchoring of the national currencies in gold limits the formation of monetary trust in these countries. With such a weak gold basis any common currency arrangement is bound to fail and will hardly gain high degrees of investors' confidence.

By studying the European experience, this paper wants to stimulate the debate about finding an adequate way for the Mercosur countries to establish common currency arrangements. In order to achieve this goal, a regional gold standard<sup>2</sup> deserves much more consideration than it currently receives. By doing this, one must keep in mind that a gold standard is not a perfect currency arrangement, yet neither are the alternative systems<sup>3</sup>, as history, particularly for Latin America has shown.

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<sup>1</sup> World Gold Council Report 2009 based on the International Monetary Fund's reserve statistics

<sup>2</sup> As to the different types of "gold standards" see Michael D. Bordo: Gold standard and related regimes: collected essays. Cambridge: Cambridge University Press 1999

<sup>3</sup> Lawrence H. White: Is the Gold Standard Still the Gold Standard among Monetary Systemes? In: Cato Institute Briefing Papers. February 8, 2008, p. 2

### The “European Sequence”

Macroeconomic convergence is generally considered as being an essential precondition for the establishment of monetary arrangements that imply stable exchange rates.<sup>4</sup> An even stricter proposition is held by the theory of optimum currency areas that postulates additional requirements ranging from factor mobility to various structural features of the economy, which would guarantee that economic policy would be capable of managing external shocks.<sup>5</sup> More recently, even political union or the existence of a “political identity” is being discussed as an essential pre-requisite for a functioning common currency<sup>6</sup> while in the new theory of an optimum currency area the requirements are less strict.<sup>7</sup>

But economic convergence in the European Union, rather than being a precondition, has been the result of specific currency arrangements. Mutual agreement on the degree of inflation tolerance and a consensus on monetary policy as to its goals, indicators and instruments have grown out of the existence of common monetary arrangements aimed at fixed exchange rates.<sup>8</sup> The European experience demonstrates that the sequence runs not from macroeconomic convergence to stable exchange rates, but that it begins with stabilizing exchange rates, proceeds to harmonizing monetary policy, and goes on from there to fiscal adjustment. A process such as this, however, requires a unifying theme, which in Europe was given in the goal of forming a political union. Although it is often so that arrangements aimed at achieving stable exchange rates are deficient as long as the consensus on monetary and fiscal policies is lacking, the European experience suggests that once when stable exchange rates have gained supreme policy status as a means for deepening integration, monetary and financial convergence results more or less automatically due to the force of facts when this precondition is clearly established. Quite similar consequences may be expected when regional gold standard arrangements are implemented. Here, too, it will not be necessary to have a deeper economic integration first, but likewise as the European experience shows,

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<sup>4</sup> Cf. McCauley, R. N., and R. W. White, *The Euro and European Financial Markets*, in: P. R. Masson, et al. (eds), *EMU and the International Financial System*, IMF, Washington, D.C. 1997

<sup>5</sup> Cf. Mundell, Robert A., *A Theory of Optimum Currency Areas*, in: *American Economic Review*, Vol. 51, 1961, pp. 657

<sup>6</sup> Holtfrerich, Carl-Ludwig: *Did Monetary Unification Precede or Follow Political Unification in the 19<sup>th</sup> Century?*, in: *European Economic Review* 37 (1993), pp. 518-524

<sup>7</sup> Melitz, Jacques, *The Current Impasse in Research on Optimum Currency Areas*, in: *American Economic Review*, Vol. 39, 1995, pp. 492 and Tavlas, George S., *The ‘New’ Theory of Optimum Currency Areas*, in: *The World Economy*, Vol. 16, No. 6, 1993, pp. 663

<sup>8</sup> Cf. De Grauwe, Paul, *The Economics of Convergence: Towards Monetary Union in Europe*, in: *Weltwirtschaftliches Archiv*, 132(1), 1996

currency arrangements by themselves can provide a factual basis from which a deeper economic integration will result.

