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AN ECONOMIC AND MONETARY 'EXPERIMENT' GONE TOO FAR?

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ABSTRACT

This paper explores the monetary foundations of the European Union (EU) and argues that the legacy of the Bretton Woods system has resulted in a setup that is skewed toward the exchange rate (and price stability) rather than overall macroeconomic policies. This is evident in the design of the currency union which revolves around the exchange rate mechanism, ensuring that members of Europe's custom union and single market do not gain unfair advantages through competitive devaluations. However, it is also evident that the EU's monetary foundations leave open the question of the relative competitive positions of member states, as well as the EU's relative competitive position vis-à-vis the rest of the world.

This, as the article argues, can be traced back to the features of the Bretton Woods system that was fundamentally a monetary setup designed to avoid competitive devaluations and 'beggar your neighbour' policy outcomes. By locking in exchange rates and constraining capital movements, the Bretton Woods system kept a lid on the deep underlying question of the relative competitive position of individual countries. But when Bretton Woods came to an end in the early 1970s and capital movements began to be liberalised, trade and financial imbalances began to re-emerge. To contain such imbalances among the EU member states – and remove the option of using the exchange rate to gain competitive advantages – a series of monetary arrangements were introduced that eventually resulted in the European Economic Monetary Union (EMU). The issue of the relative competitive position of individual countries and the macroeconomic setup appropriate for a currency union is still outstanding.

Keywords: Globalization, International, International Relations, Trade.
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Introduction

At the end of the Second World War Europe was in tatters, yet it faced a complex rebuilding – not only of its physical infrastructure, but also of its economy and its political and social systems. The main priorities in 1945 were restarting the economy, establishing institutions to limit the dangers of nationalism, and reinstating security, both from external threats and from one another (McCormick 2011: 76). Europeans were suffering from post-war fatigue and many felt that Europe "would never again rise from the ashes" (Laqueur 1992: 5). The economic losses were colossal, with output levels shrinking back to where they were several decades prior. The size of the French economy, for instance, had reverted back to 1891, while Germany and Italy were back to 1908 and 1909 respectively (Crafts and Toniolo 1996a: 4).

Trade liberalisation and exchange rate stability coupled with macroeconomic policies for the transition underpinned Europe's reconstruction and strong economic growth in the post-war years. In this article I argue that macroeconomic policies revolved around three key components. First of all, the financial support from the United States, in the form of the Marshall Plan, enabled aggregate demand to be restored and provided the means of payment for much of the needed infrastructure. The second component was the devaluation of European currencies in the late 1940s to address the lack of competitiveness at the pre-war exchange rates which had been held together in the gold-standard architecture – a point raised by John Maynard Keynes at Bretton Woods.[1] Said otherwise, Europe had a solvency problem at pre-war exchange rates. Finally, the macroeconomic policies included a payment system, underwritten by the United States, to overcome Europe's post-war liquidity problems. The dismal failure, in 1947, of the attempt to make sterling convertible had made it clear that Europe's lack of competitiveness was spilling over the payments system, constraining intra-European trade. The European Payment Union (EPU) was a way around this.

In this article I maintain that trade liberalisation and exchange rate stability were the two sides of the same coin.[2] The removal of trade barriers and the opening up of markets, internationally, through the General

[1] Keynes was concerned about the fact that the British economy was not competitive enough relative to the US economy. I owe this point to David Vines.

[2] Referring to John M. Keynes and James Meade, David Vines (2017: 142) defines the connection between trade and finance as circular, "since a well-functioning international financial system would ease the path to the trade liberalisation which they sought".

Agreement on Tariffs and Trade (GATT), and internally within Europe was the necessary condition to enable export-led growth and the creation of a market for manufacturing bigger than that provided within one country alone.[3] Exchange rate stability, through the system of fixed, but adjustable, exchange rates established at Bretton Woods was the necessary complement to trade liberalisation. It was a way to avoid situations where policymakers in one country would use competitive devaluations as a means of promoting high employment and economic growth, at the expense of other countries.

For such a system to work cooperation is critical. By acting together countries would achieve a situation of external and internal balance in each country. Exchange rates have to be adjustable between countries in order to avoid the burden of adjustments being thrown onto wages and prices in deficit countries. Fiscal and monetary policies are necessary in order to adjust domestic demand within each country. Cooperation also implies that large countries should not act on their own, but take into account the impact of their action on other countries, and the latter's response to it.

The rapid reconstruction and economic growth in Europe were possible thanks to the cooperative behaviour of the United States. When the time came, in the 1960s, for Europe to reciprocate this didn't happen because of differences between Germany and France on how to bear the burden of adjustment, and concerns about unemployment (France) and inflation (Germany). The collapse of the Bretton Woods system eventually pushed Europe towards a system of non-adjustable fixed exchange rates because of concerns, among European policy-makers, about the scope for competitive devaluations embedded in flexible exchange rates.

EMU reflects this concern and was conceived to ensure that members of Europe's single market did not gain unfair advantages through competitive devaluations. Like the gold standard (and even more than the gold standard) it is a system skewed toward the exchange rate (and price stability) and forces the external adjustment on the domestic economy. As a result, the EU's monetary foundations leave open the question of the relative competitive positions of member states, as well as the EU's relative competitive position vis-à-vis the rest of the world.

