Democracy and (Dis)-integration
The conditions for a legitimate and effective economic and political organization

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Robert Schuman Centre for Advanced Studies

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Abstract

Our aim in this paper is to address the big questions of today’s European Union, more specifically, the Union’s deep legitimacy deficit that touches upon all aspects of input, throughout and output. We make three main points. (1) That the current crisis of European integration is to be understood as a manifestation of a broader question that concerns the conditions under which liberal democracy and a market economy may be made compatible. (2) That the long-term dynamics of European integration is driven by the inherent tension in democratic systems between representative and effective governance. (3) That the most urgent task facing European integration research is the normative imperative to rethink effective and legitimate democratic practices – who is involved, at what level, in what capacity, together with whom – and to redesign the boundaries of democratic governance between the EU and the member states.

Keywords

European Union, liberal democracy, market economy, legitimacy, effectiveness, rescue of the nation-state
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1. Introduction

The Eurozone crisis placed a problem on the political agenda that had seemed solved since the post-1945 period, namely the compatibility of capitalism and democracy. The governance of the common currency, from the start, was based on the conviction that only a politically independent central bank would safeguard stability. Since the onset of the crisis, also democratic governance of fiscal policy is considered a potential threat to stability as the Fiscal Compact seeks to anchor a balanced budget rule in the constitution of each member state. Restoring market confidence in the Euro required that, as Chancellor Merkel once put it, democracy be market conforming. The conflict between democracy and the requirements of the common currency became particularly acute in the countries subjected to the conditionality of the so-called Troika. Since the Troika concluded that flexible labour and product markets in combination with budget surpluses were required to make their membership in the common currency viable, governments in the GIIPS countries found themselves engaged in policies of cutting wages, undermining labour’s bargaining power and dismantling welfare arrangements against the wishes of a majority of their electorate.

This conviction that political democracy is inimical to the requirements of a stable currency is not new to Europe. While several scholars have pointed to striking economic similarities between the current crisis and the Great Depression (Eichengreen 2015; Eichengreen & Temin 2010; O’Rourke & Taylor 2013), political dynamics also are increasingly reminiscent of the interwar period; in particular increasing polarisation and fragmentation of the party system and the rise of extremist and populist politics. Though all countries had to grapple with the issue of how to reconcile the demands of the Gold Standard and democracy, tensions also then were most acute in the indebted periphery. As the primacy of politics over fiscal and monetary policy sparked massive inflation, and hyperinflation in Austria, Germany, Hungary and Poland, the League of Nations set out to return the periphery to monetary stability by means of resurrecting the Gold Standard. This highly interventionist programme frequently bought financial stability at the price of democracy (Clavin 2013: 25 – 33; Polanyi 2001: 241).

The globalisation backlash provoked by the Great Depression eventually removed the tension between democracy and the market by establishing the primacy of politics over the currency. In Western Europe, a highly successful, and in its nature social-democratic, socially inclusive political arrangement was established (Berman 2006; Ruggie 1982). From now, international financial transactions, as well as trade could be interfered with when in conflict with the requirements of internal balance while, if necessary, the parity would be adjusted to wage cost developments rather than the other way round. The result was the so-called Trente Glorieuses, the only monetary and financial regime that has managed to combine high growth, monetary and financial stability, low unemployment and social inclusion.

The early form of European integration dovetailed with this ‘embedded liberalism’ as it was designed to help the member states cement the new social contract: a ‘European rescue of the nation state’ in Alan Milward’s (2000) felicitous words. However, since the 1980s European integration took a distinct neo-liberal turn as it increasingly reduced the policy tools available to national governments while seeking to enforce the primacy of the economy (Chiti, Menéndez & Teixeira 2012; Schulz-
Forberg & Stråth 2010). The Single European Act (SEA), Monetary Union (EMU) and the Single Market in Financial Services (SMFS) were the most important waymarks along this road. Yet, as in the interwar period, this liberal solution proved unstable. The combination of depoliticisation and the economic pathologies of heightened volatility, high unemployment and increasing income inequality, similarly to the ‘double movement’ documented by Polanyi (2001), provoked an anti-globalisation / Europeanisation backlash. This historical sequence raises two question. How did the EU stumble into a mode of economic governance that repeated many of the errors of the interwar period, and what are the prospects for a form of European integration that is socially inclusive and thus able to command sufficient political support?

In this article, we interpret the history of democratic governance in Europe from the end of the First World War until the present as an oscillation between the requirements of responsive and effective governance. We suggest that the turn to liberal policies should be interpreted as a reaction to periodic failures of the interest aggregation function of politics, which leads states reassert their autonomy over civil society, with or without the help of external actors. From this follows that the primary task the EU currently faces is to rethink its instability-prone form of economic organisation, so as to provide again that output legitimacy that west European states managed to furnish during the first three decades after 1945, while avoiding the excesses in participation and the disintegration of political aggregation that brought down Europe’s hitherto most successful political and economic regime in the 1970s.

The remainder of the paper is structured as follows. Section 2 argues that neither the changing nature of European integration nor its popular contestation can be understood within the framework of standard theories. Section 3 sets out the core argument. Section 4 illustrates our view by means of a comparison of the interwar gold standard and post-war monetary integration. The final section seeks to draw some tentative implications for rethinking European integration.

2. Integration Theory and the Second Rescue of the Nation State

(Neo)-functionalism, was inspired by neoclassical trade theory in which integration benefits all members, from which it then became possible to argue that when integration displays its benefits in one sector, political pressures will mount in favour of further integration. Admittedly, the ECSC model of integration was not extended to other sectors and the Empty Chair Crisis set limits to the integrationist zeal of the Commission. Still, in October 1971 the member states approved the Werner Plan for monetary union.

Member states had apparently recognised that, in order to draw the full benefits of the customs union, fixing exchange rates would be required. Yet, despite continuous prodding by the Commission, the Werner Plan proved to be stillborn. With the first oil price shock leading to a distinct drop in growth and the emergence of mass-unemployment, governments were unwilling to forsake a crucial element in their macroeconomic toolbox. Moreover, the economic dislocations of the 1970s revealed strongly divergence policy preferences between more liberal minded states, for whom reducing inflation became paramount, and their more interventionist brethren, that would rather prioritise low unemployment. In this constellation, as Everling (1980: 218) remarked, “the political and social forces in the member states cannot be overlaid or neutralized by the automatism of a monetary regulatory mechanism.” Nor was EMU the only victim of policy divergence. Though the customs union remained intact, non-tariff barriers proliferated in an effort to provide more tools to stimulate the economy. In short, decision-makers violated a core precondition of functional spillover, namely that they “do not anticipate that further integration in one area may create problems in other areas, which in turn would lead to further (possibly undesired) integration (so that they refuse to take the first integrative step)” (Nieman & Schmitter 2009: 58).
As the decade ended, policy divergence gave way to convergence on a neo-liberal model consisting of four main pillars. First, with the SEA, the trend of the seventies to create barriers to internal trade was reversed. Second, although already contained in the Rome Treaties, competition policy had remained a dead letter. Since the mid-1980s, however, both the Commission and the ECJ started to enforce an interpretation of competition policy that saw the earlier practices as a violation of common market principles. Third, policy preferences converged on exchange rate rigidity, from the birth of the (soft) EMS in 1979 via its hardening in the mid-1980s, to the Maastricht decision to adopt a common currency. Fourth, while article 67 of the Treaty of Rome had called for the abolition of controls on capital transactions, the 1960s and 1970s instead witnessed an intensification. Only in 1988 could the member states agree on directive 361/88 that implemented article 67.

EMU was no relaunch of the Werner plan. The latter was wedded to the embedded liberalism of the post-war years in that it accorded a role to monetary policy also in stimulating growth and employment; in postulating the need for a European budget that could be employed for macroeconomic demand management, and in suggesting an EU-wide industrial policy. In short, the Werner plan was an exercise in positive integration while EMU largely was an exercise in negative integration. Under EMU, monetary policy was to focus only on the price level while its institutional setup sought to prevent any political intrusion by creating a central bank of unparalleled independence. As envisaged by the Stability and Growth Pact (SGP) of 1996, the Euro was not to be complemented by an EU fiscal capacity but by institutionalised austerity. Finally, in preparation for the common currency, member states agreed to abolish capital controls by 1994, leaving them five years to demonstrate that they were pursuing sound policies.