The “European sequence” is not based on the “optimum currency area”-model. As a guideline for deeper integration, this concept is deficient for various reasons: Firstly, if a region composed of different countries with individual currencies were already to possess the features of an “optimum currency area”, the introduction of a common currency would no longer be necessary, as exchange rate would be stable anyway due to factor movement and other price adaptations.<sup>9</sup> Secondly, the analyses of so-called asymmetric shocks are based on the idea that these can and should be countered by fiscal and monetary policy responses in combination with exchange rate variations. But external shocks usually have specific micro-economic impacts, while the effects of monetary policy and exchange rate changes cannot be adequately specified in relation to the micro-level.<sup>10</sup> If, however, the effects of an external shock are of a general macroeconomic nature, most likely the monetary authorities of the unified currency area could also apply adequate measures. Thirdly, serious external shocks are relatively rare cases.<sup>11</sup> However, if events like drastic price movements for specific goods are included, it is unlikely that these will affect homogeneously specific national economies but would be highly heterogeneous across a regional group of countries.<sup>12</sup> In addition, external shocks, which potentially affect the exchange rate, will be more pronounced when market liquidity is small, while the existence of a larger currency area dampens the effects as it facilitates microeconomic adaptation.<sup>13</sup> Constancy of monetary policy is usually more helpful for the adaptation process, as it assists in stabilizing expectations on the micro-level and avoids the additional factor of uncertainty that comes along with economic policy activism. Economic policy makers hardly possess the prognostic capacity in order to correctly assess the severity and the duration of shocks, and there is no reliable economic model that could prescribe the correct dosage of policy measures.

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<sup>9</sup> For the application of this criterion to the stability of currency union see Vaubel, Roland, Real Exchange-Rate Changes in the European Community: The Empirical Evidence and its Implications for European Currency Unification, in: *Weltwirtschaftliches Archiv*, Vol., 112 (3), 1976, pp. 429 and Hagen, Jürgen v./Manfred J. M. Neumann, Real Exchange Rates within and Between Currency Areas: How Far Away is EMU? In: *Review of Economics and Statistics*, Vol. 5, No. 2, 1994, pp. 236

<sup>10</sup> This had been demonstrated by the application of Keynesian policy recipes in the 1970s when stagflation resulted as a consequence of deficit spending.

<sup>11</sup> Funke, M., S. Hall and R. Ruhwedel, *Shock-Hunting: The Relative Importance of Industry-Specific, Region-Specific and Aggregate Shocks in OECD countries*, Centre of Economic Forecasting, Discussion Paper No. 14-97, London Business School, London 1997

<sup>12</sup> Fatas, A., EMU: Countries or Regions? Lessons from the EMS Experience, *European Economic Review*, Vol. 41(3-5) 1997

<sup>13</sup> For a cost-benefit analysis of a monetary union see Robert Grassinger, *Nutzen und Kosten einer Währungsunion. Wohlfahrtseffekte eines gemeinsamen Geldes*, Baden-Baden 1998

The heart of the matter is not monetary union per se but what kind of common monetary policy will be conducted.<sup>14</sup> Focusing on the problem of optimality for a currency area distracts the focus from the more central problem of monetary stability and fiscal adjustment and the harmonization of economic policy in general. Additionally, waiting for “optimality” to arise may be a task for eternity.<sup>15</sup> The expectation of homogeneous conditions to arise across countries is as illusionary as the expectations that they will occur within one nation. Money as a medium of exchange works irrespective of individual wealth positions. The setting of the problem requires a different perspective once a stable currency system has gained supreme political status, the necessary adaptation in economic policy can be more easily achieved as a by-product. In the case of a regional gold standard, similar effects can be expected, and most likely these may work even to a higher degree and with less bureaucracy as has been the case with the European model.

Flexible markets at the micro-level along with fiscal restraint and monetary stability at the macro-level now serve as the major guidelines for economic policy. Most of the central aspects of the new European economic policy model have grown out of the process of integration. With an increasing number of heterogeneous countries becoming members, demand-side management proved less and less effective and appeared as a relict of the past just like a social policy whose roots were the goal of achieving national coherence.<sup>16</sup>

### **European Economic Integration and Exchange Rate Systems**

A common currency is not a new event in European history. For more than half a century until the outbreak of World War I, the gold standard system had provided a common currency.<sup>17</sup> While this period is still generally associated with prosperity, the interwar period of the 1920s and 1930s with their lack of a functioning common currency system continues to

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<sup>14</sup> Cf. Collignon, S., P. Bofinger, C. Johnson and B. De Maigret, *Europe's Monetary Future*, New Jersey 1994

<sup>15</sup> Neither a country like Brazil nor the United States or many other nation states possess the features required for an “optimum currency area”. Logic would require that those who stress the need for conditions of “optimality” when referring to common currency arrangements would have to plead also for the abandonment of a common currency in almost any country. As *reductio ad absurdum* the advocates of the optimum currency area-model would have also be forced to demand different currencies in the different areas of one and the same city given the variances of income levels, economic structure and exposure to “external shocks”.