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The article is organised as follows. First, I look at the US support to Europe's post-war reconstruction. I maintain that along with financial aid,

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[3] This argument was articulated most clearly by Paul N. Rosenstein-Rodan (1943: 202) for Eastern and South-Eastern Europe, but it can be extended to post-war Western Europe.

currency devaluations and a flexible payment system enabled European countries to trade with each other and so strengthen their balance of payments, narrowing the imbalances and eventually eliminating the dollar gap – i.e., Europe's structural deficit with the United States. Then, I discuss how exchange rate stability came to underpin trade liberalisation and the common market in Europe. By locking in exchange rates and constraining capital movements within the Bretton Woods system, European policy-makers kept a lid on the deep underlying question of the relative competitive position of individual countries. Afterwards, I look at how the system was kept together and argue that it worked as long as the United States was prepared to neglect their own imbalances and accept Europe's limited co-operation. The issue of the relative competitive position of individual European countries was then muted. In the last section I discuss the regional monetary arrangements that emerged in Europe after the end of Bretton Woods when, with the liberalisation of capital movements, trade and financial imbalances began to resurface. To contain such imbalances among EU member states – and thus remove the option of using the exchange rate to gain competitive advantages – a series of monetary arrangements were introduced. These eventually resulted in the European monetary union. I conclude that such arrangements have muted, once again, the issue of the relative competitive position of individual European countries.

1. US support for rebuilding Europe's economy

When the war ended, western European countries were stuck in an impossible situation. They needed to import the materials and machinery necessary to reconstruct infrastructure and restore aggregate demand, but they couldn't pay for these imports. As exports were depressed and the official reserves of dollars and gold had been depleted by the war effort, there was no way to generate the necessary financing on its own. Europe was in desperate need of capital inflows.

Thus, Europe came to depend on the United States, the only country in a position to offer help at that time.[4] And help came in the form of loans and the provision of a market for European exports. The United States lent western Europe almost 3.5 billion dollars between July 1945 and December 1946, followed with a further 4 billion dollars in 1947 – the year that, on the back of a poor harvest, western Europe ended up with a current-account

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[4] Even physical survival depended increasingly on food aid from the United States and the United Kingdom. For example, in spring 1947 food rations in German cities fell to less than eight hundred calories a day (Eichengreen 2007: 58).

deficit of 5 per cent of GDP and a trade deficit of nearly 4.75 billion dollars with the United States (Gilbert 2009: 19). Europe's imports of goods and services exceeded exports by 65 per cent; restoring balance to the external accounts would have required a boost to its exports by more than half, which was almost impossible.[5] The Marshall Plan provided 13 billion dollars in US government grants over four years from 1948, allowing Europe to import the machinery and materials necessary to break the vicious cycle and restart production. It sustained Europe's strategy of investment-led growth and reconciled the need for investment finance with the goal of improving living standards (Eichengreen 2007: 65). External financial assistance enabled western European governments to pursue expansionary policies and accelerated the economic recovery.

While the role played by the US intervention in the reconstruction of Europe has been widely debated,[6] it is uncontroversial that western European countries would have struggled to rebuild their economies without the US financial assistance. Even Britain, that had been the leading country together with the United States at Bretton Woods, was in no position to play a significant role in the reconstruction of western Europe. In December 1945 the British government had to borrow 3.75 billion dollars from the United States on the condition of keeping sterling convertible (a condition that was broken in August 1947 when the British government had no other option but to end the currency's convertibility).

There were political as well as economic incentives for the United States to assist Europe in its reconstruction. How the main countries of western Europe were going to rebuild their economies and how they would fit in the world economy – meaning, their relationship with the United States – was an issue of concern, as there was a substantial disparity in productive capacity between western Europe and the United States. "This disparity cannot be removed by anything this country alone can do", as stated in a report of the US State Department (1947: 60). For the United States, the liberalisation of trade and payments, and the introduction of currency convertibility in Europe – i.e. European currencies being exchangeable into dollars or other foreign currencies for trade-related purposes – were key priorities. President Truman and his administration believed that only a united western Europe that was at peace with itself would be able to create

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[5] Eichengreen (*ibid.*: 60) notes that trade was the slowest-growing component of national income and so it would have been difficult to control the external balance by boosting exports. Thus to eliminate the deficit it would have been necessary to reduce the demand for imports.

[6] According to one historical interpretation, the economic recovery in Europe was under way prior to the continent receiving the first round of Marshall Plan aid. See, for example, Milward (1984).

a front against the military and ideological threat from the Soviet Union.[7] At the same time, a united western Europe would set the foundation for the reconciliation of the Federal Republic of Germany with its neighbouring countries (Larres 2009: 153). "A Europe which includes Germany" was the solution of General Marshall and the US administration, and indeed the Marshall Plan enabled the creation of a larger political and economic structure to embed the German economy (James 1996: 75). The US leadership thus regarded the Marshall Plan as a way to encourage the formation of a 'United States of Europe' whose close economic and political relations would make war unthinkable and also constitute a united front against the Soviet Union. The process would start with the creation of the Conference for European Economic Cooperation – quickly renamed the Organisation for European Economic Cooperation, or OEEC.

The US assistance, however, did come with strings attached. European governments were expected to sign bilateral pacts with the United States and agree to decontrol prices, stabilise their exchange rates, and balance their budgets. In other words, they had to commit to putting in place the prerequisites for a functioning market economy – so to avoid any leaning towards central planning – restoring the operation of the price mechanism by reducing inflationary pressure, and removing import controls at a predetermined pace (Eichengreen 2007: 36 and 66).

As Paul Hoffmann, the chief Marshall Plan administrator, put it in his October 1949 speech to the OEEC, prosperity required "the formation of a single large market within which quantitative restrictions on the movement of goods, monetary barriers to the flow of payments, and eventually, all tariffs are permanently swept away". Hoffman concluded: "The fact that we have in the United States a single market of 150 million customers has been indispensable to the strength and efficiency of our economy" (Killick 1997: 138).

