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Abstract

The recent debate on the Eurozone failed to appreciate a particular characteristic of European crisis experiences, namely their fundamentally political character. To make my argument, I borrow from Dani Rodrik (2000) the framework of a "political trilemma" between cross-border economic integration, national institutions and democracy (in the sense of mass politics) and discuss its relation to the more commonly known "macroeconomic trilemma" as well as some limitations of the framework. The recent experience of a European debt crisis and the experience of Europe's Great Depression can be interpreted as a "political trilemma": both reflect the problem of designing effective policy responses to major economic shocks within the environment of deep economic integration across political boundaries and the regime choices that this involves. Within this framework I highlight some aspects of the 1930s that are informative to the policy choices in Europe today. Once we accept that some policy choices should be avoided, attention should be shifted to the remaining options and the obstacles that prevent their implementation, notably the challenge to transform democracy beyond national borders.

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Europe will be forged in crises, and will be the sum of the solutions adopted for those crises. (Jean Monnet)

I. Introduction

Ever since 2008, when a crisis of the US-housing market spread worldwide, commentators have noted a sense of helplessness of policymakers with regard to the extent, complexity and speed of economic events. Academic economists and policy advisers, who mostly had been taken by surprise by this series of events, started to look for guidance from two sides: first, theory - for example by several recent efforts to model the financial sector explicitly within Dynamic Stochastic General Equilibrium DSGE frameworks and to improve our understanding of the interaction between monetary and fiscal policies – and second, also from history. Unsurprisingly the focus here was put on previous crisis experiences such as the Great Depression (for example Crafts and Fearon, 2010), or earlier sovereign debt crises that apparently featured some similarities to the contemporary experience. A common point in these accounts is the conclusion that political leaders were slow to react to the challenges posed by economic developments and that once they reacted it was too little too late or altogether misguided, especially so in Europe.

In this brief paper, I want to argue that most of the contributions from both historians and theorists to the recent debate failed to appreciate a particular characteristic of European crisis experiences, namely their fundamentally *political* character and the challenges this implies to policymakers.[1] To make this argument, I first borrow from Dani Rodrik (2000) the framework of a "political trilemma" between cross-border economic integration, national institutions and democracy (in the sense of mass politics) and discuss its relation to the more commonly known "macroeconomic trilemma" as

[1] An assumption, which is implicit to my argument but not explicitly spelled out is that the main difficulties that Europe faces today and in the interwar period are and were "homemade", and not due for example to some fundamental lack of competitiveness with regard to rising international rivals such as the US or Asian economies. To be specific, I assume that Europe at least since the last third of the 19th century suffered mostly from a mismatch between economic relations at a European (in part even global) level and local or national politics.

well as some limitations of the framework. The recent experience of a European debt crisis and the experience of Europe's Great Depression can be interpreted as a "political trilemma" as both reflect the problem of designing effective policy responses to major economic shocks within the environment of deep economic integration across political boundaries and the regime choices that this involves. Within this framework I will highlight some aspects of the 1930s that are informative to the policy choices in Europe today. Finally, if we accept that some possible policy choices should be avoided, we should shift our attention to the remaining options and the obstacles that prevent their implementation. I briefly point to some of them, notably the challenge to transform democracy in a way that it can reach beyond national borders.

II. The nation-state, mass politics and economic integration: is there a "political trilemma"?

A well-established framework in international economics is known as the "macroeconomic policy trilemma" (for a good textbook exposition see Feenstra and Taylor (2008), chap. 15). It describes the impossibility to combine three generally desirable policy objectives at the same time: first, fixed exchange rates to promote stability in trade and investment, second, open capital markets to promote efficiency in capital allocation and risk sharing and third, monetary policy autonomy to manage the domestic business cycle and limit the pressure for internal adjustment to external imbalances. Under the assumption that it takes time before prices and wages adjust, it can be shown that policymakers have to give up one of the three objectives. Provided countries have more than one trading partner, they can also form a regional block such that the need to adjust to external imbalances is minimal, as suggested by the theory of Optimum Currency Areas (Mundell, 1961). Europe's historical experience strongly suggests that these constraints were usually binding. It has been argued that under the classical Gold Standard policy makers de facto chose to sacrifice monetary policy autonomy (Obstfeld et al 2005), a policy which became increasingly untenable during the interwar period as we will discuss below. The formation of the Eurozone has often been interpreted as reflecting again the logic of the trilemma. With the decision to fix exchange rates from 1999 onwards within a common monetary regime and ever deepening economic integration, economic policy at a national scale lost its autonomy. The discussion about the tenability of this decision was largely conducted within this logic, starting with Eichengreen's question "Is Europe an Optimum Currency Area?" (Eichengreen 1990). If the Eurozone would have been formed in a way that its members would face only minimal long-run external imbalances between them (or if the very formation of the Eurozone would have reduced imbalances between its members, see Frankel and

Rose 1998), it would have reduced the cost of losing monetary policy autonomy. Of course, all this is well known “textbook economics” (see De Grauwe 2009).

However, this logic understates the actual constraints on economic policy that are implied by deep economic integration. To see this it is helpful to consider what Dani Rodrik (2000) called the “augmented trilemma”, given by impossibility to combine economic integration, with national institutions and democracy in the sense of mass politics. Let us briefly define these three. National institutions would be defined by the political boundaries of a state, where we use state and nation interchangeably. Deep economic integration would encompass the reduction in barriers to commodity and factor markets, including the technology to diffuse information across political boundaries. Finally, democracy as mass politics is here understood as a political regime that is participatory with unrestricted franchise, responsive and transparent, so that it at least broadly reflects the main streams of politically mobilized groups (whatever their objectives - for example with regards to human rights). Rodrik (2000) argued that we can have at most two of these three.

“If we want true international economic integration, we have to go either with the nation-state, in which case the domain of national politics will have to be significantly restricted, or else with mass politics, in which case we will have to give up the nation-state in favor of global federalism. If we want highly participatory political regimes, we have to choose between the nation-state and international economic integration. If we want to keep the nation-state, we have to choose between mass politics and international economic integration.” (Rodrik 2000, p. 180).

Several things are notable here. To start with, Rodrik thinks about constraints in the long-run. In the short- to medium run (the perspective which often predominates in politics due to term limits and election cycles) policymakers might go a long way with solutions in-between before they will have to face some tough choices. In particular, the immediate reaction to a crisis might be some attempt by sovereign national governments to coordinate their policy rather than the emergence of transnational federal institutions. However, to be effective such a reaction would have to be quick, bold and credible. Given that coordination within and between sovereign democracies needs time and is always threatened by veto-players, this either tends to be ineffective or it will be insulated from political participation. Second, in the same way as international economic integration does not really encompass all parts of the world equally so that the logic of the macroeconomic trilemma should better be applied to the internal logic of regional blocks of integration such as Europe or North America than to the world as a whole, this “augmented trilemma” needs not to hold on a global scale but it does help understanding the choices of policy makers within Europe.

The constraints on policy makers in Europe since the late 19th century can be much better understood in terms of the "augmented trilemma" that includes the choices of political institutions, than just in terms of the macroeconomic trilemma, which suggests that economic policy can be separated from such choices. This is for two reasons. First, a long-run perspective suggests that the increasingly deep integration of markets is driven by technology rather than policy choices. Changes in transport and communication technology but also organizational innovations facilitated the formation of global holdings and multinational enterprises from the late 19th century onwards (for a sector-specific example see Hausmann et al. 2008) and more recently the emergence of fragmented value chains accompanied by rising levels of FDI and intra-industry trade. This change in technologies increased the costs associated with exchange rate volatility and it increased the pressure on policy makers to liberalize capital markets, especially in capital-poor countries to attract foreign investment. With new communication technologies today, financial markets have reached an unseen level of global integration. Hence, if we acknowledge such an exogenous trend towards deeper integration due to technological change, the set of possible policy choices in the "macroeconomic policy trilemma" becomes considerably smaller: disintegration comes at a price that is rising over time. Second, the combination of rising costs of exchange rate volatility and of capital controls reduces not only the degree of possible monetary autonomy, but limits also the scope for fiscal policy with implications for the entire political regime. The historical experience in the early 1920s prior to the (re-) formation of the Gold-Exchange rate as well as in the early 1990s prior to the formation of the EMU was that fixed exchange rates are threatened by speculative attacks unless governments, resp. their central banks signal their determination to not only adjust monetary policy but also fiscal policy to defend the external value of the currency. Membership in the Gold Standard as well as membership in the Euro was seen as a signal to international business and investors to voluntarily limit the scope for expansionary policies, be they monetary or fiscal in nature (on the interwar experience see Bordo et al. 1999, on the political economy of the EMU see for example Rotte and Zimmermann 1998). In spite of some early warnings, however, the far-reaching political implications of this self-selection into the Gold-Standard in the mid-1920s or the EMU in the early 1990s did not become apparent until a major shock hit the European economies: both in the 1930s and today the choice is not one between fixed exchange rates and stabilization policies given economic integration but rather about the reach of political institutions (within or beyond existing national boundaries) and their responsiveness to politically mobilized groups.

