Introduction

This entire … episode is a fascinating example of how important what people think about money can sometimes be.

– M. Friedman and A. Schwartz, *A Monetary History of the United States, 1867–1960,* p. 133.

When in September 2003 a sound majority of Swedish voters rejected the euro, many Scandinavian analysts highlighted the fact that all major parties had campaigned for a "yes" but obviously had failed to convince their constituencies.[1] For example, the liberal Swedish newspaper *Dagens Nyheter* concluded "that the 'no' outcome in the recent referendum on Sweden's joining the European Monetary Union is a protest against the political establishment." Similarly, the Norwegian conservative daily *Aftenposten* wrote, "Not even a massive bunch of well-meaning threats could compete with voter skepticism in a situation where fundamental values are at stake. The Swedes have said no to their leaders – an alliance of politicians, union heads, business people, and media figures."[2]

The protest against the political establishment was in fact remarkable, especially in a country where government institutions enjoy a high degree of acceptance among the population. Nevertheless, it would be wrong to interpret the referendum in negative terms. By casting a no vote, most Swedes not only rejected the euro but also expressed surprisingly strong support for the flexible-exchange-rate regime Sweden had adopted only 10 years prior to the referendum. Before that date, from the introduction of the gold

[1] The referendum took place on 14 September 2003. Voters rejected the euro by a 14-point margin, 56 to 42 percent, with 2 percent of ballots ruled invalid.

[2] *Dagens Nyheter,* Stockholm (Sweden), 15 September 2003, and *Aftenposten,* Oslo (Norway), 16 September 2003. Both articles were translated by *World Press Review* 50(12). The referendum is analyzed by Jonung (2007) and Miles (2005, pp. 219–259).

standard in the 1870s to the early 1990s, when the Swedish currency began to float, there had been an overwhelming consensus that a small European country such as Sweden needed a fixed exchange rate. "Before the 1990s," a Swedish central bank governor explained, "the predominant view was that a floating exchange rate regime was not suitable for a small open economy."[3] Thus, from a long-term perspective, the real surprise of the referendum was how readily a majority of Swedish voters accepted an exchange-rate regime that had been considered dangerous for more than a century. Moreover, the fact that the current regime has not been questioned ever since, despite tremendous international financial instability, shows that rejection of the euro was more than an accidental decision.[4]

The main purpose of this study is to highlight Sweden's historical verdict in greater detail by making a general argument about how small Western European states chose their exchange-rate regime during the twentieth century. It tries to explain why they displayed such a strong preference for fixed exchange rates, how this preference was conditioned by the small size of these countries, and why there has been such a complete reversal of these "fixed ideas" in the last 20 years. The remainder of this chapter will provide an outline of the major arguments and results. The first section discusses the relevance of the topic and provides a survey of the major exchange-rate-regime changes during the twentieth century. The second section presents the scale and scope of the study. The third and fourth sections summarize the major results. The last section briefly explains the structure of the study.

CHOICE OF THE EXCHANGE-RATE REGIME

Which exchange-rate regime is best for a country? To outsiders, this question may appear arcane, overly technical, or even aberrant. To economists and economic historians, however, the debates about exchange-rate regimes are "perennially lively."[5] One reason for this is that reality has constantly come up with new surprises. A notable example is the introduction of the euro in the 1990s. Another reason is that there is much at stake. As Argentina's crisis in the early twenty-first century has shown, a country having an inappropriate exchange-rate regime can suffer from tremendous losses in the short run. The currency board guaranteed a fixed exchange rate against the

[3] Bäckström (2000, p. 1).
[4] "Sweden PM: No Euro for Now," Associated Press, 30 January 2009.
[5] Rogoff et al. (2003), p. 4. For an introduction, see Broz and Frieden (2006).

dollar, but such a regime proved disastrous under the conditions of rising interest rates, an appreciating dollar, and a deepening recession.[6] Even today, large parts of Argentina's society have not yet recovered from the severe economic crisis.

This study also addresses the question of which exchange-rate regime is best for a country. It does not focus on the economic costs and benefits, however, but on the actual choices small European countries made throughout the twentieth century. Whether or not these choices can be considered economically sound from today's viewpoint is irrelevant because the perspective is exclusively on what *policymakers at the time* considered the optimal regime to be.[7] This selective approach is motivated by the lack of research. As Rose (2007) correctly observes, "we do not have a good understanding of how countries choose their monetary regime in practice."[8] This study tries to make a contribution to a more systematic understanding of this problem.