2. Lack of competitiveness and the dollar gap

The US post-war leadership deemed the financial support to Europe to be a necessary step towards the establishment of a multilateral transatlantic economic system that would render the continuation of American economic aid to western Europe unnecessary, and eventually create a large market for American exports (Larres 2009: 153). This was the

[7] The Truman Doctrine revolved around America's own history, in which integration and the economic convergence of North and South gradually eliminated conflicts that might lead to civil war (Eichengreen 2007: 41).

American plan, but the reality proved more complicated for a number of reasons.

First, it was necessary to find a way to untangle Europe's spaghetti bowl of bilateral trade arrangements, of which there were over two hundred by the late 1940s (Eichengreen 2007: 73; see also Diebold 1952). Second, there was the issue of the inadequate competitiveness of the European economies vis-à-vis the United States, resulting in approximately 40 billion dollars of current-account deficit in the first post-war decade – more than 90 per cent was incurred in the first four years of reconstruction. As a consequence – and this is the third point – dollars were scarce; thus, to preserve hard currency to pay for imports from the United States, western European governments were forced to impose restrictions on imports from neighbouring countries. Fourth, currency inconvertibility acted as an implicit tax on imported goods while raising the level of European incomes consistent with payments equilibrium vis-à-vis the rest of the world. Pursuing convertibility would have shrunk European incomes by 1 to 2 per cent, an effect comparable to that of eliminating the Marshall Plan. This could have threatened the fragile agreements between labour and capital, with the potential for social unrest (Braga de Macedo and Eichengreen 2001).

Against this background in 1949 the Truman administration agreed to the devaluation of western European currencies against the dollar.[8] This move was prompted by concerns that the US recession of 1949 would weaken Europe's balance of payment and make necessary additional Marshall Plan aid. Some countries chose to devalue their currencies by a significant amount: 53 per cent for Austria and 30 per cent for the Netherlands, Sweden, the United Kingdom, and the sterling area. Others did not adjust their currencies in full and instead devalued their currencies by 8 per cent (Italy), 13 per cent (Belgium), and 22 per cent (France). Germany would have chosen a larger devaluation, but France opposed it and settled on 21 per cent.

The devaluation supported the European exports. In the 1950s and 1960s they expanded in volume by more than 8 per cent a year – there were, however, differences in export growth among countries that devalued more and those that devalued less (Eichengreen 1996: 38-43). The dollar gap narrowed as a result.[9] Around the same time it became evident that

8 Apparently, as in other occasions, without prior consultation with the IMF (de Vries 1996).

9 The UN 1955 *World Economic Survey* (United Nations 1956: 71) is critical of this devaluation, hinting that "the United States recession of 1949 and the general alleviation of post-war shortages indicated the end of the period of abnormal post-war sellers' markets", so western European countries had a favourable background for expanding their exports.

currency convertibility was a long-term objective, but a payments system was necessary in the interim to help European countries trade with each other without raising concerns about using scarce dollars to settle the balance. The difficulties experienced by the United Kingdom to restore current-account convertibility in 1947[10] had persuaded the United States that putting pressure on European countries to commit to currency convertibility could be counterproductive if they could not easily open their current account because they were constrained by their trade deficits.

This thinking was a real breakthrough and informed the US support to the OEEC countries for the establishment of the Agreement for Intra-European Payments and Compensations[11] in October 1948. This agreement was then followed by EPU – established in 1950 with 350 million dollars of Marshall Plan money.[12] Although this was presented as a European initiative, it would not have happened without the US active intervention. The United Kingdom strongly opposed it and eventually accepted it in order not to dissipate political capital with the United States. France was reluctant to be in EPU together with Germany and signed in only when the plan was going to go ahead without them (Eichengreen 2007: 79-80).

Within this system participating countries made contributions in their own currency and were entitled to credits from their partners with which to finance temporary trade deficits. Each country received a quota equal to 15 per cent of its total trade with the EPU area in 1949. So long as its liability to EPU remained less than 20 per cent of its quota, it was financed entirely by credit. At the end of each month, the Bank for International Settlements assessed deficits and cancelled offsetting claims. Remaining balances were consolidated, leaving each country with claims on or liabilities to the union as a whole. Debtor countries could secure loans and so did not need to settle bilaterally. Surplus countries, on the other hand, could convert their accumulated claims into commodities or hard currency only partially and with delay.[13]

By providing a payment system when European currencies could not yet be converted under the current account – i.e. dollars that the recipient countries might offer one another to finance temporary imbalances – EPU underpinned Europe's regional integration and export-led growth (Eichen-

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[10] The United Kingdom restored current account convertibility in July 1947, but controls on merchandise transactions were reimposed a month later.

[11] See E.A.F. (1949: 131-138).

[12] See P.B. (1950: 490-498).

[13] Until its quota was exceeded, a surplus country would receive gold amounting to only 40 per cent of its cumulative net exports to other EPU countries (Braga de Macedo and Eichengreen 2001).

green 2007: 84-85). Such a system allowed European countries to liberalise trade without downward pressures on wages while achieving full employment and rapid economic growth.[14] Thus, the impact of EPU on Europe's balance of payment was significant. Europe's dollar holdings more than doubled between the end of 1949 and mid 1956. As dollars were less scarce, the need to discriminate against the United States became less pressing. The terms of EPU settlements were hardened, and the removal of quantitative controls on intra-European trade accelerated.

