
How Countries' Different Attitudes towards Inflation can thwart the European Dream

Lucian Croitoru¹

Abstract

In this paper I show that countries' commitment to maintain a fixed exchange rate is unsustainable if their attitudes towards inflation differ. This means that, if these attitudes are different, two of the solutions to the macroeconomic policy trilemma (those involving the fixed exchange rate) are unsustainable. Countries' different attitudes towards inflation are an expression of different attitudes vis-à-vis competitiveness and reflect diverse national preferences regarding the objectives of economic growth, solidarity and sustainability, which are parameterised in the economic policies of nation-states.

If countries commit themselves to maintaining fixed exchange rates and open capital accounts or they set up a monetary union, the segregation of their attitudes towards inflation engenders a mechanism that generates and perpetuates major current account imbalances across countries. The mechanism systematically places the adjustment burden on countries with a deficit, through wage and/or price deflation in countries with preferences for relatively high inflation rates, and leads to a lower effectiveness of fiscal policy or even to the loss of this policy as public debts as a share in GDP increase and come to exceed relatively elevated levels. At the end of the day, the commitment to a fixed exchange rate or to the currency area vanishes, showing that – if countries' attitudes towards inflation differ – nation-states are incompatible with monetary integration, contradicting in this case one assertion of the political trilemma of the world economy described by Rodrik (2000). Keeping the commitment in place in a sustainable manner calls for giving up nation-states and for their democratic federalisation.

In light of the above, the “executive federalism” (Habermas, 2011) instituted after 2008 in the euro area is not a solution for the survival of the currency union. It can prove useful only if it has been used in order to buy time for creating genuine demand from the public for a democratic federalisation of the euro area.

Keywords: exchange rate; inflation; macroeconomic policy trilemma; euro zone; nation-states; policy trilemma of the world economy

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¹ National Bank of Romania, Bucharest, Romania, e-mail: Lucian.Croitoru@bnro.ro

1. Introduction

The economic crisis that broke out in 2008 changed the perspective on world economic order and integration. Before the crisis, globalisation seemed to have rather positive effects on world economy and the degree of international economic integration looked almost undoubtedly set to rise. This view has now changed. As it happens every time after a financial crisis, doubts on the benefits of financial integration have increased following the 2008 crisis as well. It is hard to say whether global economic integration will re-embark on an upward path or whether it will enter a period of standstill or contraction and how long this would last.

The signs on a possible shift in world economic order and a fluctuation in the degree of integration of the global economy come from a series of changes in the economic policies of major economies worldwide. On one hand, protectionism has resurfaced in none other but the most liberal economy of the world. The rise in protectionism was anticipated as a response to the magnitude and persistence of global imbalances (Faruqee *et al.*, 2006). They have not been sufficiently reduced by the 2008 crisis, but continue to be fuelled by some countries which impose restrictions on capital flows, intervene on foreign exchange markets aiming at trade advantages, countries which are export-dependent, oil-exporting countries benefiting from the relatively high oil price, and finally countries whose domestic demand is constrained by structural factors. From this standpoint, it appears that global imbalances are, in turn, a reflex of a relatively high economic integration (globalisation) which seems to be at odds with the social organisation centred on nation-states, an insufficient organisation in terms of the need to have an economic integration without imbalances, hinting at better options for the social setup, such as federalism. With such determinants, protectionism will expand without being able to reduce – as hoped for by its promoters – global imbalances and it will weaken international economic cooperation, economic competition in the protected countries, as well as global economic growth.

On the other hand, the period following the 2008 crisis saw several measures aimed at strengthening the Eurozone – an area with the same conflict between relatively high monetary integration and its social setup based on nation-states, a conflict ultimately reflected in the existence of wide current account imbalances. These reforms ended up generating renewed concerns not only about their democratic legitimacy, but – as I will show – even about the future of the euro area, whose primary *raison d'être* is to speed up intra-Union trade and hence international economic integration. Since the rise in protectionism can largely be understood as a result of global imbalances that emerge when the social setup is centred on nation-

states, what was left to motivate most the drafting of this paper was the interest in comprehending how current account imbalances occur inside the euro area and the possible outcome of the recent reforms within the boundaries of the Eurozone, given that it is based on nation-states.

Some economic historians (e.g. Bordo and James, 2013; Eichengreen and Temin, 2010) claim that the euro area has the same type of vulnerabilities as the interwar gold standard. The resemblance comes from the fact that, given the single currency (which is tantamount to fixed exchange rates among the Eurozone countries), countries with a current account surplus avoid raising the inflation rate, leaving most of the adjustment burden on deficit-ridden countries, which have no other option but to lower wages and prices. Other economists (e.g. Crafts, 2014) believe that devaluation and default pressures in some of the Eurozone countries may increase at any time, as was the case after the 2008 crisis, but the solution to these problems – a democratically federalised Europe, with a banking union and a fiscal union – is politically impossible. If a democratic federalisation is virtually impossible, then an “executive federalism” (Habermas, 2011) – where political control remains with the states, but some economic policy coordination and monitoring powers are handed over to technocratic institutions that have to follow previously established procedures approved by governments – is preferable to dissolution (Crum, 2013).

