Why we should be interested in the history of currencies

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The history of a country – and of its population and institutions – provides us with potential lessons for the present. But that is not the only reason why it is of interest to us. When we bear in mind the multitude of ways in which the present reflects events of the past it becomes clear that history is far more fundamental. Decisions by our parents, grandparents and their ancestors, along with all the events of their own times which they could not influence, are responsible for the world in which we live today. In this way, present and past are inseparably linked. The former cannot really be understood without knowing the latter. Seen from this perspective, studying history should be a necessity – something that goes without saying.

Yet, above and beyond this, it is legitimate and reasonable to pose the question as to what specific insights and lessons for modern life can be derived from our study of history. Certainly, the world moves on continually and the problems of the present always differ in one way or another from those of the past. Nevertheless, many aspects remain more or less unchanged over longer periods of time, and many questions recur in slightly altered forms in later periods. In this sense, we can certainly learn from history.

The history of the Swiss currency offers a wide variety of experiences relating to numerous questions which, especially in view of the current upheaval in worldwide money and financial markets, are once again highly topical. I would like to pick out seven different areas.

1. The vital importance of political and financial stability for the rise of the Swiss franc

At its conception, the Swiss franc was not necessarily predestined to become one of the most stable and successful currencies of the world. Created through the Federal Coinage Act of 1850, two years after the foundation of the modern federal state of Switzerland, the new Swiss franc was essentially a satellite of the French franc. This continued for the first fifty years of its life until the establishment of the Swiss National Bank in 1905–07. This situation reflected not least the initial softness of the newly established currency. During this period, the Swiss franc often tended to be weak against the French franc and, in

the decades before the First World War, featured an interest rate surcharge or malus with respect to the French currency, rather than the interest rate bonus which we are familiar with nowadays.

Since the outbreak of the First World War, the value of the Swiss franc has risen hugely against all the major currencies. In 1914, the US dollar was worth CHF 5.18; in 2011, by contrast, it could be purchased for just over 80 Swiss centimes at times. The relative loss of value was much greater in the case of most other currencies. In 1914, the pound sterling was worth just over CHF 25; now it stands at around CHF 1.50. The relative loss of value is particularly pronounced in the case of the former partner currencies in the Latin Monetary Union – the French franc and, even more extreme, the Italian lira, whose value in Swiss francs at the introduction of the euro in 1999 had to be measured in terms of thousandths.

The advance of the Swiss franc from a French franc satellite to an independent and strong investment currency of international importance went hand in hand with Switzerland's political and social consolidation and its increasing economic success. Its firm determination to remain independent and to maintain financial and monetary stability – traits that have always been particularly characteristic of Switzerland when compared to other countries – played a key role in this respect. It is hard to establish and maintain a stable monetary order in a war-torn social and economic environment. And the fact that Switzerland has been spared the turbulence of war for one and a half centuries – due to both political prudence and fortuitous circumstances – has naturally been an important contributory factor in accumulating the capital of stability and trust from which the Swiss franc is now benefiting.

2. Monetary, financial and economic stability are interwoven

It is certainly true to say that the currency's stability has benefited from Switzerland's political and economic success. At the same time, however, the focus on stability in the monetary field has made a substantial contribution to political and economic consolidation. The two go hand in hand. Steady money and well-functioning, efficient financial structures are among the most important achievements of our economic and social system. A stable currency, in particular, is one of our most valuable public goods, comparable with a well-functioning system of law, public security or finance and taxation. Without it, a liberal economic and social order cannot develop effectively.

Economic history is full of examples that show the way in which problematic or, indeed, failing currencies have disastrously impaired the efficiency of economic

systems and, in extreme situations, led to economic and political ruin. In the course of the 19th and 20th centuries, Switzerland succeeded – to some extent through painful experience – in creating institutions and systems that proved robust and resistant to this danger. The strong Swiss awareness of the fundamental social importance of the monetary order, and of its stability and reliability, has made a strong contribution to this development and thus to the economic and political success of our country since the establishment of the Confederation.

3. Metal-based versus paper-based currencies

Together with many other countries, Switzerland made the transition from a metal-based currency to a purely paper-based currency during the course of the 20th century. The clearest and most definitive break in this process was the worldwide transition to flexible exchange rates after the breakdown of the Bretton Woods period at the beginning of the 1970s. The end of the traditional metal-based currency systems actually dates back to the early years of the century, when the international gold standard broke down following the start of the First World War. However, currency arrangements in the years between the two world wars and during the Bretton Woods system of the postwar decades remained strongly influenced by the gold-currency idea, and maintained important elements of the metal-based currency and a link to gold.

