

# Working papers



## **Why are Territorial Currencies Becoming Unpopular?**

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A striking trend in recent years has been the growing unpopularity of what Cohen calls "territorial currencies"; that is, currencies which are exclusive and homogeneous within the territorial borders of a nation-state.<sup>1</sup> One manifestation of this trend is the new enthusiasm for currency unions. Such enthusiasm is of course most pronounced in Europe, where eleven members of the European Union have agreed to eliminate their national currencies in favour of a supranational currency by 2002. But it also has spread to other regions. In North America, an active and high level debate broke out for the first time in 1999-2000 on the subject of a common currency for the members of NAFTA.<sup>2</sup> Prominent calls for a common currency were also suddenly heard in 1997-98 among the South American member countries of the trade grouping Mercosur.<sup>3</sup> Although the prospects are much more remote, there have also been some calls for a common currency in the East Asian region, particularly in the wake of 1997-98 financial crisis.<sup>4</sup> Also worthy of note has been the way in which some nationalist movements today seeking to create new independent states in these regions – such as that in Quebec or Scotland - are strong supporters of these supranational currency proposals. Their position signals an interesting departure from traditional nationalist movements that have understood the creation of a new territorial currency as an integral part of their project of building a nation–state.

A second manifestation of the unpopularity of territorial currencies today is the growing acceptance of the use of foreign currencies within national territories. This trend first took off

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<sup>1</sup> Cohen (1998).

<sup>2</sup> In Canada during 1999, the issue assumed a prominent place in public policy debates, and Senate hearings were held on the issue. In Mexico, the issue was widely debated and in mid-2000, the newly elected President Vicente Fox argued a common currency was a strong possibility in the medium-term future.

<sup>3</sup> Argentine President Carlos Menem promoted the common currency idea in late 1997. The proposal was also supported in a detailed study by Fabia Gambiagi (1998), manager of the Macroeconomic Bank of Economic Development of Brazil, which suggested the currency could be in place within 15 years.

back in the 1960s when the British state began to encourage the rapid growth of inter-bank dollar deposits in London. Foreign currency deposits had existed in earlier periods, but the rapid growth of this “eurocurrency market” in London was quite unprecedented. More recently, foreign currency deposits – again usually US dollars - have also become very widespread in many countries across Latin America, Africa, the Middle East and ex-Eastern bloc. In these instances, the phenomenon has not been restricted to an inter-bank market but has also involved many domestic citizens holding such accounts. In some cases, “dollarization” has even extended to widespread use of the dollar as a medium of exchange.<sup>5</sup> Again, this phenomenon is not new: individuals in countries with high inflation or political uncertainty in the past have often lost “trust” in the national currency and turned to foreign currency. But novel today has been the long endurance of “currency substitution” in many countries and the degree to which this trend has received official endorsement and even encouragement in many poorer countries. Dollarization in Latin America, for example, began to accelerate in the 1970s after their governments deliberately relaxed restrictions on foreign currency use as part of broader monetary and financial reforms.<sup>6</sup> By the 1990s, many poorer governments had gone so far as to extend central bank guarantees to foreign currency bank deposits, create clearing and payments systems for domestic transactions in foreign currency, and give foreign currencies full legal tender status.<sup>7</sup>

An even more dramatic step was recently taken by Ecuador when it chose in early 2000 to abolish its national currency altogether and adopt the US dollar. Again, this choice was not unprecedented among independent countries: Panama and Liberia have long used the US dollar as their currency. But they did not abandon an existing national currency and their policies were

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<sup>4</sup> Lucas (1998).

<sup>5</sup> Cohen (1998).

<sup>6</sup> Edwards (1993).

always seen as anomalous ones, linked to their close dependence on the US. Ecuador's choice also may not be an isolated one. Then Argentine President, Carlos Menem, suggested that his country move to "full dollarization" in early 1999 and similar proposals are being debated prominently in other countries such as El Salvador, Costa Rica, Guatemala and Mexico.<sup>8</sup> US Congress has also held prominent hearings on the question of whether the US should be encouraging this practice.<sup>9</sup>

One final sign of dissatisfaction with territorial currencies has been the growing interest in the possibility of privately-issued electronic currencies emerging in the near future.<sup>10</sup> Information technologies have already begun to be used to create monetary devices carrying electronic representations of prepaid value, such as stored value cards (or 'electronic purses') and software products that can be used to make payments across computer networks (sometimes referred to as 'digital cash'). In contrast to credit or debit cards, these devices do not access a bank account or credit line but rather represent general liabilities of the issuer. For this reason, some analysts are excited by the possibility that these new forms of money could be used to break the state's monopoly over currency. They argue that anyone could potentially issue these new forms of money and that private issuers might choose to issue money in an entirely new private currency.<sup>11</sup>

Particularly enthusiastic about this possibility are "free bankers" who have long

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<sup>7</sup> See for example Brand (1993), Savastano (1996), Sahay and Vegh (1995).

<sup>8</sup> Schuler (2000).

<sup>9</sup> US Senate (1999a).

<sup>10</sup> A quite different manifestation of the unpopularity of national currencies has come from the emergence of the "local currency movement" (Helleiner 2000). Since the early 1980s, hundreds of subnational currencies have been created in countries from Australia and Sweden to Japan and Canada. These currencies serve as a means of exchange within a clearly defined local community network and are not convertible into the national currency or any other currency. These currencies will not be discussed here; for a discussion, see Helleiner (2000).