These regime choices were made within a clearly defined international monetary system that has undergone fundamental changes in the last 140 years.[9] As for Western Europe, we can distinguish four major periods. From the 1870s to World War I, the prevalent regime was the *classic gold standard*. All prices of currencies were fixed in terms of a specified weight of gold, and the primary responsibility of central banks was to preserve the official parity between its currency and gold and to guarantee the convertibility of the currency. To fulfill this function, central banks were required to keep an adequate stock of gold reserves. The interwar years were marked by the protracted construction of the *gold exchange standard* and its rapid dissolution in the 1930s. The gold exchange standard was very similar to the prewar gold standard. The major difference was that not only gold but also a number of currencies were accepted as central bank reserves, in particular the British pound, the US dollar, and the French franc. This extension was adopted because policymakers feared that gold reserves were not adequate to meet the demand for international reserves.

The postwar era was the time of the *Bretton Woods* system. Like the gold standard, it was based on fixed exchange rates, but only the US dollar

6 On Argentina, see, for example, Edwards (2002) for the subsequent debate on exchange-rate regimes and Blustein (2005) for a narrative account.
7 This narrative approach owes much to the seminal papers by DeLong (1997), Romer and Romer (2004), and Nelson (2005).
8 Rose (2007, p. 673).
9 For a long-term view, see Eichengreen (1996b), Aldcroft and Oliver (1998), Bordo and Schwartz (1999), and Bordo (2003). On the interwar years, see Brown (1940) and

continued to be fixed to gold, whereas all other currencies were pegged to the dollar. It thus was a sort of "gold dollar standard," as central banks held gold and dollars as international reserves and had the right to sell dollars to the Federal Reserve for gold at the official price. After the collapse of the Bretton Woods system, Western European countries either adopted floating exchange rates or joined the two monetary arrangements of the European Community (EC): the *Snake* (1972–1979) and the *European Monetary System* (EMS) (1979–1999). At the end of the century, most Western European countries abandoned their national currency and introduced the *euro*. All other countries have a flexible-exchange-rate system.

The dynamics behind these four phases can best be described in terms of the *impossible trinity* or the *trilemma*. It states that it is impossible for a country to have all three of the following at the same time: capital mobility, an independent monetary policy, and a pegged exchange rate.[10] The classic gold standard was a system with pegged exchange rates and open financial markets. It was relatively stable because the participating countries abstained from pursuing an independent monetary policy.[11] Accordingly, the main reason why the gold exchange standard collapsed in the 1930s was the fact that governments wanted to have it all: fixed exchange rates, capital mobility, and an independent monetary policy, the latter in order to cope with the negative consequences of the war and the rising demands resulting from mass politics. During the better part of the Bretton Woods system, capital movements were tightly controlled, which allowed a relatively independent monetary policy and the maintenance of fixed but adjustable exchange rates. Finally, in the fourth phase – which was characterized by a high degree of capital mobility, such as during the eras of the classic gold standard and the gold exchange standard – two paths were chosen. Western European countries either completely abandoned their monetary independence by adopting the euro, or they shifted to a floating regime.

In sum, one can identify two long-term trends depending on the choices made during the last phase. Countries that participated in the fixed-exchange-rate systems of the EC and subsequently adopted the euro have completed a sort of circular movement because they started from and have returned to a world in which there is no room for monetary independence.

Eichengreen (1992); on the postwar years, see Ludlow (1982), Solomon (1982), James (1996), Gros and Thygesen (1998), and Dyson and Featherstone (1999).

10 The trilemma is the major theme of Eichengreen (1996b).

11 Recently, Bordo and Flandreau (2003) have tried to show that the autonomy was greater than traditionally assumed. Their view remains disputed, however. See the comment of Schwartz (2003).

In retrospect, their experiences with floating exchange rates during the interwar years appear to be isolated episodes. In contrast, countries that have adopted a floating regime pursued a more linear path throughout the twentieth century from a regime precluding monetary independence toward a regime allowing a high degree of monetary independence. Accordingly, the interwar experiences with flexible exchange rates were not isolated episodes but appear to be a first step toward the present situation. The main topic of this study is the path small Western European states followed during the twentieth century.

