2000

HOW LONG DID IT TAKE THE UNITED STATES TO BECOME AN OPTIMAL CURRENCY AREA?

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AGENDA

- History of U.S. Monetary Union & Theory of Optimal Currency Areas
- Union, Disunion & Reunion
- Misunion: Part 1 & 2
- Misunion: Part 3 & 4
- Communion & Lessons from U.S. Monetary Union

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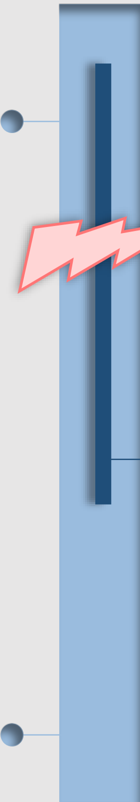
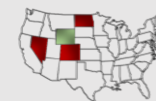
History of American Monetary Union

1788: Monetary Union began with ratification of constitution



Civil war years



150 years regional disputes: good monetary policy from the point of view of one region, was bad policy from the point of view of another

2017: Monetary Union still remains

Benefits: interregional movements of capital, labor and final products

Theory of Optimal Currency Areas

Robert Mundell was the first to use the term “Optimum Currency Area” in 1961

Theory depends on imperfections in capital and labor markets, and price and wage stickiness

Advantages for regions to join a monetary union: minimizing transaction costs

Disadvantages for regions to join a monetary union: giving up the exchange rate, and changes in the stock of money, as policy tools

Benefits of a larger monetary union:

Travel through the country without having to convert money

Prices in distant regions can be compared

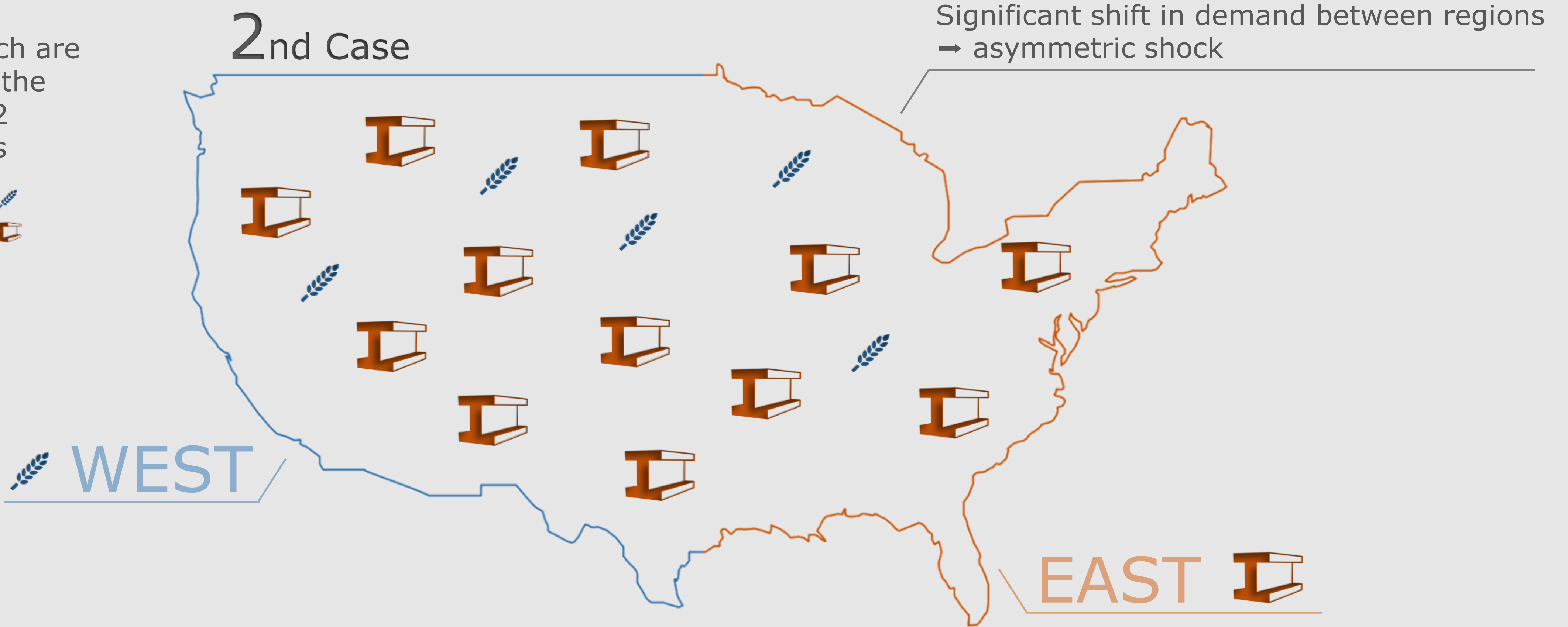
Interregional investments without the risk of currency fluctuations