<sup>11</sup> For example Kobrin (1997). For a more sceptical view, see Helleiner (1998b).

advocated the replacement of the state's monopoly of currency with a system of competing privately-issued forms of money. Although support for free banking was considerable in economic liberal circles during the 19<sup>th</sup> century, it has had few adherents during most of the 20<sup>th</sup> century. Since the mid-1970s, however, it has experienced a sudden revival. Hayek's 1978 work, The Denationalisation of Money, played a central role in this process. While 19<sup>th</sup> century free bankers had assumed privately-issued forms of money would be convertible into a common gold standard, Hayek went further in this work to argue that market forces should also determine the standard of value itself. His ideas have attracted a growing number of supporters, many of whom have reinterpreted the history of 19<sup>th</sup> century free banking experiences in a more positive light than conventional histories had portrayed them.<sup>12</sup> Many of these modern free bankers see the emergence of "electronic money" as the tool with which they can finally challenge directly the state's control over money.<sup>13</sup>

It is clear, then, that we live in an era when serious questions are being raised about the future of territorial currencies.<sup>14</sup> What are the sources of the unpopularity of territorial currencies today? This question is obviously a difficult one to answer because the nature and causes of these challenges differ considerably in various parts of the world. Despite this difficulty, the fact that territorial currencies are being called into question in such a widespread manner in this era does call out for a more general analysis of this phenomenon. In this chapter, I suggest that one

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<sup>12</sup> For example White (1984), Rockoff (1991). Hayek's ideas are outlined in Hayek (1990).

<sup>13</sup> See for example many of the articles in Dorn (1997).

<sup>14</sup> The trend should not be overstated since support for territorial currencies remains tenacious in many parts of the world. Particularly prominent examples can be found in the new countries created by the break-up of the USSR, Czechoslovakia and Yugoslavia. In each of these instances, new national currencies have been created as a central component of the process of creating new nation-states. But even in these instances, we often see foreign currencies used widely alongside these new national currencies. Many policymakers in these countries are also open to the idea of joining larger supranational currency zones, such as the euro, in the future. Lavrac (1995: 15), for example notes that monetary sovereignty is seen as transitional measure in Slovenia; the final goal is to join the euro zone.

way to begin to develop such an analysis is to recall the reasons why territorial currencies were created in the first place. I have shown elsewhere that these monetary structures were first created in most parts of the world during the 19<sup>th</sup> and early 20<sup>th</sup> centuries with four goals in mind: 1) to bolster national markets by reducing intra-national transaction costs, 2) to provide a tool for national monetary management, 3) to augment the state's revenue base, and 4) to strengthen national identities.<sup>15</sup> If territorial currencies were created for these reasons, to what extent can their growing unpopularity today be attributed to a disillusionment with these goals? I argue below that disillusionment with these goals - particularly the first two - is indeed driving many monetary transformations today. I suggest that this sentiment, in turn, is linked to a broader reconsideration of the proper economic role of the nation-state in an age when "neoliberal" ideas have triumphed and international economic integration is intensifying.

### **REDUCING INTERNATIONAL TRANSACTION COSTS**

One of the key reasons that territorial currencies were created during the 19<sup>th</sup> and early 20<sup>th</sup> centuries was to facilitate the emergence of nationally coherent markets. Pre-national monetary systems were often quite heterogeneous, with various kinds of money circulating simultaneously within the territory of a state. By constructing an exclusive and homogeneous national currency, transaction costs associated with intra-national trade were eliminated. Policymakers also sometimes used territorial currencies as a tool to discourage economic transactions with the outside world by making these currencies inconvertible.

Today, however, intensifying international economic integration has led to growing

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<sup>15</sup> Helleiner (1998a, 1999), Gilbert and Helleiner (1999).

disenchantment with the constraints and limitations of national markets, a sentiment that has, in turn, extended to the territorial currencies that complement these markets. The motivations for supporting the initial growth of the eurocurrency market in London during the late 1950s and 1960s provide an early example of this. This monetary innovation initially derived much of its support from internationally-oriented economic interests who sought to create an “offshore” or “transnational” economic space in which to operate free from the kinds of national capital controls which had become popular during the post-1945 years. In Britain, crucial support came from key financiers in the City of London, backed by British officials, who saw how this monetary innovation could allow them to rebuild the City’s traditional cosmopolitan orientation in face of the national capital controls designed to defend the British national currency. American banks and multinational firms, again supported by US officials, also saw the eurocurrency markets as a way for their transnational activities to remain unencumbered by US capital controls that were imposed in 1963.<sup>16</sup>

More recently, as capital controls have been eliminated around the world, some supporters of international economic integration have promoted supranational currencies or “full dollarization” as another tool to eliminate international transaction costs. Their goals are in fact reminiscent of the mid-19<sup>th</sup> century, a period also characterized by a dramatic growth of international economic integration driven by liberal economic policies and rapid technological changes. Then as now, a flurry of proposals for currency unions were presented for the same reason; indeed, the proposals in that era were much more ambitious, with an international conference held in 1867 to discuss the creation of a “universal currency” that could circulate in

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<sup>16</sup> Helleiner (1994: ch.4).

all countries.<sup>17</sup> In the mid-19<sup>th</sup> century, the international monetary transaction costs that most concerned supporters of currency unions were those associated with exchanging national currencies and comparing prices across countries. Both concerns are also highlighted by supporters of currency unions today.<sup>18</sup> But much more prominent today than in the mid-19<sup>th</sup> century is the desire to eliminate exchange rate instability in today's atmosphere of very high capital mobility.

