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Memo to Euroland: You Cannot Run a Gold Standard in a Democracy
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It has always been more than just a little intriguing why the only policymakers on the planet to have fully embraced all tenets of the Washington Consensus were Brussels' Eurocrats. Maybe it was because they never had to worry about running for office or being re-elected. While the whole world is adopting a pragmatic consensus on economic policy, Europe – and Germany in particular – is sticking to the neoliberal orthodoxy that reigned only briefly about twenty years ago. The euro crisis has put a serious cloud over Europe's bold decision at Maastricht in 1991 to bury the embedded liberal compromise that outlasted the collapse of the Bretton Woods regime everywhere else in the world. While from the US to Russia and Japan, and from Brazil to India and China, everybody talked the talk of market discipline and strict economic policy rules during the early 1990s; in practice they were all careful enough to preserve their domestic fiscal and monetary policy levers with a variety of capital controls, exchange rate measures, and downright prohibitions.

No such caution in Europe. A 'one size fits none' monetary policy by an independent central bank that cannot act as a true lender of last resort, a Brussels imposed pro-cyclical fiscal straightjacket that has not served a single euro member state well, and intra-European financial markets with "national" regulatory institutions and no Europe-wide deposit insurance or common debt instrument to absorb the flight to safety have pushed the eurozone in an existential crisis with no real end in sight. The euro experiment raises serious questions about the future of building legitimate institutions outside of the nation state framework with lessons for regional integration in the rest of the world.

In order to understand the Eurozone's current predicament, it is useful to see Europe's Economic and Monetary Union as an intra-EU gold standard system: a fixed exchange rate system with strict rules for external adjustment and therefore a deflationary bias. Examining the role of the gold standard during the Great Depression during the 1930s in his most famous book *Golden Fetters*, Barry Eichengreen convincingly argued that the system was structurally flawed and was one of the central reasons why the worldwide slump was so deep and lasted so long. The gold standard only worked well in the depoliticized environment of the *Belle Époque*, when the electoral franchise in most advanced economies was limited to wealthy men and labor union power still non-existent. Financial elites across Europe and America could comfortably run a system focused on "external equilibrium" (automatic balance of payments adjustment guaranteeing stable money) rather than "internal equilibrium" (full employment and high growth). The commitment to the gold standard and the value of the world economy's major currencies were never anywhere in doubt. The result was deflation, which only further enhanced the power of creditors and weakened the hand of debtors.

During the tumultuous years of the interwar period, Eichengreen pointed out, significant political changes had made a successful return to the gold standard impossible. Political and economic elites could no longer ignore the demands of their electorates and due to the growing power of labor and social democratic parties the focus had to shift towards maintaining internal equilibrium. Popular legitimacy was now at the heart of any successful economic policy, and the countries that stayed on the gold standard the longest (i.e. France), suffered the most, while the countries that left the gold standard early (i.e. Britain), saw a relatively quick recovery in the 1930s. The lessons of that period were enshrined in the Bretton Woods system of what John Ruggie called the compromise of "embedded liberalism." Countries would maintain a fixed-but-adjustable peg and keep their monetary independence through capital controls while committing to a liberalizing world economy by gradually lowering their barriers to trade. The Bretton Woods system essentially provided sovereign states a menu of choice between four different national shock absorbers in the case of an economic crisis: inflation, deflation, devaluation, and default, with the latter always thought of as a last resort. Most European countries used at least three of those four instruments during the postwar period, which allowed them the flexibility to deal with economic shocks depending on their specific national economic contexts. In the end, it was a national government's choice which path out of a crisis they followed, and no supranational entity could impose that choice. The responsibility always lay with the national political elite.

The economic turmoil of the early 1970s saw the collapse of the Bretton Woods fixed exchange rate system, given the gradual abandonment of capital controls, the dollar overhang, and the growing integration of international trade and finance. But interestingly enough the four national shock absorbers of inflation, deflation, devaluation and default were preserved everywhere. The US, Britain, the Scandinavian countries, Switzerland, Canada, Japan, Australia and New Zealand all introduced relatively flexible exchange rate systems with independent central banks, thereby maintaining their monetary independence and keeping the options of inflation and depreciation (which now replaced devaluation) firmly on the table.

Continental European countries initially pegged their currencies to a currency basket, the European Currency Unit (ECU), de facto letting the Germans run their monetary policy, already making one option – inflation – much harder. But it was not until the signing of the Maastricht Treaty in December 1991 that the Europeans decided to "dis-embed" liberalism once and for all by giving up not one but two of their shock absorbers – inflation and devaluation. With the creation of the single currency governed by a European Central Bank with the sole mandate to keep inflation just "below but close to two percent," and a Stability (and Growth) Pact to make sure fiscal policy would not be abused for domestic purposes, François Mitterrand and Helmut Kohl managed to reconstruct the gold standard – with all of its flaws – in a purely European setting. Given that the ideological consensus then was that one cannot trust politicians with one's money, the Economic and Monetary Union seemed to be well ahead of the curve. The relatively rapid economic convergence in the 1990s after the EMS crises of 1992-93 and the initial success of the euro in the early 2000s seemed to confirm Europe's audacious plan for monetary union.

Since the euro crisis took the European policy elites by surprise in the spring of 2010, it has become painfully clear that the Brussels-imposed deflationary austerity measures do not work, lack all popular legitimacy, and make the crisis go from bad to worse. It is one thing for the British to follow the austerity road given that this is the path their own government opted for. But it is quite another thing for Greece or Spain to be forced to implement draconian spending cuts by Brussels and Frankfurt, or for a democratically elected prime minister in Italy to be forced out in favor of a former European Commissioner to introduce 'unpopular but necessary' structural reforms. In the end, the euro crisis has underscored that democratic legitimacy remains first and foremost with the member states and their national elites. States still control fiscal policy and fund their national welfare states, which are bigger and more popular than ever, and are at the very heart of any European country's politics. Every euro area member state has its own peculiar welfare state makeup and historically and culturally determined priorities for economic policy. The EU's strength was always that it tried to celebrate and preserve this diversity. However, trying to make all euro members more like Germany is bound to result in an anti-Europe and anti-German backlash.

It seems hard to imagine that the current strategy of 'muddling through' can last, which leaves Europe with two serious options out of the current crisis. One option is to try to re-embed liberalism at the EU level by broadening the ECB mandate to also focus on growth and employment (making it more like the Fed in the US), for Brussels to start issuing commonly held Eurobonds, and to construct a fiscal and banking union together with a political union. This option entails an unprecedented transfer of democratic national power to the EU level for which there is simple no popular platform since it would end any notion of a sovereign nation state in Europe. This has arguably already happened in Europe's periphery with dire consequences.

The other option is to dissolve the euro and to go back to the common market of the mid-1980s. The advantage of the second option is that it would bring back the two lost shock absorbers of inflation and devaluation, restore the national economic sovereignty of states like Greece, Portugal, Ireland, Spain and Italy, and no longer give national politicians the excuse to blame Brussels and the EU for unpopular economic measures. The disadvantage of the second option is that it is not clear that the European project can survive such a dramatic slide backwards in its process of integration. But then, as Alan Milward taught us in the 1980s, states only agreed with further steps in the process of EU integration insofar as they were convinced of the benefits of those steps in the first place. Since many states are now thinking that the euro indeed was one step too far, we should not be surprised that they might at some point decide to go back one step.

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