Theory of Optimal Currency Areas

Theory of Optimal Currency Areas

Assumption:
2 regions, which are specialized on the production of 2 different goods

WEST: Crop
EAST: Steel



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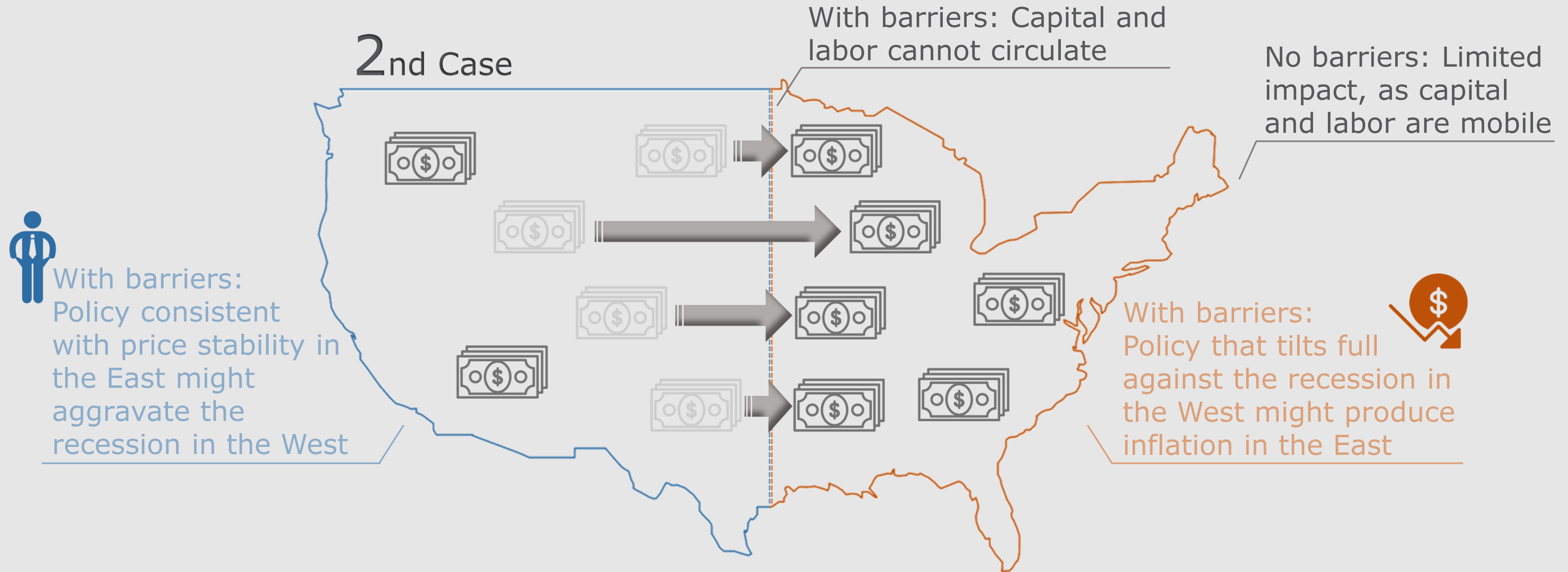
Theory of Optimal Currency Areas



With barriers: both regions would be better off with separate currencies, and floating or adjustable rates

Union, Disunion & Reunion

Prior to the Revolution the currency of the United States varied from colony to colony (British pound and Spanish peso)

individual colonies also tried to make their own paper currencies legal tenders in order to provide revenues or to aid debtors

Part of the opposition to paper money was…

- … based on the experience of the very high rates of inflation under the fiat paper money regime of the Revolution
- … increased by the development of fractional reserve banking

Union, Disunion & Reunion

Banking panics in the United States

1837 — Numerous banks failed, and the banks were forced to suspend specie payments

1838 — Specie payments were resumed, and things began to look up

1839 — Second panic inaugurated a long recession marked by falling prices and a contraction in real output was debated