Indeed, it is no coincidence that discussions of monetary unions and full dollarization have accelerated in the wake of dramatic currency crises during the 1990s. As financial capital has become increasingly mobile, governments have found it increasingly difficult to maintain a credible fixed exchange rate or even a well managed floating rate. Countries that have let their currency float freely have also often experienced significant short-term exchange rate misalignments which have been quite costly for open economies. In these contexts, the idea of creating an irrevocably fixed exchange rate through a currency union or full dollarization has become increasingly attractive to many of those seeking to promote international economic integration. Supporters of a common currency in Europe and North America, for example, have argued that exchange rate instability is undermining the project of accelerating regional economic integration. Many Latin American supporters of full dollarization also argue that exchange rate risks vis-à-vis the dollar must be eliminated in an effort to encourage foreign investment, stop flight capital, and eliminate the possibility of disruptive speculative attacks against the national currency. One of the most prominent advocates of this monetary reform,

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<sup>17</sup> See for example Perlman (1993). This initiative garnered a remarkable degree of support from international businesses and economic liberals across the world from Europe to Asia and the Americas. In the end, however, it could not find enough support in leading countries such as Britain and the US, but two more limited European currency unions – the Scandinavian Monetary Union and the Latin Monetary Union – were created.

<sup>18</sup> In making the case for currency union, the European Commission (1990), for example, has argued that the

Ricardo Hausmann, has also called attention to the need to eliminate uncertainty in international debt repayments, many of which are denominated in US dollars in Latin American countries. He notes that unexpected devaluations can cause major domestic financial crises as firms face a mismatch between their dollar-denomination debts and their local currency-denominated revenue.<sup>19</sup>

Those familiar with 19<sup>th</sup> and early 20<sup>th</sup> century monetary history may find surprising the growing popularity of the idea that exchange rate-related international transaction costs can be eliminated only by abandoning a national currency. After all, the goal of reducing this kind of transaction cost was also prominent in the integrated world economy of that era, but it was achieved simply by ensuring that all national currencies were tied to a common standard, gold. To the extent that the credibility of the peg to gold might be questioned, countries ensured that their national currencies were managed by independent central banks devoted to this goal or even currency boards. Even in the context of colonial monetary relations, exchange rate uncertainty between the colonizing and colonized country was not usually eliminated through a monetary union or the adoption of the colonizing country's currency, but rather by establishing a distinct colonial currency managed by a currency board.

Why are countries today not considering similar mechanisms to guarantee the credibility of their exchange rate peg? In a case such as the European Union, the answer is linked to the fact that monetary union is being sought for other reasons as well. In countries considering the

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elimination of costs associated with actual currency conversions will bolster Europe's GDP by as much as 0.5%.

<sup>19</sup> Indeed, in many poorer countries, Hausmann (1999) notes that most long-term domestic loans are also denominated in dollars because expectations of future inflation and currency depreciation have prevented the development of debt markets denominated in local currencies. In this context, a devaluation can cause financial difficulties for borrowers of these loans too. This provides a key reason for Hausmann to advocate full dollarization: it might promote financial stability and economic development by encouraging the growth of indigenous capital markets.

adoption of the US dollar, however, the question is an important one. There has in fact been a dramatic increase over the past decade in the use of independent central banks and currency boards across the world partly for this reason. But many countries have found that these structures still did not do enough to establish credibility. In Argentina, for example, Menem's sudden interest in full dollarization stemmed from the fact that international financiers still charged an exchange rate risk premium on loans to Argentina during times of large external shocks despite the existence of currency board since 1991. Unlike in colonial times, independent countries with currency boards today face the difficulty of convincing the markets that a change in local government will not simply eliminate the currency board. Full dollarization is seen by Menem and others as a way to eliminate this credibility problem.<sup>20</sup> As Larry Summers has noted, "the presumed irrevocability of dollarization" is its appeal.<sup>21</sup>

One final point needs to be made about the relationship between international economic integration and the growing interest in alternatives to territorial currencies: the growing support for privately-issued e-currencies is also linked partly to a desire to reduce international transaction costs. In this case, the goal is to reduce transaction costs in one of the most rapidly growing sectors of the global economy: e-commerce. The growth of e-commerce has provoked interest in more efficient electronic exchange media to facilitate transactions in this new sector. A key feature of e-commerce transactions is that they take place in a kind of "cyberspace" which does not respect traditional sovereign borders of nation-states. It is not surprising, then, that participants in this commerce would be searching for a kind of currency which is less tied to the

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<sup>20</sup> Hausmann and Powell (1999).

<sup>21</sup> Summers (1993).

sovereign nation-state. In Kobrin's words, the growing interest in privately-issued "state-less" e-currencies is linked to the fact that e-commerce is ushering in "the end of national markets".<sup>22</sup>

## **DISILLUSIONMENT WITH ACTIVIST NATIONAL MONETARY MANAGEMENT**

Historically, support for territorial currencies stemmed from their ability not just to bolster national markets but also to provide the state with a tool for national monetary management. During the pre-1914 period, this goal was a relatively modest one because of the dominance of economic liberal ideas. Policymakers simply sought to ensure that new kinds of money emerging in that era - especially bank notes - would be managed in a fashion that closely resembled the automatic market principles by which old kinds of "commodity money" had been regulated. The monopolisation of the note issue in this period, for example, was frequently driven by the desire to manage its supply in accordance with the requirements of the gold standard. As the electoral franchise was widened and left-of-center political parties grew in influence during the interwar period, the macroeconomic rationale for state control became more ambitious. In the wake of the Great Depression, in particular, governments across the world began to manage national currencies in much more active ways to promote national objectives, particularly the reduction of unemployment and the promotion of rapid industrial development. This new ambitious objective then provided a key rationale for creating fully-fledged territorial currencies in countries that had not yet done so.

