MONEY

AND THE

SOVEREIGNTY OF THE STATE

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INTRODUCTION

Monetary integration involves a consideration of two quite different types or dimensions of sovereignty. One is “policy sovereignty” and the other, “legal sovereignty.” Policy sovereignty refers to the ability to conduct policy independent of commitments to other countries. Legal sovereignty refers to the ability of a state to make its own laws without limitations imposed by any outside authority. Both concepts need to be considered in plans for monetary unions. What are the implications of a change in legal sovereignty when the national currencies of some of the oldest states in the world abandon national sovereignty, and what will they receive in exchange?

In the middle of the last century, Johns Stuart Mill recognized but deplored the sentiment that made nations so attached to their own currencies:

“So much of barbarism still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbours, a peculiar currency of their own.”[1]

Has the world--or Europe--changed to such an extent that the national populations are now prepared to scrap those hallmarks of sovereignty that have existed for thousands of years?

What is the nature of the sentiment that makes national currencies so difficult to give up? Some idea of this can be got from British or English history, whose currency goes back at least thirteen centuries. Sir Robert Peel, in 1819, quoted in the House of Commons the evidence of a London accountant given before the Committee on the resumption of Cash Payments:

“He was required to define what he meant by the pound. His answer was: ‘I find it difficult to explain it, but every gentleman in England knows it.’ The Committee repeated the question, and Mr. Smith answered: ‘It is something that has existed without variation in this country for eight hundred years--three hundred years before the introduction of gold.’”[2]

Peel quoted Smith’s opinion only to ridicule it, because Peel would become the political champion of those who held the view--with John Locke[3], Isaac Newton, David Ricardo, John Stuart Mill and a host of other classical economists that the ‘pound sterling could only rightly be defined as a ‘definite quantity of gold bullion.’[4] That makes the pound into a commodity rather than a money because the essence of money lies not in the value of the commodity of which it is made, but in its overvaluation.
This paper will discuss the relation of monetary integration to both types of sovereignty but its primary emphasis will be on the implications for legal sovereignty of different types of monetary

[1]Mill l (1848; 1909: 615).

[2]Feaveryear (1963: 1).

[3]Locke, however, would have insisted that money is a quantity of silver.

[4]*ibid.*

unions. The sections in Part I will explore the concepts of policy and legal sovereignty, and relate these concepts to the history of the monetary sovereignty as it emerged in from Roman law into the Europe of the Middle Ages. The sections in Part II will review some aspects of monetary sovereignty in the United States including the monetary battles that were waged in the Supreme Court of the United States before in the 20th century monetary sovereignty came to settle once and (perhaps) for all in the federal government. Part III will discuss explicitly some implications of the sovereignty issue for choices made with respect to sovereignty along the road to EMU.

PART I. TYPES OF SOVEREIGNTY

This part of the paper will discuss different types of sovereignty, paying attention to the distinction between legal and policy sovereignty in monetary unions, the concept of monetary sovereignty itself, the early history of monetary sovereignty in the ancient world and the Europe of the Middle Ages; and finally the landmark "Case of the Mixed Moneys" which established a legal precedent on which subsequent legal history has drawn.

Policy Sovereignty and Legal Sovereignty

One step in the spectrum of monetary integration from complete independence with freely flexible exchange rates to complete union with currency unification is a system of fixed exchange rates. When a country opts for fixed exchange rates, it sacrifices monetary policy autonomy in favor of a mechanism of adjustment for correcting the balance of payments. In short, it sacrifices policy sovereignty in the field of money.

Where does the sovereignty go? One possibility is a system in which the sovereignty is transferred to a hegemon. If a small country unilaterally fixes its currency to a larger neighbor, it in effect transfers policy sovereignty to that larger neighbor. The fixing country loses sovereignty because it no longer controls its own monetary destiny; the larger country gains sovereignty because it manages a larger currency area and gains more "clout" in the international monetary system.[5] The rate of inflation in the system will be governed by the monetary policy of the hegemon. To a very great extent, this was the type of system practiced within the great empires of the major powers leading up to World War I.

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[5]That a country's "power" or "clout" in the international system is increased by the use of its currency as a key currency can be readily illustrated by the weights of the three largest countries in making up the IMF unit of account, the SDR. The United States with a GDP of 24 per cent of the world economy, has a weight of 40 per cent; Germany, with a GDP of less than 8 per cent of the world economy, has a weight of 21 per cent; and Japan, with a GDP of 14 per cent of the world economy, has a weight of 17 per cent. The ratio of SDR weight to GDP share in the world economy is 2.6 for Germany, 1.6 for the United States, and 1.2 for Japan. These weights were determined before January 1, 1991, when several large countries, including France, the U.K. and Italy, were tied in effect, through the ERM, to the DM; the Fund would probably justify Germany's excessive weight in the SDR on the grounds that the clout of the mark was much greater before the partial breakup of the system in the crisis of September 1992.

If, on the other hand, several countries agree to cooperate in forming a currency area, the "n-1" or "redundancy problem" leaves open for policy the rate of monetary expansion of the area as a whole and therefore its rate of inflation. Some kind of "monetary authority" would determine the monetary policy for the area as a whole, and each country would share in the area's sovereignty according to the political terms of the monetary agreement. Each country sacrifices its complete sovereignty over its own monetary policy in exchange for its share--however allocated--in the more important sovereignty exercised by the joint monetary authority.

A system of fixed exchange rates with a central control over the currency area's monetary policy is by no means a complete monetary union. A further step along the road to monetary integration is the creation of a joint currency. Whether or not the creation of a joint currency represents an important or an unimportant change in sovereignty depends on its legal attributes. In the events leading up to the Bretton Woods meeting, both the White and Keynes plans had made provisions for a world currency that would have had a kind of legal tender power--bancor in the Keynes plan, unitas in the White plan. Both these proposals were rejected by the United States undoubtedly because it would have involved a loss of monetary sovereignty to the largest power.

The creation of the SDR, however, was acceptable because it was not explicitly a reserve asset and a country's liability was limited. Initially, when established in 1968, the SDR had a gold weight guarantee. As soon as the price of gold soared, however, the gold guarantee was stripped away from it and further allocations were too small to have an important impact on the international monetary system. Countries--and this meant especially the largest countries--were not willing to confer either policy sovereignty or legal sovereignty in the field of money to a supranational institution. The important decisions in the field of international economic policy have been made by the large powers unilaterally or in groups like the G-5 or G-7.

A more interesting case, perhaps, has been the creation of the ECU, which is scheduled to be the unit from which the euro will evolve in 1999. The European Monetary System, established in 1978, was a loose system in some respects patterned after the arrangements set up at Bretton Woods, but with the addition of the ECU as the unit of account for the system. The setting up of the ECU did not itself involve much transfer of policy sovereignty and almost no transfer of legal sovereignty. The national currencies were still sole legal tender in their respective authorities and--except for the transactions of the European Commission (which, admittedly have become increasingly important)--the use of the ECU was purely voluntary.

The ERM, however, did involve a transfer of policy sovereignty. Although the pegging arrangement was intended to be multinational, forces in the exchange market took over and it soon gravitated to a DM-zone, with monetary policy determined by the Bundesbank. Policy sovereignty was therefore shifted from the other nation-states in the ERM to Germany. The aftermath of German spending after the unification shock in 1990, however, brought about a conflict between stability in the German economy and its neighbors, and the system had to be changed.

When--or if--EMU is brought into being, important changes will be involved in policy sovereignty. The exchange rates of members who are admitted will be irrevocably fixed so each country will sacrifice its policy sovereignty in the field of money. At the same time, each country will gain its share of policy sovereignty by its voice in the direction of the European Central Bank (ECB). The Governors of the National Central Banks will be members of the Governing Council of the European System of Central Banks (ECSB) along with Members of the Executive Board of the ECB, and as many as six of the countries will be on its Executive Board. Even though the principle is one country, one vote, in practice the large countries will have a greater voice.[6] From the standpoint of policy sovereignty, EMU will be different from the ERM in that it will be irrevocable, and that the supranational policy sovereignty will be shared.

The EMU plan, however, goes far beyond policy sovereignty and the creation of a new currency. It involves also the *replacement* of national currencies by the euro. The implications of this change for legal sovereignty are nothing short of earth-shaking for the countries involved. The right to produce a national currency has for millennia been looked upon as a principal dimension of political independence and legal sovereignty. Yet the decision to opt for a monetary union that replaces national currencies with a single currency seems to have been taken up and accepted with little discussion of what its implications actually are.

The Maastricht plan for a single currency to replace the national currencies was a key feature of the Delors Report, which stated that:

> "The adoption of a *single currency*, while not strictly necessary for the creation of a monetary union, might be seen--for economic as well as psychological and political reasons--as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the ...union, considerably facilitate the monetary management of the Community and avoid the transactions costs of converting currencies...The replacement of national currencies by a single currency should therefore take place as soon as possible after the locking of parities."[7]

The Delors Committee was not assigned to make a case for EMU but rather to make recommendations as to how it should be brought about. The Committee's report found its way into the Maastricht Treaty but did not explicitly consider the implications of scrapping national currencies. If countries give up their legal national sovereignty, what will be the nature of the share in sovereignty they get in exchange? What are the psychological effects of abandoning the heritage? Can monetary sovereignty be sacrificed without political sovereignty? Where will the sovereignty go? What will citizens get in exchange? What are the "psychological and political reasons" mentioned in the Delors Report?

Every member of the IMF has an independent currency, which it currently regards as a mark of its political independence and national sovereignty[8] as well as a component of national heritage

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[6]This is as it should be because large countries have more to lose and less to gain by monetary union.

[7]Quoted in Kenen (1995: 14).

[8]A few of the tiny countries may be exceptions. Panama and Liberia have national

and patrimony. Will EU members of the Executive Board of the IMF be content to be represented by a single monetary authority? What are the implications for the "law of payment," that rule known in law since antiquity that specifies that an independent country has the right to determine that which is acceptable as legal tender in payment of debt? Other issues concern the potentially inflation impact of replacing several national currencies by a single "more liquid" currency, the sacrifice and redistribution of seigniorage in the union, and the mental and psychological transactions costs of shifting units of account.

Much attention in the literature has been given to the difference between monetary systems based on fixed and flexible exchange rates. Within the category of fixed exchange rates, however, there are several options depending on such factors as the irrevocability of the commitment to the parity, the width (if any) of the exchange rate margins, the asymmetry of the intervention responsibilities, and the degree of unification of the units of account. This paper will also touch on the difference, relevant to the sovereignty issue, between a system of rigidly fixed parities and a single currency.

The Sovereignty Issue

We now need to turn to the issue of monetary sovereignty itself. What is it? Where is it located? When did it come into being? What are the implications of giving it up or sharing it? By what legal process is it transferred? Who has the right to transfer it? Is transfer irrevocable? Does the state exist without it? Where does sovereignty lie in a monetary union of independent states? These are some of the questions that could be asked about monetary sovereignty in a future monetary union.

Monetary sovereignty might be thought of as one of the dimensions of political sovereignty. But therein lies a problem. According to political scientists, the concept of political sovereignty was developed in Renaissance times, starting importantly with Jean Bodin in 1576. But the concept of monetary sovereignty is far older. It goes back to the Romans and before; quite probably it goes back to the ancient empires of Sumer, India, Babylon and Egypt. The literature in the ancient world is explicit and substantial.

First, however, let us see what sovereignty means in political science. According to one view, the concept of sovereignty "implies a theory of politics which claims that in every system of government there must be some absolute power of final decision exercised by some person or body recognized as competent to decide and able to enforce the decision".[9] The simplest form of the theory is the common assertion that "the state is sovereign" which is usually a tautology, just

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coinages but use the US paper dollar for the bulk of their transactions. Luxembourg has been a passive member of a monetary union with Belgium since 1924 and thus has transferred policy sovereignty while retaining legal sovereignty.