The Maastricht Treaty heralded the end of the permissive consensus. The Treaty became highly politicised with polls indicating that in Germany and the Netherlands, there was only a very slim majority for EMU, if at all. Of those electorates that were allowed to express their opinion, France only managed a “petit oui”, while Danish voters required an opt-out from the Euro before approving the treaty. The French and Dutch “No” to the Constitutional Treaty in 2005, and the Irish “No” to the Lisbon Treaty in 2008 were other signposts marking the gap between elite and popular opinion, eventually culminating in the UK’s exit from the Union, frequent resort to differentiated integration, and the rapid rise of EU-critical parties.

Standard theories of European integration do not provide an adequate explanation of these dynamics. Concerning the rising popular contestation of integration, both the intergovernmentalist and neo-functionalist approaches could rightfully be asked the same question that the British Queen addressed to the economists of LSE in November of 2008: “Why did nobody notice it?” Though some claimed that notwithstanding its demise in the late 1960s the Eurocrisis confirmed the functional spillover hypothesis (Cooper 2011), the prediction of a “relaunch” of integration proved misguided. Schmitter’s neofunctionalism, in contrast, did allow for the possibility of disintegration (spillback). However, it never specified clearly under what conditions these might occur, though most likely they would be informed by motives of defending national identity, sovereignty and tradition against encroachment by supranationalism (Nieman & Schmitter 2009: 56). Moreover, as both theories accorded a critical role to organized sectoral interests, it became hard to explain why a profound divergence between elite and popular views could emerge at all, and why opposition to integration was voiced by new parties and the ballot box, rather than by organised interests.

Being focussed on explaining whether the process advanced and who drove it, integration theory never paid much attention to the changing nature of integration. Instead of endogenising preferences and asking why states had come to prefer a liberal versus an embedded form of European integration, they were content to refer to exogenous change. Convergence on neo-liberal integration was

3 Directive 72/156/EEC reversed the first directive on the implementation of article 67 of May 1960, as it required member states to equip themselves with the measures to curb speculative capital flows. In contrast to functionalist thinking, the 1972 directive implied that financial integration was a potential threat to the common market.
commonly explained as a result of a change in external economic conditions (Chiti et al 2012: 393; Scharpf 1999: 43-46); as the outcome of an exogenous shift in policy ideas (McNamara 1998); or by a decision-making process that was structurally skewed in favour of negative integration (Scharpf 2009). We hold none of these explanations to be convincing.

The ‘globalisation school’ interprets the interwar social contract as having favoured labour at the expense of business. As globalisation furnished capital with an exit option, that social contract no longer was tenable and had to be torn up in the interest of business. But given that the smaller European countries during the 1960s already displayed a degree of trade openness that exceeds the current level of larger countries, it is unconvincing to postulate a qualitative break somewhere during the seventies. For example, trade as a percentage of GDP in 1960 amounted to 76.3% for Belgium, 66.6% for Denmark, 64.8% for Ireland and 95.9% for the Netherlands. This is higher than the 2015 figures for the United Kingdom (56.5%), Italy (58%), Spain (63.8%) and France (61.4%) while Germany in 2015 (86%) had not reached the Dutch level of 1960. Moreover, while many countries operated restrictions on capital account transactions, foreign direct investment (FDI) in many cases was less restricted. The complaint in 1960s Europe was rather one of excessive inflows of US capital, suggesting that the European climate was not adverse to business. More importantly, globalisation is not an exogenous force but the creation of states. If external forces had pushed European governments to abandon the priority of internal balance against their will, one would have expected a form of integration that tried to construct a steering capacity at the European level to compensate for what had allegedly been lost. Accordingly, the globalisation view is hard to square with the neo-liberal nature of European integration since the 1980s. Moreover, this regime has proven immune to the balance of political power in the member states as neither the “Third Way” promoted by the social democratic governments that ruled a majority of member states during the late 1990s and early 2000s, nor individual social democratic governments have challenged its basic orientation (Bailey 2005).

Fritz Scharpf (2009, 2010) attributed the predominance of negative integration to the constitutionalisation of a liberal regime through the rulings of the European Court of Justice (ECJ) and its extensive interpretation of the four freedoms, while consensus requirements together with the wide diversity of the member states made the creation of such capacities at the European level infeasible. Yet, the type of liberalisation that could be pushed through by the ECJ and the Commission against the wishes of the member states applied largely to competition policy and state aid and not to the core macroeconomic elements of the post-war regime. Directive 361/88, the SGP, the SMFS and the Euro itself were not the result of constitutionalised liberalism, but of political agreement. Moreover, as Scharpf (1999: 61-63) himself noted, both the ECJ and the Commission traditionally are careful not to get too much out of line with the prevailing mood in the member states, so that the activation of competition policy occurred after member states had set in motion the train towards the SEA, i.e. after a change in preferences at the national level. That a social democratic vision of Europe lost out to a liberal one cannot be blamed on the EU decision-making process but merely reflects the fact that most European governments, including social democratic ones, had lost trust in the old recipes.

Constructivist approaches explain preference convergence as an outcome of the socialisation engendered by participation in European integration or to the emergence of new ideas (Checkel 2005), often prepared in well-funded liberal-conservative think-tanks and strategically taken up by the Commission (Schmidt and Thatcher 2013, Jabko 1999). The socialisation variant would require linear progression and thus is incompatible with the current and the 1970s backlash against integration. To argue that policies changed simply because governments now entertained different ideas, assumes that ideas have no roots in societal developments and thus comes closer to a tautology than to an explanation. Old ideas are hardly discarded when they provide satisfactory results. The resurrection of economic liberalism did reflect growing dysfunctionalities, and they were much of the same nature as what had driven interwar liberalism.

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4 Source: World Bank, World Development Indicators Database.
3. Representative versus Effective Governance

Political theory has long recognised a tension between participation, responsiveness and effectiveness. In Alexis de Tocqueville’s tradition, pluralist theories extolled public participation as enhancing the quality of democracy. Participation through interest groups would result in a broader representation of interests and a more informed and involved electorate. Given that the essence of democracy is government not only for, but by the people, more participation per definition means a more complete democracy.

At the same time, it has been recognised that intensified participation may foster polarisation and a diminishing capacity of the political system to aggregate interests and to reconcile contradictory demands, thus leading to government overload and eventually a challenge to governance itself (Berger 1981, Rose 1980). While extolling the rights and liberties of individuals and the uniqueness of their interests and ideas, liberal thought also recognizes the problem of reducing their range to an actionable number as a central. It is not by chance that liberalism considers a certain dose of political apathy as unproblematic. If all citizens were always constantly politically active, they would create problems of overload. Whether in its individualistic version or interest-group version, liberalism sees in the spontaneous activation of citizens on behalf of their interests the foundation of politics and, at the same time, the source of potential problems.

The classic formulation of this view was penned in the mid-1970s by Samuel Huntington (1975, also Bell 1967, King 1975). For Huntington, proliferation of interest groups had given rise to a demand overload on governments. Mancur Olson (1971) hypothesised that because of the diffused cost and concentrated benefits of most market distorting policies, civil society would be dominated by distributional coalitions that would undermine economic prosperity. With the interwar political mobilisation in mind, Almond & Verba (1963), similarly warned against the dangers of excessive public participation, and saw the key to democratic stability in an allegiant culture that combined modest levels of participation with allegiance to the political regime. Schumpeter’s (2003: 272-3) plea for an authoritarian elite-driven democracy that limited popular political participation to voting, similarly reflected interwar experiences. In his groups theory of politics, David Truman welcomed the political “slack” that apathetic citizens create, as this reservoir of energies is available to be mobilized in case politics turns “morbific” (Truman 1951). Keeping the number of collective subjects whose interests and ideas concur to forging the collective will small is a distinguishing trait of liberalism. The maximum feasible mobilization propounded in the Sixties and stigmatized by Theodeore Lowi (1971) must be carefully avoided.