The transition from fixed to flexible exchange rates at the beginning of the 1970s represented an enormous increase in power for central banks, while, at the same time, vastly extending their public accountability. Not until they were freed from the responsibility to maintain gold parity – and the obligation to subordinate monetary policy to the need for maintaining the balance of payments in equilibrium which this entailed – were they fully able to conduct an autonomous monetary policy geared to domestic targets. This brings advantages, with the disappearance of the restriction implied by a fixed link between money in circulation and the available volume of the associated currency metal, but also considerable temptations and risks. The scepticism already expressed by Niehans in the late 1970s with regard to a purely paper-based money standard is not without a certain justification. Yet – as he then wrote on commodity, or metal-based, money – “from a practical point of view, commodity money is the only type of money that, at the present time, can be said to have passed the test of history in market economies” (Jürg Niehans, *The Theory of Money*, 1978, p. 140). Not for nothing can the 20th century be described as the century of inflation. The experiences of the most recent financial and debt crisis, in particular, have again raised doubts about the current paper-based money system.

Nevertheless, proponents of metal-based currency systems would do well to remember that even these kinds of systems can lose their stability anchors – and have often done so. The history books are full of cases where the value of coins deteriorated, or where supposedly fixed metal-based parities were abolished or changed for reasons of political expediency. Consequently, we should try to avoid a romantic view of metal-based currencies. These currencies are based on a self-imposed commitment on the part of monetary authorities to maintain a fixed metal content of the currency unit 'for all eternity'. Self-imposed commitments are valuable and useful. They establish barriers that provide protection from overly opportunist changes. But ultimately they are only as valuable as the determination to comply with them.

Moreover, even metal-based currencies do not provide an unlimited guarantee of price stability. Only where the real structures of an economic system remain constant is this strictly the case. However, if there are shifts in the productivity of metal mining, or if there is a growth-based increase in periodic supplementary demand for currency metal, there may be permanent alterations in the price level, even under a metal-based standard.[1] What is more, one need only examine the history of the Swiss currency during the 19th century to find manifold illustrations of the fact that metal-based currency systems can be associated with inefficiency and instability.

4. Competition and monopoly in money and currencies

The choice between competition or monopoly in the area of money and coinage is one that has been exercising minds for a very long time. Should governments be granted a monopoly over the currency, banknotes and regulation, or is it preferable that free competition exist between the issuers of currencies and money? The question of competition and monopoly arises at various levels. At the most basic level, it concerns the definition of the currency unit and the issuance of coins. Next, it relates to the issuance of paper money in the form of banknotes, and finally, it involves the creation of money in the form of bank deposits. The history of the Swiss currency in the 19th century provides a treasure trove of different experiences in this regard.

Historically, the view became clearly established that currencies, with their strong network effects, display aspects of a public good and that they therefore naturally tend in the direction of centralisation and monopolies. In the current period, too, scholars' assessments more or less confirm this position. The history

[1] The best-known historical example of this is the 'price revolution' in Europe in the early modern period, triggered by the fact that production costs of silver in the Latin American colonies of Spain collapsed permanently.

of the Swiss currency is consistent with this point of view. After its introduction in 1850, the new Swiss franc rapidly established itself as the national currency, without any difficulties. Clearly, the transition from the previous chaos of multiple coinage and currencies to a uniform national currency met a real need, and made a long-term contribution to the efficiency of the Swiss monetary and payment system and the productive strength of the Swiss economy as a whole.

In the previous period, from 1820 to 1850, Switzerland had provided a rare example of true currency competition, with a free choice between currency denominations comparable to Hayek's proposal of 1978. The lack of any national currency unit gave independent note-issuing banks complete freedom to choose the basis on which they issued their banknotes. This competition was successful insofar as the purchasing power of the issued banknotes remained stable and there were no bank failures or crises. However, the money created by the issuing banks was put to relatively little use – an indication of its lack of attractiveness or efficiency in practice.