Finally, there is also the opinion that the creation and expansion of the euro area are purely and simply a mistake, if we consider that the public in the member countries does not wish a political and fiscal union. For instance, Mervyn King, former governor of the Bank of England, believes that “[t]he tragedy of monetary union in Europe is not that it might collapse but that, given the degree of political commitment among the leaders of Europe, it might continue, bringing economic stagnation to the largest currency bloc in the world and holding back recovery of the wider world economy. It is at the heart of the disequilibrium in the world today.” (King, 2016, p. 248). The mechanism whereby the euro might bring stagnation for the currency bloc members is triggered by the “second round of problems” (Eichengreen and Temin, 2010) brought about by fixed exchange rates or by a currency that several nation-states share, even though the first-round problems – leading to the emergence of the crisis – are tackled via monetary and fiscal policies. For example, a second-round problem is that the fixed exchange rate cannot lead to stimulating demand by increasing exports after some first-round problems – such as an asset price bubble going bust – have caused domestic demand to collapse.

In order to understand the rise in protectionism and the effects that euro area institutional reforms can lead to, in this paper I use the information conveyed jointly by the “macroeconomic policy trilemma” (also known as the impossible trinity proposition) and the “political trilemma of the world economy” discussed by

Rodrik (2000). In the case of the macroeconomic policy trilemma, only two of the three goals – fixed exchange rate, capital mobility and monetary autonomy – can be selected and sustainably maintained. According to Rodrik's (2000) political trilemma of the world economy, economic integration is compatible either with nation-states or with "mass politics". Section 2 shows that any country sees the emergence, in time, of social and political objectives which, in order to be addressed by governments, call for a change in the solution to the macroeconomic policy trilemma, the new solution inevitably including one of the goals discarded in the earlier solution. Section 3 introduces the hypothesis that the segregation of attitudes towards inflation among countries committed to maintaining fixed exchange rates or having a single currency leads to giving up the solution to the macroeconomic policy trilemma. To support this hypothesis, in the following two sections I show that – as long as the attitudes vis-à-vis inflation have been similar – the gold standard and the Bretton Woods system, which represented two different solutions to the macroeconomic policy trilemma, remained functional. However, once the countries' attitudes towards inflation segregated, they led to the replacement of the two solutions to the trilemma. Section 6 shows that, in the euro area, different attitudes towards inflation among countries lie at the root of a mechanism that perpetuates current account imbalances and, eventually, incapacitates the countries' fiscal policy in periods of recession. In Section 7 I show that, if countries' attitudes towards inflation are segregated, then the currency bloc and nation-states cannot sustainably coexist, as predicted by Rodrik's political trilemma, a sustainable monetary integration being possible only with the democratic federalisation of the euro area. Section 8 concludes.

2. The implicit sequence in the impossible trinity proposition

Obstfeld and Taylor (2003, p. 122) used the framework of the macroeconomic policy trilemma to explain the evolution of theories of how international capital mobility has evolved. They demonstrated with statistical data and historical facts that, due to the rivalry (competition) between possible economic policy choices that it implies, the trilemma has the power to explain many ups and downs of the capital market in the 20th century. In this section, I am interested in clarifying to what extent, given the conflicting policy goals, the change in a solution to the trilemma is driven by causes within – or, on the contrary, outside – the trilemma. In the former case, we should see that at least one of the two goals selected as part of the solution does not materialise, if the assumptions underlying the trinity proposition are not fulfilled.

In the latter case, we should understand that goal prioritisation is external to the trilemma, determined by deeper causes. These deeper causes lead, as I will show, to the differences in the attitude towards inflation and to the negative effects that they

generate and which I referred to in the introduction. Of particular interest in this section is the way in which a country shifts from one solution to the macroeconomic policy trilemma to another, since these individual shifts in each country – shifts that are usually contemporary for a group of countries – lead to the change in economic order, broadening or narrowing the perspectives on economic integration.

In order to see whether a solution to the trilemma is changed for reasons internal to the trilemma, we start from the impossible trinity proposition, according to which countries cannot simultaneously maintain fixed exchange rates, open capital accounts and independent monetary policies. This assertion regarding the monetary regime is based on the uncovered interest parity on international markets. It assumes that capital markets are efficient, with perfectly substitutable assets and, for this reason, with equal interest rates across countries. Consequently, the short-term interest rate accurately reflects exclusively the domestic monetary and financial conditions only if the exchange rate is fully flexible or capitals are controlled. Based on this assumption, the trilemma yields three options (predictions) regarding the two goals that can be sustainably upheld: a) a fixed exchange rate and capital mobility (the independent monetary policy objective is discarded based on the uncovered interest parity); b) a fixed exchange rate and an autonomous monetary policy (the capital mobility objective is ruled out in order to allow the interest rate to reflect exclusively the domestic monetary and financial conditions); and c) an independent monetary policy and capital mobility (the fixed exchange rate objective is overruled so as to enable the interest rate to reflect exclusively the domestic monetary and financial conditions). This outcome provided by the macroeconomic theory of an open economy was intuitively glimpsed by Keynes (1930), understood and mentioned by Friedman (1953), clearly defined and formalised by Mundell (1963) and Fleming (1962) and baptised “macroeconomic policy trilemma” by Obstfeld and Taylor (1997), a phrase also used throughout this paper.