Savings and investment rates normalised, strengthening the balance of payments and eventually eliminating the dollar gap. Even so, Europe's balance of payments remained fragile. This prevented countries from liberalizing their trade and payments unilaterally. Thus, it was only in 1958 that the European currencies were made convertible and the exchange controls that countries used to manage the demand for imports were removed. EPU was dissolved, but full convertibility on both current account and capital account was not achieved until the late 1980s.

3. The European model

The combination of financial support, currency devaluation and a flexible payment system triggered the unprecedented economic recovery in the 1950s – unprecedented both in strength and speed. By the beginning of the 1950s in most western European countries GDP had recovered to the highest pre-war level; in those years and throughout the 1950s most countries enjoyed double-digit annual rates of GDP growth. For example, the German economy grew at 13.5 per cent a year between 1945 and 1951 (Crafts and Toniolo 1996a: 4; Jackson 2009: 98-99), then at almost 10 per cent a year until mid 1950s and afterwards at around 4 per cent until 1973 (Crafts and Toniolo 1996a: 4). Over the same years the Federal Republic of Germany ran steady balance-of-payments surpluses which strengthened the deutschmark on foreign exchange markets. Western Germany was then on track to become Europe's economic powerhouse.

By the early 1960s, GDP growth in western Europe was, on average, at around 5 per cent a year. Industrial production had tripled in France, Italy, and West Germany since the 1940s; agricultural production across the continent also reached new post-war high levels; and the formation of the European Economic Community (EEC) had stimulated economic coop-

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14 This was not different from the plan that John M. Keynes presented at the Bretton Woods conference.

eration and trade between the member countries (Jackson 2009: 98-99). In less than twenty years (Table 1), western Europe, the population of which accounted for about 9 per cent of the world's population, had become the world's largest market, producing 25 per cent of the world's industrial output and engaging in 40 per cent of the world's trade (Laqueur 1992: 167).

Europe's 'economic miracle' between the end of the war and the early 1970s (Table 1) was driven by a mix of Keynesian policies, government intervention, and foreign assistance. Public sector spending in the industrial world increased from 27 per cent of GDP in 1950 to 43 per cent in 1973. Strong economic growth coupled with an extensive social safety net kept a lid on unemployment, making the 'triumph of full employment' a distinctive feature of the period between 1950 and 1973 (although there were of course some regional differences) (Crafts and Toniolo 1996a: 5).

Table 1. *European growth, 1913-1992 (average annual growth)*

Years	*Real GDP*	*Population*	*Real GDP per head*	*Real GDP per head-hour*
1913-1950	1.4	0.5	1.0	1.9
1950-1973	4.6	0.7	3.8	4.7
1973-1992	2.0	0.3	1.7	2.7*

* 1973-1987.
Note: GDP and population are aggregates for 12 countries (Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, United Kingdom, all adjusted for boundary changes).
Source: Maddison (1991) and OECD (1993), in Crafts and Toniolo (1996a: 2).

The governments of the main western European countries shared similar objectives in domestic economic management: full employment, price stability, and equilibrium in the balance of payments. These objectives had arisen largely in response to specific crises such as the mass unemployment of the 1930s. Active measures of economic management were thought to be necessary in order to contain unemployment and promote full employment. The concept of public responsibility was enlarged not only to embrace policies for the maintenance of employment but also to include a host of institutional measures to promote social and economic welfare (United Nations 1960: 3).

There were, however, some significant differences in how countries implemented Europe's overall economic policy approach (Table 2). In West Germany, for instance, the focus was on price stability and balance-of-payments equilibrium. In France, on the other hand, heavy public investment and a more flexible labour market was focused on shifting the economy away from agriculture and mining towards manufacturing; the Rueff-Pinky reforms of 1958 opened the French economy to external competition and set in motion an export-driven approach to domestic economic growth (Jackson 2009: 98-99).

Table 2. *Estimated trend rates of growth of output per person in different periods (% per year)*

	1951-1973	*1974-1989*
Belgium	3.90	2.09
France	4.92	1.42
Germany	5.11	1.26
Italy	5.31	2.05
Sweden	3.42	1.62
UK	2.24	1.83
USA	1.54	1.89

Source: Maddison (1991) and Crafts and Mills (1996), in Crafts and Toniolo (1996a: 16).

As argued by Maier (1987), post-World War II western European growth was based on a distinctive social pact. A repeat of the debilitating struggle over income distribution that had characterised the post-World War I period was successfully averted. Workers agreed to moderate wage demands if management agreed to reinvest the profits that they accrued in productivity-enhancing equipment. Each side agreed to trade short-term gains for long-term benefits so long as the other side agreed to do the same. In practice, however, workers needed to be convinced to trade lower current compensation for higher future living standards. They also had to trust that management would in fact reinvest the profits that accrued tomorrow as a result of their wage sacrifices today. Understandably, they were hesitant to agree. Governments therefore adopted policies and programmes that acted as 'bonds' which would be lost in the event of reneging. They agreed to limit rates of profit taxation in return for earnings being reinvested. They provided limited forms of industrial support (selective investment subsidies, price-maintenance schemes, and orderly marketing agreements) to sectors that would have otherwise experienced competitive difficulties. Workers were extended public programmes of maintenance for the unemployed, the ill, and the elderly (Braga de Macedo and Eichengreen 2001).

Against this background, capital formation, and in particular government-led investment, played a critical part and underpinned strong economic growth during the two decades after the end of the war. In the 1950s, for example, the rates of growth of output among the industrial countries ranged from 7.5 to 2.2 per cent per annum. The growth of capital formation, however, contributed more than proportionally to Europe's annual growth in production. In 1952 capital formation accounted for 18 per cent of Gross National Product (GNP) in OEEC countries but by 1962 the average had risen to 62 per cent (IMF 1965). At the same time, strong growth meant that an increasing share of output could be devoted to the enlargement of productive capacity. Thus, high investment ratios drove even higher rates of growth (United Nations 1960: 56).