<sup>16</sup> Cf. Mueller, A. P., Sozialdumping oder interventionistischer Wohlfahrtsstaat? Probleme und Perspektiven einer europäischen Sozialpolitik, in: *Zeitschrift für Wirtschaftspolitik*, 40(1), 1991, pp. 21-34 (Colonia, Alemanha)

<sup>17</sup> Earlier in European history, beginning with the Roman era and later on with the Frankonian Empire and the prevalence of the French monetary unit ECU, periods of a “single money” in Europe cover several hundred years.

be remembered as a period of instability, economic decline and political conflict.<sup>18</sup> At the Bretton Woods conference in 1944, John Maynard Keynes represented the consensus opinion among economists when he suggested the construction of a system that would offer the exchange rate stability of the gold standard without the limitations inherent to a metal standard. When the modern process of European economic integration began in an institutionalised form with the European Payment Union and the establishment of the European Coal and Steel Community in 1952, and when later on in 1957 the European Economic Community (EEC) was founded, the Bretton Woods System delivered a system of relatively stable exchange rates, and provided – at least until the late sixties – a fairly stable international financial framework shared by the EEC members. As soon as this system began to crumble, the need arose to find alternatives as currency fluctuations caused internal disputes ranging from conflicts about how to manage the common agricultural policy to the problem of how to calculate contributions and funding of the common budget. When the Bretton Woods System finally broke down in the early 1970s, there was little doubt that the integration process in Europe was at stake threatening to bring the integration process to a standstill and even to provoke its retrogression.

As early as in 1970, when the detailed so-called “Werner-plan” was launched which called for the establishment of a common currency for the Community by the end to the 1980s, a pre-course to the later debate occurred between the so-called “economists” who demanded the integration of the real economy before the introduction of a common currency, and the then so-called “monetarists” who claimed that a common currency was necessary in order to achieve the integration of the real economy.<sup>19</sup> But practical necessity overruled both opinions, as it became obvious during the economic and monetary instabilities of the 1970s that neither freely floating exchange rates nor demand side policies were compatible with a deeper integration. The turbulences caused after the breakdown of the international fixed exchange rate system, the two oil price shocks, and the futile attempts to apply deficit spending as a means of overcoming the slump, led to a fundamental change as to what economic policy can and should do.<sup>20</sup>

In Europe, the two major lessons that were learned from the experience during this period said, firstly, that practical experience did not confirm the expectations about the automatic

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<sup>18</sup> For the historical analysis see Bordo, Michael D., and Forrest Capie (eds), *Monetary Regimes in Transition*, Cambridge 1993

<sup>19</sup> See Krägenau, Henry and Wolfgang Wetter, *Europäische Wirtschafts- und Währungsunion. Vom Werner-Plan zum Vertrag von Maastricht. Analysen und Dokumentation*, Baden-Baden 1993

<sup>20</sup> The misunderstanding of the role of fiscal and monetary policy by ignoring the lessons that were learned, still seem to guide many analyses, such as typically represented by the analytical perspective in: *OECD, EMU. Facts, Challenges and Policies*, Paris 1999

stabilization of freely floating exchange rates, and, secondly, that demand management theories did not fulfil their promises. Some governments were more prepared to accept these lessons; but step-by-step during the 1980s a new consensus emerged among European policy makers.<sup>21</sup> A pioneer in this process of re-orientation was the German central bank, which never had quite accepted the idea that monetary policy could foresee economic cycles in a timely manner in order to overcome the lags when implementing its instruments. The German Bundesbank was one of the first to use its newly gained monetary autonomy after the breakdown of the Bretton Woods System in order to pursue a strategy of stable monetary growth.<sup>22</sup>

The European consensus<sup>23</sup> on economic policy, which was about to emerge, can be summarized in the following statements:

- The process of integration requires a stable currency system
- Monetary policy should primarily be oriented towards price stability
- Deficit spending policies are incompatible with exchange rate stability.

The same lessons could be applied to the introduction of a regional gold standard. Once the policymakers of a group of countries could agree on these lessons, the adoption of a regional gold standard would appear as the natural consequence of these insights. Emerging markets in particular, such as for example nascent regional trade blocs in Latin America, Asia, or Africa, could perform a quantum leap forward towards prosperity that would come with fixed exchange rates (as they are automatically provided by the adoption of the gold standard), non-inflationary money and fiscal restraint that would be forced upon the participating governments because of the institutionalization of a regional gold standard.