After the First World War, policymakers struggled to combine their (sometimes new) national institutions with the idea of (a sometimes young) democracy and exposure to foreign economic forces. When a major shock hit in 1929, it seemed inconceivable to sacrifice the nation states and move towards the idea of a federation of states (as suggested by some). Policymakers attempted to find some coordinated policy response between sovereign states but were painfully slow to progress. The reparations question was solved in summer 1932; a mechanism to coordinate monetary policy was installed in 1936 (between France, the UK and the US). In the meantime the question was rather to what extent and how long it was possible to keep markets open and to resist the pressure from politically mobilized groups, notably the suffering workforce (as in Germany before 1933, Poland, Austria, Hungary, Italy and to some extent France and the Gold-bloc) or rather to partially retreat from economic integration to respond to these pressures (as in the UK and the Commonwealth, Scandinavia, the US and notably Germany after 1933).

In 2008 the situation was very different insofar as member states of the EU and the Eurozone had already started to give up sovereignty to European "federal" institutions, notably the ECB in terms of monetary policy. This enabled the most powerful federal institution, the ECB to implement a first wave of policy measures to effectively counter the crisis. But it became immediately apparent that monetary policy would be too slow and altogether insufficient to affect the liquidity crisis and help faltering banks and businesses. As we will see spell out below, this shifted attention to fiscal policy. In a second wave of policy response, national governments again acted quickly and boldly to borrow money for the rescue of banks and businesses, which led to a large increase in government debt. I argue that investors started to realize that policy choices would be limited: to preserve integration of the EMU, the European governments would either have to find a way to coordinate their expansionary fiscal policies at the federal level (in terms of the ECB monetizing at least part of the sovereign debt or in terms of fiscal transfers), or to implement "national" policies of austerity measures that would face the pressure of mass politics. The challenges involved by both optionsled to a spiraling of their government bond yields, reflecting the risk of their exit from the EMU and partial debt default.

Currently, we observe a search for a coordinated policy response within the EMU in the face of mounting public discontent with restrictive fiscal policies on the one hand side and fears of a Eurozone break-up on the other. The economic challenge to design a credible policy response without compromising fiscal discipline nor the independence of monetary policy is considerable. But the political challenge is even more demanding: a credible policy response has to imply a transfer sovereignty to the federal European level that goes beyond the current European treaties to avoid time-consuming political negotiations. But this transfer needs a political legitimization without which it would be always threatened by national elections. In terms of Rodrik's trilemma, the fundamental question then is, whether European policymakers will be able to transform democracy beyond national borders.

III. The political trilemma in action

III.1 Crisis and political regime choice in the 1930s

Europe's great depression in the 1930s was not simply the result of some misguided economic policy in any particular country. European economies had built up a vast economic potential, but policymakers at large were unable to find a political response to the economic crisis that started in 1929. The European economy in 1929 was still deeply integrated, especially in terms of financial markets, and organized in sovereign national states based on participatory political systems. In the face of a major economic downturn the system collapsed, with the rise of several dictatorships and a fragmentation of the European (and world) economy. This was largely due to the effects of the First World War, which had been an "inconclusive test for hegemonic power" (Simmons) in Europe. In many ways, the war had not come to an end in 1918 but passed into a transitional period in which states continued to fight and prepared to settle their accounts. The three most important consequences of the war with implications for the coordination of economic policies were the change in character and the fragility of the new political institutions, the unsettled issues of war debts and reparations, and finally the 1920s inflation which was a consequence of the war debts, which restricted the options of economic policy. Let me briefly discuss each of them.

Everywhere in Europe, the postwar situation made it necessary for societies to struggle over the distribution of income and war-debts. The fundamental issue was "whether deflation and unemployment would saddle a major share of the load on the working class, as contrasted with the rentier" (Kindleberger 1986, p. 323). But the political bargaining power of labor had dramatically increased as a result of political compromises reached during and immediately after the war. Examples include the significant extension of the franchise or the introduction of the eight hour day in many countries. Not at least, the political threat posed by the Soviet Union raised the political bargaining power of the moderate left. This made it harder to sacrifice autonomous monetary policy geared towards external stabilization. When devaluation in response to an outflow of gold and foreign exchange was no longer a viable option, and unilateral expansion was considered risky unless accompanied by a strict regime of exchange controls, international cooperation became more important than ever before (Eichengreen 1992, p. 10). In addition, the new institutional framework made it more difficult to cooperate. The political landscape that had emerged after 1918 was significantly more democratic than prior to the war, but also less stable. There were a number of new states including Poland, the Baltic States, Czechoslovakia, and other successors of the Habsburg Empire, but also the Republic of Irleand whose borders, sovereignty and included national minorities continued to be the subject of international disputes throughout the interwar years (Wandycz 1988).

Also, this political instability was by no means limited to the new democracies. Governments in nearly all European countries were less stable after the war than before. Table 1 shows the average duration of Cabinets for a broad selection of countries.

[Table 1 about here]

Not only had the losers of the war, such as Germany or Austria and Hungary experienced a significant increase in political tribalism and government instability after the war, but equally members of the winning coalition, notably France and Britain. This instability, accompanied in countries like Germany with an increase in the fragmentation of the acting coalition governments, impeded and delayed political decisions within countries and the coordination of policies across countries (Simmons 1994).