Union, Disunion & Reunion

The Civil War was the result of the great national division over slavery

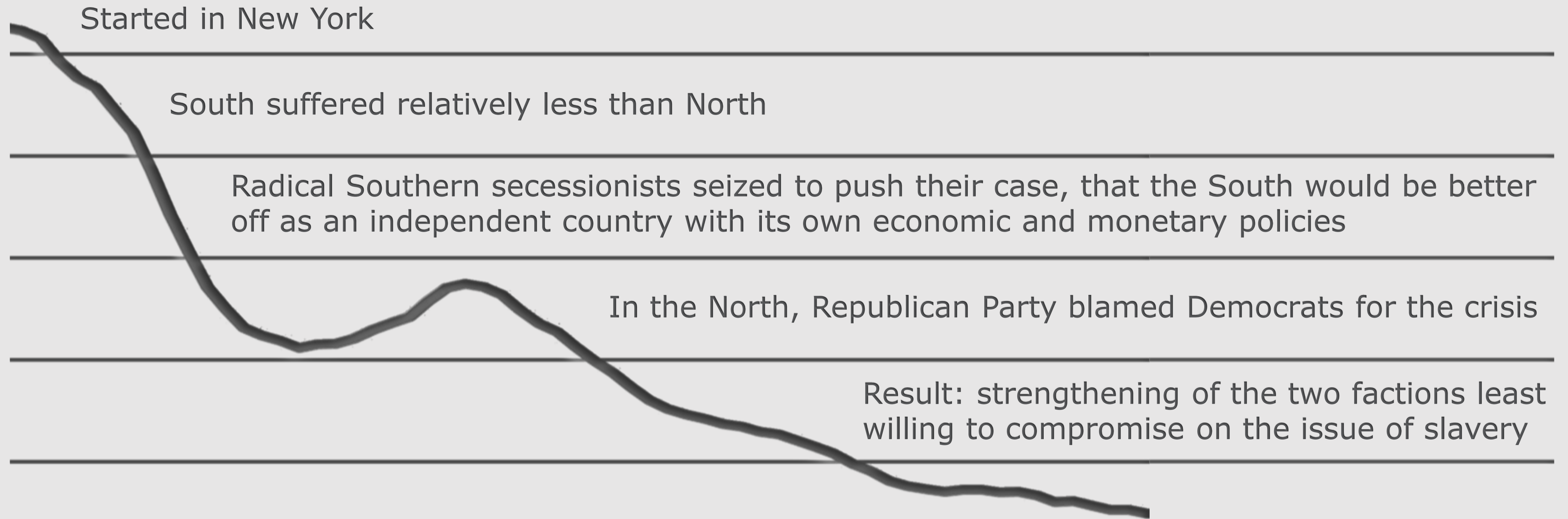
The South before the war:

- well developed banking system
- good deal of evidence for capital market integration

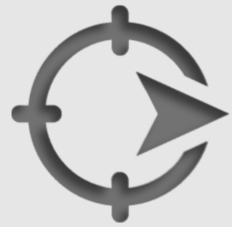
King Cotton: banking and economic system on which Southerns were proud

Union, Disunion & Reunion

Crisis in 1857



Union, Disunion & Reunion



East

Middle West

Fiat money standard prevailed based on the greenback

South

Another fiat standard held sway based on the Confederate dollar

Collapsed with the Confederacy, and came to an end in 1865.

Reunited the two currencies of the United States took until 1879.

Union, Disunion & Reunion

After **1865:** the South and Northeast were on the same monetary system

The goal of monetary policy:

returning to the prewar price level and gold convertibility

Goal was achieved on January 1, 1879 when the United States returned to the gold standard at the prewar parity

The policy of resumption faced determined regional opposition

Republicans in the Northeast favored resumption

Democrats and their allies in the Greenback Party

Optimal Currency Area Criteria

- Large Area
- Specialized on the production of certain goods
- Labor Mobility
- Capital Mobility
- Fiscal transfers

The Great Depression of the 1890s

Two severe recessions:

- January 1893 - June 1894, after that a slow and weak recovery
- Followed again by a decline in economic activity from December 1895 to June 1897

Bank runs and failures occurred in all regions (due to uncertainty)

How could this situation have been avoided?

- Milton Friedman has argued that adoption of bimetallism earlier in the post-war period would have produced a more satisfactory behavior of the price level. He concluded, however, that by 1896 the time for adopting bimetallism had passed.

- A commitment to either gold, or silver would have avoided the uncertainty, which was part of the problem.

Optimal Solution

- The optimal solution would have been separate currencies
- For the West and South the adoption of silver standard in the 1980s. On the other hand, East and the Pacific Coast regions would have stayed on the gold standard.
- "Money stocks would not have fallen in the West and the South as much as they did. Their currencies, moreover, would have depreciated against gold, making it easier to dispose of wheat, cotton, and other agricultural products on domestic and world markets. The debate over monetary policy, and the resulting uncertainty, which affected banks in all regions would not have happened."