The growing unpopularity of territorial currencies today is often closely linked to

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<sup>22</sup> Kobrin (1997).

disillusionment with the kinds of activist national monetary policies that became popular during and after the 1930s. This sentiment has emerged partly out of the experiences of inflation which often accompanied those policies. Equally important has been the success of the rational expectations revolution in the discipline of economics over the last two decades. It undermined a key idea that had sustained support for activist monetary policies: the Keynesian notion that there was a long term trade-off between inflation and unemployment. By highlighting how experiences of inflation over time will encourage people to adjust their expectations, this new economic analysis suggested that activist monetary management would simply result in stagflation. To break inflationary expectations, it argued that authorities would have to re-establish their credibility and reputation for producing stable money by a strong commitment to price stability. The need for this kind of credibility and reputation has also been reinforced by the enormous growth of international capital markets. The fear of the discipline these markets can apply against inflationary countries has encouraged a dramatic change of macroeconomic views.<sup>23</sup>

Out of these circumstances, a "neoliberal" consensus has emerged amongst policymakers that monetary policy has no long-term impact on real output and employment, and that the maintenance of price stability should be the primary objective of monetary policy. This disillusionment with activist monetary policies has also often extended to the use of the exchange rate to foster macroeconomic adjustments. Some still defend the use of floating exchanges as a tool to foster macroeconomic adjustments in a context where wages and prices are slow to adjust, or as a mechanism providing some autonomy to national policymakers seeking to pursue the goal of price stability. But others have questioned whether exchange rate adjustments have any lasting effect on the real economy. A devaluation, for example, may

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<sup>23</sup> Andrews and Willett (1997), Maxfield (1997).

simply to produce inflation, if domestic citizens anticipate and react to its consequences.

The growing disillusionment with activist monetary management has played an important role in encouraging alternatives to territorial currencies to be considered. By eliminating a key macroeconomic rationale for wanting a territorial currency in the first place, it has made policymakers less resistant to the idea of giving these monetary structures up. In Europe, the shift from Keynesian to neoliberal monetary ideas was a key precondition for the move to monetary union; indeed, many policymakers saw currency union as a better way to achieve price stability than maintaining a national currency because the union appeared to allow them to “import” the Bundesbank’s anti-inflationary monetary policy.<sup>24</sup> Many advocates of monetary union in other regions, such as North America, also subscribe to the new monetary orthodoxy and argue that there is little to be lost in a macroeconomic sense from the abandonment of a national currency.<sup>25</sup>

This shift in macroeconomic ideology has also been enormously important in putting the idea of dollarization and common currencies on the agenda in poorer countries. Many of these countries created territorial currencies for the first time only in the early post-1945 years and a key reason was their belief that activist monetary policy had a key role to play in promoting domestic economic development.<sup>26</sup> Today, it is hard to find prominent policymakers in the developing world advocating that view. Much more common is the idea that growth is best fostered by maintaining price stability as the prime objective of monetary policy because this will encourage foreign investment, reduce the likelihood of balance of payments crises, and

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<sup>24</sup> McNamara (1998)

<sup>25</sup> Courchene and Harris (1999).

<sup>26</sup> Helleiner (forthcoming).

create a more stable macroeconomic environment for capital accumulation.<sup>27</sup> Given the volatility of exchange rates in these regions, advocates of full dollarization also argue that exchange rates are not able to perform a useful adjustment function or provide autonomy for a country to pursue an independent monetary policy.<sup>28</sup> Not surprisingly, these new views have made policymakers much less resistant to the idea of adopting a common currency or the US dollar than they would have been in the early postwar years.

The changed thinking about monetary policy has not just made policymakers less resistant to alternatives to territorial currencies. It also encouraged them to see the abandonment of a territorial currencies in a positive light as a key way insulate money from the arbitrary interference by politicians. Hayek's advocacy of the "denationalization of money" represents the most radical view of this kind. For most of his academic career, Hayek was an advocate of the gold standard. Its collapse in the early 1970s, however, highlighted to him how difficult it had become to "protect money from politics" in the traditional way when the principal commitment of governments in an age of mass democracy had become activist monetary management aimed at domestic monetary objectives.<sup>29</sup> The inflation of the following years did little to calm his fears about the dangers of the new world of universal fiat money and it triggered Hayek to re-evaluate his thinking about the merits of territorial currencies. If the gold standard could not be reintroduced as a means of preventing politicians from controlling territorial currencies, he wondered whether monetary discipline could better be achieved by eliminating territorial currencies altogether. If people were given "choice in currency" (either between government-issued currencies or between privately-issued currencies), Hayek argued that they would choose

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<sup>27</sup> For example, Schuler (2000).

<sup>28</sup> Hausmann et al (1999).

<sup>29</sup> Quotation from Hayek (1990: 16)

the most stable currency. Currency competition would thus discipline governments, forcing them to maintain the value of money they issued and restrain spending. In an age of mass democratic politics when politicians were beholden to what Hayek called "special interests", he believed the nation was no longer a community which could be trusted to manage money according to his ideals.<sup>30</sup>

Written in the 1970s, Hayek's concerns about the way in which modern governments inevitably produce inflation now seem somewhat dated. Many countries have, after all, embraced neoliberal monetary goals over the past two decades without abandoning territorial currencies. They have simply come to manage their territorial currencies in a more orthodox fashion or introduced currency boards in which discretionary monetary management becomes impossible. In these instances, Hayek's objective of "removing money from the realm of politics" has in fact been achieved, but in a way that is compatible with the maintenance of a territorial currency. But in countries where fears exist that orthodox monetary policies may more difficult to introduce or sustain, support for alternatives to territorial currencies has often emerged.