In Europe, the renunciation of demand side policies in combination with the search for a new system of fixed rates became the guiding principles of the integration process since the early 1980s. Additionally, the earlier welfare state policies came under attack. The new economic policy concepts began to veer towards “supply-side economics” and a renovated

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<sup>21</sup> Cf. Eichengreen, Barry, Jeffrey Frieden and Jürgen von Hagen (eds.) *Monetary and Fiscal Policy in an Integrated Europe*, Heidelberg 1995

<sup>22</sup> See Deutsche Bundesbank, *The Monetary Policy of the Bundesbank*, Frankfurt a. M., 1995 and Issing, O., *Theoretical and Empirical Foundations of the Bundesbank’s Monetary Targeting*, in: *Intereconomics*, November/December 1992

version of the model of “ordo-liberalism”.<sup>24</sup> The new European economic policy model puts monetary stability in the forefront as a *conditio sine qua non* for most of the other economic policy aims; it deems that a market economy requires tough competition laws and their strict implementation, but it also wants to maintain broadly conceived systems of social security. While the social security has been largely left to national autonomy, monetary and competition policy have become central for the formation of a common European Central Bank and the institutionalisation of the common European competition law and its EU-wide implementation.

### **From EMS towards a single currency**

The European Monetary Systems (EMS) of 1979 that replaced the ‘snake system’, which was introduced in 1972, initiated the synthetic currency ECU (European Currency Unit). This basket currency system, based on the relative shares of all members of the Community including the currencies of those countries that would not participate in the Exchange Rate Mechanism (ERM), was aimed at overcoming the asymmetry associated with the priority of a single national currency, as it was the case with the role of the U.S.-dollar in the Bretton Woods System. As the decline of the U.S.-dominated system had indicated, an international monetary system, which exclusively depends on a national currency, is exposed to the disruptions due to changing national priorities in the country of the leading currency.<sup>25</sup> After a period of realignments, the EMS stabilized in the second half of 1980s and its existence was accompanied by falling inflation rates and solid growth<sup>26</sup> providing the basis to initiate new steps forward in the integration process with the single market initiative.<sup>27</sup>

During the period of the 1980s, earlier lessons were re-enforced while others were refined. The new consensus on economic policy that had emerged went deeper and was at the same

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<sup>23</sup> The term ‘consensus’ as used in the context here refers mainly to the European Council as the prime legal body of the European Union with the Commission as its executive branch. It includes to a lesser extent the relevant political groups within the individual countries but does not refer to public opinion or academia.

<sup>24</sup> See Walter Eucken, *Grundsätze der Wirtschaftspolitik*, Tübingen 1952

<sup>25</sup> In the second half of the 1960s, the U.S.-dollar as the anchor of the Bretton Woods System had become the major source of global money debasement, exposing the European countries to “imported inflation”.

<sup>26</sup> See Gros, Daniel and Niels Thygesen, *The EMS: Achievements, Current Issues and Directions for the Future*, in: CEPS (Centre for European Policy Studies), Paper No. 35, Brussels 1988

<sup>27</sup> Emerson, M. et al., *The Economics of 1992: An Assessment of the Potential Economic Effects of Completing the Internal Market of the European Community*, in: *European Economy*, No. 35 (Commission of the European Communities), Brussels 1988

time more pronounced than earlier.<sup>28</sup> Hypotheses had turned into convictions that were supported by a majority of the member states.<sup>29</sup>

- Stable exchange rates are highly beneficial for deepening economic integration
- Monetary policy should be confined to guaranteeing a stable price level
- Fiscal restraint is a prerequisite for stable internal and external monetary conditions.

But as the exchange rate crisis of 1992 and 1993 demonstrated, even sophisticated multi-currency systems such as the ERM do not offer the degree of stability, which would be compatible with the deeper integration that had been achieved and the goal of further deepening.<sup>30</sup> Although conceived as a “multilateral system” based on a common currency unit with symmetric intervention rules, in practice the German Bundesbank began to dominate the system. While the German mark rose to a position of an “anchor” for the system, the EMS was about to fall apart due to the pursuit of a highly restrictive monetary policy by the Bundesbank in order to ward off the inflationary consequences of German unification.<sup>31</sup> While for the rest of the 1990s, the ERM of the EMS existed only in reduced form, the “culture of monetary stability”, which had been introduced by the anchoring of the system to the German mark, continued to hold even for countries that earlier had shown substantially higher “inflation preferences”.