Pitkin points to a similar tension in the parliamentary arena. Representation is “acting in the interest of the represented in a manner responsive to them” (Pitkin 1967: 209), but the correspondence between citizens’ wishes and authoritative decisions is and should be far from tight. Representatives cannot limit themselves to being the spokespersons of their constituents, but must engage in a deliberative dialogue with other representatives, which may lead them to agree to policy decisions that stand at some distance from their constituents’ desires. It is the duty of good representatives to understand how to best serve the interests of their constituents in sometimes innovative and unexpected ways. The good representative thus escapes the Burkean dilemma and is neither only a delegate nor only a trustee (Pitkin 1967: Ch. 8). According to Pitkin, to represent implies accepting this tension and being able to both distance oneself from the immediate expression of the constituents’ demands, if this should prove necessary to better serve their interests, and to explain to them why this was necessary. While it implies accepting to be sanctioned for failing to convince them, it also implies that democracy may become dysfunctional if representation degenerates into pure responsiveness.

The original distinction between delegate and trustee was developed by Burke in 1774. At the time, the idea that individual citizens rather than communities were the object of representation had not yet

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5 Pemberton (2009: 583), saw the 1970s as a decade “in which the very future of the British state could be doubted,”
become part of political theory or of institutional practice. Burke’s words, although traditionally interpreted as a statement of the Whig conception of representation as trusteeship, are rather more subtle and warrant the interpretation as an injunction to conceive of representatives neither as delegates nor as trustees but to strike a balance between these two (Morris 2012). More appropriately, he may be considered to subscribe to what today is called “virtual representation” (Pitkin 1967: 175). In inviting the electors of Bristol to accept that their commercial interests would be represented equally well by the representatives of Birmingham, he was suggesting that it is not individual interests in their singularity that are worthy of being represented, but the categorical interests to which they give rise. In other words, the act of representation transforms singularities into collectives.

Also for Nadia Urbinati, “political representation … entails a complex political process that activates the sovereign people well beyond the formal act of electoral authorization. Representative government has the power of unifying and connecting the ‘fluctuating’ ‘atomic units’ of civil society projecting citizens into a future-oriented perspective” (Urbinati 2006: 5). And again: “Representation can never be truly descriptive and mimetic of social segmentation and identities because of its unavoidable inclination to transcend the ‘here’ and ‘now’ and to project instead a ‘would-be’ or ‘ought-to-be’ perspective that translates almost naturally into advocacy” (Urbinati 2006: 6). This is the distinguishing trait and unique feature of representation: that, in the act of being represented, the multitude of individual interests get aggregated into a finite number of wider categorical interests in the name of which political programs can be proposed. Representation is never an act of mere mirroring of existing interests, but one of forging collective subjects that may have not known to exist before being represented. Representation, in the words of Michael Saward (2010) is claims-making. Individuals may accept these claims and validate the categorical interests and the collective identities that are proposed to them or reject both. The process of representation is therefore a highly creative one. Through political representation, the inchoate many become meaningful few whose interests and ideas can be prioritized into workable political programmes.

We can conclude that the balance between responsiveness and responsibility that must be struck by individual representatives in their relationship with their constituents must also be achieved between the total sum of the demands placed on any political system and the externalities that these create to other political systems and also to itself.

In the Eighties, neoliberalism mounted an assault on the idea of democracy minimally understood as self-rule, as a communicative space for openly debating the conditions of our common existence, allowing all citizens to be the authors of the laws that govern them (Bohman 2012). It replaced this idea with two traditional tenets alongside (negative) freedom as safeguards against the possible pathologies of democracy, although never in a place of such pre-eminence. The first is that politics is the source of diffuse rent-seeking behaviour. Politicians cannot be trusted to tend to the long-term welfare of their citizens but rather, driven by their short-term interest in re-election, will dole out particularistic concessions to the most powerful interests in exchange for political support. This will in the long run create an overload of demands that will bankrupt the economy. The second is that markets are better at regulating economic activity so they should replace political intermediation whenever possible, also in areas normally entrusted to political debate and deliberation. The upshot of this dual assault on political intermediation was the deregulation of markets and the displacement of those diffuse interests that must organize and gain access to the political process in order to register their claims. This drive towards dis-intermediation, though plausible in the overinflated and apparently out-of-control context of the Seventies, therefore, unevenly hit organized interests and removed many regulations designed as social safeguards and backstops in case of market failures. Some interests, though, still had access to politics through individual lobbying and through the production of hegemonic ideas.
4. A Short Version of the Long History of European Integration

4.1 Pathologies of Neo-Liberalism

At the core of liberalism's failure to maintain sufficient political support lies another aggregation problem. While shifting the emphasis from public intervention as a corrective of market outcomes to competitiveness as the wellspring of prosperity did reduce the demands on and the responsibilities of the state, it also enthroned a fallacy of composition as the principle of policy-making. In analogy to firms, states were now to succeed through a competitive race with their rivals. But competitiveness is a relative term. Hence the new liberal orthodoxy in fact abandoned one of the main tenets of textbook liberal trade theories, namely that international trade is a positive sum game and reinstated a mercantilist view in which the most competitive would succeed while the others would fall by the wayside. While the attempt to gain prosperity by reducing costs below those of the competing nations introduced a deflationary bias in the world economy, the rigid nominal framework European nations had given themselves by enthroning inflation-targeting central banks and the sanctity of the parity further reinforced the tendency (Bagnai 2016; Micossi 2016). In contrast, the embedded liberalism of the post-war period had recognised that adjustment of the parity in case of fundamental balance of payments disequilibria was preferable to depressing the domestic economy. Nailing countries to a golden cross in the mid-1920s and to a Eurocross after 1999 imposed austerity and tight money as the solution.

But the new monetary orthodoxy also failed to restore growth irrespective of balance of payments constraints. In the political economy, as in other social system, the individual actors work under constraints that are the outcome of the sum of the decision of the individual actors themselves. This inherent self-referentiality implies that an equilibrium solution requires a focal point, a regime that shapes the expectations of the individual actors (Bicchieri 1997). Expectations of high growth rates will suggest to individual entrepreneurs the need for high investment; the outcome will be one of high growth rates, which will justify ex-post the high investment that caused them. While the switch to the new monetary orthodoxy provoked an immediate crisis, it also had longer-term effects as central banks, freed from any concern for growth, provided a focal point for low growth expectations. Accordingly the turn to neo-liberalism has given rise to secular stagnation (Baldi & Harms 2017; Summers 2016); an economic constellation marked by low investment despite historically low real interest rates, high returns on capital, a long-term declining growth trend, as well as lower total factor productivity growth despite rapid technological changes as low investment rates slow the spread of new technologies, and wage decompression promotes low productivity sectors. Instead of restoring growth, the new dogma thus created a problem that undermined political support, namely rapidly increasing inequality in wealth and income. As Piketty (2014) has shown, with the return on capital exceeding the growth rate in both pre-Great Depression and post-1980s liberal regimes, the distribution of wealth became dramatically unequal, thus undermining the credibility of the meritocratic principles that undergird democracy.

Moreover, while the restoration of unfettered international financial markets both in the mid-1920 and since the 1980s was conceived as a disciplining device of ‘unsound’ policies, in both instances international finance itself became a source of crises. Both periods were characterised by massive macroeconomic imbalances between debtor and creditor countries, a hypertrophy of speculative finance, destabilising financial flows and an escalation of banking, currency, and debt crises. Eichengreen & Bordo (2002), e.g., counted 9 banking crises and 37 currency crises in emerging and industrialised economies for the period 1945-71. IMF data (Laeven & Valencia 2013), in turn, record 147 banking crises and 218 currency crises during 1971-2011.
4.2 The Rise and decline of the Interwar Gold Standard

The liberal interpretation has it that the interwar gold standard was doomed because of the rise of political and economic democracy (Morys 2014: 731 – 732; Simmons 1994: 20-29; Rodrik 2007: 202). The primacy of external balance required the political dominance of financial interests plus high wage flexibility. The more inflexible wages, the more a tight monetary policy to defend the parity would have quantity instead of price effects. Economic democracy, in the form of strengthened trade unions and the concomitant real wage rigidity, in this interpretation, implied that the smoothly working pre-war gold standard now would become a source of domestic crisis. According to Eichengreen & Temin (2003: 212), “The inability of economic policy-makers to force down wages was at the core of the period’s [interwar] economic strains.” The emblematic example of this new constellation was the British general strike of 1926, which was called to oppose a cut in mineworkers’ pay.