A second factor that impeded international cooperation stemmed from the web of debts between the Allies and massive claims for reparations against the Central Powers, which the war had produced. This and the rivalry with commercial loans impeded the recreation of international finance in the 1920s (Kindleberger 1986, p 298). Germany in particular was opposed to reparation claims, but eager to attract commercial loans. In contrast, France wanted to get rid of war debts, had only limited interest in commercial lending, but considered reparations from Germany as necessary both to rebuild the devastated provinces in the north and east, and to repay war debts to Britain and most importantly to the United States. Britain in turn was from about 1920 onwards prepared to cancel out reparations and war debt but was interested in commercial lending. Instead, the United States had little interest in reparations. Congress wanted to collect the war debts and American financiers wanted to revitalise commercial lending (Schuker 1988). Given the extent of the various claims, they significantly distorted the incentives for policymakers in domestic and international decisions. In May 1921 the Reparations Commission announced the London Schedule of Payments that amounted to a reparations bill of 132 billion gold marks, denominated in gold and payable in gold, commodities or services. Critically, this bill came in two parts. Germany would have to pay interest and amortisation on two (“A” and “B”) bond series over about 50 billion gold marks that were meant to cover the Allied war costs and debts, while the remaining “C” bonds would be issued later depending on Germany’s capacity to pay (Schuker 1988). The former sum was comparable to pre-war experience, notably to the French indemnity of 1871, the 50th anniversary of which happened to coincide with the announcement of the London Schedule and roughly in line with Keynes’ estimation of a payable maximum (Ritschl 2002, pp. 223ff.). While payment on the second part of the bill was deferred until Germany would have become sufficiently prosperous, it had far-reaching political implications. Internationally, the C-bonds served as a strategic asset in inter-allied negotiations on war-debts. Within Germany they undermined the efforts of the so-called “Weimar coalition” (the social-democrat SPD, the liberal DDP and the conservative catholic Zentrum) to stabilise the young democracy, because the extent of this claim was considered as excessive even by moderate political forces. What is possibly more important, the link of the "C" bonds to the condition of the German economy "diminished the incentive for German policymakers to put their house in order" (Eichengreen 1992, p. 128). After the conflict of interest about the settlement of war debts and reparations, especially between France, Germany and the United States, had contributed to inflation and exchange rate instability in both France and Germany, the London Schedule was replaced by the Dawes Plan in 1924 that would stay in place right until 1929. The Dawes Plan differed from the London Schedule in several ways (Schuker 1976, pp. 180ff.). First of all, it reflected a new engagement of the U.S. in European affairs, and U.S. interest in European recovery to revitalise commercial lending. The new schedule immediately reduced the required annual payment to 1 billion marks in 1924-25 that should rise gradually to a standard annuity of 2.5 billion marks by 1928-29. After this, it was planned to adjust Germany's obligations according to some "index of prosperity". Together with an international loan of 800 million gold marks of foreign currency, this gave the German government some breathing space in 1924. Next, the plan avoided any definite statements about the extent of Germany's total liability, but rather proposed an arrangement that would allow "to restore confidence, (…) to facilitate a final and comprehensive agreement (…) as soon as circumstances make this possible" (Commission 1924, p. 35). Finally, it introduced a distinction between Germany's obligation to raise the specified annuity internally on one hand side and the problem of transferring the amount to the Allies on the other. To this end, the Plan devised a new Bank of Issue in Berlin, where the German government had to deposit the reparation payments and a special reparations agent. The reparations agent would then, joint with a Transfer Committee determine how much Germany could safely transfer to the Allies without causing foreign exchange difficulties. This arrangement essentially introduced a "transfer protection" that safeguarded the service of commercial over reparation debts (Schuker 1988, p. 35). After the very successful placement of the Dawes Loan, this new settlement of the reparations issue unleashed a wave of lending by the United States to Europe, especially to Germany. However, insofar as this flow of investment depended on the existence of U.S. surpluses relative to Europe and on the still pending issue of war debts and reparations, it produced a precarious equilibrium. A severe downturn of the business cycle, political tensions over the negotiations of the "final and comprehensive agreement", when the Dawes Plan would expire, or doubts about the rising debt-servicing burden in Central Europe could easily bring the system to a collapse (Eichengreen 1992, p. 152). Apparently, this is what happened when negotiations over the Young Plan in 1929 met with a downturn of the business cycle.

A third consequence of the war was inflation, which in several cases turned into hyperinflation. It is not so much the inflation itself, but the memory of inflation among policymakers, savers and consumers that mattered for international economic policy in the 1930s. The experience of inflation during the 1920s would prove to be one of the best predictors of which countries would allow their currencies to depreciate in the 1930s. Technically, prices rose everywhere in Europe after the war because output was weak, while several factors contributed to an increase in money supply. It is disputed to what extent the increase in money supply was an endogenous response to changes in demand or the result of explicit economic policies, and the answer to this will vary across countries. Let us briefly consider the cases of France and Germany. Table 2 gives the development of consumer prices 1920-1926 in France and Germany.

[Table 2 about here]

Clearly, inflation in France never reached the extent of that in Germany (or Poland), but it was high enough to undermine public trust in the country's monetary authorities. After the war, the French expected German reparations to reconstruct the country to the extent that reconstruction expenditures in the extraordinary budget were balanced by reparation receipts that had not yet been collected (Kindleberger 1986). When German deliveries fell into arrears over the summer of 1922, French and Belgian troops occupied the Ruhr in January 1923 in order to enforce deliveries. The failure of this occupation (not at least because of the raging inflation in Germany) shifted attention back to the ability of French governments to balance the budget and raise taxes as opposed to pursuing inflationary policies. In March 1924 it took a significant increase in taxes and an international effort with a major loan from J.P. Morgan to counter a speculative attack on the Franc (Kindleberger 1986, pp. 339-43). But this victory was short-lived. Over the year 1924 it became clear that the Banque de France had secretly increased note circulation while several governments struggled to reduce the fiscal deficit. After another 10 (!) ministers of Finance between June 1924 and July 1926, the new Poincaré government used a new American loan and a sharply deflationary budget to stabilise the Franc at around 20% of its pre-war gold parity in late 1926. With the monetary reform in June 1928 the French Franc returned at this parity also de jure on the gold standard and French monetary authorities "intended to stay there" (Mouré 2002, p. 73).

The German hyperinflation 1921-1924 was one of the most extreme cases recorded in history. The debate on it has often been described in terms of a competition between a balance-of payments school and a fiscal view, but fundamentally the origins of inflation in Germany were similar to anywhere else: there was no consensus regarding the distribution of income and tax burdens. While some progress towards such a consensus was made during 1920, this was undermined by the reparations problem. The political situation after 1919 was fragile but the "Weimar Coalition" had implemented far-reaching tax reforms in 1919 and 1920 and organised significant "interim payments" in anticipation of a formal agreement on reparations, that amounted to some 20 percent of German national income in 1921 (Eichengreen 1992, p. 129). After the Reparations Commission announced a reparations bill of 132 billion gold marks in May 1921, further tax reforms stalled. The mark depreciated dramatically, temporarily halted by a rescheduling of reparations payments in January 1922. With the occupation of the Ruhr however, the stage was set for hyperinflation. Due to the lag between tax assessment and tax collection, inflation eroded government revues. The government started to print money on an unprecedented scale to cover expenses, and from January 1923 onwards to fund the striking miners. While it is undisputable that the mounting budget deficits led to money creation, inflation and depreciation, the fundamental cause of the budget deficit is still debated. German politicians maintained the balance-of-payments view that capital flight weakened the exchange rate, which drove up import prices and triggered domestic inflation, higher money demand and hence an increase in money supply (Bresciani-Turroni 1937, p. 45). While it can be shown that the budget would still have been in deficit in the absence of inflation, the extent of this deficit can be largely explained by reparations payments (Webb 1989, p. 37). Hence, reparations can be seen as the ultimate reason why German inflation developed into hyperinflation (Eichengreen 1992, p. 141). In turn, hyperinflation could be ended for good only because a radical change in monetary and fiscal policies in November 1923 was supported by the emergence of a new reparation regime: the Dawes plan (Webb 1988, p. 73).[2]

With the stabilization of the Franc in 1926 and the Lira in 1927, Europe had essentially completed the reconstruction of the gold-standard. The political situation had also stabilized with the treaties of Locarno in late 1925,[3] some hopes for effective disarmament, and domestic stabilization in many European countries. But the new political and economic stability soon proved to be frail. Germany was at the brink of a recession already in 1927, as indicated by a fall in industrial investment (Temin 1971, p. 247) and orders to German machinery industry (Ritschl 2003a, p. 116). While the origins of the U. S. depression are still heavily disputed,[4] tightening monetary conditions in the United States started to reduce foreign lending from about summer 1928 onwards. This affected European debtor countries first, which depended on capital imports from the US. In order to serve US dollar (and other gold denominated) loans, borrowers had to shift their current account balances to surplus and

[2] The Polish experience of inflation and hyperinflation was no less dramatic. However, it had its origins not in war debts but in the weakness of the new state, reflected in its limited access to foreign capital and its difficulties to raise sufficient taxes to cover the necessary expenses; for details see Wolf (2010).
[3] The Locarno treaties were signed in December 1925. The “Rhineland pact” between France, Belgium, Germany, the UK and Italy guaranteed Germany’s western borders according to the treaty of Versailles. Instead, Germany signed arbitration conventions with France, Belgium, Poland and Czechoslovakia to negotiate Germany’s eastern borders. Finally, France signed treaties on mutual assistance against Germany with Poland and Czechoslovakia that renewed earlier agreements. The treaties were interpreted as a step towards Franco-German reconciliation but simultaneously as a threat to the new states in Central and Eastern Europe.
[4] See footnote 1, especially the recent work by Ebell and Ritschl (2008) and Ohanian (2009) and papers in this issue.

tighten monetary and fiscal policies to limit domestic demand. Hence, the monetary tightening in the U.S. and elsewhere produced a deflationary shock to Europe, transmitted by adherence to the gold-standard. From mid-1929 onwards wholesale prices started their long decline. Within the framework of the macroeconomic policy trilemma, policymakers attempted to restore external balance at the expense of macroeconomic stabilization at home. This in turn was the key transmission mechanism that turned a bad recession into the great depression (Temin 1989, p. 38). But worse, the crisis undermined the prevailing system of sovereign and democratic nation states. National governments attempted to find some coordinated policy response between sovereign states, but they were painfully slow to progress. Especially after spring 1931 the choice was between keeping commodity and capital markets open in spite of rising unemployment and growing political pressure (as in Germany before 1933, Poland, Austria, Hungary, Italy and to some extent France and the Gold-bloc) or rather to partially retreat from economic integration to respond to these pressures (as in the UK and the Commonwealth, Scandinavia, the US and notably Germany after 1933). By 1933 the European economy had been fragmented into several economic blocs.[5] To some extent, membership in the various economic blocs (the "gold bloc", "exchange control bloc" and even the "sterling bloc" that emerged around Britain) was as much a signal of strategic political orientation as of actual economic policy, which can help to explain why these blocs had little effect on trade (Ritschl and Wolf 2010).