[9]Crick (1968: Sovereignty)

as the expression ‘sovereign state” can be a pleonasm.[10] The concept of the state came into being about the same as the concept of sovereignty and it served the same purpose and had the same meaning.[11]

Not surprisingly, the concept of political sovereignty came into being at a time when it was necessary. The concept dates back at least to the work of Jean Bodin writing soon after the Massacre of the Huguenots on St Bartholomew’s Day in 1572. Bodin was a kind of polyhistor--an economist as well as a jurist. He was the originator of the partly correct quantity-of-metal theory of the value of money and held and tested the proposition that the great increase in prices in the 16th century was due to the influx of metals[12] from America, a theory Earl Hamilton would try to test more fully four centuries later.[13] Bodin was writing in the midst of the great religious wars associated with the counter-reformation. He saw civil war as the worst of all evil, held that the state was primarily concerned with the maintenance of order and not the establishment of true religion, and introduced his concept of sovereignty to bolster the power of the French king over the rebellious feudal lords and the church: “It is clear that the principal mark of sovereign majesty...is the right to impose laws generally on all subjects regardless of their consent...If he is to govern the state well, a sovereign prince must be above the law.” Bodin thought he had found in this principle a universal recipe for political stability.[14] Bodin’s views were taken up by Hobbes (1651) who also was preoccupied with the problem of civil war. In their theories, sovereignty was more or less absolute except insofar as they conflicted with divine right (Bodin) or the laws of nature (Hobbes).

Machiavelli, in *The Prince*, did not develop the concept of sovereignty, but he did recognize the distinctions in power necessary for two quite different situations--peace where republicanism can rule, and war where dictatorship is, if not inevitable, more likely. This can be seen the doctrine of constitutional dictatorship in the Greek states and in the Roman Republic, as also in the

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[10]*ibid.*

[11]*ibid.*

[12]Bodin (1568, 1946).

[13]Like all “valid” theories, Bodin’s was only partly correct. At the time Bodin was writing (middle of the 1560's), *prices measured in metallic units* had hardly changed at all; Jehan Cherruyt de Malestroict was correct in attributing the rise in French prices to the debasement of the unit of account. Gold and silver prices did rise substantially, however, between 1565 and 1594; using English prices (where Elizabeth I’s unit of account remained constant) as a measure, prices rose 50 per cent between 1565 and 1593. Bodin’s theory that the price increases were due to the influx of silver from Spanish America was not correct at the time he wrote, but it was correct for future price increases. His argument was more timely when he repeated it in 1576 in his major work, *The Six Books of the Republic*.

[14]Crick, 79.

assumption of emergency powers by Lincoln during the Civil War, and by Churchill in World War II. "Is there, in all republics,"asked Lincoln in 1861, "this necessary and fatal weakness? Must a government, of necessity, be too strong for the liberties of its people, or too weak to maintain its own existence?"[15]

Later developments of the concept tried to reconcile the theory of sovereignty with that of consent, with not much success. During the French revolution, it was asserted that "Sovereignty is one, indivisible, unalienable and imprescriptible; it belongs to the Nation; no group can attribute sovereignty to itself nor can an individual arrogate it to himself." The idea of popular sovereignty became identified with the slogan "sovereignty of the people" which Alexis de Tocqueville and John Stuart Mill both identified with the "tyranny of public opinion."[16]

Recent monetary literature has not paid much attention to sovereignty. Fred Hirsch, however, recognizes[17] the intimate connection between sovereignty and the right to issue money:

"One of the hallmarks of national sovereignty throughout the ages has been the right to "create money"--that is for the sovereign to lay down what is or is not legal tender, to require that it shall be accepted in settlement of debt within the country's borders, and to maintain the sole right of issuing this national money. None of these sovereign powers will itself control the way in which individuals choose to use this money--that will depend on the "quality" of the money itself, on its real worth in relation to the goods it buys or to other forms of money that individuals can get hold of or spontaneously create. But the ability to create its own domestic money is the key financial distinction of a sovereign state."[18]

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[15]Crick, 80.

[16]*ibid.*

[17]Hirsch (1969: 22).

[18]Charles Goodhart goes even further in emphasizing the implications of a single currency for the need for a strong centralized fiscal authority:

"It is, however, unrealistic to discuss 'optimal' currency areas without giving explicit consideration to the close links between control of the currency and national sovereignty... the right to issue legal-tender currency is one of the most important , and prized, aspects of independent, sovereign power. Monetary independence entails the power also to change the exchange rate of the country *vis-à-vis* the currencies of other areas. If, say, British Columbia, or Florida, or Scotland, was given a separate Central Bank, a separate currency and the power to vary its exchange rate *vis-à-vis* the Canadian dollar, or US dollar or English pound, how much would be, or could be, left of national union between the two areas? Not only monetary policy, common currencies and integrated markets would have gone, but it is also extremely difficult to see how it would be possible to maintain any coherent common fiscal policy between the two areas....

I have argued both that a single-currency area requires a strong, centralized fiscal authority, read and able to ease regional adjustment problems, and also that it will be difficult to establish any effective centralized fiscal authority covering areas with independent, separate currencies (i.e. both that a single-currency area cannot cover several, independent, uncoordinated fiscal areas, and the converse that an integrated fiscal area cannot extend over several independent currency areas)..."

Goodhart goes on to note, however, that the 1880-1914 gold standard constitutes an exception to the rule.

Early Concepts of Monetary Sovereignty

As already noted, the concept or doctrine of political sovereignty entered the literature of political science in the 16th century, thousands of years after the concept of *monetary* sovereignty had been proclaimed by the rulers or priesthood of the ancient theocracies. Different metals received different treatment. In early times, gold was a sacred metal, under the control of the top prelate, a position that was often combined with the top ruler. The earliest mints were temples; indeed, our word for money derives from the surname of Juno: the earliest Roman money was coined in the temple of Juno Moneta, from the Latin word, *monere* meaning "to warn": Juno "the Warner" was said to have promised that if the Romans fought only "just" wars they would never be short of money.[19]

The authority to create money was a prerogative of the sovereign or the priesthood from very early times. Coins were a fiscal resource to the extent they were overvalued. Overvaluation requires a monopoly, which must be enforced by control over the supplies of the precious metals, laws against counterfeiting, and the law of payment that make money legal tender. In ancient India, laws regarding the use of the precious metals (including copper) were precise: the Code of Manou classifies robbery of sacred gold or the gold of a priest with the highest crimes; debasers of metals are classed with rogues; and a goldsmith who commits fraud, "shall be cut piecemeal with razors."[20]

From the very beginnings of coinage in ancient Lydia (or some as yet undiscovered place), coinage was overvalued. The Lydian kings, starting with the usurper Gyges, maintained the overvalued 1/3 stater electrum coins that was the staple of the Mermnadae dynasty that ended with the self-immolation of Croesus in 546 BC. The Persian conquerors of Lydia maintained an overvalued gold coinage, with an artificial bimetallic ratio of 13:1 at a time when the silver price of gold outside the empire was half that. The coinage prerogative was rigorously asserted by the Persian state. Herodotus tells us that Darius, having coined gold money that was stamped with his own image, accused and condemned to death Ariander, his viceroy in Egypt, for having coined similar pieces in silver.[21]

The same system was adopted by the Romans after 46 BC but at a ratio of 12:1, which was maintained, through Rome's successor in Constantinople, until the sacking of that great city by the Crusaders in 1204. Protection of the monetary prerogative required draconian laws against and gruesome tortures for infringements on it. The Christian states of Western Europe acknowledged the *de jure* sovereignty in matters of gold coinage of the God-Emperor at

[19]Cicero, however, in his *Treatise on Divination*, says it was due to a *warning* voice which issued from the enclosure when Rome was besieged by Gallic Senones. See Grimaudet (1900: 14).

[20]Del Mar (1885: 62).

[21]Grimaudet, 12.

Constantinople and abstained from it as long as that authority lasted.

The formation of the Holy Roman Empire with the crowning of Charlemagne in 800 set in motion the running battle between Church and State that was to last through the Middle Ages. Within its own geographical domain, the Holy Roman Empire was sovereign, and the communes of the Empire were on occasion granted charters to coin money. In the case of Siena, this was granted by Henry VI, king of the Romans (eldest son of the Emperor):

"In the name of the Holy and Indivisible Trinity, We, Henry VI, by divine favor, King of the Romans...make known to all the faithful of the empire, present as well as future, that in view of the merits of our trusty subjects, the citizens of Siena, we grant them...the privilege of coining money in the city of Siena."[22]

The Western Emperor had local power, but their sovereignty was qualified. The right to coin gold had been from early history the mark of complete sovereignty. Neither Charlemagne nor any of his successors--until Frederick II--coined gold. The gold coinage of Europe was the bezant, that produced in Constantinople by the lawful descendants of Constantine. The circulation of gold bezants and its fractions served throughout Europe not only also as a standard for weights and measures, but as a check on debasement and devaluation. The 1/4 bezant piece had exactly the same weight as an English (silver) penny. The pretensions of Charlemagne were immense but they did not challenge the monopoly of gold that had been jealously guarded in Rome or Constantinople since the time of Julius Caesar.

The Holy Roman Empire was, it has been said, a fiction: it was neither holy, Roman, nor an empire. The German Emperors had nominal authority over the smaller communes and could grant charters and licenses, but the Basileus at Constantinople had legal sovereignty.

With the sack of Constantinople in 1204, however, that empire collapsed. It was at first clear where the coinage prerogative would go. But in 1225, Frederick II leaped into the breach with his magnificent augustals. With Frederick's death in 1250, the Empire fell (temporarily). The gold prerogative was now up for grabs. Who would fill the gap? Gold coinage suddenly flourished in France, Florence, Genoa and even England[23] in the interregnum, while other countries followed later. But the gold currencies that became the "dollars of the Middle Ages" were the ducats, sequins and florins--virtually interchangeable coins--produced by the Italian city states.

In one sense these coins were not yet "legal." The Empire had lost the mantle of sovereignty, and a few states had produced gold coins. But there was no formal transfer of sovereignty. It was not until the year 1356 that the Empire (which had been re-formed) issued its "Golden Bull" formally ceding the gold prerogative to the kings of Europe.[24]

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[22]Schevill (1909: 57).

[23]The gold coin issued in 1257 by Henry III was an imitation of an Arab maravedi and was almost immediately withdrawn.

[24]More than a decade before the bull was issued, Edward III of England had already

Before this final event, the nations of Europe had been gradually building up their independence from the Emperor and the Pope in a series of steps that gave their kings complete control over the precious metals. There were various steps in this process: the assertion of mines royal; treasure trove; coinage of gold; demonetization of the Imperial bezant and other coins; control over the movement of the precious metals; the suppression of episcopal and baronial mints; the trial of the pix; the regulation of the standard; and the doctrine of national money. In England these were accomplished by the monarch [in the 13th and 14th centuries].[25]

An early treatise on English law, ascribed to Ranulf de Glanvill (1187-89), starts off in the tone of Justinian's *Pandects* asserting the famous maxim of absolutism: "The will of the prince has the force of law," with no mention of consent of the governed; he does, however, attempt to justify the laws of England against the charge that they have not been written down. The main body fo the work begins with a specification of crimes and jurisdictions, in the course of which he outlines the dimensions of *crimen laesae maiestatis*:

"Of please some are civil, some are criminal. Again, of criminal pleas some pertain to the crown of our lord the king, others to the sheriffs of the counties. To the king's crown belong these: the crime which in the *leges* [i.e., the Roman laws] is called *crimen laesae maiestatis*,--as by slaying the king or by a betrayal of his person or realm or army,--the concealment of treasure trove, breach of his peace, homicide, arson, robbery, rape, forgery, and the like."[26]

The doctrine of mines royal holds that all mines producing one or both of the precious metals belongs to the crown. Louis IX of France was the first Christian king to assert it, and he was followed by Henry III in 1262. Henry, however, was bullied out of this right by the Pope, and it never came into force again until the reign of Edward III. With respect to the doctrine of treasure trove--a modern version is "finder's keepers"--Edward the Confessor had declared that all the gold and one-half of the silver belonged of right to the king; a later version of it in France and also England was that all the gold belonged to the king, while all the silver was relinquished to the nobles. By the time of Edward III, however, the Crown claimed all the gold and all the silver.