In practice, the three options described above have varying degrees of realism. There is no doubt that the option to maintain a fixed exchange rate and capital mobility is at odds with an independent monetary policy. In this case, the domestic interest rate would permanently reflect the international monetary and financial conditions. However, it is arguable whether, in practice, conditions are met for the other two options to have full traction. Option b), where monetary policy independence is ensured by a fixed exchange rate and by capital control, is debatable because there are administrative and/or political constraints when it comes to controlling capitals. With capitals that manage to overcome controls, the domestic interest rate no longer accurately reflects domestic monetary and financial conditions, which means that monetary policy is not fully independent, as assumed by the trilemma. Option c), where monetary policy independence is ensured by a

floating exchange rate and by full capital mobility, has recently been questioned as well. In this case, financial globalisation and financial market flows enable the monetary policies of major world economies to affect other countries' monetary and financial conditions – even though these countries have floating exchange rates and capital mobility –, thereby denting the independence of the respective monetary policies (Rey, 2018).

The invalidation in practice of the underlying conditions of the impossible trinity proposition would suffice to reject the very existence of the trilemma and hence its predictions. However, this is no easy thing to do, since exchange rate flexibility, monetary policy independence and capital mobility are concepts that cannot be defined and gauged in a single, universally-accepted way. Even when monetary policy independence is impaired by the ineffectiveness of capital controls, in case of solution b), or by the monetary policies of major economies because free floating is not enough to insulate monetary and financial conditions from the external influences transmitted, for instance, via the international credit channel or the international risk-taking channel, in case c), it needs to be assessed whether the magnitude of the phenomenon is relevant. The studies measuring these magnitudes are not convincing yet. From this perspective, it is difficult to say that a solution to the trilemma is replaced by governments with another because, for example, interest rates do not reflect strictly the domestic monetary and financial conditions or, vice versa, because they reflect strictly the external ones. Rather, if faced with these predicaments, governments would identify new measures, such as prudential ones, which would be used to address the situations (e.g. a super-activation of the credit channel fuelled by capital inflows) in which the interest rate would not suffice to ensure full monetary policy independence.

Once the issue of internal causes has been clarified, what remains as an explanation for changing a solution to the trilemma are the causes external to the trilemma's logic. The idea I advocate is that a solution to the trilemma is replaced because governments cannot maintain it forever. The reason why governments cannot uphold a certain solution for an indefinite period of time is not their administrative ineptitude. The reason is that the two goals selected as part of a solution are not only incompatible with the discarded (ruled out) objective, but they also have "external incompatibilities" to the trilemma, with objectives not covered by the trilemma, but which call for a new prioritisation of the trilemma objectives, i.e. a new solution to the trilemma. For example, Bordo and James (2013) showed that the fixed exchange rate (or a single currency in a monetary union) and capital mobility (favoured objectives) are incompatible not only with autonomous monetary policy (discarded objective), but also with financial stability and democracy. According to the terminology I have proposed here, financial stability

and democracy are the external incompatibilities of the favoured objectives in the solution to the macroeconomic policy trilemma.

The goals in connection to which the external incompatibilities occur may be present at the time of adopting the solution to the macroeconomic policy trilemma or may emerge as a result of social and political factors. To the extent to which the problems arising from external incompatibilities build up on a large scale and generate costs for the wide majority of participants in the existing economic order, then political pressures grow for changing the solution to the trilemma, namely for changing the monetary regime.

Consequently, the deep cause of a change in the solution to the macroeconomic policy trilemma is always external to the trilemma. The deep causes for which governments pick one solution or another to the trilemma are socio-political and technological, with the former prevailing. Paraphrasing Cohen (1996), Obstfeld and Taylor (2003) include among the latter: policy competition between governments to promote state interests (whatever that means), political rivalries in each country, ideology and, finally, advances in economic knowledge. However, picking a solution is not independent of the trilemma. The new solution has to favour the new objectives imposed by the socio-political causes that prompted the repudiation of the earlier solution, as well as the constraint that the trilemma imposes when it comes to choosing the monetary regime.

A new solution essentially means solving the macroeconomic policy trilemma in favour of an objective rejected in the previous solution. For instance, the gold standard emerged because governments wanted to give up monetary autonomy (discarded objective) in order to be able to maintain fixed exchange rates and open capital accounts. As we will show, the solution sought to insulate monetary policy from government intervention. The Bretton Woods agreement was reached because governments chose to close capital accounts – more or less, as it turned out – in order to be able to maintain fixed exchange rates and render monetary policy independent (the goal ruled out in the previous solution) in support of domestic economic policy objectives. Finally, after a transition period between 1968 and 1973, the countries decided to give up fixed exchange rates in order to be able to keep in place floating exchange rates (the goal rejected in the former solution), meant to insulate them from external monetary policy shocks, and autonomous monetary policies, to help stabilise output and employment. Milton Friedman explained as early as 1953 that the new regime needed a monetary policy rule, which would result in monetary stability, the absence of which would mean both the instability of prices and real income and the instability of nominal exchange rates. Nevertheless, this lesson was learned gradually, with most advanced economies leading the process. Even in these countries, low inflation, central bank

independence and the use of rules came to coexist as late as towards the end-1980s (Bordo and Schenk, 2017).