In parts of the South which have experienced very high rates of inflation, the circulation of foreign currencies has often been seen as a desirable because it helps discipline national macroeconomic policymakers and societal groups. This connection was evident in the 1970s among Latin American policymakers who first encouraged dollarization by relaxing rules concerning foreign currency deposits. Although this move was often designed simply to curb flight capital, it also was frequently introduced as part of dramatic "neoliberal" economic reforms of the time. In the face of populist pressures from the left and dramatic political

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<sup>30</sup> For Hayek, the denationalization of money also had particular appeal because of his scepticism about the value of any kind of government planning. Thus, he attacked not just Keynesians but also monetarists for believing that even conservative monetary planning was desirable.

upheavals of the period, these neoliberal reforms were designed to radically shift the institutional context by encouraging market forms of discipline that would restore business confidence and promote neoliberal outcomes.<sup>31</sup> In the monetary sector, neoliberal reformers sought to replace activist monetary policies with a passive monetary policy that was determined by changes to the balance of payments. For this reason, some saw little reason to maintain the integrity of the territorial currencies. Indeed, in Chile in the late 1970s, Diaz-Alejandro notes that some reformers “dreamed of doing away with the national currency altogether, but feared the military might not wish to go that far”.<sup>32</sup> More recently, a decision by Argentina in 1991 to allow dollars to be used as legal tender was designed to send a signal to the population about the seriousness of the government’s intent to reestablish the ‘trustworthiness’ of the national currency by subjecting state monetary managers to the ‘competition’ provided by a more ‘credible’ foreign currency.<sup>33</sup> In Ecuador, too, “full dollarization” was introduced only after a period of hyperinflation and it was designed to restore monetary stability by removing control of monetary management from domestic politicians altogether.

In Europe, some support for EMU has also had a similar motivation, particularly in economic liberal circles: abandoning the national currency in favour of the Euro will prevent national policymakers from pursuing ‘out-dated’ Keynesian macroeconomic policies.<sup>34</sup> The goal of “locking in” neoliberal reforms has also been made explicit by some supporters of North American monetary union. In Canada, one of the more prominent advocates of a common currency, Herb Grubel, told the Canadian Senate: “I would like to have an institution that protects me against the future, when another generation of economists is rediscovering

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<sup>31</sup> Foxley (1983), Canitrot (1980).

<sup>32</sup> Diaz-Alejandro (1988: 370-1).

<sup>33</sup> de la Balze (1995).

Keynesianism, or whatever threats there might be in the future”.<sup>35</sup> Some neoliberals in both regions have also seen the abandonment of national currencies as a way to force domestic deregulatory policies that might have been difficult otherwise to promote politically. In Europe, the elimination of exchange rate adjustments is seen as a tool to fostering more flexible domestic wages; in the European Commission’s words, the euro will bring “increased labour market discipline” as devaluations can no longer be used to offset higher wage demands from workers.<sup>36</sup> In Canada, the elimination of the devaluation option is seen as a move that will force manufacturers to bolster productivity and workers to moderate wage demands.<sup>37</sup>

It is not just those opposed to activist national macroeconomic policies who back these alternatives to territorial currencies. Support has also come from traditional advocates of activist macroeconomic management who have concluded that the nation–state’s capacity to pursue this kind of management in an age of global financial integration has been curtailed. One response to this situation has been to embrace partial dollarization as a way of signalling to the markets that national macroeconomic trends will be disciplined by currency competition. Another more ambitious response has been to support the delegation of power to a supranational authority such as the European central bank which might be able to challenge the markets more effectively and insulate countries from their effects.<sup>38</sup>

## **CONSTRAINING THE FISCAL RESOURCES OF THE STATE?**

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<sup>34</sup> McNamara (1998).

<sup>35</sup> Government of Canada (1999: 62)

<sup>36</sup> European Commission (1990: 47).

<sup>37</sup> Courchene and Harris (1999).

<sup>38</sup> Verdun (1996).

In addition to bolstering national markets and the capacity to conduct national monetary policy, a third objective that drove the creation of territorial currencies during the 19<sup>th</sup> and early 20<sup>th</sup> centuries was the desire to strengthen the fiscal resources of the state. The seigniorage gains to be realised by monopolizing the currency were attractive as a means to help finance the expanding fiscal needs of the state, particularly in the context of the emergence of mass warfare.<sup>39</sup> If the fiscal priorities of the state played this important role generating support for territorial currencies, are those rejecting territorial currencies today driven by an opposite goal: that of restricting the fiscal resources of the state?

To be sure, some advocates of the abandonment of territorial currencies hope this move will constrain the state's ability to finance large budget deficits through money creation. This motivation is apparent among some supporters of monetary unions in Europe and North America, and is also evident among many of those pushing for full dollarization in many poorer countries of the world. Many supporters of privately-issued e-currencies also see this as one of the central reasons to pursue this monetary reform.<sup>40</sup>

What explains these new fiscal priorities? Some analysts point to the changing military-security context as one factor. David Glasner notes that currency monopolies were particularly useful in the past for financing unexpected, short-term and small-scale wars when other sources of quick finance were difficult to find. Their importance has diminished today, he argues, because changes in military technology (e.g. nuclear weapons) and the advent of large standing

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<sup>39</sup> More broadly, the creation of a single homogenous currency also greatly reduced the transactions costs associated with the administration of taxation and the running of modern bureaucracy associated with the nation-state. For this reason, initiatives to consolidate the currency often took place at the same time as modern accounting, taxation and financing systems were introduced into government.