SCALE AND SCOPE OF THIS BOOK

Reconstructing the motivation behind the regime choices required the analysis of a variety of evidence: archival material, published sources, descriptive statistics, and, of course, secondary literature. In fact, the amount of written documents to be considered was so abundant that the scale and scope had to be narrowed. In particular, two restrictions needed to be imposed. First, only the experience of economically advanced small states of Western Europe is considered. This group consists of Austria, the Benelux countries (Belgium-Luxembourg[12] and the Netherlands), three Scandinavian countries (Denmark, Norway, and Sweden), and Switzerland. Smallness is defined by the population figure, the gross domestic product (GDP), the degree of trade openness, and the self-perception of small states. Small states are primarily small because their inhabitants are convinced that they are small and therefore enjoy only limited power in international relations.[13] Today, the Netherlands is the largest of the small countries, with 16.5 million inhabitants and a GDP of US$766 billion, and Norway is the smallest of the group, with 4.8 million inhabitants and a GDP of US$388 billion.[14] Trade openness ranges from roughly 150 percent (Belgium) to

[12] In 1922, Belgium and Luxembourg formed an economic union, the first step toward monetary cooperation. Parity was established between the Luxembourg franc and the Belgian franc. In 1935, Belgium and Luxembourg formed a currency union: Belgian coins and banknotes became legal tender in Luxembourg, and from then on until 1999, the Belgian National Bank was in charge of monetary policy for both countries. Because of the dominance of Belgium in this currency union, this study does not deal with Luxembourg.

[13] Hey (2003) highlights the crucial importance of self-perception. See Alesina and Spolaore (2003) for an economic approach to the size of nations. Because I take the size of nations as exogenous, their perspective goes beyond the main question of this study. I also do not address the question of whether or not small European states are more successful in economic terms than large states.

[14] GDPs in US dollars are calculated on the basis of official exchange rates and do not express purchasing-power parities. The GDP figures are World Bank estimates for 2007.

75 percent (Norway). By contrast, the big four – France, Germany, Italy, and the United Kingdom – have population figures ranging from 60 to 82 million inhabitants, GDP figures between US$2,100 and US$3,300 billion, and degrees of trade openness that lie within the range of 50 to 70 percent.

Admittedly, this selection of countries is rather small, given that there are presently more than 30 small and very small European states. However, because no scholar has ever studied the monetary history of more than four small states at a time, the restriction appears to be legitimate.[15] In addition, three other considerations are relevant. First, throughout the twentieth century, these seven small European states belonged to a group of economically advanced European economies. This similar level of development makes it possible to compare them with one another as well as with large European states and allows us to focus on the importance of country size. Otherwise, if the small states being studied were too different regarding their trade structure, their degree of trade openness, or their financial maturity, the analysis would be strongly biased by the differences between countries in the core and those in the periphery. Second, Katzenstein, in his seminal work on small states in world markets (1985), has dealt with the same country group, which makes it easier to see the implications of the exchange-rate-regime choices for overall economic policymaking. And third, because the analysis is based largely on narrative evidence, it was necessary to learn several languages, which proved to be time consuming.[16]

The second restriction is that the study does not encompass the whole of the twentieth century but is focused on two periods in which exchange-rate-regime changes were particularly frequent: the interwar years and the decades from the end of the Bretton Woods system until the Swedish referendum on the euro in September 2003. Accordingly, not every country gets the same attention at every point of the analysis. The study will focus on crucial episodes in which one or a group of small states changed the exchange-rate regime. Altogether, the argument is based on eight such episodes – four during each of the two periods. The following two sections will outline the major results of this comparative analysis.

[15] See, for example, Scharpf (1991), Kurzer (1993), Moses (1995), Notermans (2000), and Jones (2008).

[16] For a German-speaking Swiss historian, it is feasible to learn Dutch-Flemish and the Scandinavian languages within a reasonable period of time. Learning Finnish, however, as well as the Eastern European languages, simply was beyond my intellectual capacity.