With these clarifications made, we can use the Western countries' current solution to the trilemma in order to analyse whether there are presently any conflicts between different solutions to the trilemma in various countries or interactions between domestic political pressures in certain economies and the solution to the trilemma, including in order to provide several answers to the question of why protectionism increases.

For instance, some Western countries might look upon the current solution to the trilemma found by the majority of developed Western economies – floating exchange rate, autonomous monetary policy and open capital account – as conflicting with the solution found by some Asian economies. Of the latter, Japan alone has solved the trilemma the same as developed Western countries. In Hong Kong and China, the exchange rate is pegged to the US dollar, which is good for their exports to the US, while Brunei Darussalam's currency is linked to the Singapore dollar. As for the rest, most East Asian economies pursue independent monetary policies, some restrictions on capital movements, and some degree of currency flexibility (Morgan, 2013, p. 23).

The protectionist practices recently resorted to by the US may be viewed as an outcome of the interaction between domestic political pressures and the US solution to the trilemma, leading to a breach of the constraint imposed by the trilemma. More precisely, protectionist practices are tantamount to an alteration of exchange rate flexibility and hence of its signalling role in resource allocation, as capitals remain mobile and monetary policy aims for independence (the restriction on imports plays a similar role to an exchange rate depreciation on the current account balance).

From another standpoint, it might be said that the Western countries' current solution to the trilemma redefines in a subtle manner the internal objective that had been favoured by the solution to the trilemma found through the Bretton Woods system. Specifically, in some west European countries, the output and employment stability goal – which lay at the core of the former solution – is secondary in the current solution, which centres on strictly anti-inflationary monetary policies that may result, in certain conditions (Blanchard and Gali, 2008) in sizeable fluctuations of output and employment.

A future solution to the macroeconomic policy trilemma in Western countries may very well seek to re-establish the core role for the objective of stabilising output and employment, which was “altered” through conceptions oriented much too firmly towards controlling inflation, such as inflation targeting, or else it may attempt to

reassign the leading role to the fixed exchange rate. The latter solution seems less likely today, but the rise in protectionism is indicative of the nostalgia that the fixed exchange rate manages to stir.

Finally, the current solution (flexible exchange rates, independent monetary policy and capital mobility) may pose problems to small countries which, for example, once flooded with capitals, are faced with relatively high inflation and inflation expectations, despite the fact that the exchange rate appreciates in nominal terms (Isărescu, 2009, p. 24), denting exporters' competitiveness. In this context, raising the interest rate would attract new capital inflows, which – if leading to an increase in output above potential – fuel inflation expectations, while lowering it would also result in higher inflation expectations. In the end, the rise in inflation expectations regardless of the direction in which the interest rate changes is tantamount to a loss of monetary policy independence. The Romanian economy found itself in this situation and the central bank lost *de facto* the interest rate as a monetary policy tool in the period from 2007 Q3 to 2008 Q3 (Croitoru, 2017, pp. 125-132). In order to slow down the massive capital inflows, the National Bank of Romania (NBR) resorted to macroprudential measures, initiated and developed for this purpose starting 2003, including by raising the minimum required reserves to a record 40 percent of eligible liabilities. The macroprudential measures developed by the BNR during 2003-2008 and the underlying rationale are described in Isărescu (2008 and 2009), Popa *et al.* (2009), Georgescu (2011) and Croitoru (2015a).

Some might say that Romania lacked during 2003-2008 sufficient protection for the autonomy of its monetary policy in the face of the “Global Financial Cycle” (which, in Rey's (2015) vision, is influenced by the US monetary policy), because the leu's floating is not fully flexible. For this reason, the international credit channel and the international risk-taking channel combine with the domestic credit channel and with the domestic risk-taking channel to generate excessive credit growth during booms and credit crunches during downturns. However, this potential observation should be weighed considering that, as Rey (2018) showed, the monetary policies in free floating economies were not fully independent either from the global financial shock prior to 2008, because the free float cannot fully insulate from external shocks, given the financial globalisation and financial market flaws.

3. The impossible trinity, the political trilemma of the world economy and countries' attitudes towards inflation

In the previous section, I dwelt on the idea that a country's solution to the macroeconomic policy trilemma is a political choice that hinges on deep socio-political causes. The objectives on which the political decision is exerted are conflicting, so that compatible objectives must be chosen. In the end, picking the

solution to the macroeconomic policy trilemma by any given country is a political decision informed by the impossible trinity proposition.

The countries' decisions regarding the solution to the trilemma are seldom taken without considering the objectives of world economic order and the outlook for global economic integration. For instance, the countries' decisions on establishing the Bretton Woods system or setting up the euro area were not only political decisions informed by the impossible trinity proposition (regarding the three options for possible combinations between the exchange rate regime, the capital regime and monetary policy independence), but rather decisions that considered a certain economic order and a certain outlook for monetary integration.

