STEIN BROTHERS

LONDON-STOCKHOLM

Breaking up is not so hard to do

- **The euro crises have (temporarily?) receded**
- **If they reoccur, a combination of creditor and austerity fatigue could trigger an exit**
- **Contrary to received wisdom, monetary union break-up need not be very costly**

Last week I was at a dinner arranged by the Centre for the Study of Financial Innovation (CSFI, www.csfi.org). The guest speaker was Vaclav Klaus, former President of the Czech Republic. Klaus is famous for many things, but one of them is for saying 'Don't tell me that you cannot break up a monetary union – I have done it' (the quote may not be exact). This triggered the idea of revisiting the issue of the consequences of a monetary union break-up. (A somewhat different version of this Comment was published in the June Bulletin of the Official Monetary and Financial Institutions Forum, www.omfif.org).

Over the past few years, when the possibility of a partial or full-scale break-up of EMU has been on again/off again, one of the arguments against a break-up has been the tremendous cost it would allegedly involve. Both for the country/countries leaving and for those staying, the numbers quoted have occasionally been double-digit GDP losses. Perhaps the most amazing quote came in a report from UBS, published on 6th September 2011, which said "It is also worth observing that almost no modern fiat currency monetary unions have broken up without some form of authoritarian or military government, or civil war,".[1] The report also said "Past instances of monetary union breakups have tended to produce one of two results. Either there was a more authoritarian government response to contain or repress the social disorder (a scenario that tended to require a change from democratic to authoritarian or military government), or alternatively, the social disorder worked with existing fault lines in society to divide the country, spilling over into civil war. These are not inevitable conclusions, but indicate that monetary union breakup is not something that can be treated as a casual issue of exchange rate policy."

Both these comments are amazing in their ignorance – in fact, you can probably not find a single monetary union dissolution where the dissolution has led to authoritarian or military government or civil war. There have been breakups of countries where one of the consequences has been the end of a monetary union and other consequences have been dire – but, as far as I know, and it is difficult to be sure, since merely since World War II some 70-80 monetary unions have dissolved, not a single one where the end of the monetary union caused the problems.

Why bring this up now? Because although the euro crises have receded, they have not disappeared. There could be another flare-up; and payment fatigue combined with austerity fatigue could again raise the issue of one or more countries leaving the euro. In fact, since the euro will only survive if it does move towards a political union, its survival almost certainly depends on countries who would not be welcome in such a union leaving the single currency. At a time when the issue is therefore not on the immediate agenda, it might be worthwhile to look somewhat more dispassionately at the experience of some past monetary unions.

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[1] UBS, *Euro Breakup – the consequences*, September 2011.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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This is not an attempt to calculate the cost of an EMU partial or full break-up, nor an attempt to claim that this would be costless. It would be costly and messy. It is an attempt to show from history that it would probably be neither as costly, nor as messy as is frequently claimed.

Different types of monetary unions

There are essentially two kinds of monetary unions. One is where national currencies are locked together but still exist, such as the Scandinavian and Latin Monetary Unions (SMU and LMU) of the late 19th and early 20th centuries. The second is rarer, with only one currency circulating in more than one country. Examples are the Austro-Hungarian Empire – two countries with one currency – and the short-lived Czech-Slovak monetary union following the breakup of Czechoslovakia itself in 1993.

Monetary unions work only if no part insists on creating money or having its own monetary policy. What the European Central Bank today calls the 'singleness' of monetary policy is an existential condition. For this to happen, countries must be willing to give up sovereignty – a step that is still very difficult for many countries. There is another lesson, too, from the break-up of the Czech-Slovak monetary union in 1993, as described by the authors of a seminal paper on the issue: 'While the formation of a monetary union is a tedious job taking many years, its dissolution can occur quickly and does not need to be very costly. The temptation to secede is higher if the expected cost of exit …. is small.'[2]

The Latin and Scandinavian Monetary Unions

In the 19th century, SMU and LMU show the great interest in monetary unions at the time, promoted by globalisation and the belief that standardising currencies would benefit exports. A monetary union would do away with foreign and domestic currency instability. Standardising currencies would be simplified by the move to more 'scientific' decimal currencies, and metal-backed coinage – generally silver, more rarely gold. (The SMU was based on gold from its start in 1873. The LMU was based on silver from 1865, but shifted to gold in 1867.)

The idea was to harmonise currencies on the basis of a common unit, based on a precious metal – such as the French five franc silver coin or the Scandinavian 10 crown gold piece. But monetary unions were intended to be more than that. The currencies – including divisionary coinage – were meant to be interchangeable and accepted in all countries of the union. Therefore, there had to be rules governing the issue of coinage, including divisionary coins, as well as for the return of coins from other countries.