Productivity growth also played an important role in post-war Europe. It altered the economic landscape of Europe (and the rest of the world) enabling the region to regain and indeed exceed its pre-war level of living even while devoting a higher share of output to investment for future growth, to improvement of the balance of payments and to defence. Once the reconstruction was under way, incomes rose rapidly and steadily, and more than the growth of domestic demand. The result was that the pressure of domestic demand against supply subsided and the extra margin could be used to increase exports, reducing imports and thus overcoming the enormous balance of payments deficits with which the region was saddled immediately after the war (United Nations 1952: 71).

The expansion in manufacturing was the main driver of aggregate demand in post-war Europe. The shift in the composition of foreign demand from consumer to capital goods in particular helped transform Europe's engineering industries into principal export industries.

As the US aid programmes were phased out, Europe's exports continued to increase faster than its imports as production rose and their most pressing accumulated needs for domestic reconstruction and consumption were gradually met. Between the first nine months of 1950 and of 1951, for instance, European exports to the rest of the world rose by 25 per cent, while imports increased by only 11 per cent. Particularly significant improvements in trade balances in 1951 were recorded in Belgium and western Germany on the back of excess capacity and a sharp rise in productivity. In western Germany an additional factor was the restriction on imports imposed in 1951. In Denmark and the Netherlands, disinflationary governmental policies contributed to the relatively greater rise in the volume of exports than of imports (United Nations 1952: 76). Overall, intra-European trade expanded vigorously, from 10 billion dollars in 1950 to 23 billion in 1959, while imports from North America grew more slowly, from 4 billion dollars to 6 billion.

Most of Europe's exports were absorbed by demand in the United States that became Europe's most important export market. Europe's exports to the United States more than doubled between 1954 and 1959, with the latter accounting for 22 per cent of nine European countries' (Belgium-Luxembourg, Denmark, France, Italy, Netherlands, Norway, Sweden and Switzerland) exports by 1960 (GATT 1961: 13 and 63).

Europe's expansion of exports further resulted in an accumulation of gold and dollar reserves which, in turn, made it possible to raise imports from the dollar area despite the phasing out of the US financial aid. For the United States, this development resulted in a diminution in its current account surplus; US exports fell from 1948 to 1949, returning to the 1948 level in the first half of 1950, while imports remained unchanged (United Nations 1952: 71). It wasn't until the 1960s, however, that the drop in the US share of total international trade became evident; the US share of merchandise exports of the fifteen largest industrial countries fell from 25.2 per cent in 1960 to 20.5 per cent in 1970, and to 18.3 per cent in 1979, while exports of manufactures fell from 22.8 per cent to 18.4 per cent, and to 15.5 per cent over the same years (Baldwin 1984: 22).

4. Trade liberalisation and exchange rate stability

Trade played a critical role in Europe's reconstruction and economic expansion, encouraging European nations to exploit economies of scale. Following the creation of GATT in 1948 that drove the reduction of tariffs on non-agricultural goods, the establishment of the EEC in 1957 intensified trade among western European nations, provided protection from foreign competition outside the continent, and allowed member governments to fund domestic welfare states and regional economic development (Jackson 2009: 99). Europe's long-term prosperity and security were thought to be dependent on an open trade system, the reparation of industrial capacity – with Germany as the economic centre of Europe despite the initial reservations [15] – and the creation of a unified common market. This, in turn,

[15] US Treasury Secretary Morgenthau's vision of a Germany that concentrated on farming and light manufacturing was displaced, in the late 1940s, by the fact that the Allies could not afford to dismantle German industry and that other means would have to be found to contain Germany. In the end even France had to accept this.

made it imperative for European countries to raise productivity in order to compete against each other.

There were, however, concerns – expressed, for instance, in the Treaty of Rome [16] – that a macro policy of fixed exchange rates would be necessary if Europe's model of export-led growth was to be workable. The experience of the 1930 where exchange rate instability was associated with 'beggar your neighbour' policies, macroeconomic instability and ultimately political upheavals was still too vivid to be ignored. Free trade in a flexible exchange rate system would create the incentive for competitive devaluations for countries with weak relative competitive positions. Trading partners, in turn, might retaliate with the risk of undermining international cooperation while tolerating unfair practices.

As a result, the idea of implementing arrangements to achieve exchange rate stability in Europe was complementary to the idea of promoting trade liberalisation and the common market. The concern was indeed that shifts in intra-European exchange rates could equate to competitive devaluations and so improve the competitiveness of some countries at the expense of others and eventually disrupt the European custom union project. In 1955 European governments negotiated the European Monetary Agreement (EMA), which committed countries participating in EPU to keep the exchange rates within 0.75 per cent either way of the dollar and provide one another with expanded amounts of emergency balance-of-payments assistance. And in the Treaty of Rome member states established a committee of central bankers (the Committee of Governors of the central banks of the Member Countries of the European Community) to discuss problems of monetary policy at monthly meetings on the premises of the Bank for International Settlements (Eichengreen 2007: 191).