The panic of 1903 and the panic of 1907

Rich’s man panic (1903)
➞ Did not produce banking panic or a severe economic contraction

Panic of 1907
➞ Banks were forced to restrict convertability of bank notes and deposits into gold
➞ All regions were affected
➞ Monetary reform was needed
➞ Creation of a type of central bank

The great depression of the 1930s

- ➞ No region was immune to the crisis, but significant regional differences
- ➞ Rregional loyalties had declined (WW I)
- ➞ Federal Reserve did not act as a lender of last resort for the banking system

The great depression of the 1930s

By June 1935 New York, Richmond and San Francisco districts had all recovered their 1929 levels

Deposits and employment rose 20-30 %

Needed restrictive monetary policy

The great depression of the 1930s

In ‘heartland’ districts conditions were very different:

➞ Deposits were low, uneployment was still high
➞ Some regions needed stimulations; others needed restraint (optimal-currency-area dilemma in 1936)

Communion

- It is assumed that the U.S became a smoothly functioning monetary union, but we may tend to exaggerate how well it functions
- One institutional change was the development of federally funded transfer programs such as unemployment insurance, social security and agricultural price supports, which cushioned regional shocks and redistributed reserves lost through interregional payments deficits
- Penelope Hartland (1949) showed that the regions that had been hit by terms of trade shocks during the 1930s lost reserves to other regions through trade deficits, but that government transfers materially offset these losses
- Ex: Between 1929 and 1933 the Minneapolis Federal Reserve district loss $247 M in reserves on private transactions but this was offsett by a gain of $229 M on federal government transactions
- On the other hand, the Boston Federal Reserve district gained $644 M in reserves on private transactions, while losing $575 M on federal government transactions

Communion

- Second institutional change was the breakdown of long-term isolation of the Southern labor market
- During the war a strong northern labor market and the absence of immigrants pulled workers, from the South and established networks that provided information and support for later migrants
- In addition, federal labor legislation in the form of minimum wages and regulation of hours and conditions of work, as well as federal incentives to mechanize agriculture, established during the 1930s added to the postwar flow of migrants from the South
- A Third factor that improved the functioning of the U.S monetary union after the war was the absence of major baking and financial crisis emanating from regional shocks
- Deposit insurance and monetary policies that reacted quickly to economic downturns, tended to minimize the regional banking problems that characterized recessions in the prewar era

Lessons from U.S. Monetary Union

- On the one hand, monetary unifications means reduced transaction costs, easier comparison of prices in different regions, long-term investment without fears of devaluation, and so on
- On the other hand, unification means relinquishing the capacity to use exchange rate changes and monetary policy to prevent monetary problems from magnifying distress originating in other sector
- The experience of the U.S. is cited as evidence that the benefits greatly outweigh the costs
- But the survival of the U.S monetary union is at best weak evidence that the net effects have been positive

Lessons from U.S. Monetary Union

- Many government policies, tariffs for exemple, which have survived for decades for political reasons, often the support of special interests, even though the claim that these policies contributed positively to the general welfare is dubious
- U.S. experience shows that fears about the loss of monetary autonomy are far from baseless. American monetary history provides numerous examples of regional shocks that were magnified by monetary reactions

Lessons from U.S. Monetary Union

Tipically, a region-specific shock to financial markets produce a loss of regional bank reserves through an:

Internal drain, caused by fears about the solvency of the regional banking system

External drain, caused by a regional balance of payments deficit

The result would be a regional contraction of bank Money and credit and a political battle would often follow.

Regions which experienced the contraction would demand a reform of the whole monetary system and resulting uncertainty about the future of existing monetary institutions would further aggravate the initial contraction in economic activity

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Lessons from U.S. Monetary Union

- During these episodes the U.S might well have been better off, from a purely economic view if it had been divided into separate currency areas
- Regions hit by severe asymmetric shocks would have been able to devaluate their currencies, which would have reduced interregional losses of reserves
- Within the region, expansionary monetary policies would have shored up the banking system, preventing runs or severe contractions of credit
- Other regions would have been free to follow more conservative monetary policies, eliminating political battles over monetary institutions

Lessons from U.S. Monetary Union

Lessons for countries contemplating joining or remaining within a monetary union:

The lesson is that the facile argument that the U.S has had a monetary union and therefore monetary unions must be good, does not stand close scrutiny

For countries already firmly committed to a monetary union, the lesson is that it is extremely important to adopt the institutions adopted by the U.S in the 1930s ➞ a system of inter-regional fiscal transfers and some form of deposit insurance, or regionally sensitive lender-of-last-resort facilities, so that asymmetric real shocks are not aggravated by banking crisis

Lessons from U.S. Monetary Union

- Although the Eastern financial centers and industrial Middle West had been integrated by the turn of the century, it was not until the 1930s that all regions, including the South, could be said to be parts of a single optimal currency area
- To end up, how long dit it take the U.S. to become an Optimal Currency Area?
- A reasonable minimum might be 150 years !
- Hopefully, it will not take the European Monetary Union quite so long

The

Thank you for your Attention

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