Political considerations and economic necessities worked together in establishing the additional pillar of consensus among the majority of the Community members that only a common currency could provide the stability needed in order to maintain and deepen the integration process. The conclusion of the European Union Treaty of 1992<sup>32</sup> set clearly forth the goal of establishing a monetary union. Since then, economic policy in the EU operated under the guidelines set by the criteria of the plan to achieve a common currency until the end of the decade. This regime of convergence – requiring low inflation rates, reduced fiscal

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<sup>28</sup> European Commission, Commission’s Recommendation for the Broad Guidelines of the Economic Policies of member States and the Community, Brussels, May 1998

<sup>29</sup> Although some modifications are under way, the principle of decision-making at the EC is unanimity. In practice, France and Germany *together* form the basis for new initiatives, i.e. while individually France and Germany have an informal ‘veto’-right, with very few exceptions (most prominently the United Kingdom) other members usually follow the consensus when these two countries give unanimously strong support to a proposition.

<sup>30</sup> See Fratianni, Michele and Jürgen von Hagen, The European Monetary System Ten Years After, in: Carnegie-Rochester Conference Series on Public Policy 32 (1990) pp. 173-242

<sup>31</sup> For the monetary effects of German unification see A. P. Mueller, The Supply-Side Economics of German Unification, in: International Trade and Finance in the 1990s, ed. by Mordechai Kreinin, New York (Taylor & Francis) 1993 (New York, USA)

deficit and debt levels, and stable exchange rates - worked within the framework of the loosened ERM, while the convergence criteria on price stability and fiscal adjustment were aimed at eliminating the roots of currency instability. By adopting a common standard for economic policy, most member states experienced a period of relatively stable exchange rates in the absence of a strict system. In certain respects the plan to achieve a common currency worked as if a common currency was already established. This, however, was only due to the earlier consensus that had emerged in the past decades and had become an integral part of the European Union Treaty.

The preparatory steps for the introduction of the common currency in Europe were well conceived and implemented,<sup>33</sup> as the introduction of the euro followed a series of phases, which were aimed at providing a solid basis for the adoption of the common money.<sup>34</sup>

The steps included in the first phase the

- Completion of a single market
- Coordination of economic policies
- Implementation of the program of convergence.

In the second phase the convergence process called for

- establishing autonomy and independence of national central banks
- eliminating central bank financing of government expenditure
- The supervision of national government finances by the Community.

The third phase established the

- Prerogative of the Community to establish time frames for fiscal stabilization of member states and the
- Authorization of the Community to impose sanctions on individual states including fines if fiscal stabilization is not attained.

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<sup>32</sup> This treaty serves as a preliminary "European Constitution".

<sup>33</sup> Cf. McKay, J. E., Evaluating EMU Criteria: Theoretical Constructs, Member Compliance and Empirical Testing, in: KYKLOS, 50, 1997, pp. 3-82

<sup>34</sup> See Buti, M. D. Franco and H. Ongena (eds.), Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact, in: Oxford Review of Economic Policy, Autumn 1998

In conjunction with these steps, a number of convergence criteria had been established which would guide the process of convergence:

- An inflation rate of joining members of no more than 1.5 percentage points above the inflation rate of those three countries with the lowest inflation rate
- Long-term interest rates no higher than two percentage points of those three countries with the lowest rates
- Participation in the Exchange Rate Mechanism of the EMS for at least the two last years before joining the euro-area
- A fiscal deficit of no more than three per cent of GDP and a government debt not beyond sixty per cent of GDP<sup>35</sup> or a trend towards obtaining these norms.

Quasi-constitutional elements were laid down in the articles of the Treaty of Maastricht for the European Central Bank<sup>36</sup> such as

- A strict orientation of monetary policy towards price stability
- Price stability has priority over external exchange rate stability
- Price stability has priority over other macroeconomic goals
- The Central Bank may not accept instructions or suggestions from the Community organs or from national governments.

With the exception of debt convergence, the preparatory process for a common currency worked well, and eleven members member states joined in with Britain and Denmark opting out for internal political reasons while Greece did not meet the convergence criteria<sup>37</sup>, and Sweden's central bank lacked the requirements of central bank independence.<sup>38</sup>

When the date of decision approached, policy makers of the joining countries did not feel to give up substantial autonomy. A broad consensus had formed that neither fiscal nor

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<sup>35</sup> These requirements can be derived from a model, according to which these debt figures are stabilized given a real growth rate of around three per cent and an inflation rate of around two per cent in accordance with a nominal GDP growth of five per cent.