Simultaneously, the Gold Standard came under fire from political democracy. The spread of general (male) suffrage meant that the political power of the lower classes would result in demands for policies prioritising internal balance thus making the balanced budgets and the quasi-automatic conduct of monetary policies unviable. Obstfeld & Taylor (2004), interpret the advent of mass suffrage as a fundamental turning point in the management of macroeconomic policies as it made fixed exchange rates and free capital markets infeasible, instead requiring either flexible rates, or capital controls and fixed exchange rates.

However, that interpretation to a considerable extent is an exercise in deductive history. Even before 1914, the picture of a smoothly operating gold standard at best applied to core countries like the UK, France, Germany and the USA. Peripheral countries frequently left when the costs became too high. Similar to the interwar gold standard and the Euro, the combination of fixed exchange rates and free capital markets gave rise to large imbalances, with the core countries building up large net asset positions (Obstfeld & Taylor 2004: 231). While orthodoxy has it that due to the greater credibility it derived from its solid political underpinning (Bordo & Kydland 1999), capital flows were stabilising during the Gold Standard, in reality, peripheral countries were vulnerable to sudden stops of capital inflows in reaction to changing conditions in the core countries (Triffin 1964).

Like the Euro, also the classical gold standard suffered from a deflationary bias. The rapid expansion of Gold Standard membership during the 1870s set off a scramble for reserves leading to higher interest rates. Not by coincidence did the spread of the Gold Standard coincide with what at that time was known as the Great Depression (1873-96). Despite limited suffrage in many countries, the priority for external balance did not go unchallenged. The Gold Standard ended the heyday of free trade. Italy e.g. increased tariffs in 1878 and 1887, Germany followed in 1879, France in 1880, and the US raised tariffs repeatedly during the 1880s. As Findlay & O’Rourke (2007: 398) remarked, it seemed that “globalization undermined itself”. Opposition to the pre-war gold standard came primarily from the agricultural sector. As agricultural producers commonly incurred loans at the beginning of the growing season to repay them when the harvest was brought to market, an intervening drop in prices increased real debt and might spell default. In the United States, opposition to the 1873 decision to return to gold came from agrarian interests in the Populist and Greenback Parties (Frieden 1997), while an attempt to form a farmer labour alliance with the Greenback Labour party did not meet with success. Likewise, in pre WW1 Italy the protest that created several currency crises and contributed to repeated decisions to suspend convertibility had more to do with peasant unrest than with the rise of labour. In Germany, opposition came primarily from Prussian landowners (Gerschenkron 1943: 57). That the strengthened position of organised labour after 1918 critically undermined the gold standard is improbable. That stronger labour meant more wage rigidity lacks solid empirical evidence (Galarotti 1995: 35). Obstfeldt (1993) e.g. finds evidence for significant price rigidities during the 1882-1913
period in a sample of six countries\textsuperscript{6}. Indeed, nominal wages proved too flexible. During the 1930s governments sought to put a floor under wages to combat deflation through such devices as making wage agreements binding on the entire sector (Netherlands, 1937), the National Industrial Recovery Act (USA, 1933), the Matignon agreements (France 1936), and the wage decrees of the NAZI board of Labour Trustees (1933) (Notermans 2000). The strengthened position of labour after 1918 did not add significantly to the political opposition to the Gold Standard. Labour parties did not operate with a Keynesian framework in which capitalism can be made palatable through growth-oriented macroeconomic policies. Instead, their framework was one of a distributional struggle between capital and labour emphasising such issues as taxation of the wealthy, extension of welfare arrangements, labour standards and socialisation of industry. Leftist parties were either supportive of or ambiguous on the Gold Standard. Though France clung to Gold at great costs to for five more years after Britain had abandoned it, the Communist Party remained a staunch defender because it interpreted abandoning gold as tantamount to inflation and lower wages. Leon Blum, who became prime minister of France’s first leftist Popular Front government in May of 1936 had campaigned on defending gold and did so until massive currency speculation made the effort futile in September.

Though organised labour may not have opposed Gold, the shift in the political balance of power did prompt governments to prioritise internal balance. In 1918, governments faced too deep a legitimacy crisis to give priority to deflating the price level. As Feinstein et al (2008; 49) summarised it “conflicts over the distribution of incomes and the burden of taxation stand out as a principal source of financial instability in most other European countries”. To greet the millions of soldiers that had been conscripted into a gruesome war with unemployment and economic hardship seemed unwise to even the staunchest advocates of the Gold Standard. The perceived threat of a Bolshevik revolution spreading to Western Europe provided additional arguments. Many of the new states that emerged from the breakup of three empires initially also lacked legitimacy, while governments on the losing side had little enthusiasm for imposing austerity on very fragile societies in order to foot what was considered a grossly unfair reparations bill. The result was that rather than preparing for a return to gold, governments embarked on policies of cheap money and increased spending to promote growth and social inclusion, allowing the currency to depreciate if necessary.

Thus, it was not a foregone conclusion that the Gold Standard would be revived. Labour militancy and social unrest did not doom the Gold Standard but instead inspired its resurrection. In view of endemic distributional struggles and a crisis of legitimacy of national elites, a domestically oriented regime in most countries proved unable to reconcile the claims on domestic product, with inflation and budget deficits as the most visible manifestation. The Gold Standard option became more attractive the more the alternative of a domestically oriented regime appeared a recipe for dislocation. Like the 1980s, how the turn away from internal balance would be orchestrated depended on the strength of democratic state institutions. On the one extreme stood Germany where a stabilisation crisis was considered too risky. Consequently, inflation was allowed to run its course leading to a total destruction of the currency in a spiral of hyperinflation. This was followed by the introduction of a new currency, which was put on gold in November 1923 and was to be administered by a central bank that was under foreign control and assisted by a foreign reparations commissioner with far reaching authority over fiscal policies. In many of the new states that emerged out of the Austro-Hungarian Empire, and thus like Germany had found themselves burdened with foreign debts, stabilisation similarly was achieved with foreign assistance primarily through the League of Nations.

In Italy, the solution instead involved the destruction of democracy. While the government did intervene in the foreign exchange markets after the armistice with the aim of reversing wartime depreciation, that policy ended with the premiership of Francesco Nitti (June 1919-1920). In a country increasingly polarised between socialist, anarchist and fascists, Nitti embarked on an interventionist policy of economic reconstruction, which he hoped would promote political reconciliation. Yet, Nitti

\textsuperscript{6} France, Germany, Italy, Japan, UK, USA.
never managed to create the consensus on which such a programme could have succeeded. Until shortly before the fascist takeover, the Socialists refused to enter government with the other mass party the catholic Partito Popolare. For the liberals, Nitti’s tax and industrial policies seemed a prelude to socialisation. Unable to balance the budget with taxes, while abolishing the bread subsidy - whose costs exploded after the Lira had started its downward slide - was unacceptable to the Socialists and the Catholics (Forsyth 1993; ch.6). The solution to this democratic aggregation deficit would be fascism as liberal political forces came to side with Mussolini; a solution, by the way, which was highly welcomed in British and American circles (Mazower 1998: 26).

While similarly fragmented, liberal democracy was not successfully challenged in France. Instead, France clad its distributional conflicts in the straitjacket of the Gold Standard, though it took until 1926 to do so. Marking the gradual unravelling of the coalition of national unity, the last year of the war already saw widespread social unrest that intensified after the armistice. Though the political right recorded one of its greatest victories in the 1919 elections, social unrest suggested making concessions to labour in the form of social protection and the 8-hour workday. At the same time, wartime destruction mandated a large reconstruction budget. The government had no intention of balancing the books – also because it hoped to extract significant reparations from Germany – nor to defend the currency. Accordingly, no steps towards austerity were taken when allied support for the Franc ceased on March 14 1919. Alongside the fear of becoming dependent on foreign creditors, inflation did lead to a first attempt at austerity in 1920, not in the least because of middle class protests. However, the policy was short-lived. When it emerged that German reparations would be much smaller than expected, the Franc continued its downward slide, while the Left was victorious in the 1924 elections. Consequently, by 1926, France had become unable to borrow on international markets while inflation escalated further. It was left to Raymond Poincaré’s government to stabilise the Franc in 1926 and prepare for the return to gold. Though both the 1920 and 1926 austerity measures created recessions, overall France only delayed stabilisation: the return to gold, at a vastly depreciated rate, meant that in real terms the country performed better than most other European countries.