In a system like Bretton Woods that was based on pegged but adjustable exchange rates, exchange rate stability required capital movements to be constrained. Capital flows limited the scope for countries with pegged exchange rates to go their own macroeconomic way as interest rates were determined by the need to avoid rapid depletion of reserves, but were not a fully-fledged policy tool for macroeconomic stabilisation. As trade picked up and economic integration deepened, it became more difficult to contain movements under the capital account. Trade invoicing, arbitrage techniques and the development of the Eurodollar market – a pool of offshore dollars unconstrained by US capital controls – became central to the increase in capital flows. This limited European countries' scope to maintain

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16 The Treaty of Rome had recognized exchange-rate and macroeconomic policies as matters of "common concern" [46, in paragraphs 103-107] (Eichengreen 2007: 191).

a level of interest rates significantly different from the one in the United States and so run independent monetary policies (Eichengreen 2007: 189).

Already in the early 1960s central banks became aware of these flows that also were fuelled by events and expectations such as, for example, German and Dutch revaluations. Monetary authorities in Europe responded with tighter capital-account restrictions – Britain and France did so at various points in the 1960s; Germany tightened controls on inflows in 1970, 1972, and 1973 (Eichengreen 2007: 189-190 and 242). It was, however, the 1967 sterling crisis that highlighted how capital mobility undermined the exchange rate stability and how difficult it was to constrain capital flows – and certainly not without coordinated measures.

The expansion of the world economy in the 1960s brought to the fore another critical issue, that was the supply of international reserves to smooth the balance of payments. Under Bretton Woods only two forms of reserves were available, gold and dollars, which were pegged to one another at a fixed price of thirty-five dollars an ounce. With gold in inelastic supply, the demand for additional reserves inevitably took the form of dollars. Reflecting the operation of these forces, external dollar holdings exceeded US gold reserves as early as 1960. As the United States was coming under pressure from public spending on social programs and the Vietnam War, inflation and gold losses on the back of foreign-policy ambitions were eroding confidence in the dollar. Expectations for a devaluation of the dollar became widespread. Capital inflows to Germany and Japan increased substantially on the back of expectations for deutschmark and yen's revaluations.[17] Britain's inability to keep the value of sterling stable had fuelled expectations for the British government to convert dollar reserves. Sterling was finally devalued in late 1967, giving some respite, albeit only temporary, to Britain.[18] The devaluation of sterling, together with the collapse of the Gold Pool and the creation of a two-tier gold market in 1968, suggested that a change in the value of the dollar was no longer a matter of if, but when (Eichengreen 2007: 244).

By then the United States was less willing to sacrifice its domestic objectives to support the international system that it had done so much to create. Its new attitude was epitomized by Treasury Secretary John Connolly's notorious observation, "The dollar may be our currency, but it's

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17 Harold James (2012: 423) notes that from January 1970 to May 1971 capital inflows to Germany and Japan amounted to approximately \$9.6 and \$4.9 billion respectively. These are not significant amounts for modern standards with no capital control, but they were substantial at the time.

18 Throughout the 1960s the balance of payment was "the central problem" of the British economy (Cairncross 1996: 18).

your problem. It was clearly the problem of countries that were holding dollars under the Bretton Woods system. It was also evident, as the Belgian economist Robert Triffin predicted, that Europe needed to secure its monetary and financial future" (Eichengreen 2007: 190).

Against this background the US government felt that it could no longer defend the dollar convertibility and in in August 1971 closed the gold window, marking the end of the Bretton Woods system.

5. The burden of adjustment and the issue of cooperation

As I have already discussed, in the years immediately after the war the Marshal Plan, currency devaluations and EPU [19] mitigated the burden of adjustment that was necessary to narrow Europe's large external deficit. There was no other way for the decimated European economies to reduce the large current account deficit and achieve the external balance predicated under the Bretton Woods arrangements of fixed exchange rates and closed capital markets. Even relatively small deficits could not be financed without producing immediate pressure on the foreign exchange markets, forcing the deficit countries to apply fiscal brakes in a stop-go cycle. With the political turmoil of the 1930s still fresh in mind, European leaders were adamant that restoring the domestic balance – ideally a situation of full employment – had to take priority over external equilibrium – i.e. a balanced current account.

In a system like Bretton Woods, it was critical to have some insulation from international markets in order to allow smooth interventions in the operation of domestic markets. To avoid a repeat of the 1930s, this insulation was achieved through import licensing and foreign exchange rationing under the benevolent watch of the United States, as I have already discussed. The US support and cooperation helped narrow the dollar gap without the need to cut employment, squeeze wages and lower labour costs. After the realignment of the exchange rates against the dollar in 1949, exchange rate stability contributed to keep wages and labour costs stable in Europe and facilitated not just export growth but also the other elements of the post-war bargain, in particular, the agreement to trade wage moderation for high investments (Eichengreen 2007: 188).

As western Europe was gaining control of its balance of payments and the dollar gap had significantly narrowed, it became evident that trade lib-

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[19] US help to Europe was not limited to the Marshall Plan and EPU. Support was given to the European Coal and Steel Community, the Common Market, and even the Common Agricultural Policy, in recognition that regional cooperation was essential for trade, investment, and ultimately Europe's security.

eralisation was unfolding not quite in the way that the US administration envisioned. Rather than being all-embracing, European economic integration was concentrating on a limited number of countries and just a few economic sectors (i.e., the coal and steel industries). Moreover, it was clearly protectionist, raising concerns about discrimination against US trade.

Trade figures show that between 1955 and 1970 the share of Western Europe's trade that stayed within the region rose by ten percentage points, from 56 to 66 per cent. The boost to trade among the founding members began immediately following the formation of the EEC and continued through the 1960s, peaking in 1965-1967. Intraregional trade increased by ten percentage points between 1960 and 1970, from 56 per cent in 1960 to 66 per cent in 1970,[20] and intraregional exports increased by the annual average rate of 13.2 per cent between 1950 and 1973 (Table 3). The same trend, albeit with somewhat smaller trade-creating effects, is also evident in the case of the European Free Trade Association (EFTA) (Eichengreen 2007: 179).