Gold coinage, as we have seen, was first asserted--timidly--by Henry III, but boldly by Edward III in the next century. Before that time, the Basileus was conceded universally to have been the lawful successor of Constantine and therefore the lawful suzerain of the Empire to which in certain respects they owed fealty.[27] In an important sense England achieved her complete

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issued his gold nobles, under the authority of his position as Vicar-General of the Holy Roman Empire.

[25]Del Mar (1895: 277)

[26]Haskins (1927, 1957: 219).

[27]Del Mar, 279.

independence only in 1356 or perhaps 1366 or even later.[28]

It was around the year 1291 that Edward I ordered that no foreign coins should be admitted into the kingdom except such as might be in use by travelers and others for casual expenses; and to these, he provided public offices where they might be exchanged. This law was probably aimed at the bezant, the most important foreign coin in circulation; other coins continued to circulate as before.[29]

The power to regulate gold and silver movements had not been asserted before the 13th century, and the assumption of this regalian right, along with the purging of baronial and episcopal mints, was an important part of the process of centralizing the money power in the hands of the sovereign. A related development was the appointment of the Monetary Commission of 1293, in the 22nd year of the reign of Edward I, with the mandate to examine the coins employed in the kingdoms and report on them to the king.

The "trial of the pix"is a test for the standard of the coinage.[30] Of Roman origin,[31] it was

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[28]England would not finally achieve spiritual sovereignty until the 1532 when the final breach with Rome over the annulment of Henry VIII's marriage with Catherine of Aragon was decided in an English court; thereafter, the Catholic church in England was a national institution.

[29]*ibid.*

[30]What came to be called the "trial of the pix" was instituted as a test of the fineness of coins submitted to the Exchequer for payments of taxes or debt. The Exchequer's problem was to test the adequacy of the coins received. To allow payments by tale would invite bad coins, while to test every coin was clearly impossible. The first precaution taken was to exact from the debtors an extra sixpence with each pound to make up a presumed shortness of weight; this was payment *ad scalum.* This was found not to be enough, so each counted pound was weighed and the debtor could either make up the difference or pay an additional shilling for any shortfall; this was payment *ad pensum.* These precautions protected against the lightness of the coinage, but they were of course no protection against debased money. In Henry I's reign, Roger of Salisbury introduced a new plan of "blanching" money, that is, testing the fineness (or whiteness) of it. When any payment was made, forty-four shillings' worth of coin was selected at random out of the heap, weighed and handed to the Master of the Assays, who carried off a pound's weight of it, and, accompanied by the sheriff and his own subordinates, proceeded to the furnace to make the assay. The coins were melted and the dross skimmed off until pure silver alone remained. So long as the surface of the melted mass was clouded there was still dross to be removed, but when the surface was bright and mirror-like, the impurity was gone, and nothing but silver remained. Both sides watched the operation, the sheriff anxious to prevent any waste of silver, the Exchequer officials careful to see that all dross was removed. The assayer had an interest in being accurate, for if either side challenged the assay, he had to make a second, for which he received no fee. When the operation was complete the mass was weighed , and if it was short of its proper weight the sheriff had to cast in enough pence to turn the scale. These pence were counted, and the sheriff had to pay that number on each pound of his total "form" as a quittance.

introduced in the reign of Henry I and became widespread two centuries later in the reign of Edward I. Its widespread use was a tell-tale indication that the coinage had deteriorated. So long as the sacred Empire remained, the coinage prerogative of the Basileus acted as a continual check on any tendency to adulterate the coinage. Yet once this yoke was thrown off, adulteration became prevalent in all parts of Europe.[32]

The right to produce and control money is a clear-cut test of a country's independence and sovereignty. The most important dimension of this monetary sovereignty, however, is the right of a state to declare that which counts as legal tender. This principle, called the Law of Payment, goes back to ancient times, to Paulus and the Pandects of Justinian. But nothing is heard of it before the downfall of the sacred Empire, and it is first noted in England in the reign of Edward III.

See Warner (1907: 72-73).

[31]During the Roman social wars, around 91 BC, Livius Drusus, a tribune of the people, authorized the coinage of silver denarii, alloyed with one-eight part copper, lowering the established standard. Later, copper pieces were plated to resemble silver. The discontent produced by this law induced the College of Praetors (84 BC) to restore the silver money to the ancient standard by instituting what would later be called the "trial of the pyx." Sylla was so enraged by this interference with the coinage that he annulled the decree of the praetors, proscribed their leader, Marius Graditidianus, as a traitor, and handed him over to the ferocious Cataline, who "slew him barbarously" (Del Mar, 123).

[32]Dante produces a colorful account of the passions aroused by monetary crimes in the Middle Ages in the case of Master Adam, who adulterated the florin:

"And there I saw another husk of sin,
who, had his legs been trimmed away at the groin,
would have looked for all the world like a mandolin...
He strained his lips apart and thrust them forward
the way a sick man, feverish with thirst,
curls one lip toward the china and the other upward.
"O you exempt from every punishment
of this grim world (I know not why)," he cried,
"look well upon the misery and debasement
of him who was Master Adam...
Inflexible Justice that has forked and spread
my soul like hay, to search it the more closely,
finds in the country where my guilt was bred
this increase of my grief; for there I learned,
there in Romena, to stamp the Baptist's imagine
our alloyed gold--till I was bound and burned...
Because of them I lie here in this pigpen;
it was they persuaded me to stamp the florins
with three carats of alloy."

The countries of Europe had not only to deal with the residual powers of the Empire, but also with the Church, which at all times in the Middle Ages was a multi-national power seeking to impose its authority over the nations of Europe. But the larger nations did not always comply. When Pope Boniface VIII wrote to Philip le Bel, claiming him as “a subject both in spirituals and temporals,” Philip replied: “We give your Foolship to know that in temporals we are subject to no person.”[33] This made clear France’s independence of both the Empire and the Papacy--in this reign at least. In England, however, the test came somewhat later. It was not until 1366, in the fortieth year of the reign of Edward III, that England broke free of Rome. In that year it was ordered that Peter’s-pence should no more be gathered in England nor paid to Rome.[34] Finally, in that year, England could be considered an independent, if not completely sovereign state, free at last from the ghost of Roman authority and monetary tribute to--if not spiritual authority from--Rome.

The concept of political sovereignty was born out of need: civil war created the need for authority and the power of the church created the need for an independent temporal power. England broke free of the Church and established her spiritual sovereignty early in the 16th century, but France was still Catholic and the counter-reformation was in full swing on the frightful day of St. Bartholomew in 1572. Bodin’s doctrine of sovereignty filled the need of the nationalist party (led by Bodin’s patron, the king’s brother) which,[35] while still catholic, wanted to end the persecution of the Huguenots and reestablish civil order. Bodin’s concept of sovereignty explicitly incorporated the money prerogative.[36]

Bodin’s conception of sovereignty was not original with him. A contemporary, François Grimaudet (1520-1580), born ten years earlier than Bodin, had already printed a book in 1560 that explicitly proclaimed the doctrine “That the welfare of the State demanded the subjection of the ecclesiastical to the civil power, in whose hands all the functions of society were legally invested.” It would be surprising if Bodin had not seen this work. Grimaudet also wrote several books on money and the law, including a major treatise on the “Law of Payment.” At one point he insists:

> “The value of money depends on the State; that is to say, in a monarchy, upon the prince, and in an oligarchy, upon the State, which alone has the right to coin money, or to have it coined and to stamp a valuation upon it.”[37]

The Case of the Mixed Moneys

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[33]Quoted in Del Mar, 276.

[34]Del Mar, 283.

[35]Duc d’Alençon.

[36]Bodin (1576) I, chap. 11: 213. Quoted in Nussbaum (1950: 34).

[37]Grimaudet, 11.

Monetary sovereignty can be broken into three parts: (a) the right to determine what constitutes the unit of account--the commodity or token in which price lists are specified; (b) the right to determine the means of payment--legal tender for purposes of the discharge of debt; and (c) the right to produce money--or else determine the conditions under which it is to be produced by others.

Under a pure commodity money system, the relevance of monetary sovereignty was restricted to debtor-creditor problems of inter-temporal exchange arising from changes in relative prices. In the ancient empires, this right was manifested in debt-reduction -cancellation decrees, which were not uncommon among the early empires.[38]

Monetary sovereignty took on its great importance in the age of overvalued money.[39] Whether the overvalued money arose as a result of coinage, paper money or bank money, the question of profit or seigniorage arose. In the transition from commodity money to overvalued money, the government had access to a great fiscal resource which it could either exercise itself or sell (e.g., in the issue of charters to banks) to the private sector. To overvalue a money, the state had to keep its supply restricted, by means of a monopoly, and thus arose the draconian penalties[40] that became associated with the infringement of monetary laws. Infringement of monetary sovereignty was invariably classified with crimes of high treason.

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[38]Saggs (1955: 97) writes: “One facet of this [the king Lipit-Ishtar’s sense of social justice] was his claim that he had ‘made justice’. This claim, not unusual among old Babylonian rulers, referred to the cancellation by royal decree of certain debts, such as any which had forced free people to sell themselves or their families into slavery....” Debt cancellations occurred from time to time in all the ancient empires, including the Roman; Julius Caesar, as Consul in 48 BC, eliminated interest already paid on debts prosecuted in magistrate’s court, in effect making the loan interest free.

[39]In his *Treatise* Keynes (1930: Ch. 1) used the term “representative money” to mean what I mean by overvalued money.

[40] The following account related by Nussbaum (1950) illustrates the situation in France in the 15th century:

"Among the numerous trials of counterfeiters in the Middle Ages, records of which have been preserved for us in the public archives, certainly one of the most moving is that of the goldsmith Louis Secretain, condemned at Tours, 1486, to be boiled and hanged after having been convicted of the crime of counterfeiting. On the day of the punishment, Secretain was led from the prison to Foire-le-Roi Square, in Tours, where a huge caldron filled with water had been set upon a blazing fire. The unfortunate one was bound by the executioner and thrown into the caldron; but the water had not yet reached the boiling point and in his struggles the victim disengaged himself from his fetters. He reappeared on the surface of the water holding out to the crowd, which was speechless with pity, his suppliant arms and crying out 'Jesus! Mercy!' The executioner, armed with an iron fork, smote him on the head several times to make him sink again to the bottom of the vat. The crowd and the judges, themselves exasperated, cried at last: 'Death to the executioner!' An affray ensured in which the executioner was killed and Secretain rescued. The half-cooked unfortunate one was carried into a neighboring church where he found refuge until the king’s pardon was brought at last, returning him his freedom."