While national borders mattered, European commodity and capital markets in 1929 were still deeply economically integrated, both internally and with the US as a trading partner and major creditor. One indicator of this is the simultaneous movement of manufacturing output and wholesale prices across Europe and the US between 1928 and 1931 (see figures 1 and 2).

[Figure 1 and 2 about here]

In this situation of deep economic integration, all European governments initially reacted to the shock with restrictive fiscal policies and continued adherence to a common monetary framework (the gold-exchange standard) against growing public resistance. As argued earlier, war debts and reparations limited the scope of fiscal policy responses, as did the memory of large-scale inflation,

[5] A group of countries that followed Britain off gold in September and October 1931 (with several currencies pegged to sterling) started to recover from about mid-1932 onwards. Another group of countries tried to follow France in her policy of strict adherence to the gold-standard without imposing exchange controls and at prevailing parities, including Belgium, Czechoslovakia, Italy, the Netherlands, Poland (with Danzig), and Switzerland. All of them experienced a continued deflation, and further economic decline (see figures 1 and 2). Finally, there was a group of "exchange control countries", including Germany, Austria, Hungary and several other Central and Eastern European countries that had openly introduced exchange controls to limit further capital losses, but did not devalue. Instead, they introduced a complex web of clearing agreements to manage trade on a bilateral basis at increasingly inappropriate exchange rates (Nurkse 1944, pp.162-189).

even when all economies were experiencing a dramatic fall in prices. This and the new institutional framework after 1918 also hindered the coordination of national policies. In many parts of Europe, the First World War had been fought for gaining a sovereign state, and the moderate left that had increased its political influence during the war (for example SPD in Germany, Labor in England, the PSL in Poland), did not question the idea of national sovereignty. Attempts to adjust the political framework to the realities of increasing integration were made, notably with the formation of the League of Nations in 1919, Coudenhove-Kalergi's Pan-Europa movement, or Aristide Briand's proposal for a European federal union. However, all of them were international and intergovernmental rather than supranational in character and did not question national sovereignty. While the situation differed somewhat in all European states, the cases of Germany, Austria, Poland and Britain may serve as an illustration that all governments acted within the limits of a "political trilemma".

The crisis of autumn 1929 hit an already fragile German state, with high levels of unemployment and a political system at the brink of civil war. From March 1930 onwards Germany had no government with a stable parliamentary majority any more, but a series of cabinets that ruled either by presidential decree or by ad hoc majorities. The September election in 1930 showed another massive radicalization of the electorate, when (based on a voter turnout of 82%) only two major parties could increase the share of their votes: the communists from 10.6% to 13.1% and the Nazis from 2.6 % in 1928 to a spectacular 18.3%. The latter was directly related to a popular campaign from the far-right under the leadership of Hitler to fight a new international agreement on the settlement of the reparations question (the "Young-Plan"). The government of chancellor Heinrich Brüning relied more than ever on tangible success in the international arena to secure political support at home. And it was pushed by the environment around President Hindenburg to look for exactly this. The three most important elements on the foreign policy agenda were therefore revisionist in nature: to end reparations, to lift restrictions on Germany's market access to Eastern and South-Eastern Europe, and to remove restrictions on Germany's military capacity. In March 1931 the German and Austrian governments announced a preliminary agreement to form a customs union (Orde 1980, p. 52) that was considered as a serious threat in Czechoslovakia and caused a political confrontation with France. When the Austrian government attempted to secure an international loan in the wake of the deepening crisis of the Creditanstalt in May 1931 the French demanded a renunciation of the customs union. Negotiations over an international loan required more than two weeks that intensified the run on the Schilling. The loan that was finally arranged at the end of May 1931 was exhausted within five days (Kindleberger 1986, p. 361). Due to the still significant reserves of the Austrian Nationalbank this process continued for several weeks until September 1931 when the country was forced to introduce exchange controls and hence left the gold standard (Eichengreen

1992, p. 269). With the effects of the American depression spreading, and German creditworthiness in decline[6] the Young loan in June 1930 gave briefly some breathing space, before the political radicalization with the September elections triggered a significant wave of capital flight. Great branch banks such as Deutsche Bank, Danatbank and Dresdner Bank experienced large withdrawals of foreign (but not domestic) deposits between June 1930 and March 1931 (Schnabel 2004, p. 851). This was clearly related to their deteriorating liquidity positions but combined with mounting doubts by investors about the Reichsbank's ability to support these banks with foreign exchange in times of a crisis. It was in this situation that the Brüning government attempted to use the crisis and its very limited room for manœuvre as an opportunity to get rid of reparations once and for all. According to his confidant, state-secretary Hans Schäffer of the Finance Ministry, Brüning was convinced that the issue of reparations could not be resolved once the world economy started to recover.[7] His policy in 1931 can be described as an explicit effort to signal to the Allies that German goodwill was ultimately futile without far-reaching concessions on reparations. Without doubt, this policy involved great risks, but the same applied to potential alternatives. As described earlier, any signal of political "goodwill" during the crisis of 1931 essentially amounted to the announcement of radically deflationary policies. On the eve of a visit to the British prime minister, the cabinet had decided on another bundle of deflationary measures on an unprecedented scale that appeared to be unacceptable to the majority of the German parliament (Schulz 1992, pp. 357). During Brüning's stay in Britain, on 6th June 1931 the government published a carefully drafted statement that announced the deflationary measures together with a dramatic appeal that the German people had now reached the limit of its ability to suffer and needed relief from the burden of reparation (Schulz 1992, p. 382). The ensuing run on the Reichsmark came to a halt when several parties, including the moderate left, decided not to overturn the new budget on 16 June (Winkler 1993, p. 413) and president Hoover proposed a moratorium on war debts and reparations on 20 June to gain time for international negotiations. However, France showed strong resistance against the moratorium until 7 July. In the meantime, news spread about massive losses of Nordwolle, a textile company, which sparked a run on its main creditors, Danatbank and Dresdner Bank (Kindleberger 1986, p. 363). The remainder was a repetition of the events in Austria, but now in the setting of a "twin crisis" (Schnabel). International efforts to halt the run on the Reichsmark and support the Reichsbank in her attempt to bail out the banks were too little too late, largely due to disputes about reparations and Germany's ability to continue deflation. Between August and September Germany imposed

[6] There was actually one successful major international loan to Germany after the Young loan of June 1930, organised by Lee, Higginson and even with French participation, see Ferguson and Temin (2003), FN 67. However, the circumstances of this loan were rather particular and included not at least French demands for additional securities and further fiscal tightening in Germany; see James (1985), pp. 121ff. and Ritschl (2002), pp. 133-37.

[7] See the letter by Hans Schäffer to Hans Staudinger, 12. July 1952, cf. Schulze (1982), p. 351.

increasingly stringent exchange controls and hence defected from the gold standard (Eichengreen 1992, p. 276). Following the logic of the monetary policy trilemma, Germany should have been able to pursue expansionary policies after it had been forced to abandon the gold-standard, similar to Britain (from February 1932 onwards). In contrast, the German government continued its deflationary policy after the summer 1931, accompanied by political turmoil and heated discussions about the appropriate course of economic policy, which clearly contributed to the further political rise of the NSDAP (Komlos and Stoegbauer 2004). The Brüning government essentially tried to rescue Germany's integration in the European and world economy by (temporarily?) sacrificing democracy.