<sup>40</sup> See for example Dorn (1997), Hayek (1990).

armies now require constant, much heavier expenditures in peacetime.<sup>41</sup> In the European context, Goodhart speculates in a similar vein that the EU countries may have been more willing to give up national seigniorage privileges because of the lack of prospect of war between them.<sup>42</sup>

While these factors may play some role, a more important explanation can be found in a development we have seen already: the growing dominance of neoliberal economic ideas around the world today. Those who celebrate the fact that currency unions will diminish the state's ability to finance fiscal deficits are usually advocates of the neoliberal goal of reducing the economic size and role of the state more generally. Support for privately-issued e-currencies also comes primarily from neoliberal thinkers who see this as part of a broader project of attacking "big government".<sup>43</sup>

The role of these new fiscal goals in undermining support for territorial currencies should not be overstated. As Glasner acknowledges, one reason is that the enhanced tax collection and borrowing powers of contemporary states have greatly reduced the fiscal significance of currency monopoly. For most countries, seigniorage revenue is only a small share of the country's GDP, usually below 1%.<sup>44</sup> From the standpoint of policymakers, the more relevant statistic may be its share of government revenue, but this figure is still not large. When Israel launched its well-known and successful de-dollarization program in 1985, for example, one rationale mentioned was that of recapturing seigniorage. But as Bruno notes, this was hardly a major consideration since seigniorage revenue had been only approximately 4% of government revenue even in the period of high inflation. He notes that this figure was also true for high

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<sup>41</sup> Glasner (1989: 45-50, 205; 1998).

<sup>42</sup> Goodhart (1995: 455).

<sup>43</sup> For example Dorn (1997).

<sup>44</sup> Hausmann (1999). Fischer (1993: 8) notes that in late 1988, it was higher in some unusual cases such as Peru (6%), Jordan (8%), China (6%), Turkey (4%), Greece (3.8%).

inflation countries such as Argentina and Mexico.<sup>45</sup> These figures could be somewhat higher if one included the indirect fiscal effects of inflation that result from income tax “bracket creep”, or the devaluation of government debt (in cases where the debt was issued at an interest rate that did not anticipate inflation).<sup>46</sup> But Friedman and Schwartz highlight how these two inflation effects are diminishing in many countries as indexation of income taxes is introduced and as financial markets become better at anticipating inflation.<sup>47</sup>

The diminishing fiscal significance of territorial currencies may thus help to explain why challenges to territorial currencies are less likely to be resisted on fiscal grounds than in the past.<sup>48</sup> For countries experiencing dollarization, or considering abandoning their national currency, the costs of forgoing seigniorage revenue have often been raised as a possible objection, but the issue rarely seems to be the decisive one influencing policy decisions one way or the other. Indeed, supporters of these initiatives are often able to argue easily that this loss will be clearly offset by other economic gains to be realised by their proposals.<sup>49</sup> The European Commission, for example, argued that the loss of seigniorage revenue generated by inflation in poorer EU countries will be more than offset by lower inflation premiums on these countries’ borrowing in the new euro zone.<sup>50</sup>

Supporters of these initiatives have also noted that seigniorage revenue could still be found in alternative ways in the absence of a national currency. The new European Central Bank,

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<sup>45</sup> Bruno (1989: 88). A former Minister of Finance from El Salvador, Manuel Hinds, also recently noted that in some Latin American countries, seigniorage can even be negative since the central bank is paying banks a higher rate of interest for their reserve deposits than it is receiving for its reserves backing these deposits and other currency (US Senate 1999b).

<sup>46</sup> Fischer (1994: 286).

<sup>47</sup> Friedman and Schwartz (1986: 57).

<sup>48</sup> Similarly, David Glasner (1989: 38) notes that fiscal considerations did not inhibit the growth of the eurodollar markets since states encouraging its growth on their territory were not undermining their own seigniorage but rather that of another state.

<sup>49</sup> Schuler (2000: 14).

for example, will divide its profits among its shareholders that are the national central banks of the participating countries. In advocating the adoption of the dollar in Latin American countries, Hausmann and Powell also highlight that countries could still generate some seigniorage revenue in a fully dollarized economy through the use of non-remunerated reserve requirements on certain deposits (the “seigniorage” would be the interest earned on the reserves).<sup>51</sup> More prominent has been the suggestion that the US might agree to share seigniorage as a way of reducing opposition to the adoption of the dollar. Larry Summers, before he became US Treasury Secretary, had in fact proposed this as early as 1993,<sup>52</sup> and a bill was introduced into Congress in November 1999 to support this notion.

### **EFFORTS TO TRANSCEND NATIONAL IDENTITIES?**

In addition to objectives relating to transaction costs, monetary policy and fiscal concerns, contemporary challenges to territorial currencies may also reflect some new ideas concerning political identities. Economists usually restrict their analyses of national currencies to their economic purposes. But territorial currencies were also created for a more political-cultural reason in the 19<sup>th</sup> and early 20<sup>th</sup> centuries: they were seen to strengthen national identities.<sup>53</sup> In a symbolic sense, territorial currencies came to be seen as one of the key attributes of the sovereignty of a modern nation-state in that era. Policymakers also recognized that coins and notes could act as important carriers of nationalist imagery aimed at constructing a sense of collective tradition and memory. By reducing transaction costs within a nation, territorial

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<sup>50</sup> European Commission (1990).

<sup>51</sup> Hausmann and Powell (1999: 8).

<sup>52</sup> Summers (1993:32).

currencies were also seen to play a role similar to that of a national language: they would create a sense of collectivity by facilitating “communication” among members of the nation. As a tool of national macroeconomic management, territorial currencies have also been associated with a sense of national collective purpose. Finally, because trust plays such a large role in the use and acceptance of modern forms of money, territorial currencies were often seen as encouraging identification with the nation-state as a deeper psychological level.