That the restoration of the Gold Standard was a foregone conclusion has been most forcefully argued for Britain. With Sterling standing at the centre of the pre-1914 world and international finance contributing significantly to its current account, returning to gold seemed crucial to economic recovery and restoring British might. The seven years between the armistice and the return to gold then appear as a transition period without any particular significance. In fact, British politics displayed a similar dynamics to most of Western Europe. Social tensions and a radicalised labour movement mandated policies of expansion and social inclusion. Accordingly, returning to parity was postponed into an unspecified future. The Cunliffe Report of August 1918, which strongly recommended a return to gold, was simply ignored. Instead, the Gold Standard was abandoned in March of 1919 and further restrictions on capital account transactions were imposed while the budget turned expansionary. Eventually, it was the inflationary dynamic provoked by a growth-oriented policy not backed by a coherent social contract that prompted a policy change in the early 1920s. The Treasury’s John Bradbury’s argument that the Gold Standard would be “knave proof”, i.e. immune to political tinkering, convinced Churchill (Catterall 2017: 36-37). The British case was peculiar only in that it was the only one of the victorious European powers that risked a deflationary policy strong enough to return to the pre-war parity.

All the other nations that returned to gold at the pre-war parity had not been belligerents (Denmark, Netherlands, Norway, Sweden, Switzerland). Though they may have suffered lesser hardships during the war, that did not make them immune to pronounced social tensions. Similar to Britain, the Netherlands, Norway and Sweden had decided in principle to return to the gold parity at some time after the war, but the policies of the first post-war years did nothing in preparation for this. Instead, central banks were reluctant to raise interest rates and the currency was allowed to depreciate to prevent compromising the priority of internal balance. The turn to restrictive policies and recession,
came in the early 1920s when this policy orientation was seen to provoke high inflation and, as in the case of the Scandinavian countries, financial instability.

In sum, the Gold Standard was not resurrected as a utilitarian device to facilitate trade or gain cheaper access to credit, nor did it reflect nostalgia. Instead, it served as the anchor to the system of interest intermediation, as the institution that would give coherence to societies and guarantee their governability. That explained the tenacity with which states clung to this “barbaric relic” in the Great Depression, preferring austerity to loosening society’s moorings. Similar to the post 1980s regime, the stabilisation crises in the early 1920s gave way to relative stability. Yet, much of this feeble prosperity was built on growing indebtedness and capital flows that gave rise to serious macroeconomic imbalances. The system started to unravel in 1929 when the Federal Reserve’s policies to reign in the stock market boom exposed Germany to a sudden shock requiring ferocious policies of internal devaluation, followed by the collapse of banking system in the former Austro-Hungarian Empire that quickly spread abroad. Notwithstanding the centrality of the gold standard in structuring interwar politics, its institutional structure did not make it irrevocable. Unwilling to be seen to voluntarily abandon Gold, governments such a Britain, Belgium, France, and the Netherlands let markets force their hand as increasing doubt about its viability provoked capital flows that drained the central banks of reserves. Only Germany, with its memories of hyperinflation, did not dare take this step but instead de facto suspended the Gold Standard by trade restrictions and draconian exchange controls.

4.3 Neoliberalism and the Second European Rescue of the Nation State

The political foundations of the post-war growth regime came undone in the late 1960s. Though the process was uneven, it was marked by increased political participation and polarisation alongside rising labour militancy. The earliest and strongest manifestations of labour militancy occurred in Italy and France where the post-war social contract had excluded the communist left. But the proliferating distributional struggles were fought out just as much in the political arena. Increased public spending became a common device to appease various actors while governments sought to structure political intermediation by strengthening tripartite corporatist negotiations. Alongside labour market pressures, a variety of development conspired to make the hold of political elites more tenuous. While the traditional mass parties had been governed in hierarchical fashion, the disintegration of traditional social milieus, the decreasing salience of social and religious cleavages and increasing levels of education combined to create an electorate much less willing to defer political leadership. Alongside decreasing party membership and the decline of party-based media outlets, political elites were now confronted with a more volatile electorate. The first and second oil price shocks further destabilised the system.

Radicalisation translated into a stronger left on the continent. The German Sozialdemokratische Partei Deutschlands (SPD) first participated in government in 1966 and three years later Willy Brandt became its first chancellor. France elected its first socialist president after Vincent Auriol (1947-57) in 1981. In 1972, the Dutch social democrats managed to conquer the prime minister seat after 14 years, but the Den Uyl’s cabinet was unique for its confrontational strategy. In 1970, Bruno Kreisky became the first social democratic chancellor of post-war Austria. But with its political preconditions rapidly unravelling the rise of social democracy heralded the end of a social democratic regime that had been built on the continent largely by Christian Democrats.

Though the road through which it was arrived at differed from case to case, in the end Europe arrived at a broadly similar neo-liberal solution. First, to break the escalating wage-price-wage spiral, lower growth and higher unemployment were required. As Alan Budd, advisor to Margaret Thatcher would put it later: “What was engineered in Marxist terms was a crisis of capitalism which recreated a reserve army of labour, and has allowed the capitalists to make high profits ever since.” (Quoted in Stone 2014: 183). Secondly, to contain competing claims on GDP the macro-economy had to be
provided with a binding budget constraint. Finally, expectations on what state intervention in the economy could actually achieve needed to be toned down radically.

The principal device in bringing about such a regime change was a crisis induced by central banks that were freed of any concern for growth and employment. In the late seventies, the independent German Bundesbank executed this regime change on its own, while formerly dependent central banks, like e.g. the Nederlandsche Bank and Sveriges Riksbank, were given the political leeway to implement this change. In Italy, the process was more gradual. While in the 1950s and 1960s the Banca d’Italia bought all unsold treasury bonds, in 1973 Guido Carli introduced some limits to bank lending and currency exchange restrictions in view of an inflation rate continuously above 10%. In 1975, Paolo Baffi further tightened those controls. After having had to exit the Snake in 1976 and the EMS three years later, Baffi was replaced by Azeglio Ciampi, who, together with the Treasury minister Andreatta, carried out the “divorce” in 1981, which separated the Bank of Italy from the Treasury.

To some extent, escalating inflation and budget deficits in themselves undermined the political support for the old regime. Nevertheless, a politically induced crisis might have incalculable consequences for legitimacy so that only few governments chose to take direct responsibility for it. Depending on national peculiarities and the strength with which different party systems allowed the new policy regime to be challenged, governments to varying degrees relied on legitimating devices that helped to deflect responsibility. For the Left, for whom it was ideologically difficult to locate the decline of the post-war growth model in its internal contradictions, globalisation became the preferred device. Later, Europeanisation, either in combination with a globalisation that was argued to require a European solution or as a self-standing justification, was invoked as a constraint on policy making beyond control of the national government. Overall, one can distinguish three different paths to the end of the post-war model, two of which needed another European rescue in order to be feasible.

The British Labour government imposed cash limits on public spending since 1975 in an attempt to lower inflation while trying to import an external constraint via the IMF in 1976. Margaret Thatcher needed neither the IMF nor Europe or globalisation to deflect the blame. Assisted by a generous dose of political courage and the virtual absence of veto points in the political system, Thatcher chose to end the post-war regime by confronting the trade unions head-on. Though being swept into power in the wake of the infamous ‘winter of discontent’ of 1978, in which radicalised trade unions virtually brought the country to a standstill, Thatcher’s strategy of not deflecting the blame nevertheless turned out to be politically risky. Without the Falklands War, she most likely would have failed to be re-elected in 1983.