The right of the sovereign to determine what constitutes legal tender was unquestioned in Roman times and re-affirmed in the modern age. A landmark case in England arose in the wake of the Irish rebellion of 1598. To stretch the royal budget, Queen Elizabeth I issued a special "mixed" money that was forbidden in England--in short, occupation script.[41]

"Sometime before this proclamation, an Irish merchant had bought some goods for which he specifically promised to pay one hundred pounds in English sterling. He appeared in Dublin on the day fixed for payment and tendered one hundred pounds--in occupation coinage--in settlement of the debt. The creditor refused to take the debased money and sued for payment in sterling. However, in 1604, the court held for the debtor..."

This landmark decision, referred to as the "Case of the Mixed Moneys", became the law of the land.[42] The importance of the decision is not so much in the great injustice associated with changing monetary rules *ex post facto,* but rather the great importance of the institution of legal tender[43] and the authority of the sovereign to determine what that legal tender is.

Part II. THE STRUGGLE FOR MONETARY SOVEREIGNTY IN AMERICA

The development of the doctrine of monetary sovereignty is America has relevant lessons for monetary unions. US experience is specially interesting because, within a few short centuries, the United States began as a colony, tried (but failed) to assert its monetary sovereignty; established monetary sovereignty for the States by breaking free of England; experimented--not very successfully--with pooled sovereignty under the Confederation; fudged some aspects of monetary sovereignty in order to get agreement on the Constitution; spent several decades trying to resolve the division of fiscal, monetary and banking authority between the States and the Federal government; finally established, after long legal battles the primacy of the Federal Government in monetary matters; established the "law of payment" concerning legal tender; and granted Congress the right to annul any retroactive gold clauses. Many of these issues are bound to appear in different forms in connection with the transfer of sovereignty from the nation-states

[41]See Dunne (1960: 3).

[42]*ibid.* The landmark decision read:
"as the king by his prerogative may make money of what matter and form he pleases and establish the standard of it, so he may change his money in substance and impression, and enhance or debase the value of it or entirely decry or annul it..." Moreover, "...although ...at the time of contract...pure money was current in the kingdom...yet mixed money being established...before the day of payment...may be tendered...and the obligee is bound to accept it..."

[43]"Legal tender" is a term of the courtroom; a plea of legal tender is what lawyers call a "plea of avoidance," an admission whose damaging effect is immediately nullified by bringing in some addition factors. Thus a defendant charged with debt might admit the borrowing and plead "legal tender"--namely that at some previous time he physically had offered his creditor money which the law deemed acceptable for debt payments and had been refused. Such a suit, if proved in an early English tribunal, ended the creditor's suit then and there. The creditor's total loss was "accounted his own folly that he had refused the money when a lawful tender of it was made him." See Dunne (1960: 4).

of Europe to the EU Commission and the European Central Bank. Moreover, because the United States is the major superpower, its actions have an influence than go far beyond that of an ordinary country.

Lawful Money in Colonial America

In colonial America, money was always scarce and when pounds were available, they were quickly spent on urgent imports; one might say there was a perennial pound shortage. Both as cause and effect, the colonies used money substitutes of which the most important was wampum. When the time came for the colonies to issue their own currency, they ran into difficulties with the home government. The first money struck in the colonies was coined in New England in 1652, and consisted of silver shillings, sixpences and three-pences marked on one side in a sweeping scroll with NE (for New England) and on the other with Roman numerals to indicate the value in pence, the marks being placed as near to the edge as possible.[44]

This coin was looked upon as an infringement of the royal prerogative, and its prohibition by the home government led to a curious sequel. In the absence of any currency provided by the home country, and little opportunity to provide for money by generating a balance of payments surplus, the New Englanders proceeded to provide for their own needs by issuing a currency of more elaborate design but without any device that might appear to challenge the authority of the king. These coins, which were called pine-tree shillings on account of the tree within a beaded circle on the obverse, were issued until 1686 but all were of the same type and carried the same date 1652, so as not to appear to have contradicted the government prohibition.

Somewhat later, the American colonial governments caught on to an experiment that had already been tried north of the border. Paper- or more exactly card-money had been used nearby in French Quebec when funds from France were temporarily held up. Apart from an earlier experiment by the Dutch during the siege of Leyden in 1573, this was the first use of paper money outside of the Orient.

War had been declared between England and France in 1689 and, in 1690, Massachusetts sent an expedition of soldiers to capture Quebec. Massachusetts then passed a law providing for ten-shilling bills to pay off the militia. Knowledge of the successful experiment in Quebec probably gave the Massachusetts legislature the idea, because two pamphlets printed in 1691 refer to the facility with which the Intendant at Quebec floated his card money, one writer saying: "The French (I hear) at Canada pass such Paper mony without the least scruple."[45] The Massachusetts issues, begun in 1692, were quickly followed by the other colonies. The notes were at first made legal tender for tax payments, but when over-issue brought the threat of devaluation, were made general legal tender within the colony. Like earlier and later experiments with overvalued

[44] Rawlings, *loc. cit.,* 318.

[45] *Colonial Currency Reprints, Vol. I* (1939: 41).

currency, lacking a theory of the "breaking point" at which replacement of specie with paper[46] turns to inflation, the colonial government did not know when to stop, resulting in depreciation and inflation. Finally, the home government, which first banned further issues, and then, in two measures adopted during the reign of George III, exercised its prerogative to forbid all further colonial legal tender laws.[47] It was apparent that Britain who, in the case of Ireland had condoned debasement, took a different view when the profits went to the colonial government! The British actions must surely rank as one of the most important root causes of the American revolution.

Split Monetary Sovereignty

The right to determine what constitutes legal-tender money and the right to create it are closely associated with the sovereignty of the nation-state. At what point in the creation of a new nation-state does this sovereignty begin? When war broke out between Britain and her colonies, every state issued paper money: it was said that "the rattle of the musketry near Boston was quickly followed by the rattle of the printing presses from New Hampshire to South Carolina."[48] The Continental Congress usurped the prerogative as it turned to bills of credit as the principal means of financing the war, two years before the central government was given such specific power in 1777 under the ninth Article of Confederation.[49] At the end of the war, the continental dollar was paid off at one-fortieth of par, despite the "solemn pledge" of "the United States and the public faith" for payment and satisfaction.[50]

At the time of the Constitutional Convention in 1787, the drafting committee included a proposal from the old Articles of Confederation authorizing Congress to coin money and emit bills of credit. Debate turned on whether the right to coin money and/or create paper money should be explicitly prohibited; one man proposed that the whole Constitution be rejected if it retained the paper money authority. A compromise of sorts was reached with the draft authorizing coinage alone, but no explicit prohibition was made of paper money.

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[46]It was not until the 17th and 18th centuries that some economists and a few statesmen learned that some but not all specie could be replaced by paper or overvalued metal without creating inflation, and that the "breaking point" came when the ratio of specie to overvalued money was so low that confidence in convertibility broke down.

[47]The two laws, promulgated in 1751 and 1764, gave rise to the following comment by Adam Smith (1790, 1976: 348) in his *Wealth of Nations*: "No law could be more equitable than the act of Parliament, so unjustly complained of in the colonies, which declared no paper currency to be emitted there in the time coining, should be a legal tender of payment."

[48]Nevins (1924: 420); quoted in Dunne (1960: 9).

[49]Dunne (1960: 9).

[50]i*bid.*

Another important issue concerned the distribution of the money power between the states and the central government. The drafting committee proposed to bar states from coining money without congressional consent. Two delegates moved that the prohibition be extended to emitting bills of credit and to making anything but gold and silver coin a legal tender, and that the bar be absolute instead of revocable at the direction of Congress.[51] These provisions passed and settled the matter in favor of the central power, but left up in the air the important question of whether Congress had the right to establish a bank.[52]

The great debates settled some of the issues relevant to the money power: Congress can, and the states cannot, mint coin and establish its value; the states cannot issue currency as they did in colonial times. But some other issues were left unresolved. Could Congress charter banks that could issue their own notes? Could it control banks chartered by the states? Could Congress (a) issue paper money and (b) make it legal tender? What was the relationship between the monetary authority of Congress and its seemingly unrestricted borrowing power?[53] These issues were so contentious that had they been forced to a conclusion, they would have risked the unity needed to pass the Constitution.

With the states now out of the business of money creation, commercial banking in the new republic soared: three state-chartered banks in 1784 grew to eighty-eight by 1800. Hamilton's brainchild, the Bank of the United States, which had been chartered in 1791, was partly public; the national government owned 20 per cent of the stock. It had the effective power to curb note issue by the state banks by returning state-bank notes received for specie instead of paying them out again. But opponents of the bank took advantage of anti-British sentiment--70 per cent of the stock of which was in foreign (largely British) hands—to get Congress in 1811 to reject a renewal of its charter. This and the War of 1812 gave a great impetus to state banking, but gave rise to mass confusion due to the proliferation of different notes. President Madison therefore in his out-going State-of the Union message overcame his Jeffersonian opposition to the Bank and asked for the establishment of a second federal bank; his successor, James Monroe, signed the revived institution's charter in 1816.[54]

A main function for the Second Bank of the United States was correction of the deranged

[51]*ibid.*

[52]It had been proposed Congress be empowered to provide for a system of canals, and Madison had suggested that the proposed authority be enlarged to "grant charters of incorporation when the interest of the United States might be required and the legislative provisions of the States may be incompetent." (Dunne 1960: 14). Nothing came of it partly because of the fear that the authority might be used to establish a bank, "a subject of contention." (*ibid.*).

[53]Dunne (196); 15).

[54]Dunne (1960: 27)

currency of the state banks. This required getting the banks back to redeeming notes in specie and limiting state note issues by presenting their notes for redemption when they arrived at the Bank. Both these measures aroused strenuous opposition which, compounded by the fact that the Bank was badly managed, led to a wave of retaliatory state enactments, the most important of which was a tax levied on the federal bank's notes.[55] This opened up the legal case of the century.

James McCulloch was cashier of the Baltimore branch of the federal bank; his supposed offense was putting untaxed notes in circulation. He was taken to court and the Baltimore Court returned a judgement against him, which McCulloch appealed to the Supreme Court. Luther Martin, an inflationist at the Constitutional Convention, representing the government, quoted Hamilton's statement in the thirty-second federalist paper to the effect that the Constitution left states with "an independent and uncontrollable authority to raise their own revenue...in the most absolute and unqualified sense." Daniel Webster, defending the Bank, claimed that "an unlimited power to tax is the power to destroy."

The decision was rendered by the fourth Chief Justice, John Marshall, an economic conservative with a nationalist bent.[56] A principal clause in the Constitution was that residual powers went to the states, but nevertheless Congress had the power to achieve its ends by "necessary and proper means." Marshall made the argument that "necessary" did "not always import an absolute physical necessity so strong that one thing...cannot exist without the other...The subject is the execution of those great powers on which the welfare of a nation essentially depends...This provision is made in a constitution intended to endure for ages to come, and, consequently, to be adapted to various crises of human affairs...The exigencies of the nation may require that the treasure raised in the north should be transported to the south, that raised in the east conveyed to the west, or that this order be reversed. Is that construction of the constitution to be preferred which would render these operations difficult, hazardous, and expensive?"[57]

In pronouncing the Maryland levy unconstitutional, Marshall wrote:

"If the states may tax one instrument, employed by the government in the execution of its powers, they may tax any and every other instrument. They may tax the mail; they may tax the mint; they may tax patent-rights; they may tax the papers of the customhouse; they may tax judicial process; they may tax all the means employed by the government, to an excess which would defeat all the ends of government."[58]

This McCulloch case had a sequel in 1824, when the state auditor seized $100,000 of the federal

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[55]Dunne, *loc. cit.,* 28; the federal bank was not named in these tax provisions; the taxes were levied on all banking institutions in the enacting state that were not chartered by it.

[56]*ibid,*

[57]McCulloch v. Maryland (1819), 17 U.S. (4 Wheaton), 316, 413. Quoted in Dunne, *loc. cit.,* 31.