There is a vast literature on the German crisis, which I will not even attempt to summarize, but instead present a perspective on recent and ongoing research. Let us start with some data. Chancellor Brüning was dismissed in late May 1932; after the von Papen government, Hitler was appointed Chancellor in late January 1933. The data on manufacturing output (figure 1) shows that the crisis in Germany had reached its low point in July 1932, roughly coinciding with the conference at Lausanne that ended reparations. Orders to German machine builders started to increase in autumn 1932 (Buchheim 2008, p. 384) and the German Institut für Konjunkturforschung declared on 21 December 1932 that the German economy showed clear signs of recovery (IfK 1932, p. 151). But similar to the experience elsewhere this recovery was slow and could result in a reduction in unemployment only with a significant time lag and from an extraordinary level of German unemployment above 40% in 1932 (Galenson and Zellner 1957). The focus of the still ongoing debate is on the assessment of Brüning's economic policy between June 1931 and May 1932. Following the logic of the monetary policy trilemma, Germany should have been able to pursue expansionary policies after it had been forced to abandon the gold-standard, similar to Britain (from February 1932 onwards). In contrast, the German government continued its deflationary policy after the summer 1931, accompanied by political turmoil and heated discussions about the appropriate course of economic policy (see Borchardt 1979, 1990). In 15/16 September 1931, several leading German economists discussed the available policy options, including Colm, Eucken, and Roepke (Borchardt and Schoetz 1987). The explicit aim of the meeting, convened by the Reichsbank and the Friedrich-List society, was to discuss a stimulation of the economy, which was considered to be necessary to reduce mass unemployment. The discussion focussed on the feasibility of a credit expansion to fund public labour programmes as suggested by Wilhelm Lautenbach, a high-ranking official at the Economics ministry. In summary, the economists warned against any expansionary policy without international consent. Once the international constraints were removed, they recommended implementing expansionary policies without further delay. This paradox double-strategy was apparently also the one followed by Brüning, who prepared in early 1932 several expansionary programmes that were implemented by his successors von Papen and Hitler (Ritschl 2002, pp. 172-

176, Buchheim 2008, p. 391). But the crucial negotiations on reparations (and related to this war-debts) following the Hoover moratorium of June 1931 were delayed, not at least by elections in France and the United States, while unemployment and support for the NSDAP rose in Germany. When reparations were finally cancelled at Lausanne in early July 1932 (still subject to U.S. consent on a reduction of war-debts), Brüning had already been forced to resign and Hitler was within reach of power.

Hence, the question is whether expansionary economic policies to fight unemployment and kick-start the economy could have succeeded prior to the summer of 1932. The perceived risks of unilateral monetary or fiscal expansion ranged from another uncontrollable inflation, renewed pressures by the Allies such as another occupation of the Ruhr, to forced autarky. Holtfrerich (1982, 1990, 1996) and Temin (1989) argued that none of the alternative could have been more risky than the policy pursued: "even a certain amount of chaos on the way to recovery might well have been preferable to (…) the rise of Hitler" (Temin 1989, p. 73). While this is certainly true by hindsight, it can hardly do justice to the historical circumstances. First, the international risks of unilateral steps taken by Germany in 1932 were indeed considerable. The government must have weighted the risks based on the experience of the Ruhr occupation ten years earlier, which was followed by the dramatic collapse of the Mark. Second, expansionary policy would have been the remedy in the narrow logic of the macroeconomic policy trilemma, not in a broader sense of a "political trilemma". Clearly, the deflationary policies made things worse in the short-run. But from the perspective of spring 1932 it was far from obvious that any type of expansionary policy would have produced a significant and quick reduction in unemployment (and German economists and policymakers were rather more optimistic in that respect than most of their European counterparts in Britain and certainly France).[8] One notable aspect is that all parts of Germany's economy that supported the Weimar democracy (the moderate left, centre, and liberals) had an interest in Germany's re-integration into the strong economies of Western Europe and the US, because they saw a connection between integration and the liberal democratic regimes in the West. In contrast, both the traditional and the extreme right argued for protectionism or outright autarky. This may help to explain why Brüning could find a (silent) majority for many of his deflationary measures for so long in spite of public discontent, even among the moderate left. It also suggests a reason why an initially limited fiscal expansion under a right-wing alliance was so surprisingly effective, and why a Brüning government may not have done it: because German expansionary policy in 1932 under the prevailing reparations settlement essentially implied autarky, only the far-right could provide a credible regime change comparable to

[8] Recent studies cast doubts on the effects of fiscal expansion in Germany after 1933 (Ritschl 2003b, Weder 2006).

that in the U.S. (Eggertsson 2008, see also Temin 1989, pp. 112-117). Hence, the Brüning government ignored public opinion to keep the option of integration, which led to a political disaster. In January 1933 mass politics returned with the rise of Hitler and the NSDAP to power, accompanied by a disintegration from Western Europe and attempts to adjust the borders of Germany's economy to its political aspirations.

The case of Poland illustrates the trilemma from a different angle. The country had been reborn in 1918 as an independent state after more than a century of occupation by Prussia/ Germany, the Habsburg Empire and Russia, hence all political parties (with the exception of the communists) had Poland's national sovereignty at the top of their political agenda. The Piłsudski regime that ruled Poland since May 1926 was predominantly concerned with strategies to defend the independence and territorial integrity of the new Polish state against foreign aggression (especially from Germany and the USSR, see Wandycz 1988). Similar to Germany in 1929 it was a debtor country that relied heavily on capital imports. With the crisis of 1929, the Polish government reacted with desperate austerity measures to keep the country on the gold-exchange standard. The perceived risk that leaving the gold standard would produce monetary instability and capital flight was in part due to the Polish experience of hyperinflation until 1923 followed by a second inflation in 1925-26 (as for example argued in the earlier Polish literature, see Knakiewicz 1967). But in difference to other Central-European countries that experienced a hyperinflation in the 1920s (such as Austria or Hungary), the Polish government was afraid of an additional cost of leaving gold: loosing acess to „friendly" capital in terms of the political system of Versailles.[9] At the same time, the question of how to finance the urgent modernization of the Polish army came up again because the depression started to produce growing budget deficits and because the government feared the growing political instability in Germany. After a Polish attempt in July 1929 to negotiate a new French armament credit over 1.5 billion Francs had failed, renewed efforts to at least get the final installment of the 1921 credit – frozen since Locarno - succeeded in February 1931. The deliveries were scheduled for May 1931 until December 1933 (Ciałowicz 1970, p. 162f). In this political environment of 1931 it is hardly surprising that Poland followed neither Germany (still her largest trading partner) nor later Britain off gold – while Poland suffered the deepest decline of industrial production in the world. Here, the integration of capital markets was directly related to the defense of national sovereignty. In addition to a possible risk of inflation, the Polish government feared to lose access to French capital

[9] For example, in August 1931 (!) the Polish chargé d'affaires Muehlstein discussed in Paris the possibilities to replace the influence of German banks in Upper Silesia by French capital. "As long as the situation was normal, the fight with the German banks was very difficult, but now, when the German *krach* had undermined their authority, it would just be a political sin not to use this opportunity and not to try to replace the German capital by French capital", Own translation from a Letter of Muehlstein to Polish Foreign Minister Zaleski, August 8, 1931, cited after Landau and Tomaszewski (1964), p. 315.