Following these informed decisions, countries of the world adopt one of the solutions to the macroeconomic policy trilemma, picking either one of options a)-c) described in the previous section or a "middle" solution, through deviations from the mentioned options, in which case none of the goals is fully attained. The countries' breakdown by the solutions to the trilemma and the economic, financial and monetary agreements and treaties generated around these solutions are a defining factor of the world economic order. A major change in the countries' breakdown by the solutions to the trilemma leads to a major change in world economic order.

However, a change in economic order does not necessarily mean an increase in global economic integration (in the globalisation of the economy). For example, Aizenman, Chinn and Ito (2010) and Aizenman (2013) show that, in the period from 1970 to 2006, developing countries with emerging markets shifted to relatively more flexible exchange rate regimes, to a relatively lower independence of monetary policies and to a deeper financial integration compared with non-emerging developing countries. In emerging countries, the configuration of the macroeconomic policy trilemma converges towards the "middle" solution via managed exchange rate flexibility, supported by the build-up of international reserves, as well as via the maintenance of monetary independence and financial integration at medium levels (Aizenman, Chinn and Ito, 2013, p. 456). Conversely, developed countries stepped up their financial openness as early as the beginning of the 90s and increased the exchange rate stability after the introduction of the euro in 1999 but, as a consequence, the degree of monetary policy independence dwindled, as predicted by the macroeconomic policy trilemma. Nevertheless, monetary policy independence diminished to a smaller extent in developed economies than in emerging ones (Aizenman, Chinn and Ito, 2013, p. 451).

In order to deepen, global economic integration needs increasingly free markets from the restrictions coming from national jurisdictions (states) as regards

economic and financial transactions. Thus, enhanced economic integration depends on identifying the ways to limit political influence on economic policies and, through them, on markets. Or, looking from markets towards economic policies, we need to find the ways in which international markets can transpose their competitiveness requirements in economic policy parameters, so that economic integration might continue and stabilise at high levels. Röpke (1959, pp. 33-65) compellingly argued that there is only one solution to such a problem, namely “*Federalism*” (p. 45). He justified the uniqueness of the solution in that nation-states are too large for “true and permanent integration” and too small for “those intellectual, political and economic relations which today can only flourish satisfactorily in an international community” (p. 45).

However, much more recently, the uniqueness of the solution was questioned by Rodrik (2000), who argued that not only federalism, but nation-states as well can be compatible with global economic integration. By analogy with the macroeconomic policy trilemma, Rodrik (2000) came up with “the political trilemma of the world economy” to show that countries’ options to reduce the influence of politics on economic policies while enhancing economic integration are limited. It is in the interest of this paper to conduct our analysis starting from the existence of this trilemma, so as to see whether and under what circumstances it is valid.

One of the nodes of the “political” trilemma is economic integration, while the other two are nation-states and mass politics. Rodrik’s trilemma claims that international economic integration, nation-states, and “mass politics” cannot co-exist. Just like the macroeconomic policy trilemma for the monetary regime, Rodrik’s trilemma is also indicative of the scarcity of policy tools that can be resorted to in order to deepen economic and financial integration.

According to the “political” trilemma, international economic integration is compatible with nation-states as long as the institutions (understood as written rules administered by organisations or as moral rules widely accepted across the society) and organisations in charge of various economic policies (central banks, fiscal authorities) are truly insulated from political participation. A case in point is the gold standard, whose demise occurred when national economic policies could no longer be adequately insulated from political influence.

In Rodrik’s (2000) view, economic integration is also compatible with mass politics, where nation-states – although they do not disappear – diminish their role to make way for global federalism, meaning that “national jurisdictions do not interfere with arbitrage in markets for goods, services or capital”, while politics would not shrink, but merely “relocate to the global level”. This seems to be the right solution – both economically and politically – for the euro area, with the caveat that the public seems

reluctant for the time being to the idea of relocating politics to the global level via a political union. Finally, according to the political trilemma of the world economy, if international economic integration is sacrificed, there may be a combination of nation-states and mass politics, as was the case during the Bretton Woods system, which saw international economic integration take a back seat.

In light of the two trilemmas, in the sections that follow I shall analyse, as stated in the Introduction already, the gold standard regime, the Bretton Woods system and the euro area in order to support two assertions: the first is that, although the decision to move from one solution of the macroeconomic policy trilemma to another is political, in the countries committed to keeping fixed exchange rates in place, the abandoning of the solution is technically determined by the segregation of countries' attitudes towards inflation, a segregation which reflects complex, highly diversified and persistent socio-political preferences.

The second assertion I advocate, which is a consequence of the first and which I will explain in detail in the last but one section, is that segregated attitudes towards inflation render impossible the sustainable monetary integration based on nation-states.

Before providing arguments for the two claims in the following sections, it should be made clear that the attitude towards inflation is nothing else but a way in which the social attitude vis-à-vis firms' competitiveness manifests itself. Neo-Keynesian theory defines current inflation as the "discounted sum" – over an infinite horizon – "of current and expected future deviation of real marginal costs from steady state" (Galí, 2008, p. 45). These deviations depend on shocks in real variables such as consumer preferences, technology, workforce, etc., but also on shocks triggered by macroeconomic policies, by regulation in general and by other policies. Consequently, the attitude towards firms' competitiveness and, hence, towards inflation is essentially an attitude towards the expectations regarding the unobservable deviations from marginal costs (as an expression of competitiveness) of firms.