This phase came to an end with the introduction of the new Swiss franc in 1850. From 1850 to 1881, the Swiss currency system – which now featured one common, dominant currency, the new Swiss franc – was characterised by competition between independent note-issuing banks (both private and public). Until the Banknote Act of 1881, however, the banking system remained largely unregulated. Measured by the criteria of financial and currency stability, this competition between issuing banks while banknotes were being freely issued did not have any negative consequences. In this respect, therefore, it can be judged to have been successful. Nevertheless, if we consider that, for a long time, banknotes played a relatively minor role in the Swiss payment system and that the resulting monetary system was characterised by major shortcomings as regards efficiency, and, in particular, the acceptance and reciprocal recognition of banknotes, this conclusion is put in perspective. The shortcomings meant that there was a tendency for common quality requirements to be introduced, either through regulatory interventions or via cartel-type agreements ('concordats', compacts).

From 1881, statutory requirements placed severe restrictions on the reserve, liquidity, encashment and issuance policies of banks. Until 1905, a policy of limited banking freedom prevailed. This featured a system with a joint currency – now compulsory – as well as heavily regulated banknote transactions, but as yet no state banknote monopoly. Although the banknote 'homogenisation' achieved through this regulation promoted the acceptance of banknotes as well as the efficiency of the monetary and payment system, competition was no longer in a position to carry out its disciplinary function in this environment. As a result, too many banknotes were issued and the monetary and currency system

was weakened. This was the situation which finally led to the establishment of the Swiss National Bank and the centralisation of banknote issuance.

Ultimately, therefore, the cause of the move towards centralisation was the pursuit of efficiency and stability – consistent with the idea of money as a natural monopoly. Although the system based on competition worked, it displayed shortcomings in terms of efficiency. Consequently it gave rise to regulatory interventions which, in their turn, destroyed the foundation for the disciplinary effect of competition and finally led to centralisation.

5. The importance of monetary stability as the main target of central bank policy in a paper money system

Through the transition to a purely paper-based currency lacking a link to gold or any other currency metal, the position and importance of the central bank and its policy changed fundamentally. This applies to Switzerland just as it does to other countries. Previously, the rules of the metal-based currency, under which money in circulation was tied to the available supply of the associated currency metal, automatically ensured the long-term stability of the value of money (the price level). Once this link disappeared, this was no longer the case. Ensuring and reinforcing the stability of the value of money became the overriding, central task of central banks.[2]

In a purely paper-based money system, the central bank's capacity for creating money is, in principle, unlimited. Monopolies can give rise to misuse, even in the case of state currency monopolies. It is not hard to find examples of this if we look back through the history books, although luckily none have occurred in our own country. How can we ensure that the central bank will meet its responsibilities, withstanding the temptation to abuse its powers and over-issue? From today's vantage point this can best be achieved with clear constitutional and statutory standards and specifications which commit the central bank to a precise mandate in its policymaking, and are associated with a duty of accountability with respect to the general public and the world of politics.

In the past, central banks often pursued a large number of targets (as specified by their mandates) including price stability, full employment, growth, a stable exchange rate and equilibrium in the balance of payments. However, over time, it became evident that through the simultaneous determination of a large number

[2] Naturally the former tasks of central bank policy – those of lender of last resort to the banks and the banking system, of promoting the efficiency of payment transactions and ensuring an appropriate elasticity of money supply – which had led to the establishment of that policy during the time of the metal-based currency systems of the 19th and early 20th centuries, have not lost their legitimacy through this.

of – often irreconcilable – targets, monetary policy was being overloaded. Fundamentally, this approach was making the central banks' monetary policy task arbitrary and meaningless.[3] If, for instance, central banks are required to pursue long-term employment and growth targets in addition to their price stability goals, they are being asked to achieve the unachievable. The result is often that neither of the targets is met.

It is obvious and logical that ensuring the long-term stability of the price level be established as the main task of monetary policy, in other words, that the central focus of monetary policy should be the task which only the central bank and no other political or economic institution can perform. In a paper-based money system, ensuring price stability is the intrinsic and primary task of monetary policy. Ensuring a balanced economy can be added to this as a subsidiary, secondary task. However, at the same time, in avoiding inflationary and deflationary processes and thereby preventing the associated expectations, the framework is created within which monetary policy has the greatest possible scope for fulfilling this additional task. Typically, modern central bank mandates, including the Swiss mandate, have appropriated these insights.[4] The Swiss National Bank's monetary policies in the era of flexible exchange rates since 1973 which, by comparison with other countries, have been exceptionally successful, can provide us with some important examples.