SMALL VERSUS LARGE STATES

According to official classifications of exchange-rate regimes, during the twentieth century, small European states made roughly the same choices as large European states.[17] After World War I, they let their currencies float and introduced the gold exchange standard, with the small neutral states fixing the exchange rate at the old parity (like the United Kingdom), and the small war-stricken states devaluing (like France) or even replacing their currency (like Germany). In the 1930s, some small states left the gold exchange standard (like the United Kingdom) or abandoned it by introducing capital controls (like Germany), whereas other small states joined the gold bloc and devalued (like France). After Bretton Woods, we find both small and large states pursuing the paths toward the euro and a floating-exchange-rate regime. Today, Austria, Belgium, and the Netherlands have the euro (like France, Germany, and Italy), whereas Norway, Sweden, and Switzerland have a flexible exchange rate (like the United Kingdom). In addition, Denmark has tied its currency to the euro.

There is also narrative evidence suggesting that small states enjoyed as much room to maneuver as large states. In fact, the differences between small states appear to have been bigger than those between small and large states. Under the regime of floating exchange rates during the early 1920s, Sweden and Switzerland are said to have pursued a hard-currency policy, whereas Danish historians have pointed out that their central bank took an accommodating stance.[18] As for the 1930s, Sweden is known to have been the first European central bank to adopt price-level targeting as its official monetary policy framework.[19] By contrast, Belgium, the Netherlands, and Switzerland maintained the gold standard until 1935 and 1936, respectively.[20] And in early 1973, Switzerland abandoned the fixed exchange rate against the US dollar earlier than France, Germany, or Italy, while the other small European states maintained a fixed exchange rate.[21]

Finally, there is statistical evidence showing that country size was secondary. According to this research, only small states with a very open economy and one major trading partner have always preferred to have a fixed

[17] Until 1996, the International Monetary Fund (IMF) Annual Report on Exchange Rate Arrangements and Exchange Restrictions reflected only the regimes as reported by the IMF members themselves.
[18] See Chapter One.
[19] See Chapter Three.
[20] See Chapter Four.
[21] See Chapters Five and Seven.

exchange rate.[22] In all other cases, the evidence is not conclusive. Economists have explained this result by the fact that the type of exchange-rate regime does not affect long-run macroeconomic performance.[23] The argument is that importers and exporters can hedge their exchange-rate risks.[24] Thus, in sum, the choice of the exchange-rate regime seems to be more or less accidental. Whether small or large, Western European countries had the same options.

Yet, despite this considerable evidence, the view that country size was of minor importance is flawed because it neglects the fact that official classifications are often misleading.[25] It is true that after World War I Swedish and Swiss central bank and government officials declared that they wanted to bring the currency back to the prewar parity as soon as possible, but because the authorities of every European country made such a statement at the time, these declarations are not particularly revealing. Conversely, Danish central bank officials wanted to facilitate the difficult change from a war to a peacetime economy by pursuing a policy of cheap money, but again, every other European central bank had the same policy goal. It is correct that the Swedish finance minister explained in 1931 that monetary policy would be aimed at stabilizing the internal price level, but in reality, the Swedish central bank continued to target the exchange rate.[26] And finally, Switzerland shifted to a floating exchange rate earlier than some large European states, but the regime change was not really completed until the late 1970s, and since the early 1980s, the floating of the Swiss franc has been rather "dirty." Therefore, it would be completely wrong to consider the Swiss case representative.

More generally, if the analysis of exchange-rate-regime choices is based on actual policies, country size becomes highly relevant. During the interwar years, this factor determined the timing of regime change, that is, when countries introduced and abandoned the gold exchange standard and which exchange-rate regime they adopted before and after the operation of the gold exchange standard. Small European states always reacted to the regime changes of large states and hardly pursued an independent

[22] Honkapohja and Pikkarainen (1994). Seminal papers are Heller (1978) and Melvin (1985). For a comprehensive summary of this literature, see Edison and Melvin (1990).

[23] Influential papers are Baxter and Stockman (1989), Flood and Rose (1995), and Ghosh et al. (2003). For a survey of the literature, see Goldstein (1995) and Begg et al. (2003).

[24] Recently, this finding has been questioned. See Begg et al. (2003) on the new literature. See also Klein and Shambaugh (2004) on the positive effects of fixed exchange rates on trade.

[25] Until about 10 years ago, economists, including Honkapohja and Pikkarainen (1994), based their calculations on the official classifications of the IMF.