[58]*ibid.*

banks' 'delinquent' taxes from its Cincinnati branch. The bank went to court and the case wound up in the Supreme Court, which re-affirmed the position of the earlier case. For the first time, Chief Justice Marshall explicitly mentioned the money issue:

"The currency, which [the bank] circulates, by means of its trade with individuals, is believed to make it a more fit instrument for the purposes of government that it could otherwise be..." More important was a dissenting opinion (on grounds of jurisdiction) by Justice William Johnson (based on a jurisdictional issue), who, on the monetary question, was both explicit and prophetic:

"A specie-paying bank, with an overwhelming capital, and the whole aid of the government deposits, presented the only resource to which the government could resort to restore that power over the currency of the country, which the framers of the constitution evidently intended to give to Congress alone."[59]

A subsequent case concerned the right of a state to issue interest-bearing notes that could also be used for money. In the depression of the 1820s, caused partly by the appreciation of gold when Britain and some other countries restored the gold (in the case of Britain) or silver standard, banks came under attack, leading to pressure on states to support them. Missouri enacted a statute setting up state loan offices to extend credit in the form of "loan certificates," which were negotiable, small-denomination, interest-bearing instruments that were acceptable for taxes and for the payment of state salaries. Two borrowers of these certificates, after spending the proceeds, refused to repay on the ground that the certificates were state "bills of credit" outlawed by the Constitution.

The majority opinion, expressed by Marshall, was as follows:

"To cut up this mischief by its roots...the people declared in their Constitution that no State should emit bills of credit. If the prohibition means anything, if words are not empty sounds, it must comprehend the emission of any paper medium by a State government for the purpose of common circulation."

Three dissenting opinions were also written. One, by Justice Johnson, argued that the certificates were "of a truly amphibious character" and that the case being a doubtful one the Missouri law should be upheld, even though it "does indeed approach so near a violation of the Constitution as it can well go..."; Justice John McLean likewise felt the majority opinion was too strong and suggested that the definition of bills of credit should be restricted to an instrument issued by a state whose circulation as money was enforced by statutes providing for, or approaching, legal tender; finally, Justice Smith Thompson argued that the majority opinion might even preclude the right of banks to issue notes: "If these certificates are bills of credit, inhibited by the Constitution, it appears to me difficult to escape the conclusion that all bank notes, issued either by the States, or under their authority and permission, are bills of credit falling within the prohibition."[60]

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[59] Dunne, 34.

[60] Dunne, *loc. cit.* 40.

State authority came charging back in the 1830s. Kentucky did not itself issue any paper notes, but it set up a corporation, the Bank of the Commonwealth of Kentucky, with authority to receive deposits, to make loans, and to issue bank notes in the usual form; the president and all the directors were chosen by the legislature. Again some debtors refused to repay loans on constitutional grounds, and the case came to the Supreme Court in 1837. By this time, Marshall had died, and every member of the Court was a Jackson appointee. The decision raises two issues: (1) could a state charter a note-issuing bank? and (2) could it control such an institution through stock ownership? With a lone dissent, the Court answered yes to both questions, validating the Kentucky law.[61]

By this time, the attack on the Bank of the United States by President Andrew Jackson (and his Attorney-General, later Secretary-of-the-Treasury, and then Chief Justice Roger Taney) had accomplished its ends. The Bank's charter was not renewed, and government deposits were withdrawn from the successor bank chartered in Pennsylvania. This represented a coalition of three groups (1) the frontier community that distrusted paper money of any kind; (2) the financial community in New York that wanted to shift the financial center of the nation from Philadelphia to Wall Street; and (3) the State Banks. As always, the self-interest of seigniorage was a factor. As a result, from 1837 until 1861, the tide had turned strongly away from federal authority to state banking.

State banking, however, was a mess from the standpoint of currency. The hundreds of state bank notes issued exchanged at different rates of discount; what was needed was a currency that was valid in New York as well as Boston and Philadelphia. Salmon Chase recognized this need in his inaugural address as Governor of Ohio in 1856, when he stated that "Such a currency...is only attainable through the legislation of Congress and the action of the General Government" and, as Lincoln's Secretary of the Treasury, and later Chief Justice, he was to have a curiously ambiguous role in bringing it about.

As Secretary of the Treasury, Chase needed to find funds to finance the war. When bond sales were lagging, he came up with the idea of financing the war and reforming the currency with the National Bank Act, which Lincoln signed on February 25, 1863. Under this law any five or more persons could form a bank by raising the required capital, filing their papers with the Treasury, and buying the required amount of government bonds. The bonds were then deposited with the Treasury, and engraved notes equal to 90 per cent of their par value were returned to the bank. State banks could have the same note-issuing privilege by buying the bonds.[62] Chase hoped--

[61]Dunne, 42. The dissenting opinion by Justice Joseph story, argued:
"...it has been argued that if this bank be unconstitutional. All State banks founded on private capital are unconstitutional. That proposition I utterly deny...The States may create banks as well as other corporations, upon private capital; and so far as this prohibition [against emitting bills of credit] may rightfully authorize them to issue bank bills or notes as currency; *subject always to the control of Congress, whose powers extent to the entire regulation of the currency of the country."* [italics supplied]. Dunne, 42.

[62]Dunne, 47.

incorrectly--that this system would bring most state banks into the national system.

The struggle between federal powers and the state banks, however, waited until 1865 when, reversing the McCulloch v. Maryland case, the government levied a 10 per cent tax on all state bank note issues, in effect sounding the death knell for state banking. The constitutionality of this measure was challenged and heard in 1869 when Chase had become Chief Justice. In apodictic tones, he squashed whatever was left of "any pre-existing right" in the area of currency issuance:

> "...it is settled....that Congress may constitutionally authorize the emission of bills of credit...there can be no question of the power of the government to emit them,' 'to make them a currency, uniform in value and description, and convenient and useful for circulation. These powers, until recently, were only partially and occasionally exercised. Lately, however, they have been called into full activity, and Congress has undertaken to supply a currency for the whole country.
>
> Having thus, in the exercise of its undisputed constitutional powers, undertaken to provide a currency for the whole country, it cannot be questioned that Congress may, constitutionally, secure the benefit of it to the people....To [this] end, Congress may restrain, by suitable enactments, the circulation as money of any notes not issued under its own authority. Without this power, indeed, its attempts to secure a sound and uniform currency for the country must be futile."[63]

The verdict was by no means unanimous. A dissenting opinion by two justices pointed out that state banks had been accepted as part of the financial scene for three-quarters of a century, and their constitutionality given a resounding endorsement; they further insisted that the tax was not so much an abrogation of the powers of private corporations as it was an unprecedented amputation of state authority. They accordingly rejected the majority opinion as finding "no support or countenance in the early history of the government or in the opinions of the illustrious statesmen who founded it."[64]

The Great Legal Tender Controversy

The absence of a common currency from 1837 until 1861 has to rank as a major passive factor in causing the Civil War. The absence of a common means of payment--convertibility of bank notes into gold and silver was difficult to enforce--made secession cheaper and at the same time left open to the Secession States the opportunity to create a confederate currency that could facilitate, by the inflation tax, war finance. As it was, the Confederate currency--at least at the beginning of the War--could be considered a monetary improvement.

Less than a year after the opening of the War, in December 1861, all the banks in the North suspended specie payments in anticipation of war finance, and on February 25, 1862, the Legal Tender Act came into effect. This Act, authored by Elbridge G. Spaulding of Buffalo,[65] opened

[63]Quote in Dunne, 50.

[64]*ibid.*

[65]Sumner (1874: 197).

up one of the great legal battles of the century. It made "greenbacks" legal tender; the phrase "legal tender for all debts..." is still written on every piece of paper money issued by the United States today. The phrase "In God We Trust" also dates from this year. Note issues increased by leaps and bounds in the spring and by August all specie had disappeared from circulation.

In the Constitution, paper money had been left as an open question; it was neither mandated nor forbidden. Actual issues of paper money had been emitted between 1812 and 1859, but they were not made legal tender; in the War of 1812, Congress had decisively rejected a proposal to give this feature to Treasury notes. Chase himself was opposed to the legal tender feature of the Spaulding Bill, and his objections were echoed by members of Congress who challenged its constitutionality as well as its economics. But the pressures of wartime finance made Chase give way, and thus, for the first time since colonial days, a legal tender paper money circulated legally in the United States.[66]

From its very signing, the Legal Tender Act was headed for the Supreme Court. Chief Justice Roger Taney (President Jackson's hatchet man in killing off the second Bank of the United States) had died in 1864. Lincoln needed someone "who will sustain what has been done in regard to emancipations and legal tenders" and he nominated Chase as his successor. The series of "greenback" decisions began on January 16, 1869 and, as it turned out, Chase became a recidivist.

The first case was a revenue suit growing out of a tax exemption that Congress had given the greenbacks.[67] Ordinary money had always been within the range of state taxation. New York claimed the exemption was unconstitutional on the ground that the greenbacks were nothing but money and therefore within the reach of its taxing arm. Speaking for a unanimous Court on January 16, 1869, Chief Justice Chase agreed that there was "much force" in the argument, but nevertheless concluded that the instruments were "strictly securities" and hence their tax immunity was perfectly constitutional.[68] This decision was the beginning of a retreat away from the monetary status of the greenbacks, with Chase returning to his original position of opposition.

The retreat from legal tender became a rout. Less than a month after this decision, the Court held that the clause of the Legal Tender Act making the notes legal tender for all debts "has no reference to taxes imposed by state authority, but relates only to debts in the ordinary sense of the word..." Only a week later, the Court held, in a case involving a contract specifically requiring payment in gold and silver coin, that "the agreement could not be satisfied by a tender of greenbacks of equal nominal amount." Under federal law, coin continued to be legal tender

[66]Dunne, 68.

[67]Dunne, 70.

[68]In 1894 Congress would pass a statute which permitted nondiscriminatory state taxation of all circulating money issued under the authority of the United States. See Dunne, 71n.

and there was no express prohibition of such settlements in the Legal Tender Act.[69] He concluded, therefore, that a specific commitment to pay gold was not a “debt” that could be satisfied by a tender of the notes.[70] Chase then hinted that the legal tender clause may not itself be constitutional.

With this hint, the unity of the Court was broken; other members did not agree that the legal tender clause was unconstitutional. On December 10, 1869, the head-on battle over the constitutionality of the Legal Tender Act began with the Hepburn v. Griswold case. This involved an $11,200 note signed in 1860 and due February 20, 1862, five days before the Legal Tender Act was signed. The Supreme Court’s decision, handed down on February 1870, held by a vote of 4 to 3, that the Legal Tender Act could not apply before its passage. The decision implied the complete unconstitutionality of the Act.

The Hepburn v. Griswold decision was not the end of it. The 4 to 3 decision was taken with a Court of only seven members; during the Johnson Administration, Congress had reduced the number of Justices to preclude presidential appointments during the reconstruction controversy. Congress now restored its full complement of nine Justices and two new justices took their seats. The reconstituted court now heard two new cases, covering the same points as the earlier case. Instead of just referring to the earlier decision, the new Court overturned it; the Legal Tender Act was held to be valid for *both* contracts after February 25, 1862, *and* pre-existing contracts.