Table 3. *Growth of intraregional and total exports, 1950-2002 (average annual percentage growth rates)*

	Intraregional exports		*Total exports*	
	1950-1973	1974-2002	1950-1973	1974-2002
Belgium-Luxembourg	13.5	8.5	12.1	8.8
France	15.0	8.5	12.6	8.4
Germany	18.6	8.3	19.8	8.5
Italy	15.9	9.1	13.8	9.3
Netherlands	14.5	8.8	13.4	8.8
Spain	14.0	13.2	12.5	12.0
Sweden	11.8	7.2	11.2	7.5
UK	9.3	9.7	6.9	8.4
EU-15	13.2	9.6	12.2	9.5

Source: "IMF, Direction of Trade Statistics" (1948-1980 and 1980-2003 versions), in Eichengreen (2007: 25).

20 This refers to Western Europe that included Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy,, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and West Germany (Eichengreen 2007: 25). For the increase of intra-trade in Europe in the 1950s and 1960s see also Bayoumi and Eichengreen (1997), Aitken (1973), and Eichengreen and Vasquez (2000).

By the end of the 1950, it began to dawn on Washington that the European governments might consider the cooperation needed to mitigate the burden of adjustment to be a one-way road. Concerns were therefore arising around Europe's common market, the establishment of which coincided with the beginning of American balance-of-payments deficits and could turn Europe in a trading rival for the United States. According to Federico Romero, this marked the end of the post-war era for the Europeans while the Americans came to realise that European integration might not necessarily be aligned with and serve the US own interests (Romero 1993: 167).

The exchange rate adjustment epitomises the limited scope for cooperation shown by the European governments. When, in the 1960s, the United States were pushing for adjusting the exchange rate on the back of the US widening current account deficit, there was no political inclination in Europe to go down this route and so fix the current account balance if this risked shifting the equilibrium in the labour market and making it hard to maintain a generous welfare state. In other words, the European governments carefully avoided changes in the exchange rate that could affect the relative demand for domestic and foreign goods, and continued to rely on external demand to absorb excess manufacturing capacity.

Germany, in particular, was not keen to embrace policies, such as expansionary fiscal policies, that could affect the overall level of domestic demand and domestic expenditure, and trigger inflation. If imbalances had to be, then Germany was determined to avoid the zones of "economic unhappiness" (Krugman, n.d.), i.e., those where, for example, the deficit in the current account is coupled with unemployment and/or inflation.

When in the late 1960s the issue of the currency realignment came to the fore in Europe, Germany and France refused to cooperate. Faced with the revaluation of the deutschmark, Germany firstly refused to do so on the basis that the adjustment should be borne by the franc.[21] But France was not keen to embrace austerity and deflationary policies in order to correct their deficits. This would have been the equivalent of a political suicide for the French government. But the franc was under pressure and so the government decided to tighten exchange and credit controls in order to avoid being forced in a unilateral devaluation.

The currency realignment crisis dragged on for more than a year. Eventually, in October 1969, the German government – it was the government,

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21 At a meeting of the G10 in Bonn in November 1968, Karl Schiller, the German economics minister, lectured the French finance minister, François Xavier Ortoli, on the need for stable policies. Ortoli's request to revalue the mark was rejected (Eichengreen 2007: 240).

not the central bank, who decided on whether to change the parity – reluctantly agreed to revalue the deutschmark by 9.3 per cent against the strong opposition by the German exporters and farmers who complained that they should not have to bear the consequences of French profligacy (Eichengreen 2007: 191-192). Despite all this, the German economy continued to strongly grow at full employment, prompting the Christian Democrat opposition stir concerns about inflation and claim that the government had "not learned from the past" (Stueck 1970).

This episode highlights that monetary adjustment in Europe required cooperation between France and Germany, while a cooperative approach to monetary adjustment required readiness to compromise domestic objectives to stabilise the system. This was easier for the surplus country than for the deficit country. However, political pressures and the inflation legacy made this difficult to achieve. Germany was prepared to consider the revaluation of the deutschmark only when faced with the fact that difficulties in managing the monetary situation could result in the new French president Georges Pompidou being less oriented toward European economic integration. It was, however, only after the French government announced, in August 1969, an 11.1 per cent devaluation backed by an IMF programme that Germany followed through with the revaluation of the deutschmark.

Conclusion

The end of Bretton Woods came about as the economic boom began to run out of steam; the very rapid catch-up growth that Europe had enjoyed during the 1950s and 1960s was drying up even though the productivity gap with the United States had still not completely closed (Crafts and Toniolo 1996b: 576). In 1973 the oil crisis triggered a recession in the industrial nations. Internally, inflation was undermining growth and called into question the efficacy of Keynesian demand-management – governments jettisoned fiscal for monetary policy approaches in the late 1970s and early 1980s (Jackson 2009: 101-02). The world economy had become more complex and competitive than in the two previous decades (Larres 2009: 151), and there was a widespread sense of a structural international crisis; in Europe there were fears for the survival of the common market.