In turn, the attitudes towards competitiveness and, implicitly, towards inflation hinge deeply on preferences vis-à-vis social and political objectives (external to the trilemma), whose vast diversity across countries can nevertheless be structured, in my opinion, by reference to "growth, solidarity and sustainability" (the phrase belongs to Crum, 2013, p. 618).

The preferences vis-à-vis the three objectives take shape in time, under the influence of (i) social, cultural, educational and political factors, (ii) the individual's freedom from the state, including his/her freedom from redistribution, and finally (iii) the soundness of institutions and the individual's trust in them. The combination of all

these factors differs from one country to another, so that nation-states may persistently display significantly different attitudes towards inflation (the attitude towards competitiveness or that towards inflation will hereinafter be used interchangeably). For example, Juselius and Takáts (2018) showed there is a strong link between the population age structure and inflation, the young and old (dependants) being associated with higher inflation, whereas the working age population is associated with lower inflation. The higher the ratio of dependants to working age population, the higher the inflation. This ratio depends on the policies regarding education, the public pension system, the state's intervention in the economy, etc. The age structure differs across countries, so that it influences the countries' preferences vis-à-vis growth, solidarity and sustainability and, hence, their attitude towards inflation, given the link between the population age structure and inflation.

Consequently, it is unlikely that all countries participating in the solution to the macroeconomic policy trilemma through their commitment to maintain a fixed exchange rate have similar preferences vis-à-vis growth, solidarity and sustainability. These preferences, which are deeply rooted in those countries' social and political networks, probably differ among countries, reflecting in different attitudes towards competitiveness.

Different preferences for social and political objectives are the reason why nation-states do not succeed, all to the same extent, in facilitating the transposition of market requirements on competitiveness in the parameters of national economic policies (or, in other words, not all nation-states are able to insulate *de facto* their economic policies from political influence and to maintain their commitments vis-à-vis inflation), which leads to the segregation of attitudes towards competitiveness and implicitly towards inflation. Reducing discretion in macroeconomic policymaking by setting monetary or fiscal policy rules aims to guarantee that preferences vis-à-vis growth, solidarity and sustainability do not end up reducing and eventually obliterating the transmission of market requirements on competitiveness in the national policy parameters. Differences in the attitude towards inflation can be devastating if the solution to the macroeconomic policy trilemma favours a fixed exchange rate, regardless of whether monetary policy is independent (as in the case of the Bretton Woods system) or not (as in the case of the gold standard or the euro area). As I will show in Section 6, the effect is at its peak when a number of nation-states agree to be part of a monetary union, because – with the same interest rate – different attitudes towards inflation widen the inflation differentials, which will fuel the segregation of countries' attitudes towards inflation and, at a deep level, towards competitiveness levels and of the attitude towards competitiveness. The difference in attitudes towards inflation within a

monetary union made up of different nation-states has seldom been explicitly considered a “basic problem” (King, 2016, p. 221) or a “fundamental, even fatal, flaw” (Walters, 1986, p. 127).

With fixed exchange rates and segregated attitudes towards inflation, two possible outcomes emerge as regards the economic order generated by the solution to the macroeconomic policy trilemma in favour of the fixed rate. Either the differences in terms of welfare and the imbalances across countries will widen, leading to the wiping out of the economic order, or the economic order will fall apart under the pressure that may come either from relatively poor countries or from relatively rich countries, even before the imbalances witness a brutal adjustment. In the Bretton Woods system, the economic order fell apart before the gaping of welfare differences to the point of entailing disorderly corrections. For the gold standard and the euro area, the countries’ different attitudes towards inflation led to their segregation into countries running current account deficits and countries on a surplus. These imbalances cannot be reduced via cooperation; thus, in the event of a crisis, the bulk of the adjustment burden would fall on deficit-ridden countries, through internal devaluations. As I will underline in Section 7, the solution for avoiding stagnation in the euro area is none other but the democratic federalisation of the European Union.

4. The gold standard and the attitudes towards inflation

The gold standard provided a mechanism which, up until World War One, ensured the compatibility between two types of goals pursued by countries: an internal and an external one. The former has been understood primarily in two distinct manners across time. At one end, it was understood as an automatic constraint imposed on monetary policy, in line with the Currency School thinking, to give a fixed value in gold to fiat money, in which the central bank did not significantly interfere with demand for and supply of monetary gold. At the other end, it was understood as a monetary policy rule (Bordo and Kydland, 1995), in modern-day terms regarding time consistency, defined by Kydland and Prescott (1977). Moreover, using a DSGE model, Newby (2009, p. 32) showed that the very “resumption of the gold standard at the old par value in the future is a sustainable plan that replaces the gold standard as a commitment technology during war”. In any case, the internal goal was to prevent the monetary authority from implementing a discretionary, i.e. time-inconsistent, policy.

Since fixing the value of money in gold quantity terms aimed to discipline monetary policy and each country adhered to the gold standard (or to any other standard implying convertibility into precious metals) freely, it follows that the internal goal

prevailed over the external one. Countries did not peg their currency in gold quantity terms with a view to participating in the gold standard, but rather the emergence of the gold standard became possible because countries wanted a certain rule to govern monetary policy.