The majority opinion was written by William Strong, who had come from the Supreme Court of Pennsylvania, and had already written an opinion there validating the Act. Besides rehashing what had been said before, Strong added two new arguments: (1) every other government in the civilized world had the power to pass a legal tender act; and (2) the constitution did not deny this power but, on the contrary, granted it. The second argument rested on Hamilton’s earlier position that the right to create legal tender “grew out of the aggregate of the powers conferred on the government, or out of the sovereignty instituted.”[71]

Justice Bradley delivered a concurring opinion of considerable interest. Citing the Case of the Mixed Moneys, he endorsed the doctrine that the power of legal tender was implicit in sovereignty itself. He shifted, however, the emphasis of the majority opinion to the borrowing power by holding it to be the prerogative of every government to anticipate its resources via legal tender, not only in wartime but in other emergencies, unless restrained by a specific constitutional prohibition.[72] A background reason for this position was the link of the Legal Tender Act to the

[69] Dunne, 71.

[70] *ibid.*

[71] Dunne, 78.

[72] Justice Bradley’s separate opinion was made necessary because he could not get the majority of the Court to say that Congress could, if it wished, make greenbacks payable for all debts, even those specifically calling for gold coin. Dunne, 79.

familiar American condition of bank suspensions; banks often did not close nor did their notes become worthless.

A practical argument underlay defense of legal tender. Had the position that debts had to be repaid in specie or its dollar equivalent, with the then depreciation of greenbacks of 25 per cent, every debtor would have been obliged to repay $4 for every $3 borrowed, at a time when the vast majority of all debtors had been contracted in greenbacks.

Both Strong and Bradley, however, emphasized the temporary nature of the Legal Tender Act. As it turned out, however, the greenbacks were not to be all retired. Deflation in the 1870s had turned the hard-money frontiersman into easy-money populists; agrarian debtor interests led to a statute passed in 1878 forbidding further redemption of greenbacks and requiring reissue upon receipt by the Treasury. This statute was challenged in a creditor's suit contending that, while Congress could impress currency with the power of legal tender during wartime, the power lapsed after the war was over. With one dissent, the Supreme Court in 1884 handed down its decision upholding the right of the government to issue legal tender in exigencies that were not necessarily restricted to wartime, and that it was a "political" matter, not up to the courts, to decide what constituted the need for legal tender:

> "The question, whether at any particular time, in war or peace, the exigency is such, by reason of unusual and pressing demands on the resources of the government, or of the inadequacy of the supply of gold and silver coin to furnish the currency needed for the uses of government and of the people, that it is...wise and expedient to resort to this means, is a political question, to be determined by congress..."[73] .

Why was the question of legal tender a "political" (i.e., non-judicial) question, whereas other rights were not? The Court had in fact freed a civilian who had been imprisoned by a military tribunal, with the following ringing proclamation:

> "The Constitution of the United States is a law for rulers and people, equally in war and in peace, and covers with the shield of its protection all classes of men, at all times, and under all circumstances. No doctrine, involving more pernicious consequences, was ever invented by the wit of man than that any of its provisions can be suspended during any of the great exigencies of the government. Such a doctrine leads directly to anarchy or to despotism..."[74]

The difference between the two cases was one of practicality: "A prisoner can be freed, but a million business transactions cannot be undone."[75]

The legal tender battles were not over, but the battle lines had changed. Inflationist forces had

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[73]Vol. 19, Lawyer's Edition, Supreme Court Reports, p. 516; quoted in Dunne, 82.

[74]*ibid.*

[75]*ibid.*

been succored by long deflation that lasted between 1873 and 1896.[76] The tide was already turning, however, and William Jennings Bryan's "Cross of Gold" speech in Chicago was almost its last gasp. McKinley's decisive victory in the election of 1896, which brought in its wake an American Empire in Cuba and the Phillippines, coincided with the nadir of the long price cycle, and the next two decades of the gold standard were to be associated with rising prices, fed by the new flood of gold entering markets from South Africa. Ironically, it was during this period of conservatism that a major precedent was set for exchange control.

The Commission set up to run the Phillippines adopted an overvalued silver coinage, i.e., its face value was greater than its bullion value, and forbade the export of silver coin from the islands. A Chinese resident tried to ship some coin out, and he was caught and convicted. He carried his appeal to the Supreme Court on the grounds that the export prohibition deprived him of property without due process. The Court was unanimous in rejecting the appeal with a decision that included the following argument:

"However unwise a law may be, aimed at the exportation of such coins...there can be no serious doubt that the power to coin money includes the power to prevent its outflow from the country of its origin..."[77]

The importance of this decision was great, because it separated the monetary metals from a general doctrine that the Supreme Court had been developing for a quarter of a century, namely that the free market should not be impeded by either private combination or public interference.[78]

The case of money was made an exception. That this decision was no fluke became apparent in another decision by the same court. This decision upheld an Oklahoma statute establishing a depositor's guaranty fund from assessments levied on banks. Justice Oliver W. Holmes noted that "checks replace currency in daily business" and that this circumstance had profound implications on the whole philosophy of free banking. Addressing himself to the question as to "whether the right to engage in banking is or can be made a franchise," he seemed to go all the way to total control in his response:

"...It is not answered by citing authorities or the existence of the right at common law...We cannot say that the public interests to which we have adverted, and others, are not sufficient to warrant the state in taking the whole business of banking under its control. On the contrary, we are of opinion that it may go on from regulation to prohibition except

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[76]The deflation was policy-induced. In 1871, the German government decided to shift from the silver to the gold standard, creating an excess demand for gold and an excess supply of silver that made bimetallic countries like France (which had suspended specie payments during the Franco-Prussian War) and the United States (still on the now deflationary greenback standard) reluctant to return to bimetallism. Had Germany instead gone onto a bimetallic standard there would have been much less if any deflation over the period 1973 to 1896.

[77]Ling Su Fan v. United States (1910), 218 U.S. 302, 310; quoted in Dunne, 86.

[78]Dunne, 86.

under such conditions as it may prescribe." [79]

Devaluation and the Gold Clause

President Woodrow Wilson signed the Federal Reserve Act on December 23, 1913. This was the fourth attempt to create a national banking institution, the first two being strong central institutions, the third, not actually a central bank at all. The new venture has proved to be an outstanding success as far as creating a federal monetary authority was concerned, but a dismal failure from the standpoint of the stability of the currency and inflation.

The Federal Reserve System was composed of twelve regional institutions which were to hold the reserves of the member banks in their respective territories. The system might have forced both state and national banks to be members of the system, but in fact, membership was required only of national bank; state banks had the option of joining or staying out. A later amendment, however, allowed non-member state banks to open accounts with the System for clearing purposes.

A major purpose of the new system--planned since the Knickerbocker crisis of 1906--was to increase the elasticity of the currency, an object achieved in principle by allowing the System to issue notes against commercial paper.

The most dramatic changes in money occurred during the administrations of Franklin Roosevelt. The first occurred two days after his inauguration, on March 6, 1933, when, under an almost forgotten World War I statute, he ordered the closing of all banks.[80] Three days later, Congress passed the enabling legislation ensuring its legality, and granting the President Absolute power over gold. In the meantime, a supposedly closed Mississippi bank went out and foreclosed a mortgage.[81] Its action was challenged as illegal and void, but the Mississippi Supreme Court held otherwise on the grounds that the President had no power under the old World War I statue to close state banks, and that Congress could not give retroactive validity to this action. The significance of the decision was not, however, its defense of the Mississippi bank's action, but its declaration that once Congress had acted, the nationwide banking blackout was valid, constitutional and final.[82]

The second issue concerned the gold clause. The bank holiday meant that the gold "content" of

[79]Dunne, 87.

[80]Dunne, 62.

[81]*ibid.*

[82]For reference to the case see Dunne, 62. No appeal was apparently taken to the Supreme Court, probably because the State Court decision had established the Constitutionality of the action, and an appeal might have "rocked the boat" of this favorable decision.

the dollar now fluctuated, meaning that the dollar price of gold was no longer fixed at $20.67 an ounce. Partly as a result of free-silver agitation, fears of devaluation, and the Bronson (1869) decision (which affirmed the right of the creditor to collect on a gold clause provided Congress had not ruled to the contrary), gold clauses had become routine in all long-term debt obligations.

On June 5, 1933, a Joint Resolution of Congress made a frontal assault on the gold clause. It denounced all gold clauses as “against public policy,” forbidding their discharge in existing contracts, and making all coins and currencies of the United States legal tender.[83] As the following quotation from Senator Thomas of Oklahoma, who sponsored the legislation, suggests, its ulterior purpose was to transfer hundreds of billions of dollars worth of assets from America’s “haves” to it “have notes”:

> “Mr. President, the amendment, in my judgment, is the most important proposition that has ever come before the American Congress. It is the most important proposition that has ever come before any parliamentary body of any nation of the world. Saving the single issue of the World War, there has been no issue joined in 6,000 years of recorded history as important as this issue pending here to-day.
>
> Mr. President, it will be my task to show that if the amendment shall prevail it has potentialities as follows. It may transfer from one class to another class in these United States value to the extent of almost $200,000,000,000. This value will be transferred, first, from those who own the bank deposits. Secondly, it will be transferred from those who own bonds and fixed investments.
>
> I want to make that statement clear. No issue in 6,000 years save the World War begins to compare with the possibilities embraced in the power conferred by this amendment. Two hundred billion dollars now of wealth and buying power rests in the hands of those who own the bank deposits and fixed investments bonds and mortgages. That $200,000,000,000 these owners did not earn, they did not buy it, but they have it, and because they have it the masses of the people of this Republic are on the verge of starvation---17,000,000 on charity, in the bread line.
>
> If the amendment carries and the powers are exercised in a reasonable degree, it must transfer that $200,000,000,000 in the hands of persons who now have it, who did not buy it, who did not earn it, who do not deserve it, who must not retain it, back to the other side--the debtor class of the Republic, the people who owe the mass debts of the nation.”[84]

The sequel went as follows:

> “It was within this framework that January 17, 1934 became the deadline for the surrender of all gold into the treasury, and two weeks later, the President, acting under delegated powers, devalued the dollar 40 per cent by reducing its defined gold content from 25 8/10 grains to 15 5/21 grains. Three creditors resisted: a railroad security holder, the owner of a gold certificate, and the owner of a liberty bond. The creditors conceded the government’s right to take their gold, but they disputed its attempt to make them accept in return devalued currency of nominal equal value. Their claims were rejected by the Court on February 18, 1935. Chief Justice Charles Evans Hughes wrote all three opinions.”[85]

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[83]Dunne, 88-89.

[84]From Daily Congressional Record, April 24, 1933; quoted in Holzer (1980: 39-40).

[85]Dunne, 89.

The Chief Justice's argument noted that: (a) the contract called for payment in gold as money and not as a commodity; (b) the gold clause was intended to protect the holder against the very devaluation that did come about; (c) the clause was a valid contract when made; (d) the clause was within the protection of the Fifth Amendment[86] *provided* the congressional power which it attempted to anticipate and avoid could not be turned aside. But it was precisely on this point that the case against the government foundered: "Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them."

On the issue of the government's repudiation of the gold clause on its own bonds, the Court specifically denied that Congress could adjust its own debts the way it had done with private contracts, since the Fourteenth Amendment provided that "the validity of the public debt of the United States, authorized by law...shall not be questioned." There was, nevertheless, a legal question of how much the bondholder could recover. Another case had rejected the criterion of the gold price. This left the domestic price level as the only available measure or "a consideration of the purchasing power of the dollars which the plaintiff could have received." But the price levels had not moved much from pre-devaluation lows, so the Court accordingly dismissed the suit on the ground that the "plaintiff has not shown, or attempted to show, that in relation to buying power he has sustained any loss whatever."[87]

The decision's elaborate logic was somewhat arbitrary, and the Court was divided. The five associates who upheld the legislation were Easterners; the four dissenters were Westerners[88] from frontier-type communities with a clear sense of right and wrong. Justice McReynold's dissent went as follows:

"...if given effect, the enactments here challenged will bring about confiscation of property rights and repudiation of national obligations. Acquiescence in the decisions just announced is impossible...