when it felt to need it most. Polish monetary policy apparently hinged to a large degree on the strategic considerations of the authoritarian regime. This is supported by a private memorandum of late 1935 by W. M. Zawadzki, an eminent Polish economist, founding member of the Econometric Society, who served as Minister of Finance between 1931 and 1935 (Landau and Tomaszewski 1965). In this he recapitulated his monetary policy. Importantly, this memorandum was never meant for publication (see Landau and Tomaszewski 1965). Zawadzki stressed that his monetary policy was based on two principles: first, to finance the military (!) budget of the Polish state to which the whole economy must be adapted, and related to his second, to stick to the gold exchange standard. He describes his motivation for the latter as threefold: first, to gain access to foreign capital. Second, to avoid domestic turmoil after a destabilization of the currency that could undermine the authority of the regime; Zawadzki was apparently neglecting the fact that the implementation of fiscal austerity measures contributed to a rise in unemployment and could also undermine political stability. And finally third, Zawadzki mentioned the fact that a devaluation of the Złoty would "automatically decrease the military budget", because it would decrease its purchasing power abroad.[10] In addition, he was positively convinced that it was possible to overcome the crisis by a downward adjustment of prices,[11] and pursued this policy until his demission in October 1935. Polish economic historians agree that this policy of deflation was largely responsible for the significant increase in unemployment. Poland suffered through a severe economic crisis, with more deflation and a worse decline in industrial output than in other European countries. From 1932 onwards, a growing number of economists and politicians argued for a change in monetary policy, most notably the Kraków group around Krzyżanowski and Zweig that proposed in June 1932 a cautious devaluation without expansionary monetary policy; probably not a solution to the problem (see Knakiewicz 1967, p. 96). Members of the Central Bank's board were split over the question of devaluation in mid 1932, but Zawadzki as minister of finance had the final say (Karpiński 1958, p. 113). What is more, the number of industrial strikes, factories affected and hours lost during strikes, started to increase slowly in 1932 (Mały Rocznik Statystyczny 1939, p. 284). The authoritarian government certainly had tools to oppress this opposition not available to democratic governments, but it was also helped by several other factors. The very high share of agriculture in the Polish economy implied that the suffering of a large part of the population during the depression years was limited, as they were unaffected by unemployment and not threatened by starvation. As stated in the Economist "Polish peasants have been accustomed for centuries to hard work and privation. (…) They have plenty to eat and enough to wear, and to the great bulk of the population such problems as bank deposits, currency stability,

[10] Zawadzki (1935), reprinted in Landau and Tomaszewski (1965), pp. 127-151, here especially page 134.
[11] Ibidem, p. 132.

etc., are not matters of consequence."[12] Given the extreme decline in industrial output, the by European standards still comparatively low rate of unemployment is explained by the low share of industry in the country. Another factor that actually helped the Polish regime to stay on gold and tamed the political opposition was the suspension of the gold exchange standard in the US in 1933. Since the Great War, the dollar had been a de facto second currency, especially in the southern parts of Poland (due to the tight migration relations of Galicia to the US), used for hoarding but also for common bank transactions. After the dollar devaluation, many people exchanged their dollar holdings into złoty in fear of further losses, and the government perceived this as a gain in the currencies reputation. Besides, the depreciation also brought about a relief in Poland's foreign indebtedness, which had already started with the depreciation of the pound sterling, but most foreign debt was in dollar (Zweig 1944, pp. 62-64). Among the several effects of the death of Marshall Piłsudski in May 1935 was the political comeback of Kwiatkowski, "father of the harbour of Gdynia" who stood for the idea to reduce the economic dependency on German trade. In October 1935 Kwiatkowski replaced Zawadzki as minister of finance, and in December 1935 the Cabinet decided on a 4-year investment plan, that merged older plans for "big-push" industrialization to fight unemployment with plans for setting up a large-scale Polish armament industry to be concentrated in the "Security Triangle" formed by Vistula and San (see Strobel 1975, Landau and Tomaszewski 1999). In the meantime the economic pressure to finally release the "golden fetters" had increased sharply, with a large decline in Poland's reserves from mid-1935 onwards, mainly due to the imposition of new exchange restrictions in Germany and elsewhere. Poland's membership in the Gold-Bloc had become a mere façade without any economic foundations. The time to act finally came in March 1936 with the remilitarization of the Rhineland, when Germany de facto cancelled the treaty of Locarno. Poland signalled her preparation to support France in an armed conflict in the spirit of the 1921 convention, but France did not even react (Ciałowicz 1970, p. 216f). Moreover, the changing political climate in France, with an expected success of Blum's Front Populaire questioned the future of the gold bloc altogether (Mouré 2002, p. 209ff.). On April 9th, 1936 a National Defence Fund was set up by presidential decree to be equipped with 1 billion Złoty over the period 1937-40 in order to finance the modernization of Poland's army (Krzyżanowski 1976, p. 146), apparently in anticipation of a radical change in monetary policy. Only two weeks later, on April 26th another presidential decree introduced exchange controls, and thereby ended Poland's adherence to the gold-exchange standard. The half-official Monthly Bulletin of the state-owned Bank Gospodarstwa Krajowego (BGK), published in French, defended this step as follows: "Therefore, the introduction of exchange controls was not directly determined by economic difficulties. The Polish government saw itself forced to this radical step in the first place in order to fight the currency speculation, which has

[12] Economist, September 26, 1931, p. 568.

developed recently and to stop the tendencies of hoarding, encouraged mainly by events from the domain of international politics. The aggravation of the political situation in Europe and the threat of war had a negative impact on all countries and in the first place on the members of the Gold Bloc (…).” (BGK 1936, p. 2). Hence, only when all attempts to attract (esp. French) foreign support for the defense of national sovereignty failed, the government eventually started to fight unemployment and the industrial crisis in an effort to mobilize the domestic resources for military defense and hopefully economic recovery – an effort that proved to be futile in September 1939.

Finally, the economic and political developments in Britain after 1929 show that mass politics (nor democracy) had not to be sacrificed during the crisis, provided that policymakers considered the country to be strong enough to allow for a partial retreat from economic integration. However, until at least 1932 the most remarkable feature of British economic policy after 1929 was its similarity to that of other European states. When Germany was forced off gold in July 1931, attention of the markets turned to the other large weak gold currency, Sterling. From mid-July 1931 the Bank of England was losing gold at an alarming rate. In a situation of already very high unemployment, the incumbent Labour government was unable to agree on any further spending cuts that would have been large enough to calm the markets and the government fell in August 1931. The following “national government” under Ramsay MacDonald had to face the impossibility of further deflationary policies. It suspended convertibility on September 19 1931, and many European countries followed immediately. This was quickly accompanied by the introduction of protectionist tariffs, first with the Abnormal Importations Act in autumn 1931, followed by the Import Duties Act of February 1932 and the Ottawa agreement of summer 1932 that established a preferential trading zone within the British Commonwealth. Fearing the pressures from capital markets, Britain introduced a system of a managed float that allowed a significant devaluation of sterling but stood ready to intervene in the markets (Howson 1980). The Bank of England *increased* the bank rate to 6.5% accompanied by discussions about the course of future monetary policy. These discussions were “strongly coloured at the beginning by fears of a dangerous inflation” (Sayers 1976, p. 418). Even more so, officials at the Treasury continued the tight fiscal policy stance they had followed during the depression. Fiscal policy did not become expansionary before the extension of Britain’s rearmament programme in 1937/ 38 (Middleton 1981, Thomas 1983). What caused the recovery visible in price and output data then was the combined effect of devaluation in 1931 and a monetary expansion that started in early 1932. According to Broadberry (1986), the competitive gain of devaluation and growth impulse was particularly large in 1932. Given devaluation elsewhere and a significant reorientation of trade in the wake of a universal rise of trade barriers in terms of tariffs, quotas and exchange controls, the effective exchange rate actually increased from 1933 onwards

(Cairncross and Eichengreen 1983[2], p. 92). But from late February 1932 onwards, the Bank of England started a stepwise reduction of the bank rate. This new policy of "cheap money" was introduced once Britain had constructed safeguards against external pressure in the hope of recovery within the newly created economic bloc. For another part it was done to reduce the cost of government debt service and help to balance the budget, which was considered crucial to regain confidence in the markets (Howson 1975, p. 89). The consequent recovery was visible but not spectacular, at least in terms of unemployment rates that never consistently fell below 10% (Thomas 1988, p. 99). The experience in other countries of the "sterling bloc" was similar. In a broader perspective then Britain (and countries dependent on trade with Britain) chose the option of national sovereignty that is compatible with mass politics due to a partial retreat from economic integration.