The external objective was to ensure a stable system of international economic exchanges. This general objective resulted in two operational objectives. On one hand, there was the objective of guaranteeing that the exchange rates of participating countries' currencies remained fixed or varied within very narrow limits, called "gold points". On the other hand, the purpose of the gold standard was to guarantee an automatic equilibrium for balances of payments, in order to avoid the build-up of external imbalances jeopardising the expansion of world trade. From this standpoint, the gold standard was a cooperation and coordination system in the monetary field among participating countries, designed without international coordination organisations. For as long as it worked, cooperation and coordination fostered the expansion of world trade and economic growth.

In order to simultaneously achieve the internal goal, namely insulating economic policies from political influence, and the external one, i.e. broadening international economic integration, the mechanism needed three rules (see, for instance, Argy, 1994): (i) fixing the currency price in gold quantity terms. To this end, the monetary authority had to buy and sell gold without any restrictions. This obligation guaranteed the time consistency of monetary policy; (ii) free movement of gold across countries; and (iii) linking the quantity of money to developments in participating countries' balance of payments. This linkage meant, on one hand, that countries running a deficit were losing gold and diminishing the money supply accordingly. On the other hand, it meant that countries with a surplus were earning gold and increasing the money supply accordingly.

The three rules were a correct answer to the "impossible trinity" problem. The first two make sure that there is an implicit fixed exchange rate between currencies and that the deviations of effective exchange rates from the implicit rate do not exceed the cost of trading currencies indirectly, via gold (fees for buying gold *loco* and selling it at destination, gold shipping costs, interest lost during shipment, freight insurance, etc.).

The third rule guarantees that, if currencies are one hundred percent backed by gold, any disequilibrium of the balance of payments will eventually be automatically corrected. David Hume (1752) explained that, in countries losing gold and diminishing the money supply, prices would go down, making exports cheaper, i.e. more competitive, and imports costlier (the so-called "price-specie flow mechanism" coined by Hume). In the end, this would lead to the restoration of the

equilibrium. In surplus countries, the increase in the money supply entailed higher prices, rendering exports costlier and imports cheaper, reinstating the balance.

Worth pointing out is that the adjustments occurring under the gold standard are, at the end of the day, adjustments in prices, the latter presumably being flexible (implicitly wages are flexible) and set on competitive markets. Being competitive essentially means producing more cheaply than competitors. Given this connection between prices and competitiveness, adjustments in prices are basically adjustments in competitiveness. Deficit-ridden countries, which were losing gold, were seeing their internal competitiveness eroded, namely witnessing a rise in inflation and in inflation expectations. These would push the real interest rate down and stimulate consumption and investment, widening the deficit. In order to narrow the current account deficit, countries eventually had to lower prices, i.e. to increase their competitiveness. Countries on a surplus, which were earning gold, were recording internal competitiveness gains, namely a reduction in inflation and in inflation expectations and, hence, an increase in the real interest rate, fostering savings. In order to diminish the current account surplus, they would need to raise prices, i.e. to lower competitiveness.

By adjusting prices, the currency's *de facto* internal value, namely that value influenced by policies as well, aligns to the *de jure* (external) value, set as a fixed exchange rate against other currencies. In this vein, the adjustment in the level of domestic prices means an adjustment in internal competitiveness (*de facto*). Since internal competitiveness rises in countries where prices shrink from the relatively high levels that led to a deficit and decreases in countries where prices go up from the relatively low levels that led to a surplus, it follows that the gold standard was a mechanism that aimed to ensure convergence as regards the competitiveness and inflation of participating countries. The gold standard was a means whereby countries sought to ensure a common attitude towards inflation.

The formal expression of the common attitude towards inflation is rule (iii) of the gold standard – which requires that changes in money supply reflect strictly the changes in the gold amount. In order for this requirement to be met, central banks should have had the incentives to abstain from sterilising the monetary effects of gold flows. Nevertheless, the structure of incentives contained in the gold standard against sterilisations was asymmetrical (Temin, 1989), inducing the system's propensity for deflation (Bernanke and James, 1990, p. 7).

On one hand, there were implicit penalties for deficit countries. In particular, they had to adjust if they wanted to stay in the gold standard, and adjustment meant deflation. Deflation was the penalty for losing the gold reserves, which was tantamount to losing the ability to maintain the internal (*de facto*) value of the

currency at the *de jure* value. For this reason, it was almost a guarantee that central banks in deficit countries would not sterilise the monetary effects of the gold reserve deficit. On the contrary, in order to restore the balance, central banks had to reduce the money supply to lower prices, thus making exports cheaper and imports costlier. The balance-of-payments deficit reflected, in the end, relative prices that were too high. To sum up, deficit countries had no choice but to accept deflation so as not to lose the gold reserves in their entirety, which would have translated into a loss of convertibility.