Just men regard repudiation and spoliation with abhorrence, but we are asked to affirm that the Constitution has granted power to accomplish both. No definite delegation of such a power exists; and we cannot believe that the far-seeing framers....intended that the expected government should have authority to annihilate its own obligations and destroy the very rights which they were endeavoring to protect...

The [gold] clause is not new or obscure of discolored by any sinister purpose. For more than 100 years our citizens have employed a like agreement....From the housetop men proclaimed its merits while bonds for billions were sold to support the [First] World War....It appears in obligations which have rendered possible our great undertakings--public works, railroads, buildings....

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[86]*Inter alia, t*he Fifth Amendment, asserts that "no person...shall be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

[87]Dunne, 94.

[88]Dunne, 96.

Loss of reputation for honorable dealing will bring us unending humiliation; the impending legal and moral chaos is appalling."[89]

The majority decision had opened up the possibility that a creditor of the government could seek damages if it could show harm, using a purchasing-power criterion rather than the price of gold. However, the government removed this possibility when Congress, as of January 1, 1936, withdrew the government's consent to be sued on monetary claims. With this decision, the centralization of monetary sovereignty became complete and unambiguous.

PART III. SOVEREIGNTY AND MONETARY UNIONS

Part III will discuss explicitly some aspects of monetary unions as it relates to the sovereignty issue. The first section will make discuss different types of currency areas, utilizing the distinction between "true" and "pseudo" currency areas. The second section will identify key differences in policy and legal sovereignty in three different types of monetary unions. The third section will discuss the choice made along the road to EMU and alternative possibilities that involve different commitments of sovereignty.

Types of Currency Areas

I have elsewhere defined a currency area[90] as a zone of fixed exchange rates, and made a distinction between "true" and "pseudo" currency areas.[91] A true currency area is a zone of fixed exchange rates where the balance of payments determines (or at least dominates) monetary policy. By contrast, in a pseudo currency area, monetary policy may be allocated to domestic objectives.

The anchored dollar system (often called the Bretton Woods system) that extended from 1936 until 1971 was a pseudo currency area because reserve countries like the United States and Britain automatically sterilized the monetary impact of gold flows. Such sterilization was the exception rather than the rule under the international gold standard that existed between 1873 and 1914, and under the bimetallic system that characterized the international monetary system between 1815 and 1873.

The bimetallic system covering most of the world from 1815 to 1873, and also the gold bloc from 1874 to 1914, could be characterized as true currency areas; there was both a commitment to parity and a semi-automatic system of adjustment: sterilization of the monetary impact of gold flows was the exception rather than the rule. Any departure from parity in an emergency was expected to be restored after the emergency passed so speculation tended to be stabilizing.

[89]Norman v. Baltimore & O. R. Co. (1935); quoted in Dunne 96.

[90]Mundell (1961).

[91]Mundell (1997a, 1997b).

By contrast, the restored international gold standard between 1924 and 1933 was a pseudo currency area because for much of the time the leading reserve centers, the United States and the United Kingdom, focused on the requirements of international balance, frequently, if not systematically, sterilizing the impact of gold flows on bank reserves and the money supplies. The system therefore broke down.

In an important sense also, the anchored dollar standard that lasted from 1936 until 1971 (sometimes erroneously called the “Bretton Woods system”) was also a pseudo currency area. The responsibility for fixing the price of gold was left to the United States, and the responsibility for fixing exchange rate parities was left to the other countries. There was a commitment to parities, but it was by no means absolute; James Meade characterized the arrangement as an “adjustable peg” system. Countries did, however, make an effort to maintain the parities, but did not allow the self-adjusting monetary mechanism to operate. Most important of all, the key-currency country and major reserve center, the United States, automatically sterilized the impact of gold flows on bank reserves and the money supply. Thus, when gold outflows were accompanied by expansionary monetary policies, the United States set itself on a collision course with convertibility, and the pseudo currency area broke up.

The re-formed fixed exchange rate system established at the Smithsonian Institution in December 1971 was similarly a pseudo currency area; it broke down because there was no mechanism for disciplining the reserve currency country. It was a pure dollar standard in which the rate of inflation was determined by the Federal Reserve System acting--as should be expected--in its view of national rather than international interests.

The Exchange Rate Mechanism of the European Monetary System was likewise a pseudo currency area. Exchange rates were fixed but the balance of payments did not automatically determine the monetary policies; as a result, there were frequent exchange rate changes and speculators won in every battle they had with the authorities. The ERM system was defective also for the same reason that the Smithsonian system broke down: it was a DM area with monetary policy in Europe determined by the Bundesbank. When the unification shock created a major conflict between the interests of Germany and Europe, the Bundesbank followed its legal mandate to protect internal balance in Germany, leaving other countries the option of appreciating and disinflating with Germany, or leaving the system.

There were only two important differences between the breakup of the Smithsonian system in 1973 and the ERM system in 1992: One was that, from the standpoint of its partners, the U.S. was excessively inflationary in 1973, and Germany while excessively deflationary in 1993. The other major difference was that, unlike the situation in 1973, when international monetary system was falling apart, the ERM countries had signed an agreement to pursue monetary union by 1999 without, however, establishing an arrangement for sharing in the determination of the common rate of inflation in the early stages of the integration process.

Under a true currency area, interest rates converge and speculation is stabilizing; adjustment takes place between countries just as it does between regions sharing a common currency. Under a pseudo currency area, on the other hand, interest rates diverge by an extent determined by expected exchange rate changes; speculation, based typically on a one-way option, is destabilizing. A pseudo currency area has little to recommend it as an alternative to more fixed or more flexible systems.

Recent history is replete with stabilization programs using pegged exchange rates to brake inflation, but with little recognition that the stabilization policy will fail unless central bank lending is curbed. As a result of the failure of pseudo-stabilization policies in such countries as Argentina and Brazil in the 1980's, many policy makers have rejected the idea of fixed exchange rates.

Failure to make the necessary distinction between true and pseudo currency areas has frequently led policy makers to lump them both types together under the umbrella of "fixed exchange rates." Even today there is an influential view that holds that, under fixed exchange rates, there is no mechanism for adjusting the balance of payments. Yet these attacks on fixed exchange rates are only valid for the pseudo-fixed exchange rates of pseudo currency areas. They do not apply to true currency areas.

If there is no mechanism for adjusting the balance of payments under fixed exchange rates, how does adjustment take place between regions sharing a single currency? This is a problem for those who reject fixed exchange rates between countries yet would abhor the thought of breaking up a common currency area like the United States. For a time, some economists argued that fixed exchange rates were workable between different regions of large countries like the United States because of fiscal stabilizers, inter-government transfers, and big government. Yet this forgets the fact that the United States has had a common currency since 1792, long before the movement to big government that came in the wake of the two world wars. It also neglects the fact that the bimetallic and gold standard systems worked perfectly well, from the standpoint of international adjustment, at a time when there was a complete absence of international transfers or fiscal "stabilizers." The idea that balance of payments adjustment requires fiscal stabilizers or big government is the opposite of the truth.[92]

In view of the unpromising experience with stabilization plans, and the skepticism that greets new ventures in this field, some countries have resorted to partial or complete currency board arrangements. Currency boards fall into the category of true fixed exchange rate systems because they prohibit, or drastically curtail, purchases of domestic assets; the money supply therefore rises and falls with purchases and sales of foreign exchange reserves automatically ensuring equilibrium in the balance of payments. A currency board, like any truly fixed exchange rate, is not subject to destabilizing speculation[93] and leads eventually to the same rate of inflation as the

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[92]The theory that international adjustment is made easier by such "built-in-stabilizers" as high marginal tax rates is a colossal fallacy. On the contrary, the phenomenal increases both in marginal tax rates and in the ratios of government expenditure to GDP in all the European countries has clogged the arteries of commerce, raised unemployment and reduced mobility, making international adjustment more rather than less difficult.

[93]There are, of course, many different types of currency boards, differences based

that country whose currency is the object of the fix.[94]

A currency board represents an ideal monetary arrangement for a small country economically close to a large one with a stable inflation rate that is compatible with domestic inflation preferences. A currency board closes the exchange rate margins, equates domestic reserve creation with changes in foreign exchange reserves, and rules out exchange rate changes. In a well-functioning currency board system, spot and forward exchange rates are fixed and interest rates converge to those in the partner country.

In a pure currency board arrangement, central bank money is completely backed by foreign exchange reserves. Much of the seigniorage lost by this arrangement can be made up by investing the foreign exchange in interest-bearing liquid assets, such as U.S. Treasury Bills. But larger countries that lack full cover for central bank money may choose a currency-board arrangement that involves less than 100% cover.[95] A currency board that operated initially with 50% foreign exchange cover could still maintain 100% cover for *increments* in reserve money.

Countries with exchange rate arrangements as diverse as Hong Kong, Panama, Estonia, Luxembourg, Argentina and, as of July 1997, Bulgaria, have diverse fixed exchange rate arrangements that have in common a strong (but not absolute) commitment to parity combined with a monetary policy that is for the most part committed to equilibrium in the balance of payments. However, the experiences of Austria and the Netherlands have shown a convincing commitment to a fixed parity with the DM and with an adjustment of monetary market conditions

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primarily on the size of exchange rate margins, the reserve ratio (which may be less or greater than 100 per cent), and the legislative procedure for changing either the exchange rate or the target currency. See Hanke and Schuler (1994) for a good recent discussion of currency boards.

[94]It should be understood that when one country fixes its currency to another as in a currency board regime, the two members of the currency area will enjoy the “same rate of inflation,” provided the index of inflation is the same in both countries. It does not mean, however, that national price indexes will record the same rate of increase inasmuch as these have different weights. Since 1983, for example, when Hong Kong inaugurated its currency board with the US dollar, the index of inflation has consistently been higher than that in the United States to the extent that the “real exchange rate” of the HK dollar has appreciated substantially against the US dollar. This appreciation can be explained partly by an initial undervaluation of the HK dollar, requiring a correction, and partly by rapid productivity growth in the traded-goods industry.

[95]Some small countries find it advisable to maintain more than 100 per cent reserves so that the excess can be used as cover for the central bank’s role (if it is maintained) as lender of last resort to the commercial banking sector. Several writers have made the mistake of asserting that currency board systems are flawed because of the risks to the commercial banking sector. However, it is not a currency board system as such that presents the danger to the commercial banks as much as the impact of stabilization policies of any kind, as real interest rates rise and the quality of commercial bank assets fall.

to preserve equilibrium in the balance of payments.

The essential distinction is not so much whether a country has a currency board or not; whether its exchange margins are 1/2% or 2%; or whether its international reserves backing domestic notes are 50% or 100%. It is rather whether a country has committed itself to the parity and to an adjustment mechanism that ensures that economic conditions are kept consistent with that parity.

Three Approaches to Monetary Union

Let us suppose there are two countries considering different forms of monetary integration. There are four possibilities to consider: (A) a currency board regime in which currencies are locked "irrevocably;" (B) a currency board regime combined with the creation of a parallel currency and a supranational central bank; there are three sub-versions of this case, depending on whether: (i) the parallel currency is *not* legal-tender; (ii) the parallel currency *is* legal tender along with the national currencies; and (iii) the parallel currency is the *sole* legal tender; and (C) a supranational central bank and a legal tender common currency that completely replaces national currencies.

A. Consider first the currency board regime. The fixing arrangements are likely to depend on the relative sizes of A and B. If the two countries are of greatly different size, the relationship is likely to be hegemonic, with the burden of fixing falling on the small country, while monetary policy--and the joint rate of inflation--are determined by the large country.