6. The importance of central bank independence from politics and social interest groups

Switzerland is also an example of why it is important that the central bank be independent of politics and interest groups. At the same time, it is obvious that central bank independence can never be more than relative in a democratic state. Although it can be granted by the legislator, it can always be repealed again. Independence removes the central bank from everyday political life, although at the same time it implies a clear responsibility towards politicians and the general public and presupposes a precise mandate for central bank policy. Theoretical arguments and empirical evidence demonstrate that there is a clear connection between the independence of a central bank and the quality of its policies – measured by the degree of monetary stability. At the same time there is no indication that, in long-run average terms, this is achieved at the cost of below-

[3] At present there is a considerable danger that this fundamental insight will again be overlooked, as a result of the problems that have arisen out of the financial and sovereign debt crisis.

[4] Given this background, the idea of a fixed rule for monetary policy became very attractive. However, it was soon clear that an excessively rigid and inflexible rule was neither economically optimal nor feasible in political or economic terms. A practicable monetary policy rule needs to establish the necessary balance between short-term flexibility or 'elasticity', on the one hand, and long-term restriction and stability, on the other. Indeed, this was one of the reasons why central banks were established in the first place.

average performance in the real economy or a higher level of instability in real economic variables. Central bank independence is a key instrument for the creation of credibility, and for ensuring a policy of money value and monetary stability. Here, too, Swiss monetary policy over the past four decades provides us with compelling examples.

What is particularly important here is the independence of monetary policy from government financial policies. From a historical point of view, the possibility that monetary policy might be overshadowed by financial policy and subordinated to fiscal considerations is the greatest threat to ensuring stable monetary conditions. In Switzerland, the condition of independence has always been completely fulfilled, apart from a short period at the time of the First World War. It is to be hoped that this will remain the case in future.

7. Fixed versus flexible exchange rates, and the value of monetary sovereignty

Switzerland has had extensive experience with both fixed and flexible exchange rates throughout its history. There are considerable advantages to a system of fixed exchange rates as long it works smoothly. This was the case during the era of the classical gold standard, but also for the early years of the Bretton Woods system. However, a fixed exchange rate system presupposes that the main parties involved are prepared to conduct mutually consistent monetary policies. They must agree on a joint stance with regard to the possibilities, targets and procedures of monetary policy for it to be functional and viable.

Ultimately a system of this kind calls for agreement not just in the monetary field but also as regards certain economic policy parameters in other areas, particularly with respect to fiscal stability and flexibility of goods and factor markets. Insufficient willingness to respect these conditions leads to the development of untenable international imbalances in the long term and to efforts to stabilise the system by means of administrative measures. These measures might either be trade impediments and restrictions on capital movements or the establishment of international transfer mechanisms. Inevitably, this means that the system becomes unstable.

In the absence of these conditions, a system of fixed exchange rates may develop considerable potential for tension and turbulence. Switzerland has experienced this on several occasions, to its cost – during some of the Latin Monetary Union period in the 19th century, particularly extensively in the Great Depression of the 1930s, and again during the final years of the Bretton Woods system. Our country learned that, under such conditions, life with fluctuating exchange rates is the lesser of two evils, and a regime of flexible exchange rates

can be the more attractive alternative. Where it is impossible to achieve reliable, internationally well-anchored belief in and commitment to a community of stability it is better (when in doubt) to live with the possibility of occasional turmoil in a system of fluctuating exchange rates than to exist with the dangers of a non-credible system whose coordination is only skin-deep.

In this situation, the maintenance of monetary sovereignty is to be recommended as a valuable good, an option that should never be relinquished thoughtlessly or frivolously. In principle, even where fixed exchange rate commitments are entered into, such sovereignty allows for a return to an autonomous, self-determined monetary policy course at any time. The dangers and risks that can be linked to the premature surrender of monetary sovereignty to a higher community level – without prior credible agreement on joint political and economic values – have been clearly documented by the current confusion in the euro area. This is clearly seen if we compare the European Monetary Union of today with the Latin Monetary Union of the 19th century. At that time, there was no surrender of monetary sovereignty at union level. Both the definitions and the statutory basis of the participant nation currencies remained national. The union was no more than an international agreement for the joint adoption of a given metal currency standard. In principle, members could leave and return to a different currency policy at any time, and this was relatively easy to do – very unlike the situation in the present currency union in Europe.