Similarly, by the early 1980s Denmark was plagued by highly fragmented and aggressive unions that made promoting full employment impossible without escalating inflation and budget deficits. Committed to internal balance, the social democratic governments of the 1970s reacted to the oil price crisis with fiscal expansion and devaluation, the latter to counter an escalating current account deficit. Though the prime ministers seat from 1975 to 1981 was uninterruptedly held by a social democratic trade unionist, unions were adamantly opposed to incomes policies and instead focussed on what they called “industrial democracy”. In an international environment where more and more countries were resorting to recession to combat inflation, devaluation was the only viable strategy to maintain the focus on internal balance, but without any agreement on incomes policies and instead focussed on what they called “industrial democracy”. In an international environment where more and more countries were resorting to recession to combat inflation, devaluation was the only viable strategy to maintain the focus on internal balance, but without any agreement on incomes policies, the result would be even higher inflation and twin deficits. The cycle was broken by Paul Schlüter in 1982, Denmark’s first post-war conservative prime minister, who came into power for reason similar to those that handed Margaret Thatcher her first victory. Like Thatcher, also the Danish government could not hope to derive legitimacy from a recourse to the constraints of European integration. Unlike Thatcher, Schlüter employed an external constraint by declaring a fixed exchange rate target while simultaneously ending the practice of negotiating crucial policy measures, such as the abolishment of wage indexation, with the trade unions. The obvious failure of the Social Democratic strategies, together with a party system that imposed more moderation on Schlüter in terms of welfare cutbacks and budget austerity, kept the
Democracy and (Dis)-integration. The conditions for a legitimate and effective economic and political organization

Social Democrats out of power until 1990, and when they did return, very much similar to New Labour, it was a party very much concerned to demonstrate that it was economically responsible and would not fundamentally challenge the new regime.

While suffering from an even more thorough disintegration of the post-war consensus – partly because of the exclusion of the Left from the post-war contract – the British road was not available to France or Italy. Though also the French government had, signed the Werner plan in October 1971, the economic dislocations that soon emerged seemed rather to call for the full use of micro and macroeconomic policy tools. The plans for a single currency were collecting dust on the shelves of some ministry, but defending a growth orientation without the ability to impose wage moderation soon proved self-defeating. With little or no European constraints on their use, fiscal and monetary policies could indeed be used to stimulate growth while exchange rate flexibility was needed to protect the external flank of such policies, as the Swedish Social Democratic government successfully practised. Yet, with any devaluation of the currency leading to immediate demands for wage compensation, exchange rate flexibility became a tool for more inflation, while fiscal policy concessions served to inflate the budget deficit without being able to enlist the cooperation of the unions. Problems came to a head with the Mitterrand government in the early 1980s. At a time when Germany was pursuing a tight anti-inflationary course, Mitterrand promised deficit spending, shorter working hours, wage increases and nationalisation of industries.

Mitterrand’s solution to choose an external scapegoat to deflect the embarrassment of his U-turn inaugurated the second European rescue of the nation state. The reason for this spectacular failure, so the story went, was the Bundesbank, and globalisation in general, which had made domestic policy instruments unworkable. Accordingly, European integration would be required to restore policy autonomy. However, the integration that French governments signed up to was designed not to empower some Keynesian state but to cement the neo-liberal solution to the disintegration of the post-war model. As Andrew Moravcsik (1994: 49) put it: “Mitterrand’s appeal to European ideology appears to have been entirely tactical – an ideological cover for the abandonment of the Socialist experiment and the adoption of conservative policies…” The price for agreeing to a form of European integration that did much the opposite of what its official justification claimed was the “French disease”, a political disease that would gradually spread as more and more member states adopted similar solutions. The French solution created bitter disappointment in European integration and the political class. Indeed French politics since the mid-1980s can be fairly accurately described as an oscillation between promises of more expansion – from Chirac’s pledge of 3 million new jobs in 1995, via Jospin’s EU-wide jobs creation pact of 1997, to president Hollande’s election pledge in 2012 to renegotiate the Fiscal Compact – just to make a U-turn justified by the constraints of European integration. Indeed a direct line runs from the fundamental decisions made in the early 1980s to the rise of anti-politics, the Front National and the near endemic contempt for the political class in French society.

The Italian post-war social contract was concluded without the Left. As of May 1947, the Communist Party (PCI) (the largest one in the West) was excluded from government. Nevertheless, on the microeconomic side, policies, if anything, were more interventionist than in much of Western Europe. The post-war state continued the policy inaugurated by Mussolini of industrial modernisation by means of a large sector of state-backed or state-owned companies benefiting from directed credit by a largely state-owned banking sector. On the macroeconomic side, instead, Italy, like Germany and the Netherlands, pursued an export-led growth strategy, characterised by current account surpluses and a hard but undervalued currency.

This constellation ended in an explosion of social unrest with the “hot autumn” of 1969. This might have furnished the occasion for a more inclusive social contract along the lines concluded elsewhere in the late 1940s. Two and a half decades after the war, the sense of national unity and purpose that marked the late 1940s had evaporated. Not only was Italian business deeply suspicious of the Left, fearing their subversive potential, the fragmented unions with tenuous links between the leadership
and the shop-floor lacked the will and the organisational capacity to be tied into corporatist concertation. The organisational weakness of the social partners found its counterpart in weak coalition governments. Thus, Italy became nearly ungovernable and drifted close to civil war, particularly in the first half of the seventies when various extreme-left and right wing groups claimed a large number of victims. Budget deficits exploded as governments tried to content the numerous demands, while the Banca d’Italia accommodated inflation and absorbed public debt that could not be placed in the market. Similar to the position of the Reichsbank in the German hyperinflation, Banca d’Italia Governor Guido argued in 1976 that it would have been ‘subversive’ to do otherwise.

As Carli clearly recognised, in this constellation the rescue of the Italian nation-state had to proceed through the European Union: “the European Union represented an alternative path for the solution of problems which we were not managing to handle through the normal channels of government and parliament” (quoted in Heartfield 2007: 141). The Lira entered the EMS in 1978 with a band of 6%, but two years later the regular 2.25% band was adopted, while the EMS evolved from an adjustable to a fixed rate regime after 1987. To support EMS membership, in 1981, the ‘divorce’ was consummated which freed the Bank from its obligation to buy public debt. Eleven years later, the EMS constraint served as the clinching argument to gain union agreement on abolishing wage indexation.

According to neoclassical theory, importing credibility through fixed exchange rates, may make disinflation costless, but such cases have been confined to the textbook. Nevertheless, the link to Europe helped muster the necessary political support. First, ECSC and EEC membership was closely associated with economic modernisation. Secondly, as in France, Europe could be presented as protecting the country from the pressures of globalisation, though Italian governments were less outspoken and confident about their reform plans for Europe. Finally, membership in the EMS and the common currency became a matter of national pride; a recognition that Italy played in the first league. This became particularity evident after 13 September 1992 when the Lira was forced to devalue. Ironically, it were the financial markets to question whether the cost of disinflation were politically viable by unleashing a wave of speculation. Similar to the Gold Standard, the fixed exchange rate had become the anchor of a project to fundamentally reform Italy. Even though devaluation provided a much-needed economic boost, qualifying for the Euro eventually became the overriding priority of the government to such an extent that even corporatist concertation became a viable proposition in order to combine welfare cuts with more flexible labour markets and fiscal rigour. Yet, not even Euro membership freed Italy from its anaemic growth while placing insistent demands for austerity, more flexibility and less welfare onto the lower strata of society. Similar to France the concept of Europe as the rescuer of the nation now came to sound hollow to a substantial part of the electorate.

Initially, those countries that could rely on corporatist interest intermediation seemed to have an effective antidote to the unravelling of interest aggregation. In Scandinavia, corporatist policymaking had become a staple since the Social Democrats turned from a class-based to a nation-based approach in the 1930s. Dutch labour had been tied into an export-led growth strategy of low wages since the late 1940s. In Austria, Soviet occupation of its Eastern part until 1955, together with the memory of the civil war of 1934 helped cement a corporatist polity. In Germany corporatist patterns emerged somewhat later with Ludwig Erhard’s formierte Gesellschaft of the early 1960s, followed by the first SPD governments’ emphasis on “concerted action”.