III.2: The Euro-Crisis

The choices that policymakers in the 1930s had to face were essentially about economic integration, mass politics and democracy. The choices that policymakers face in Europe today are about governance structures, given economic integration: how to effectively regulate supranational markets, and how to design a framework for economic policies that is robust and credible. While different in many respects, the choices today as in the 1930s reflect fundamentally the same political trilemma.

In autumn 2008 a crisis that had started in the US housing market in August 2007 had turned into a global financial crisis. This was a largely exogenous shock to the European economy, where it put first financial institutions and next many companies under pressure. However it exposed the fragility of the Eurozone, which can be largely traced back to the mismatch between deeply integrated capital and goods markets and national policies. In the words of Baldwin and Gros (2010), the crisis highlighted the "home-grown" problems in the Eurozone, notably the uncoordinated fiscal policies that led several European countries enter the crisis period with already high debt ratios (some above the Maastricht criteria agreed in 1992) and had failed to foster competitiveness policies to reduce intra-European current account imbalances. Moreover, the mismatch between a transnational economy and national policies became clear in the area of financial regulation: national banking policies had failed to provide capital cushions that would have been sufficient to absorb difficulties in the periphery (notably Ireland and the southern member states) without putting the banking systems in the core at risk (Baldwin and Gros, 2010, p. 16).

Compared to the 1930s, the situation was very different insofar as member states of the EU and the Eurozone had already started to give up sovereignty to European "federal" institutions. The European Central Bank conducted monetary policy at the "federal" level, which allowed a swift response to the first wave of a liquidity crisis in 2008/9. However, the ECB was not equipped to guarantee financial stability of the Eurozone, because banking supervision at the “federal” level was (and still is) in its infancy. Moreover, two difficulties became apparent. First, monetary policy all over the world had only limited effects, especially the closer interest rates moved to the lower bound of zero. Second, in such a situation it is crucial that a central bank can “credibly commit to inflation” in order to affect market expectations and hence real interest rates. But the more the ECB would pursue expansionary policies, the more it was perceived as a “supranational fiscal agent” (Thomas Mayer) suspected by both policymakers and their electorate in the core of secretly bailing out the periphery. After national governments had acted quickly and boldly to borrow money for the rescue of banks and businesses – not least with the warnings from the interwar period in their mind – this had led to a large increase in government debt. In some cases debt levels that had already been high, started to look unsustainable. At this stage, investors started to realize the choices: to preserve integration of the EMU, the European governments would either have to find a way to coordinate their expansionary fiscal policies at the federal level (in terms of the ECB monetizing at least part of the sovereign debt or in terms of fiscal transfers), or to implement “national” policies of austerity measures that would face the pressure of mass politics. The risk that the first would fail and the second would be too costly at least in some countries led to a spiraling of their government bond yields, reflecting the risk of their exit from the EMU and partial debt default.

The current situation of the EMU reflects the search for a coordinated policy response in the face of mounting public discontent with restrictive fiscal policies on the one hand side and fears of the consequences of a Eurozone break-up on the other. The challenges are considerable. The economic challenge is that a credible policy response, which would have to be designed to weather another major crisis, needs to encompass both the deep pockets of European taxpayers and that of the ECB as lender of last resort. It also has to provide a European framework for financial regulation. But this needs to be implemented in a way that it does not undermine the independence of the ECB, nor fiscal discipline in EMU member states (Pisany-Ferry 2012). The political challenge is even more demanding: a credible policy response has to imply some further transfer of political sovereignty to the federal European level to avoid time-consuming political negotiations, without compromising political participation. In terms of Rodrik’s trilemma, the fundamental question then is, whether European policymakers will be able to transform democracy beyond national borders, or in the words of Paul De Grauwe “ how to embed the Eurozone in a political union”. However, the prospect of a full political union seems not very realistic in the next future; indeed there are signs of a nationalist backlash in many parts of Europe. According to De Grauwe (2010) a minimalist solution would involve steps towards a closer political union that address two major fault-lines of the Eurozone: first, policies that address the large current account imbalances that lie at the heart of rising debt burdens in the periphery and the massive exposure of the core (especially Germany) to this debt. One might add that there is also a need to develop a common regulatory framework for financial markets, including European bankruptcy procedures that allow the quick dissolution of financial institutions in distress. And second, De Grauwe argues for policies that allow acting quickly and on a sufficient scale in the face of another crisis: essentially an automatic insurance mechanism (De Grauwe 2010, p. 31) that would provide a robust fiscal capacity at the federal level. Here one might add that there is also a need for mechanisms that avoid the moral hazard, which goes with every insurance scheme. The recent agreement on a “fiscal compact”, which provides for debt-brakes enforced by the European Commission and the agreement on the European Stabilization Mechanism (ESM) address De Grauwe’s second point. But little is done to address the first.

The reason for this seems to be that policymakers still do not see the need to tackle the political nature of the crisis. The ESM and mandatory debt-brakes all reflect the intergovernmental approach to the European economy. But it is questionable whether these agreements are any more credible than the earlier versions of the Stability and Growth Pact. What is needed is a political legitimization of European federal policies that in effect has to transfer some political sovereignty from the national to the federal level. Otherwise, political pressures arising at the national level will always threaten these intergovernmental agreements. For example, it is essential that debt-brakes are introduced into the national constitutions. But if national constitutions can be changed now, they can be changed again in the future. To create a union that is both economically and politically sustainable, Europe needs effective policies that would address the large current account imbalances within the Eurozonethat are at the heart of the current sovereign debt crisis.. Such policies would have to address differences in labor market regulations, education policies, and bureaucratic procedures. As an example, the structural deficits that we observe in countries like Greece or Portugal are not only a result of a lack of competitiveness in particular economic sectors but stem to a considerable extent from specialization sectors that compete with the emerging economies of China or India. To change this pattern of specialization, it is clearly insufficient to reduce inefficiencies in the administration of these countries. Instead, Europe needs to invest heavily not only in the infrastructure but also in the education of its southern periphery. It is hard to see how this could be implemented without some very powerful federal institution. This in turn would require a clear and far-reaching political mandate. All this does not seem to be very realistic in the foreseeable future, but it seems to be the most promising way ahead. While still in their infancy, there are signs for the emergence of a European public sphere, with a strengthening European Parliament and a considerable intensification of political coordination among national political movements of related background. Europe will have to transform democracy beyond the national borders or it will not stabilize.

IV. Conclusion

Several observers have highlighted the parallels between the state of the Eurozone today and the US Confederation at the end of the 18th century and the beginning of the 19th (Bordo et al. 2011, Sargent 2011, Henning and Kessler 2012 among others). While the timing of events and many circumstances differed widely, the fundamental choices of policymakers are related: how should the political governance evolve in the presence of increasing economic integration? In the US it took until 1935 before a full political and economic union was reached, and history will not repeat itself in Europe. However, sovereign nation states in Europe today clearly face pressures to adjust to economic shocks that undermine their political legitimization. Their responses look increasingly like that of technocrats reacting to anonymous market forces that ignore the public voice. In this respect, there are parallels to the situation in the 1930s, where policymakers continued deflationary policies to avoid further economic turbulence. They neglected the political risk of these policies to their peril. While not entirely impossible, it is increasingly difficult and costly to contain the integration of markets for goods, capital and even of labor. However, the deeply integrated markets of today can only be effectively regulated and "tamed" at a level beyond the single nation state. Therefore, the main challenge to European policymakers seems to be how to transform a federation of sovereign national economies into a sovereign economic federation of Europe. With Jean Monnet: *Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.*