<sup>36</sup> See European Commission, Maastricht Treaty on European Union, Brussels 1992

<sup>37</sup> In the meantime, on January 1, 2001, Greece joined the euro-area, while Denmark practices a policy of fixing its currency to the euro. The British government wants to wait a few more years until certain economic criteria are met. All three non-euro-participating EU member countries participate in the EMS II.

monetary policy nor the exchange rate represented effective means for fine-tuning economic policy.<sup>39</sup> On January 1st, 1999, the European Central Bank (ECB) came into existence assuming responsibility for monetary policy in the euro region. The ECB began to conduct monetary policy; it holds the currency reserves and manages the payments systems. Since then, the ECB is the sole institution with the right to issue the common currency as the legal tender.

### Lessons

Among the numerous endeavors of economic integration in the world, the EU represents the most advanced system. European economic integration serves as a model for a number of other regional blocs, while its attractiveness in Europe is shown by a series of enlargements accompanied by the process of deepening.

The study of the integration process suggests the requirement of a strict link between economic and monetary integration with the establishment of currency goals first and then taking the steps in order to maintain the arrangement. Another major result is political in nature and suggests that deeper economic integration requires a commonly held political goal. The European integration is peculiar in the respect that it represents primarily a political endeavour.<sup>40</sup> By having a well-established and largely undisputed political goal<sup>41</sup>, the integration process obtains constancy. To overcome the various impasses, political stamina is necessary that feeds on the source of constant political energy directed towards this goal. Only by taking into account that European integration is primarily politically motivated, and economic integration serves as a means to obtain this objective, the major features of the European integration process can be adequately evaluated:

- It has been the deeply rooted political will towards integration that was essential for overcoming disputes, obstacles, and setbacks, which by necessity accompany an integration process
- From the beginning, political union was supposed to include monetary union

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<sup>38</sup>See European Monetary Institute, Convergence Report, Frankfurt, March 1998

<sup>39</sup> For a contrasting view see Cangiano, M. and E. Mottu, Will Fiscal Policy be Effective under EMU?, in: IMF Working Paper WP 98/76, 1998 and Caesar, Rolf/ Renate Ohr (eds.) Maastricht und Maastricht II: Vision oder Abenteuer?, Baden-Baden 1996

<sup>40</sup> See Lindberg, L. N., The Political Dynamics of European Economic Integration, Stanford 1963

- As the political union served as the premier aim, matters of economic integration and later on how common monetary arrangements should be handled, became largely technocratic matters, and as such could be assigned to bureaucracies and the experts.

While the political setting in Europe is unique, transferable features can be derived from the European experimentations with various currency systems. By pursuing the aim of forming a European Union, the necessary consensus on economic policies grew out of the establishment of common currency arrangements. While working with various forms of systems and later on when following the guidelines set by the aim of introducing a common currency, the necessity emerged of finding a consensus about what monetary policy should and can do, and, more technically, which aims, indicators, and instruments should be used in conducting monetary policy. In addition, to make the common monetary arrangements work, the need arose to extend the consensus to other parts of economic policy, most importantly to fiscal policy. The logic of integration in Europe is based on a sequence of steps that are deduced from the overriding aim of achieving political unity and deeper economic integration.

- Political unity needs economic integration
- Economic integration needs stable exchange rates
- A stable exchange rate system requires common monetary policy
- A common monetary policy requires a harmonization of the other economic policies.

The concrete steps of integration have always been taken pragmatically. There has also been a remarkable absence of either rigid ideologies or specific models derived from economics or from other disciplines.

This feature of the European integration process must be carefully taken into account when the “European integration model” is to be studied as a guideline for other regional integration effort. Then, in general terms and limited to economic policy, five aspects can be

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<sup>41</sup> In contrast to the ‘consensus’ on economic policy, which is mainly confined to the prime decision making bodies of the EU, the political consensus on European integration runs deep among most nations with few exceptions.

derived as the primary lessons, which may serve as orientations for other regional integration processes:

- Without constancy and an unwavering adherence to the goal of economic integration, the process will likely encounter abortion due to a standstill and neglect
- If deeper integration such as a single market is wanted, common monetary arrangements aimed at stable exchange rates are one of the major preconditions for achieving this aim
- Stable common currency arrangements require the formation of a consensus on rules for monetary and fiscal policy
- Applying fiscal and monetary policy for short-term purposes is incompatible with stable currencies and thus indirectly responsible for aborting the integration process
- Stable exchange rates require constancy of economic policies aimed at stabilizing expectations by limiting policy activism.