Yet, participation in corporatist governance frequently undermined the ability of functional interest associations to internally aggregate interests. Especially for trade unions adhering to government-induced wage moderation in tight labour markets, the problem might become acute. Since the 1970s, e.g. the Austrian ÖGB held that monetary policy should not be part of policy concertation since a fixed exchange rate functioned as an anchor that guaranteed its internal coherence. In Sweden, the central bank de facto was a partner in tripartite concertation, most spectacularly so in 1982. But as the 1980s progressed also here the growing inability of labour and business to internally aggregate interest promoted a regime change, by taking monetary policy out of the bargain and making the Riksbank formally independent in 1996.
German corporatism might appear to have been hampered by the institutional anomaly of an independent central bank. Yet the Bundesbank’s single-minded focus on inflation is somewhat of a myth. Since the 1960s, the Bretton Woods system obstructed the fight against inflation. Yet, the Bundesbank was opposed to revaluation for fear of the consequences for German exports, instead preferring to resolve the dilemma by tighter capital controls. The brief float of the D-Mark in 1969 was implemented in response to international pressures and against the opposition of the Bank. Where German post-war policies did differ, with the exception of the Netherlands, was that the growth orientation of the regime was built on an export-led model. Except for the first post-war years, both countries ran persistent current account surpluses. When leftist governments during the 1970s did attempt to introduce Keynesian elements, the higher inflation faster nominal wage growth and threat to the current account surplus this implied provoked a counter-reaction in which Christian democratic and conservative parties managed to exclude the social democrats from government in order to impose a tight constraint on corporatist bargaining through an independent monetary policy and tight budget constraints.

After their breakdown between the late seventies and early eighties, corporatist bargaining was frequently revived, but now monetary and fiscal policy were removed from the negotiating table and bargaining proceeded under the threat of unilateral state intervention. Where corporatism survived, it turned into competitive corporatism. Sweden, Denmark and Austria now joined the German-Dutch club of countries with substantial current account surpluses. Ironically, it was primarily the German mercantilist orientation that opened the way for a second rescue of the south European nation states through a European external constraint. A simultaneous insistence on tight money, low inflation, wage moderation, fiscal rectitude – Stabilitätskultur in short – and current account surpluses is an inconsistent set of preferences under flexible exchange rates, as it should put upward pressure on the currency forcing a choice between defending the current account surplus or their restrictive macroeconomic policy orientation. What was required to make this set of preferences consistent was the cooperation of the European neighbours, getting them to agree to fix their exchange rates while adopting a similarly restrictive monetary and fiscal regime. Indeed the quest for an asymmetric fixed exchange rate regime that would limit D-Mark revaluation while not diluting its monetary and fiscal policy orientation has been a constant of Germany’s European policies since late 1969 when Chancellor Willy Brandt first proposed a European monetary union at the Hague Summit, shortly after the D-Mark and Dutch Guilder had been forced to float upwards.

In short, the disintegration of the post-war model necessitated a second European rescue of the nation state, though its nature was fundamentally different from the first one. Whereas the first rescue was instrumental in cementing the growth policies that supported post-war social contract, the second rescue sought to restore cohesion to policy-making in the face of the disintegration of social consensus. Accordingly, the second rescue from the start pointed towards depoliticisation and technocracy.

5. Rethinking Europe

In contrast to expectations of the political Left (Habermas 1973), the economic crisis, permanently lower growth, and higher unemployment that accompanied the liberal governance mode did not immediately lead to a legitimacy crisis. The economic dislocations of the preceding years in combination with the uneven distribution of the costs of those crises and the various blame avoidance strategies that singled out globalisation as the culprit were able to muster sufficient political support or resigned acceptance. Unemployment could frequently be concentrated in the lower segment of increasingly dualistic labour markets. The possible political fallout on middle class support could be contained by budget deficits that cushioned the impact of lower growth and tax revenues on the welfare state and by a deregulated financial system that boosted private indebtedness and home ownership (Mau 2015). Indeed, having declined since 1946, public debt to GDP ratios now embarked
on a continuous increase, while household indebtedness ballooned almost everywhere since the 1990s (Table 1).

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<th>1995</th>
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1: Figures for Spain refer to 1999. Source: OECD.

The solution to the overload crisis gave rise to what many saw as a crisis of democracy marked by decreasing participation (Mair 2013). While the trend toward falling party membership and political de-alignment had set in earlier (Dalton et al 1984), the new regime saw a distinct decline in political participation. In Europe, voter turnout in parliamentary elections reached a peak in 1970s (Table 2). Like unemployment, non-voting frequently was concentrated amongst lower income and lower education groups. The trend was only reversed when populist parties after 2008 succeeded in mobilising many non-voters.

The long-term effect of the second European rescue of the nation state was to condemn social democracy to irrelevance. Though more drawn out in time, the process was similar to the destruction of East European social democracy after transition (Gryzmala-Busse 2007; Innes 2014). In a zero-sum world where allegedly the only road to growth is to stay ahead of the competition by reducing wages, shrinking welfare states, cutting taxes on business and reducing forms of social protection that might give rise to market rigidities, a meaningful definition of social-democracy becomes impossible. Hence, at a time when the North Atlantic financial crisis has shaken the trust in markets, income inequality escalates, unemployment is widespread and the middle class is gripped by the fear of social, it is not European social democracy but populist anti-politics that prospers.
The populist revolt is not only directed at the EU, but just as much at a national political class that allegedly has lost touch with “the people”. It is not primarily driven by a revival of traditionalist-communitarian values, nor by a post-functionalist politicisation in which the lack of a European identity engenders opposition to redistribution (Hooghe & Marks 2009), but by the realisation that the neo-liberal philosopher king wears no clothes. Populism is thriving on traditional social democratic themes after the depoliticisation and la pensée unique that affected all the mainstream parties, abandoned the losers of neo-liberalism (Mastropaolo 2008; Mudde & Rovira Kaltwasser 2017: 101). Though the origins of parties like the Front National (FN) and the Alternative für Deutschland (AfD) may lay in an appeal to nationalist-communitarian values coupled with economic liberalism, they are undergoing a rapid transformation. Substantial electoral success only emerged when the nationalist appeals were married to policies of reclaiming more national autonomy in order to protect “the nation” from the economic ravages of Europeanisation / globalisation so as to embrace traditional leftist concerns for better social protection, more jobs and less inequality.

A 2015 Pew survey did not detect any rise in anti-minority sentiment. Also in a longer-term perspective, anti-immigrant / anti-foreigner sentiments cannot account for the rise of populism. In Germany and the Netherlands such sentiments correlate well with the economic cycle, reaching a high point in the early 1980s to decline until 2004-2009, after which an upturn to roughly the level of the 1980s can be recorded. In Spain anti-immigrant sentiment peaked in 2004-2009 to decline slightly afterwards, while Sweden recorded a slight decline from a very low level since 2004-2009 despite the electoral success of the Sverige Demokraterna.7 What Europeans do consistently worry about since the onset of the crisis is unemployment and the economic situation in general (Table 3). And for these issues an increasing share of the population sees the EU as a problem instead of the solution. Though included in the Eurobarometer surveys since 1983, the question whether one’s country had benefited from EU membership was removed in 2011 when the percentage of respondents answering “No” edged closed to 40%. More recent surveys (Pew Research Center 2016) indicate that a majority in Greece, Italy, France, Sweden and the UK disapprove of the way the EU handles economic issues while only in Germany and Poland more people approve than disapprove. In sum, in terms of the two dimensional space that structures political contestation, what Grande & Kriesi (2012) diagnosed as a little occupied “structural hole” of interventionist-nationalist positions, is rapidly being filled.

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7 Based on question V37 of the World Values Survey: “On this list are various groups of people. Could you please mention any that you would not like to have as neighbours?” Mention of “immigrants / foreign workers” was interpreted as expressing xenophobic sentiments.
### Table 2: Voter Turnout, Parliamentary Elections (%)

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<td>83.7</td>
<td>77.2</td>
<td>70.6</td>
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Note: Voting is compulsory in Belgium and Luxembourg.

Source: Own Calculations, ParlGov database.
Table 3: European Citizen’s Main Concerns: The Three Most Frequently Mentioned issues

<table>
<thead>
<tr>
<th>Date</th>
<th>Issue</th>
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<th>Issue</th>
<th>%</th>
<th>Issue</th>
<th>%</th>
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<td>Crime</td>
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<td>23</td>
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<td>Crime</td>
<td>23</td>
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<td>12.05.2012</td>
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<td>10.05.2013</td>
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<td>33</td>
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<td>28</td>
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</table>

Source: Own calculations; Eurobarometer.
As a result, in terms of the role of the state in the economy, the left and right edges of the political spectrum again start to touch, similar to what happened during the Great Depression. For example, the FN’s emphasis on the nationalisation of banks, import quotas, a national industrial policy, more welfare entitlements and higher wages for low income earners is not only reminiscent of the views of the Parti Social Français – France’s largest right-wing party in the 1930s – but also bears many resemblances to the Policies of Leon Blum’s Popular Front (1936-37) and François Mitterrand’s programme of the early 1980s. In the Netherlands, the socio-economic points of Geert Wilders’ Partij voor de Vrijheid (PVV), are largely identical to those of the left-wing Socialistische Partij. Even the euro-critical British Conservative Party seems to be undertaking a move to the left in terms of its socio-economic policies. For Brexit minister David Davis, cutting the ties with Europe may seem an opportunity to replace the dirigisme of Brussels with a liberal agenda. For Conservative PM Theresa May and for the rapidly growing anti-integrationist parties on the continent, popular discontent with Europe points in a rather different direction.