[26] Lester (1939), Jonung (1979, 1992), and Berg and Jonung (1999).

monetary policy. They were forced to change course when large states made a regime shift. After World War I, all five small neutral countries were looking to London when they returned to the gold standard at the prewar parity. Even Sweden, which made the *de jure* restoration one year earlier than the United Kingdom, tried to be in synchronization with the policy of the Bank of England. Only Austria and Belgium followed their own path when returning to the gold standard, but for obvious reasons: The negative consequences of the war were so profound that appreciation to the prewar parity proved impossible – just as for France and Germany.[27]

In the early 1930s, the policy of the United Kingdom continued to play a crucial role. Denmark, Norway, and Sweden abandoned the gold standard a few days after the British government took this step. And after suspension of the gold standard, Denmark, Norway, and Sweden maintained a stable exchange rate against sterling informally from autumn 1931 to summer 1933 and officially from summer 1933 onward. Belgium, the Netherlands, and Switzerland followed France and formed the gold bloc during the London Economic Conference in 1933. The Netherlands and Switzerland did not devalue until France took this decision. Only the Belgian franc was devalued somewhat earlier, but only because of an imminent collapse of the financial sector.

After 1971, country size was even more relevant. First, small European states needed more time than large states to accept the idea that a floating exchange rate was a viable option for them. With the exception of Switzerland, all small states either participated in the Snake and the EMS or shifted to a basket peg after leaving the Snake, whereas all large European states abandoned their fixed exchange rates during the 1970s: the United Kingdom in 1972, Italy in 1973, and France in 1974 and again, after a short interlude, in 1976; Germany, although still participating in the Snake, adopted monetary targeting in early 1975. Thus, contrary to the view based on official classifications, small states in fact displayed some "fear of floating" during the 1970s and 1980s. Only in the early 1990s, when Norway and Sweden abandoned the fixed-exchange-rate regime, did it become normal for the currencies of small European states to float. Switzerland ceased to be an exception confirming the rule.

Second, country size also mattered with respect to the causes of the regime shift from fixed to floating. In the case of the small states, the combination of open financial markets and the lack of EC membership proved

27 For this reason, the monetary history of Austria and Belgium during the 1920s will not be discussed in detail.

crucial. In January 1973, Switzerland had no choice but to let the franc float when massive capital inflows put enormous upward pressure on the Swiss franc. Had it been a member of the EC, it would have joined the Snake, the first monetary regime of the EC, and revalued within the Snake. Similarly, Norway and Sweden were forced to let their currencies float in the course of the 1992 crisis of the EMS, which was the successor regime of the Snake. If the countries had been EC members, they would have either defended or devalued their currencies within the EMS – just as the small EC member states Denmark or Portugal did. But, owing to the lack of EC membership and the concomitant weak credibility of the currency peg in a world of high capital mobility, Swedish policymakers opted for a temporary float and finally decided to remain outside because the floating regime proved viable. Norway took this step some years later after a failed attempt to maintain a stable exchange rate vis-à-vis the EMS currencies without officially fixing it. Large states, by contrast, were all EC members at the time they left the Snake or the EMS. Accordingly, the causes of their regime shifts were different.

Why did small European states closely follow large states during the interwar years, and why did it take longer for them to adopt a floating regime? The main thesis of this study, as expressed by its title, is that neither economic interests nor specific institutions but rather the macroeconomic models of policymakers ("fixed ideas") determined their actions.[28] Until the early 1990s, there was a widespread consensus that small, open economies needed a fixed exchange rate. It was argued that under a regime of floating exchange rates, trade and investment would be hampered by the volatility of the foreign exchange markets. Because, during the interwar years, policymakers in large states shared the same view, the resulting exchange-rate policies of small and large states were quite similar. Policymakers across Europe considered the years before the return to the gold standard and after its dissolution as periods of transition. Accordingly, the main difference was, as noted, the timing of regime changes.

Of course, the early 1920s and 1930s differed from the time when the gold exchange standard operated. In those two periods, central banks were able to function as lenders of last resort in case of a banking crisis or could be forced more easily to continue printing money in order to finance the

[28] In recent times, several economists and political scientists have highlighted the importance of ideas for the choice of exchange-rate regimes, especially with respect to the interwar gold standard and the making of the European Monetary Union (EMU). As for the interwar years, see Eichengreen and Temin (2000), Mouré (2002), and Balderston (2003); on the EMU, see McNamara (1998) and Maes (2002).