All this helped setting the foundations of deeper economic integration that were cemented through the reorganisation of Europe's monetary and financial relations on a regional basis. The main concern was to rein in exchange rate flexibility, that had come to replace the dollar-pegged exchange rates, and remove the option of using the exchange rate to gain competitive advantages. As in the post-war years, exchange rate stability was still a main concern for European policy-makers; the use of the exchange rate to achieve unfair advantages over trade partners was seen as a threat to Europe's trade liberalisation.[22]

European countries established a zone of monetary and financial stability by creating the Exchange Rate Mechanism (ERM). New institutions of transnational governance such as the European Council were established to fill gaps in European coordination, provide mutual surveillance and oversee convergence programmes (Mourlon-Druol 2020: 13).[23] The deutschmark ended up supplying stability for the European currencies, most of which could neither float comfortably nor fix credibly. It was not the first time that EEC/EU member states participated in a stability-oriented monetary framework, supported by the peer pressure applied through European institutions. Unlike EPU, however, where the United States had encouraged compliance with the rules through a system of rewards and sanctions administered by the OEEC, the success of the ERM depended on the member states alone (Braga de Macedo and Eichengreen 2001). The emergence of a more volatile economic and financial environment on the back of liberalised capital movements and a series of banking and financial crisis – such as Black Wednesday in 1992, the Asian financial crisis of 1997, and the global financial crisis of 2008 – tested Europe's commitment to deeper economic and monetary integration.

Throughout this article I have discussed how monetary arrangements have been at the core of Europe's common market since the post-war years. The Bretton Woods system and EPU allowed a rapid period of trade expansion in Europe thanks to the United States' commitment to trade liberalisation that accommodated free-riding and even uncooperative behaviour in Europe (as well as in Japan). The undervaluation of major currencies would not have been possible for more than two decades without such a commitment that caused the post-war US administration to 'benignly neglect' the development of their balance of payment.

The legacy of the Bretton Woods system, that was fundamentally a monetary setup designed to avoid competitive devaluations and 'beggar your neighbour' policy outcomes, is evident in the design of EMU that

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22 At the Hague Summit in 1969 it was therefore agreed to explore prospects for monetary unification, leading to the formation of the Werner Committee. Its report sketched a compromise between the hopeful view that monetary union could foster economic convergence, and the more cautious 'coronation theory' that economic convergence and the harmonization of policies had to come first (Eichengreen 2007: 192).

23 The Bank of England and the Swedish Riksbank took a different approach and abandoned ERM peg; instead they implemented a well defined, alternative monetary-policy operating strategy – inflation targeting.

revolves around the exchange rate mechanism. This ensures that member states do not gain unfair advantages through competitive devaluations. The issue of the relative competitive position of individual countries and the macroeconomic setup – i.e. fiscal policies – that would make the adjustment manageable – the issue that brought Bretton Woods to an end – remains unaddressed.

Like in the post-war years when countries within the Bretton Woods system were confronted with the US current account surplus, the European policy-makers have been grappling with current account imbalances since the 1970s. Germany's surplus, in particular, has widened since the early 2000s, and is mirrored by the United Kingdom's deficit and, until the global financial crisis, Italy's also. However, unlike the United States that accepted the costs of adjustment and helped western Europe to narrow its current account deficit and reduce the dollar gap, Germany has insisted that this costs should be borne by deficit countries. Unconstrained capital movements have contributed to widen the imbalances. This is the key difference between the current setup and Bretton Woods. Liberalised capital movements allow current account imbalances to build up to a much greater extent and sustain them for much longer periods (Subacchi 2020: 56-59).

In the late 1980s and early 1990s these imbalances were taken to be an example of the problems that Europe's monetary union should address, notably a monetary solution to the problem of competitiveness within the European internal market, as the Bretton Woods system did for international trade. The monetary union, the argument went, would remove the risk of recurrent crises and the need for continued currency realignments. The concern was, once again, about the impact of the exchange rate instability on trade policies and the internal European market (James 2012: 426). By depoliticising the issue of who would take the burden of adjustment and moving it away from the political arena, it became easier to implement the necessary adjustments as complex bilateral negotiations to persuade the French or the Italians to control public spending, or to push the Germans to be more flexible vis-à-vis price stability and domestic demand, were no longer required. However, like under Bretton Woods the onus of reducing the imbalances is on the deficit countries,[24] and is somehow built in the design of the monetary union, leaving – at least in theory – no scope for political negotiations.

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[24] Of course, the Bretton Woods system would have been less constraining if the Americans would have accepted symmetric adjustments – for the deficit as well as for the surplus countries – that the Keynes plan of 1943 had put forward.

The problems of EMU are deep-seated and stem from an unwillingness to recognise the fundamental tasks facing macroeconomic policy in a monetary union. With common monetary policy and inflation targeting, and floating exchange rates between countries within Europe, it is necessary to have a macroeconomic setup in which fiscal policy is used to manage demand, financial regulation is used to constrain private sector booms in booming countries, and the inflation of wages and prices and the level of competitiveness of countries are objects of concern for policy. All these were not present in the first decade of EMU and are still not adequately present. The problem, as I have discussed here, is that of the development of *trading relations* which threatens the workings of *monetary institutions*. It is, in other words, the same old problem which brought down the Bretton Woods system.

Although Europe has seen politicians and constituencies more willing to accept compromises on national sovereignty than other parts of the world (Bayoumi and Eichengreen 1999), cooperation remains an issue. During the sovereign debt crisis countries struggled to coordinate their fiscal policies and so provide an adequate response to the crisis. Until the Covid-19 pandemic there was limited support among the EU member states for anything that resembled shared fiscal capacity for the euro area.[25] Being the current crisis a natural event, this has removed the issue of moral hazard that had crippled coordination during the previous crisis and so has brought to the fore the importance of central fiscal intervention. Whether this will lead to achieve an appropriate stance of policy coordination, it remains an open question.

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[25] The proposals to set up a euro area fiscal capacity, as in the *Four Presidents' Report* and the *Five Presidents' Report* did not gain political support (Van Rompuy 2012; Juncker 2015).

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