The European experience suggests a strategy of an early adoption of common currency arrangements and to work towards consensus on monetary policy that implies fiscal restraint. Any deeper regional economic integration is severely hampered when stable currencies are lacking. On the other hand, the European experience demonstrates that maintaining stable currencies is difficult to achieve because currency stability does not only require a functioning formal system but also a profound consensus on monetary policy and the role of fiscal policy. Such a consensus cannot be gained in a purely theoretical way but requires active experience guided by strongly felt political convictions.

As to the technical aspects of the process, the important lesson appears to be that common monetary arrangements are necessary to induce the convergence process in the first place. Integration and common monetary arrangements require for their stability a set of common beliefs or even a belief system, i.e. a common vision of “Ordo”<sup>42</sup> that goes beyond the agreement on macroeconomic goals and the concepts of stabilization policies. By definition, such a consensus cannot be imposed but must grow out of common experience guided by a common goal. In this respect, the European experiment demonstrates the prevalence of politics over economics, and the prevalence of a common vision over politics.

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<sup>42</sup> Since the beginning of political philosophy the discrepancy between the given order (the empirical system) and the ORDO as an ideal has been the recurrent topic in the thinking about statehood and communities, and

Each region's efforts towards economic integration must be evaluated on the specific conditions of the area, including the political and geo-strategic aspects. Although learning from other experiences is limited it is also essential for those – nevertheless few – areas where comparisons can be made. In this paper, the focus of comparison has been economic policy and monetary policy in particular, in their relation to economic and monetary integration.

While the political situation and the general economic conditions are very different in their concrete forms, on a more abstract level, the essentials for obtaining economic and monetary integration are quite similar. Seen in this way, the European experience holds a series of basic lessons that can be – in a modified way – applied to the integration process in the rest of the world. Foremost among these lessons stands the political will to pursue peace and prosperity. Secondly, the European experience highlights strongly the sequence of economic and monetary integration, which does not wait for “optimality” to be there but tries to obtain more favorable conditions by doing the steps towards currency arrangements first. Finally, the European experience points strongly to the need of achieving consensus on monetary and economic policy with the special feature that economic integration requires the abandonment of short-term demand management policies in favor of long-term stability considerations.

In many parts of the world, the integration process is severely hampered by monetary and exchange rate instability. This can be seen as a reason that deeper economic integration is not feasible. However, it is exactly here that the European experience becomes relevant in that it points out that by itself monetary and currency stability are the preconditions of a stronger economic integration which in turn provides the foundation to render external shocks and disturbances easier to absorb.

### **Towards a Regional Gold Standard**

The ideal – as the first best solution – would be a common “world currency” beyond any single national domain, i.e. a global gold standard. But, like with international trade, ideal solution often must give way to second best solution, i.e. implementing the ideal in limited regional form. This has led to the establishment of economic blocs in the form of free trade areas and economic communities and is now entering the second phase with the establishment of currency areas. The establishment of a common currency in Europe must be seen in this

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dialectical analyses of politics and economics in these terms cannot be adequately replaced neither by pure empiricism nor by pure theory. Cf. Eucken, op. cit.

context, which requires currency stability for the sake of economic prosperity within an expanded regional area as long as a non-national world currency is absent.

Regional integration does not exclude multilateral trade-agreements but may serve as a complement and thus bring about a viable “second best-solution” in contrast to the “first-best solution” of global free trade, which may be unattainable. Regional integration, which is limited to “free trade areas”, represents a deficient solution in contrast to those forms of integration that go beyond trade and extend the free movement to all goods, services, labor and capital. When regional free trade areas work as a substitute for full trade liberalizations, the drive towards global free trade may get blocked. In some case, free trade areas include more trade restrictions than the WTO wants to tolerate.<sup>43</sup>

Part of the move towards regional integration comes from the cost-benefit-analysis that by giving up some of the less important features of sovereignty, the country may gain other factors that are perceived as being more essential to the national interest. In contrast to integration processes that are oriented towards deepening, other types of loose integration seem to lack long-term stability. Institutions like currency boards, for example, are hard to maintain, as they come along with a net loss of both autonomy and a voice in the world. In areas like this, pure economic considerations are deficient from the beginning, when they do not include the conditions set by the socio-political environment. In order to achieve levels of deeper integration, exchange rate stability represent a major factor. But in order to maintain stable exchange rate conditions, a consensus must be found that covers fiscal and monetary policy and is held together by a commonly held view about the goals of economic policy. Here, the European experience speaks quite clearly as it demonstrates the necessity to abandon short-term demand management. Additionally, the European experience suggests the lesson that waiting for the macroeconomic conditions to be anywhere close to optimality as defined by some economic models may be a task for eternity. It is rather the establishment of common currency arrangements among countries that strive for deeper integration that is necessary to achieve this deeper integration in the first place.