If the two countries are of roughly equal size, a hegemonic relationship is unlikely. Both parties would contribute to the fixing. If there are small margins, each country could defend its own currency when it is weak--a potentially deflationary solution. Alternatively, each country could defend the partner's currency when it is weak--a potentially inflationary solution. Whichever method of fixing is adopted, joint decision-making will be required to determine the monetary policy and the rate of inflation of the area as a whole. Although this policy could be determined by fixed rules regarding annual increments of domestic assets, it would more probably be facilitated by a formal institution designated as the monetary authority.

B. Consider next the case of a currency board combined with a parallel currency (G-currency) and a group central bank (GCB). Suppose that the currency is (like the ECU) a weighted average of the national currencies and that it is to be used as the focus of intervention. National central banks cease their purchases of domestic assets, and lock exchange rates with each other by fixing the national currency to the central currency. Monetary expansion in the group is determined by asset expansion of the GCB over and above any purchases of the national currencies.
In this setup, the central currency and the national currencies (except for calculation purposes) are close substitutes. The degree to which they are substitutes, however, depends on their legal tender status. There are three approaches to consider in ascending order of proximity to true monetary union:

(i) The G-currency is not legal tender. In this case, the demand for G-currency would depend on its convertibility into the other currencies; it is unlikely that the G-currency would become an important unit of account and it is difficult to see how this approach would provide the momentum needed for a unified currency system.

(ii) The G-currency is made legal tender along with the other national currency. In this case, the demand for the G-currency would grow over time as the countries become familiarized with it, and, if it is also used as an invoice currency, it could in the long run become an important share in the total legal-tender money supply.

(iii) The G-currency enters as legal tender. The national central banks cease their purchases of domestic assets, and lock exchange rates with each other by fixing the national currency to the central currency. The GCB opens a window at which it stands willing to buy (from commercial banks) national currencies in exchange for the G-currency. Monetary expansion in the group is determined by asset expansion of the GCB over and above any purchases of the national currencies.

After a certain period of time--say three years--the national currencies will cease to be complete legal tender. Because this represents a draconian shift of sovereignty, the process could be accomplished by stages.[96] The recognition that national currencies will cease to be complete legal tender after a date will greatly strengthen the use of the G-currency as unit of quotation and contract for deferred payments. Of the three approaches thus far considered, this is the quickest, but it is also flexible as to the timing when national currencies are phased out. .

C. Consider now the case where national currencies are scrapped in exchange for the G-currency, and the ECB becomes a full-fledged independent monetary authority. Exchange rates are locked, national central banks cease purchases of domestic assets, and the ECB stands willing to exchange all national currencies for G- currency, in addition to carrying out the monetary policy of the group with open market operations in community assets or foreign exchange.

In principle, the third approach--adopted by the European Union--is the most direct approach to monetary union. All of a sudden, national currencies are demonetized and a supra-national authority conducts irrevocably monetary policy. This approach transfers sovereignty at once from the national state to the supranational power; put another way, it at once relinquishes national sovereignty over money and gets in return a share in the supranational sovereignty. This approach has the advantage that the location of the sovereignty is unambiguous. At the same time, this approach may act as an impediment to those countries that are not yet prepared to relinquish monetary sovereignty, the implications of which may not be well known.

An Alternative Approach to Monetary Union

It should be stated at the outset that abolition of national currencies is not a prerequisite for a common monetary policy. This was recognized in both the Werner Report of the early 1970s, and the Delors Report of the late 1980s, which proposed three necessary conditions: (a) the total

[96]Phasing out the national currencies as legal tender could be done in stages, making it legal tender for small but not large transactions.

convertibility of currencies; (b) the complete liberalization of capital flows and full integration of financial markets; and (c) an irrevocable locking of exchange rates. If these three conditions were achieved, the European Community or Union would function as if it were a single monetary area.[97]

To be sure, these three conditions leave unclear the nature of the mechanism for controlling the monetary policy of the monetary area. Suppose all national currencies are fixed to one another with no margins. If the fix is "irrevocable," all forward rates would likewise be equal to spot rates, and interest rates on credit instruments with the same non-currency risk would converge despite being denominated in different currencies, an important condition for monetary integration.

Nevertheless, this arrangement leaves open-ended both the nature of the mechanism for fixing exchange rates and the mechanism for ensuring appropriate monetary growth in the area as a whole. A requirement that each country buy and sell its partners' currencies at fixed prices forever would be sufficient to keep spot and forward exchange rates fixed, but it would not guarantee either adequate monetary growth or price stability. If national central banks had no restrictions on the purchase of domestic assets, competition for seigniorage could lead to hyperinflation. Centralization of decision-making with respect to the provision of domestic assets would be required to ensure that the objectives of monetary policy for the area as a whole are achieved. To these three provisions must therefore be added a fourth, the creation of an institution for determining the monetary policy of the area as a whole.

Suppose now that one existing currency is designated as the pivot currency, and that all other central banks fix exchange rates to that pivot currency, at the same time eschewing any further purchases of domestic assets. Now exchange rates would be fixed and monetary growth would depend entirely on the purchase of assets by the designated pivot central bank, which would now have complete control over monetary policy.

Suppose for a moment that the DM and the Bundesbank are delegated to be the interim European currency and the European Central Bank. All other countries fix their currencies to the mark and cease all other operations, in effect, turning themselves into currency boards. Exchange rates would now be fixed and the expansion of the European money supply would depend solely only on purchases of new European or foreign assets by the Bundesbank. In this setup, the mark would eventually become the European currency and European monetary policy would be completely controlled by the Bundesbank. With exchange rate changes ruled out, the demand for marks would grow at the expense of the other currencies and the Bundesbank could open a window for sales of other currencies in exchange for marks. There would, however, be no coercive phasing out of national currencies beyond what the market wanted.

From the standpoint of getting a single currency quickly and having monetary policy conducted by an experienced and capable central bank, such a solution would have much to commend it.

[97]See Kenen (1995: 14).

The use of a "living" currency is a safeguard against mistakes made by inexpert monetary doctors. This was the mechanism I suggested in my plan for a European currency presented first in December 1969.[98] It is more flexible than the Maastricht approach because does not involve the same commitment of legal sovereignty. National currencies, far from being suddenly scrapped, would continue in existence while habit and efficiency are allowing the euro to take over.

There are, nevertheless, some relevant objections that must be considered and answered:

(1) One objection to such a solution might be that the solution would involve German rather than European control of monetary policy, with German rather than European inflation preferences. This problem could be corrected, however, by changing the directorship of the bank from German to European directors, just as the European Central Bank will be constituted. The institutional framework set up at Maastricht could be implemented with the European System of Central Banks composed of both the national central banks and the European Central Bank. The ECB's Executive Board, under the supervision of the Governing Board of the ECB, would implement the Union's objectives from the standpoint of monetary policy.

(2) A second objection might be that the mark is a national symbol peculiar to Germany.[99] But it would not be difficult to change it to European symbolism. In the interim period, an over stamp on DM notes could recognize the EU character of the money, pending the introduction of the euro.

(3) A third objection might be that the use of the mark would confer on Germans the great benefit of not having to change their unit of account and learn a new system of reckoning. In every other country citizens will have to go through the agonizing mental process of transferring list prices from the familiar national unit of account to an unfamiliar euro. Germany would be specially favored by the continued use of its national unit of account as the euro.

This objection could be answered as follows: First, the cost to the other countries of changing units of account would not be harder in using the mark-euro than it would be in using the ECU-euro. Because the mark is the most important European currency in most EU members' exchange

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[98]"A Case for a European Currency" (Mundell 1969) was presented at an American Management Association Conference in New York in December 1969; a revised version of this paper was presented at the Optimum Currency Areas Conference in Madrid in March 1970, and published in Mundell (1973). At that time (1969 and 1970. I suggested the use of the pound as the interim European currency, but the mark is the obvious candidate today. .

[99]Actually, the mark was an ancient coin and weight, widely used all over Western and especially northern Europe, including France and Britain. The mark, like the pound, originated as the amount of silver that had the same value as the Roman solidus. Because, however, the Gothic bimetallic ratio was 8:1 while the Roman-Byzantine-Carolingian ratio was 12:1, the mark meant eight ounces while the pound (troy) meant twelve ounces. The pound was 20 shillings, while the mark was 14 2/3 shillings.

markets, exchange rates on the mark are more familiar than any other exchange rate (except the dollar). By contrast, the ECU exchange rate is not well known at all to the general public.

Second, the fact that German citizens will not have to change their unit of account can be looked on as a benefit not a cost, because it would give Germans some compensation for their sacrifice of the most important currency in Europe, the second most important currency in the SDR, and the currency with the best inflation record in Europe. Germany has the most to risk and the least to gain by scrapping the mark for the euro[100] and, in view of the substantial majority of German citizens that oppose EMU, the mark-euro solution should be seen as good European politics.

Third, the identification of the euro with the mark would fit in more conveniently with rest of the international monetary system, where the three most important currencies quoted are the dollar, the mark and the yen.

All these factors tend to favor, rather than controvert the use of the mark as the foundation for the euro. It should not be forgotten that the use of the mark would involve a sacrifice for Germany too. The other countries will lock their currencies to the mark, and lose policy sovereignty while retaining legal sovereignty. Germany, however, will retain, at least at first, a measure of policy sovereignty, but in effect, lose its legal sovereignty as the mark-euro becomes the currency of the EU rather than the nation-state of Germany.

A Final Comment

Members of the European Community signed the Treaty of Maastricht that formed the European Union and developed a plan for European Monetary Union to begin in 1999. This plan involves the sudden sacrifice of policy and legal sovereignty to the central government in which, of course, each member will share control. It remains to be seen, however, whether, in the final analysis, many countries will be willing to completely scrap their legal sovereignty in the way prescribed.

The choice made at the time of Maastricht to take such a drastic step in the field of legal sovereignty before other commitments to political union had been made will remain one of the most intriguing questions for historians. That the Maastricht Plan followed the Delors Report is well known. But the Delors Report said (to repeat): "The adoption of a *single currency*, **while not strictly necessary for the creation of a monetary union...would clearly demonstrate the**

[100] I have elsewhere argued (e.g., Mundell (1994) that dominant countries have the least to gain and the most to lose by giving up monetary sovereignty to a supra-national institution, and that is the reason why, historically, the dominant powers have always resisted international monetary reform. This was true of Britain in the 19th century, of the United States at Paris in 1933 and at Bretton Woods in 1944, and it has underlay the German insistence on convergence before locking exchange rates, instead of locking exchange rates as a route to convergence. If President Kohl's enthusiasm for monetary and even political union is seen as an exception to this theory, it could be pointed out that Kohl's position can be explained completely by his commitment to Europe on the eve of German monetary unification.

irreversibility of the...union...The replacement of national currencies by a single currency should therefore take place as soon as possible after the locking of currencies."(my emphasis). The EMU plan adopted, after analysis by the European Monetary Institute, will mean that the national currencies will disappear by the year 2002, three years after locking currencies.

There are, of course, some advantages to a single currency over a common currency in which national currencies remain. The single currency forces brutally quick adjustment and, as Machiavelli knew, one hard blow is more effective and possibly less painful than a long series of irritating punches. It is also true that the single currency approach would make it difficult to return to the *status quo ante* EMU; there would therefore be no currency speculation against potentially weak currencies or countries whose fiscal deficits got out of hand. The transactions costs in a single currency area are inevitably less than in one where costs of exchange have to be taken into account. These advantages to the Delors-Maastricht approach should be recognized.

It will be interesting to see whether the big bang approach works. If it does, it will have shown that Europe at least has lost the "barbarism" that John Stuart Mill spoke of (quoted in the introduction) in his recognition of the national attachment to local currencies.

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