To what extent is the growing unpopularity of territorial currencies indicative of a desire to transcend national identities? The creation of a supranational currency in Europe presents an interesting case to examine. It is clear that some of the motivation for creating EMU stems from a sense that it will promote a greater sense of European political unity. As one group of scholars put it, EMU has “acquired symbolic meaning as a cornerstone of European political unification” and it is driven partly by political forces committed to a more “Europeanized” form of identity.<sup>54</sup> More concretely, enthusiasts for European integration also hope that EMU will encourage spillover effects – particularly the need for stronger federal fiscal arrangements - that foster further European political integration. In addition, many Europeans have seen EMU as an initiative that could bolster Europe’s collective identity on the global stage.

Although those with a more “Europeanized” identity may be key supporters of this initiative, they have been quite hesitant to use the new currency in a symbolic sense to promote a collective sense of identity. It would be difficult to argue, for example, that the imagery on the euro has been designed in a way that is meant to foster a strong sense of common European identity. Although the face of the coins has a common image of a map of the EU and the stars of the EU flag,

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<sup>53</sup> Helleiner (1998a).

<sup>54</sup> Engelmann et al (1997: 105).

each Member State has been allowed to continue to decorate the obverse side with its own motifs and the various State have chosen traditional nationalist images for those motifs. The banknotes are also quite timid in their invocation of a new European identity. On their front side are images of windows and gateways, while the back side of each denomination has a map of Europe and an image of a different bridge. The official EU website suggests that the former is meant to be “a metaphor for communication among the people of Europe and between Europe and the world” and the latter are “symbols of the spirit of openness and cooperation in the EU”.<sup>55</sup> But nowhere do we find kinds of images of a common history, landscapes, or culture of the kind that is found on most national banknotes.<sup>56</sup> In the words of one journalist, “[t]he currency looks as if it has been designed for a ‘Star Trek’ episode about some culturally denuded land on Mars – not for the home of Socrates, Charlemagne, Martin Luther, Notre Dame, the Uffizi, Bach, Beethoven and Mozart”.<sup>57</sup>

The quite limited use of imagery on the new euros to cultivate a common European identity undoubtedly reflects the limited extent to which political support exists for such a conception of identity within the EU. There is much stronger support among Europeans for the EU as a community that offers certain political rights and economic benefits than there is for the EU conceived as a unified organic-people with a common cultural identity that replaces the nation. For this reason, EMU supporters appear much more comfortable discussing how the euro will promote “one market” than its role in cultivating a sense of “one people”. While opponents have seized on the idea that the euro might “dilute” national identities<sup>58</sup>, supporters have generally downplayed this

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<sup>55</sup> <http://europa.eu.int/euro/html/rubrique-defaut5.html?lang=5&rubrique=100>

<sup>56</sup> The EU website attempts to suggest that “[t]he designs are symbolic for Europe’s architectural heritage” but it quickly goes on to say that “[t]hey do not represent any existing monuments”. It also notes that graphic symbol for the Euro “was inspired by the Greek letter epsilon, in reference to the cradle of European civilisation and to the first letter of the word ‘Europe’”.

<sup>57</sup> Zakaria (1999).

<sup>58</sup> Quotation from Helleiner (1998a).

potential. In a 1995 publication discussing the introduction of the euro, for example, the European Commission acknowledged briefly “for some people, the change will feel almost like a change of identity”, but it felt compelled to add quickly that “[n]ational identity is not in peril, however.”<sup>59</sup>

This kind of defensiveness is also apparent among supporters of monetary unions and dollarization in other regions. In North America, supporters of monetary union are quick to acknowledge the nationalist opposition they anticipate to their proposals, leading some to stress that each country could retain nationalist images on one side of the new common coins and notes.<sup>60</sup> Similarly, advocates of the adoption of the dollar in Latin America have wondered aloud whether that the US might help reduce nationalist objections to their proposals by replacing images of past US Presidents on US dollars with that of Columbus, or even allowing dollars printed for use in Latin America to carry the images of people such as the Mexican revolutionary Emiliano Zapata.<sup>61</sup>

Many supporters of monetary unions or dollarization have tried to deflect nationalist opposition by suggesting that these monetary reforms will not in fact dilute national identities. In countries which have experienced high levels of inflation or currency instability, the argument is sometimes made is that the national currency has come to be seen as a liability rather than a source of national pride and unity. In Argentina, for example, Menem has argued that his country’s national identity would be strengthened by adopting such a hard currency as the US dollar: “It is stupid when we affirm that this is an attack against sovereignty...Real sovereignty

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<sup>59</sup> European Commission (1995:48-9).

<sup>60</sup> Courchene and Harris (1999: 22).

<sup>61</sup> For the first suggestion, see Hausmann et al (1999: 19). The second is Guillermo Calvo’s idea, reported in Andres Oppenheimer, “Zapata Dollar in 2010?” The Miami Herald, Jan.25, 1999. Schuler (2000: 16) suggests that also countries with strong concerns about national identity might retain national coins, as Liberia and Panama have.

is the one that gives the people the possibility of having more security in their economic affairs”<sup>62</sup> Similarly, an American advocate of full dollarization told US Congress that the use of the dollar should not be seen in foreign countries as “act of political submission” but rather as “an act of economic liberation” permitting citizens to “build a better economic future for their families”.<sup>63</sup> Many nationalists in the poorer EU countries also seem quite happy to abandon their currencies in favour of a more stable common currency for this reason.