There were concerns (in the case of the LMU, strongly articulated by the Banque de France), that members with weak public finances would destabilise the union. The LMU's founding members in 1865,

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[2] Jan Fidrmuc, Július Horváth, Jarko Fidrmuc, Center for European Integration Studies, University of Bonn, Stability of Monetary Unions Lessons from the break-up of Czechoslovakia, ZEI Working Paper B 17, 1999.

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France, Belgium, Switzerland and Sardinia, wished to expand the union. But only two countries ever joined: the Papal States, later expelled for cheating, and Greece, admitted on the condition that its coins were minted in France, under French supervision.

Further attempts at expansion were stymied by British and American opposition, partly based on unwillingness to adjust even minimally the gold content of their own currencies to conform to the LMU standard. Another half dozen countries unilaterally aligned their currencies. In theory, LMU lasted until 1927, but, in fact, was broken up by the First World War. During the war, countries suspended gold convertibility and – in some cases – banned gold exports. Most of its members had to abandon fiscal and monetary probity, issuing large amounts of paper money which was not considered part of the 'union money'. Silver coins were melted down and exported to pay for imports. This led to a massive overhead of paper money following the war, which could not be redeemed in silver. The Union eventually broke up in 1927.[3]

In contrast to the LMU, the SMU, formed in 1873-75, was a 'true' monetary union. The currency – the crown – was the same, there was cheque clearing, paper money was included and all coins were legal tender in the union. But its aims were much more limited than that of LMU, and its life was rather calmer. However, here too, World War I, with diverging economies, different inflation and exchange rates and suspension of gold conversion, caused the union to eventually break up.

The Austro-Hungarian Empire[4]

The dissolutions of the LMU and the SMU were simplified by the continued existence of national currencies. Upon dissolution, these were no longer legal tender in the other union countries. A more complicated break-up was necessary in the case of the Austro-Hungarian monetary union, which was formed as the result of Austrian weakness following the Empire's defat by Prussia in 1866. This provided Budapest's Magyar elite with an opportunity to wrest major concessions from the Austrian Hapsburg Empire by threatening secession.

To prevent this, Vienna and Budapest agreed the 'Compromise of 1867', a constitutional treaty that recognised the sovereign autonomy of Austria and Hungary under a single monarch – the Austro-Hungarian Dual Monarchy. With a common currency and common national bank, the dual monarchy had all the trappings of monetary union. Somewhat ominously, its combination of independent sovereign political and fiscal arrangements, along with joint monetary structures, has notable similarities to the euro area.

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[3] Curiously, however, the Bank for International Settlements – the Central Banks' Central Bank – retained the LMU gold franc as its numeraire for its accounts until about a decade ago when it was replaced by the SDR.
[4] This section is heavily based on an article by Professor Richard Roberts in a Lombard Street Research Special Report, *EMU – Fuse or Split*, October 2010.

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The euro area is a voluntary convergence of states with new common monetary arrangements. The Austro-Hungarian monetary union was the outcome of a political separation that resulted in independent sovereign states, while preserving existing common monetary arrangements. Yet we see similar challenges and dilemmas.

The 1867 Compromise established a two-tier fiscal system, with a 'confederate-level' and a 'country-level' – as with Europe today. At the 'country-level', each national government decided its own expenditures and taxes as voted by its parliament. The country budgets were not required to balance. Initially, both countries ran large and volatile deficits, funded by borrowing, leading to a significant build-up of debt.

Although contemporary investors did not monitor debt to GDP ratios, a concept that had yet to be invented, they carefully watched the quantity and quality of government tax revenues as well as levels of spending and public debt. It appears likely that by 1890 Austria and Hungary had reached the limits of their ability to tap international investors. Recognition that deficits and borrowings were becoming unsustainable seems to have complemented the concern about currency volatility in the early 1890s, prompting financial reforms in 1892-1896. Following these and until the outbreak of war, the country-level budget deficits of both countries tended to be in the range of up to 5% of GDP.

The break-up of the Austro-Hungarian monetary union was a direct result of the Empire losing World War I and breaking up, with its territory ending up in seven different countries, some of which had not even existed before the war. The unwinding of the dual monarch's monetary arrangements had several dimensions: the separation of outstanding Austro-Hungarian crown notes into national holdings; creation of successor-state currencies; establishment of successor-state central banks; liquidation of the Austro-Hungarian Bank; and stabilisation of successor-state currencies.