However, though more moderate than the interwar extremists, also the current populism in essence is anti-democratic. With their claim to represent the “true people”, their emphasis on a direct link between the leader and the people and their disdain for pluralism, populism is on a collision course with democratic pluralism (Müller 2016). This suggests that in order to defuse the populism by separating those whose concern is for social inclusion from the xenophobes, a resurrection of the philosophy of ‘embedded liberalism’, or soziale Marktwirtschaft, seems the most promising strategy.

For the globalisation school, the only possibility for pursuing the policies of a reconstituted soziale Marktwirtschaft lies in recreating a steering capacity at the EU level (Bofinger et al 2012; Fratscher 2016; Habermas 2016). However, to function democratically, political union would presuppose the common European identity that is currently lacking. If instead one recognises that the member states have conspired to emasculate themselves and that the current legitimacy crisis largely is provoked by an EU that for at least three decades has pursued integration with the argument of its social and economic superiority, the road is open to rethink effective and legitimate democratic practices. What policy competences are best left to or returned to the member states? What European competences are required for an effective soziale Marktwirtschaft? Do the policies of the Trente Glorieuses hold lessons for today? What role can the EU play in ensuring the political viability of a policy of embedded liberalism?

Much of the debate about the potential incompatibility between “deep globalisation”, integration and democracy is informed by the microeconomic argument of a race to the bottom. The liberalisation of trade and capital flows, differential cost levels resulting from lower wages, taxes, social security contributions and a lighter regulatory burden is expected to cause trade to flow from, and capital to the countries with the lowest levels. Accordingly, the room for democratic determination of core socio-economic policies shrinks in line with the deepening of integration. Also this argument is not. When negotiating the ECSC and the Rome Treaties, France (and Belgium) voiced concerns that its more generous welfare system, shorter working hours and higher wages would result in a competitive disadvantage that could only be neutralised by harmonisation on the French level. However, such microeconomic issues are but a relatively minor problem. France never obtained the harmonisation it sought and thrived nevertheless. Despite its generally lower wages and tax levels and minimalist welfare states, the EU’s Eastern periphery is not facing a deluge of FDI and a surge of exports. Instead, the area is stuck in a middle-income trap, which promotes westward labour migration and brain drain. If anything, opposition to harmonising social policies is driven by member states with

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9 Others are more willing to concede that, in the interest of democracy, economic integration cannot be sacrosanct (O’Rourke 2011: 24; Rodrik 2011).
more extensive welfare arrangements. Apparently, the Nordic members see the lack of an EU policy capacity more of a guarantee than a threat to their welfare regimes.

Instead, as we have suggested, Europe’s problems have mainly macroeconomic and political roots. The tenacity with which European countries stuck to the Gold Standard in the midst of the Great Depression for fear or a resurgence of the dislocations of the early 1920s is mirrored in the tenacity with which Europe clings to a model that was designed to address the problems of the 1970s. In contrast to the interwar period, the EU, in its quest to create a knife-proof solution, has equipped itself with institutional safeguards of constitutional strength, first and foremost a common currency and a central bank totally devoid of a political counterweight. Also in contrast to the Gold Standard, the EU’s supranational solution has created its own pressure groups for more integration.

This suggests that rather than using “the rear-view mirror as a compass” (Jonung 1999), the EU should abandon its dogma that more integration is always the superior choice in favour of a “partial retreat of the Union into a sensitively co-ordinating role of managing economic diversity” (Everson 2005: 105). A partial retreat would seem necessary to end its institutionalisation of a deflationary regime that engenders economic divergence rather than convergence. Three, elements are crucial.

First, the SMFS has proven to be an engine of instability while the envisaged capital market union seems apt to exacerbate the problem. To avoid a re-emergence of the destabilising capital flows of the interwar period, most countries restricted capital account convertibility after 1945. Indeed, in several EU countries they remained in place until 1994. Though already practised in the Cyprus crisis, the EU needs a safeguard clause that allows for exceptions to the free movement of capital for reasons of strengthening the tools of domestic economic management. External financial repression in the postwar period was complemented by domestic financial repression. Promoting growth meant obstructing speculative finance, and as a result, West European governments equipped themselves with tools that allowed them greater control over the price, the quantity and the direction of credit by means of interest rate ceilings, selective credit allocation and credit ceilings. De facto, much of Western Europe’s banking system was cartelised with market shares and competition frozen thus removing an incentive for the speculative finance that was to destabilise Europe after Maastricht. Given that the SMFS has backfired, a return to the compartmentalisation of financial markets along functional and regional lines—would seem advisable.10

Secondly, the uncontested political priority for growth after 1945 (Mazower 1998) may itself provide the main explanation for the spectacular growth that did occur as it anchored the expectations that undergirded the high investment rates. Safeguarding that political priority for growth, in particular from balance of payments constraints, required a set of new policies and institutions. The Marshall Plan, the European Payments Union (EPU) and the inconvertibility of currencies until December 28, 1958 served that purpose during the reconstruction period. Once the recovery had taken hold, current account inconvertibility became superfluous, thus opening the way for further trade liberalisation under the EEC, while allowing the Bretton Woods system to come into operation. But this system had been designed to make exchange rate management subservient to economic growth. IMF assistance was available to address balance of payments problems without compromising growth, while in case of a “fundamental disequilibrium” the parity had to be changed. Given its deflationary bias and the high costs of the EU adjustment programmes, this suggests that the Euro would likewise need a temporary escape clause,11 together with a set of criteria that places more emphasis on real instead of nominal convergence.

10 Another possible solution would be to impose a financial transaction tax or a pan-European corporate tax, with which to finance pan-European investment, which would also have the advantage of taxing the additional revenue generated by the common market.

11 A macroeconomic imbalance procedure equipped with a mechanism requiring countries with large current account surpluses to boost domestic growth, would have taken a significant step in mitigating Europe’s deflationary bias, but this was blocked by countries like Germany and the Netherlands.
Finally, the concern for structural economic weaknesses does not distinguish neo-liberal Europe from its predecessor. Indeed, after 1945 most West European governments diagnosed their economies to suffer from acute structural weaknesses. Especially in France and Italy, the War had created an awareness of economic backwardness. In contrast to the EMU era, the remedy was not flexibility but industrial policy. France for many years provided the model of how to operate such a vertical type of policy. Based on an overarching indicative plan – the implementation of which required the European rescue of the ECSC in 1951 – a host of selective measure were employed including credit allocation, preferential access to hard currency, complementing infrastructural investment, a host of non-tariff barriers – perfectly legal under the then EEC – and outright state aid. The results soon far surpassed expectations. The current EU’s single market and competition policy framework however, rule out such a type of vertical industrial policy.

This does not imply the need for a unilateral retreat from the Union. As argued above, the demise of the Trente Glorieuses occurred in response to the disintegration of its political underpinnings. Though the political constellation of the 1970s is no longer with us, it is by no means clear that all member states have the political capacities to engage in such policies. It is noteworthy that even in the hardest hit Eurozone members there is no political and popular majority for leaving the Euro. The soaring disapproval ratings of the EU commonly were only matched by similar levels of distrust in the abilities of the national political system. A European Union that understand its role as coordinating the management of economic diversity thus primarily should focus on strengthening the political preconditions for the successful pursuit of policies of internal balance in those member states that face difficulties doing so on their own. In practice, this may involve a focus on strengthening state capacity in the framework of a cohesion policy that operates with strict real performance criteria while allowing for a large degree of flexibility in the means employed to that end.
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Democracy and (Dis)-integration. The conditions for a legitimate and effective economic and political organization

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