Another common argument is that the abandonment of a territorial currency will not undermine national identities because monetary sovereignty a thing of the past. Nationalists are asked to recognize that global financial markets have already rendered monetary sovereignty a hollow shell (a point disputed by many economists). As the European Commission puts it, members of the monetary union “will only lose a [sovereign] prerogative, which in practice they cannot use.”<sup>64</sup> Indeed, by pooling their resources, members of a monetary union are sometimes said to be able to regain a degree of the sovereignty that had been lost to global markets. The way in which national currencies are being challenged around the world is also invoked as a sign that territorial currencies need not any longer be considered as key part of the sovereignty of a nation-state. In North America, supporters of monetary union frequently cite the European example to make this point. As Thomas Courchene in Canada put it: “the euro is also signalling that in a progressively integrated global economy, currency arrangements are emerging as one of those supranational or international public goods, an international public good that will be fully

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<sup>62</sup> Quoted in Julio Nudler “No vamos a ser menos soberanos” [www.pagina12.com.ar/1999-01/99-01-24/pag03.htm](http://www.pagina12.com.ar/1999-01/99-01-24/pag03.htm). (I am grateful for the translation to Laura Chrabolowsky).

<sup>63</sup> Shelton (1999: 3).

<sup>64</sup> European Commission (1995: 4). This has also been a common argument of Quebec nationalists for why they do not need a national currency upon achieving independence (e.g. Levesque 1979: 86).

consistent with the 21<sup>st</sup> century notion of what national sovereignty will be all about”.<sup>65</sup>

What is interesting about these various arguments is that they explicitly reject the idea that the abandonment of territorial currencies is intended to challenge national identities. This marks an interesting contrast to the nineteenth century period. In that era, monetary reforms were explicitly linked to political projects designed to alter political identities. This was true not just of the nation-builders who created territorial currencies, but also of liberal advocates of the universal currency during the 1860s. Walter Bagehot, for example, argued in favour of this proposal in 1869 on the following grounds:

"[if England were to introduce the universal currency] all Englishmen would lose some of the exceptional national feeling which retards their progress, which makes them look at others as strange, which makes them think us singular too. If civilization could make all men of one money, it would do much to make them think they were of one blood".<sup>66</sup>

Today, with the partial exception of the EU case, the goal of using monetary reforms to alter political identities in these ways is much less prominent.

## **CONCLUSION**

The widespread nature of the challenges to territorial currencies is one of the more interesting phenomena in the contemporary world. Perhaps because these challenges are so uneven geographically and heterogeneous in form in the contemporary age, scholars have not devoted much attention to the development of a general analysis of the causes of this

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<sup>65</sup> Government of Canada (1999: 9).

<sup>66</sup> Quoted in Perlman (1993, p.318).

phenomenon. In this chapter, I have attempted such an analysis by returning to the four goals that drove the creation of territorial currencies in the first place during the 19<sup>th</sup> and early 20<sup>th</sup> centuries: 1) the bolstering of national markets by reducing intra-national transaction costs, 2) the provision of a tool for national monetary management, 3) the widening of the state's revenue base, and 4) the strengthening of national identities.<sup>67</sup> I have suggested that an examination of the question of whether policymakers are turning their backs on these goals may help us to explain why territorial currencies are becoming unpopular.

My conclusions can be quickly summarized. Growing disenchantment with the first two goals is playing a significant role in encouraging challenges to territorial currencies today. Concerning the first, deepening international economic integration has led many to question the limitations of national markets. While territorial currencies eliminated *intra*-national transaction costs, many policymakers are now more concerned to reduce *inter*-national transaction costs associated with the existence of distinct territorial currencies, particularly those associated with exchange rate instability. Concerning the second goal, disillusionment with the kind of activist national monetary policies that became prominent after the 1930s has also been important in lessening support for territorial currencies; indeed, some policymakers have seen alternative monetary structures as tools to prevent states from pursuing such policies. This new disillusionment reflects both the growing power of global financial markets and the emergence of a "neoliberal" consensus that monetary policy has no long-term impact on real output and employment. In these two ways, the growing unpopularity of territorial currencies can be seen to be associated with broader reconsideration of the proper economic role of the nation-state generated by the triumph of "neoliberal" economic ideas and intensifying international economic

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<sup>67</sup> Helleiner (1998a, 1999), Gilbert and Helleiner (1999).

integration.

What, then, about the role of the other two motivations that drove the creation of territorial currencies, those relating to fiscal goals and political identities? Has disenchantment with them also played a role in encouraging challenges to territorial currencies today? I have argued that they are less significant. Revenue goals have played a role in some instances; some of the contemporary enthusiasm for currency unions, dollarization or private e-currencies has stemmed from a "neoliberal" desire to curtail the size of the state and the ability of governments to finance deficits through money creation. To the limited extent that fiscal goals are important, then, they seem to fit my general thesis the challenges to territorial currencies stem from a reconsideration of the proper economic role of the nation-state in the contemporary age. New conceptions of political identities have also played some role in generating support for a supranational currency in Europe. But their significance should not be overstated there and in most other parts of the world, policymakers are usually bending over backward to explain that alternatives to territorial currencies are *not* designed to undermine national identities. In contrast to the 19<sup>th</sup> century, monetary reformers are driven primarily in the current age by political-economic goals rather than political-cultural ones relating to national identities.

My analysis in this paper is not designed to provide a comprehensive explanation of the growing unpopularity of territorial currencies. To explain the different ways that territorial currencies are being challenged and the different intensities of these challenges in each country, we would need to move away from this general level of explanation to examine regional and country-specific variations in the factors cited above. By explaining some general reasons why territorial currencies are becoming unpopular, however, I hope to have provided insights that help to guide that kind of specific research. I also hope to have reminded researchers of the ways

in which the diverse challenges to territorial currencies share some common causes in the current era.

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