As it is shown by the European experience, although limited to the creation of an artificial common currency, a new global gold standard can be implemented in a similar fashion as a common currency arrangements first and a deeper economic integration as its consequence. It is not hard to imagine that some countries begin by forming a common gold standard and –

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<sup>43</sup> While the plans for the Free Trade Area of the Americas wants to exclude agriculture, for example, its inclusion is a central item on the long-term agenda of the WTO along with the inclusion of services.

likewise as the Europeans inspired by the common goal of peace and prosperity – demonstrate the beneficial effects of such an arrangement and in due course open up to new members that are attracted to the bloc in a voluntary fashion.

In many regions of the world countries suffer from political weaknesses that prevent the adoption of economic policies that would foster prosperity. Political pressure often puts an obstacle to the pursuit of sound monetary policy and fiscal restraint. Anchoring the currency to a major foreign currency (usually the US dollar) often served only as a temporary solution and came along with high unexpected costs when the arrangement was abandoned. Often it was only realized when it was too late for a change that the neglect of regional currency arrangements would bring further economic integration to a standstill.

In many parts of the world, particularly in developing and emerging markets, the lack of credibility, technical incompetence of central bank management, and an ever-present political interference, produce highly volatile exchange rates. As these currencies present a miniscule share of the global financial markets, even moderate movements in and out of these currencies imply massive exchange rate changes. In addition, the authorities in these countries often prefer the easy way of exchange rate changes to compensate for other economic policy errors. As a result of these disturbances, regional trade integration falls short of optimality. Under these conditions, the potential in gains from trade remains unrealized and huge losses of prosperity occur.

As the analysis in this paper has demonstrated, the European sequence of economic monetary integration runs from regional currency arrangement to national monetary policy, and from money to domestic fiscal policies, and on from there to the harmonization of the other policy areas. Most countries in the developing world lack the technical know how and institutional setting to imitate in any serious form a European-like project of regional economic and monetary integration. Yet what they could do is actually something better than the European project. If a regional group of countries would adopt a gold standard they could earn almost overnight a series of benefits that otherwise are extremely hard to obtain or outright impossible for these countries, i.e. stable monetary conditions, exchange rate stability, and the gains from trade that would come under such an umbrella. It is also not hard to imagine that such a project of implementing a regional gold standard could begin with very few countries (two or three) while the expansion could come in a complete voluntary and individual fashion so that the new member need not even “join” the club, but could become a member of the group simply by installing a gold standard at home.

In some ears the suggestions made here may sound utopian, but one should not forget that in the 1950s a rapid recovery of Europe appeared as utopian and even in the early 1990s, many

an observer called the implementation of single European currency utopian. In fact, one should argue the other way around: it is highly utopian to expect that prosperity can be achieved and maintained in an environment that is characterized by highly volatile exchange rates and instable monetary policy. The implementation of a regional gold standard would do away with the major obstacles that undermine regional economic integration, particularly in developing countries.

### **Conclusion**

The “European sequence” shows that stable currency arrangements must come before deepening economic integration. Likewise, it is not “economic convergence” which is the precondition of common currency arrangement, but it is a common currency arrangement that provides the condition for economic convergence. The European experience also demonstrates that the theory of “optimum currency area” does not apply to the way how Europe achieved its high degree of economic integration.

For Latin America, with its absence of a wide pool of highly qualified technocratic officials in the area of international finance, a simpler path than the Europeans have taken must be found in order to overcome the somewhat paradoxical situation that a common currency arrangement must become before economic convergence. Regarding the situation in Latin America it is also important to note that a simple and – as far as it goes – “apolitical” institutional setting should be searched. Thus, the simple functioning of a gold standard system is well suited to both needs of the Mercosur: gold-based currency arrangements do not need high expertise and it is a system which is relatively remote from politics once established and thus will quasi automatically enhance the degree of monetary trust.

In this paper, we did not go into the technicalities of how to establish such system. In this paper, the main intention was to show, by example of the European experience, how a high degree of economic integration can be achieved and that the European sequence is different from the economic convergence theory and the theory of optimal currency areas. Secondly, it has been the aim of this paper to draw attention to the establishment of a regional gold standard as a condition to move towards deeper economic integration and to challenge the widely held prejudice against monetary gold as a so-called “barbarian relic”.

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