Currency separation and the creation of successor-state currencies proceeded in two stages: the stamping of Austro-Hungarian crown notes, and the exchange of stamped crown notes into national currencies. The peace treaties after the First World War specified that the successor states should stamp Austro-Hungarian Bank notes and then introduce their own notes within a year. In February 1919 37.6bn paper Austro-Hungarian crowns were in circulation, but successor states' claims regarding circulation in their territories totalled 44.9bn. The separation of pre-Armistice crowns among the successor states was negotiated, taking account of populations and stamped banknotes, with the total reduced to 29.1bn crowns.

During 1919 and early 1920, in uncoordinated succession, Yugoslavia, Czechoslovakia, Austria, Romania and Hungary, stamped the Austro-Hungarian Bank banknotes in circulation in their territories with a national emblem, converting the crown notes into national currencies. The process was complicated by the successor states imposing varying conversion taxes or forced loans on the stamped notes. There was widespread avoidance of the levies by forgery of national stamps. Many holders initially withheld notes from stamping seeking the most favourable terms, resulting in substantial illicit cross-border flows of unstamped crown notes. A further complication was the substantial circulations of other paper currencies.

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Czechoslovakia led the way in the exchange of stamped Austro-Hungarian Bank banknotes into the national currency, a new Czech crown, in 1919. Yugoslavia and Romania undertook currency exchanges in 1920, the former at four crowns per dinar and the latter at two crowns per leu. Austria and Hungary initially persevered with stamped Austro-Hungarian crowns and subsequently introduced new currencies, respectively the shilling (1925) and the pengö (1927). Afterwards came the stabilisation of successor state currencies. Newly-created Czechoslovakia, comprising the most economically developed regions, led the way. The Czech central bank was prohibited from lending to the government. This immediately stabilised the new Czech currency, since the driving force behind monetary expansion had been removed. Austria and Hungary, the defeated and impoverished aggressors, faced much greater challenges including huge budget deficits and hyperinflation. Stabilisation was achieved in the 1920s through international reconstruction loans issued under the auspices of the League of Nations.

The Czecho-Slovak monetary union

The end of Austro-Hungarian monetary union supports those who argue that such break-ups are messy, costly and drawn-out. However, the mess, cost and time were arguably a consequence of the World War. By contrast, the dissolution of the Czech-Slovak monetary union, following the 1992 ‘velvet divorce’ of Czechoslovakia into two states, illustrates an orderly, relatively inexpensive and swift process – even though it was not initially planned.

The two successor states initially decided to maintain a monetary union. Because the Slovak Republic was perceived to have a weaker and less developed economy than the Czech Republic, it was assumed that the new Slovak currency would depreciate upon establishment, so capital flowed from Slovakia to the Czech Republic. The Czech-Slovak monetary union was run by a monetary committee with equal representation from both nations. There were provisions for dissolving the union if either state had a budget deficit above 10% of GDP; if foreign exchange reserves fell below one month's exports; if an inter-republic capital transfer was over 5% of bank deposits; and if agreement could not be reached on fundamental issues. The two economies were well-integrated. Half of Slovakia's foreign trade was with the Czech Republic; one-third of the Czech Republic's foreign trade was with Slovakia, representing much more trade integration than within EMU.

For a monetary union to work there must be intra-union fiscal transfers. As with EMU today, the countries transferring funds must feel that political, economic or other advantages outweigh the costs. In the Czecho-Slovak monetary union, the Czechs making the transfers did not see these advantages. The flood of capital from Slovakia to the Czech Republic turned into a torrent. Slovak debtors to the Czech Republic hastened to pre-pay their invoices, while Czech debtors postponed paying theirs. The run on Slovak banks unnerved the Czechs, who soon decided to break the union in 1993. In the intervening period, the border was closed, currencies were exchanged and notes stamped, with limits imposed on bank withdrawals in both countries.

Because only 4,000 crowns could be exchanged in cash, people were encouraged to deposit money in banks. Cash is not as important as often stated. About 90% of all cash circulating in any advanced

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economy is used in the black or illegal sector. By far the greater volume of transactions of any kind is cashless – electronic, with credit cards or other methods. One frequently-raised objection to dissolving a monetary union – the need to create new notes and coins and reprogram vending machines and cash registers – is actually minimal. The costs are not substantial enough to stop an otherwise desirable process. In 1993 Czech GDP fell by 1% and Slovak GDP by 4% - a relatively painless transition by the standards of southern states suffering multiyear recessions in the euro area. Both countries began to recover by 1994.

The Czech and Slovak Republics were far more integrated than the EMU countries are today. The dissolution of the monetary union was unplanned. Yet it took less than six weeks from start, to decision to dissolve, to implementing the dissolution. There were costs, but they were bearable – in fact, they were much lower than the costs – social and economic – inflicted on some of the countries currently clinging stubbornly to EMU membership

Gabriel Stein 2013-06-26
gabriel.stein@steinbrothers.co.uk

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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