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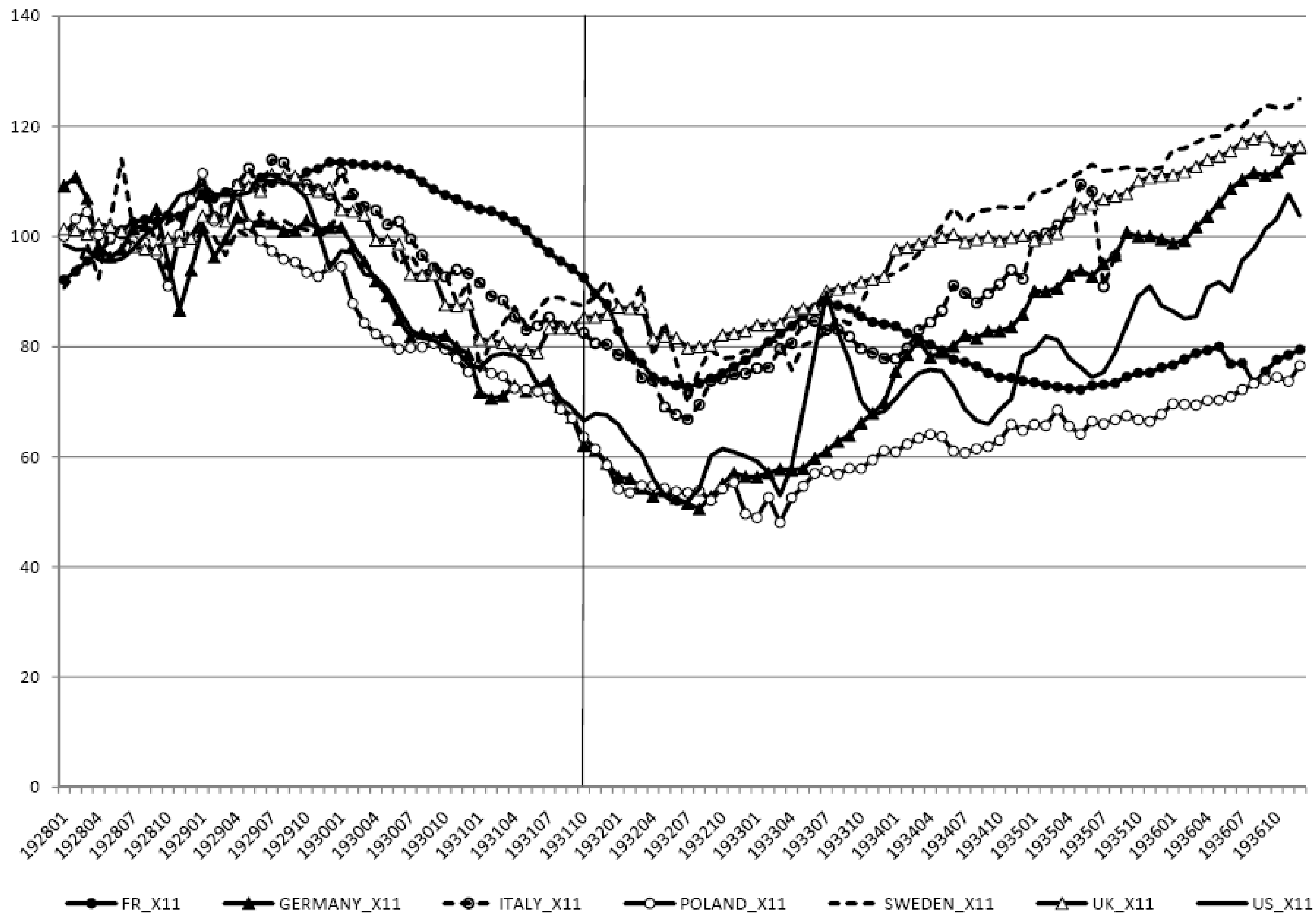
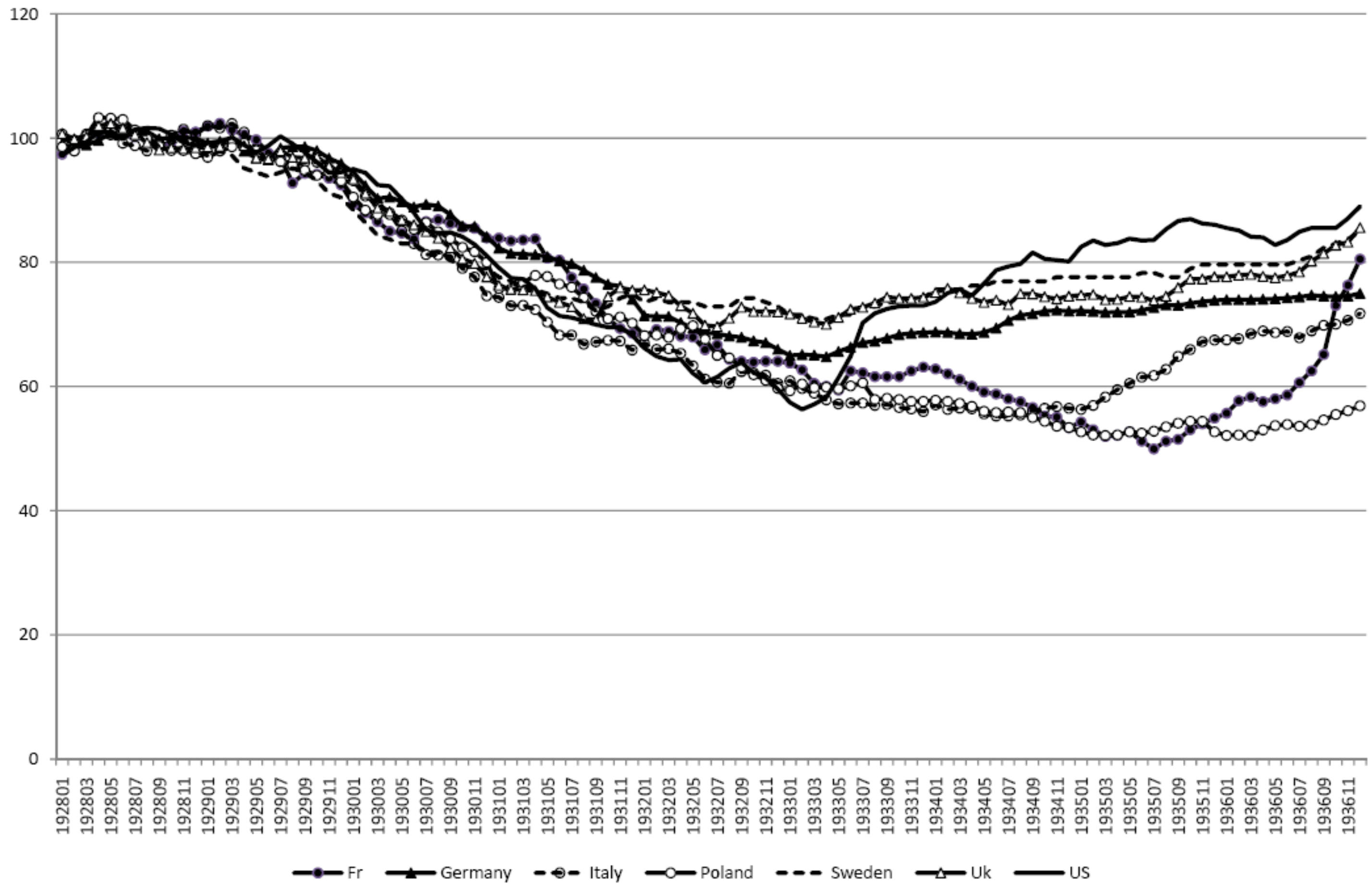
Figure 1: Manufacturing Output in Various Countries, 1928-1936 (1928=100)



Source: Wolf (2008)

Figı

Figure 2: Wholesale Prices in Various Countries, 1928-1936 (1928=100)



Source: Wolf (2008)

Table 1: Average Cabinet Duration (Years)

	1870-1913	1923-1939
Austria-Hungary	2.3	09. (Austria)
		1.5 (Hungary)
Belgium	3.3	1.3
France	1.3	0.6
Germany	1.9	1.4
Italy	1.5	1.4
Netherlands	2.3	2.1
Romania	1.3	0.7
Sweden	2.7	1.7
United Kingdom	1.7	1.3

Source: Banks and Textor (1971)

Table 2: Consumer Price Indices in Germany and France 1920-1926

	1920	1922	1924	1926
Germany (1914=100)	990	14602	128	141
France (1914=100)	371	315	395	560

Source: Feinstein, Temin, Toniolo (2008), p. 40

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