On the other hand, there was however no penalty for countries sterilising the monetary effects of the gold surplus, defined as the difference between the requirement regarding the gold reserves necessary for covering the currency issue – on one hand – and the gold reserves in excess of this requirement (free reserves), on the other. There was only a loss of interest income, due to the gold amount not reflecting in money. The lack of an incentive or of a constraint to guarantee that central banks in surplus countries, which were earning free gold reserves, would have wanted to increase the money supply in line with the rise in free reserves was a weakness of the gold standard, considering that – in order to restore balances globally – the deficit adjustment mechanism had to work simultaneously in deficit and surplus countries alike.

The aforementioned asymmetry was not visibly manifest prior to World War One because the prerequisites for a “perfect” functioning of the gold standard – price flexibility, the existence of competitive markets and the authorities’ indifference vis-à-vis other objectives than ensuring gold parity – were fulfilled. Another reason, suggested by Bernanke and James (1990, p. 8), was that in the pre-war period the gold standard was centred on the experienced Bank of England, which – with the assistance of other central banks – managed the system in line with the price-specie flow mechanism. Nonetheless, after the war, two developments occurred that led, on one hand, to a manifest asymmetry of sterilisation incentives and hence to a separation among countries in terms of their attitude towards inflation and, on the other hand, to the emergence of a new internal goal on the stability of output and employment, which created the broad-based illusion that it was only fair for nation-states to enter the sphere of the economy. Röpke (1959, p. 77) showed that the gold standard was “a phenomenon with a moral foundation” (p. 77), based on the principle of “a thorough separation between the spheres of the government and of economy, between sovereignty and the apparatus which provides material goods” (p. 75), which “reduced the economic importance of the existence of sovereign states, with their different legal provisions, their frontiers, their independent administrative systems and civil rights, to a minimum” (p.75), while the “disregard”

for “the rules of the game” by countries, later on, meant that “the gold standard was no longer understood”.

The first development – which led to the manifest asymmetry of sterilisation incentives and implicitly to a separation among countries in terms of their attitude towards inflation – was that, after 1922, some countries relevant for the gold standard re-joined the system at undervalued exchange rates, France being a case in point, while others – such as England, for the instance – re-entered at overvalued exchange rates. The undervaluation incentivised exports, which enabled those countries to accumulate more gold. On one hand, the central banks in countries with a current account surplus, which had returned to the system at undervalued exchange rates, found it beneficial to maintain this advantage by sterilising the monetary effects of gold, without allowing prices to rise according to rules. On the other hand, central banks in Central Europe lacked sufficient power, because – given the stabilisation programmes launched in the 1920s – governments had forbidden them or had limited their right to hold government bonds in order to curb inflation (Bernanke and James, 1990, p. 10), as required by the “Real Bills” doctrine.

France, which had generally accumulated large quantities of gold, a build-up that gained momentum after 1927, with the return to the gold standard *de facto* in 1926 and *de jure* in 1928, resorted to massive sterilisations once the Great Depression set in (Eichengreen and Temin, 2013). In the US, the central bank, where the quantity theory of money had lost ground to the “Real Bills” doctrine, was concerned with the inflation that might have emerged from the capital market boom, diminishing the money supply (sterilising) in 1929. The central banks in these countries practically became concerned with price stability.

The surplus countries’ concern for keeping inflation at a lower level than that resulting from applying rule (iii) meant abandoning the monetary policy rule contained in the gold standard, namely the authorities’ commitment to time-consistent policies. However, the other rules of the gold standard were not cast off, so that – for a short while before discarding the gold standard – surplus countries tried to maintain simultaneously the exchange rate stability, monetary policy independence and capital mobility. This unsuccessful attempt was based on the ideology (termed by Eichengreen and Temin (1997, 2010b) the “gold-standard mentalité”), built especially on the experience from 1880 to 1916, according to which keeping the gold standard in place was a prerequisite for prosperity.

The rift in attitudes towards inflation, which materialised in the aforementioned sterilisations, made it so that the entire burden of adjustments fell on England and Germany, which ran relatively wide current account deficits. Surplus countries used

discretionary monetary policies to avoid the temporary loss of internal competitiveness required by the proper functioning of the gold standard. In other words, surplus countries resorted to “beggar thy neighbour” policies, as they were called back then.

The countries’ different attitudes towards inflation made it possible for the problems occurring in Germany and the US at the end of the 1920s to spread to other countries as well. The reduction in the money supply in deficit-ridden countries (natural from the gold standard perspective) combined with the insufficient supply (from the gold standard perspective) of money in surplus countries (US and France) to lead to shrinking demand worldwide. Friedman and Schwartz (1963) and Hamilton (1987) said that the restrictive monetary policy in the US spread the problems from that country to all other countries, most of which could not recover from an economic point of view, the same as the US, until they dropped the gold standard.

The second development I have referred to above – which led to the emergence of the objective on the stability of output and employment – was the increase in the size of firms and trade unions, on one hand, and governments’ growing interference in the economy, on the other. Leaving government influence aside for the moment, the expansion of the size of firms and unions was enough to alter a key prerequisite for the proper functioning of the gold standard – market competitiveness. The competition thus altered on the goods market and on the labour market reduced the flexibility of prices and wages, which had previously allowed that the necessary adjustments for mitigating balance-of-payments disequilibria – i.e. competitiveness adjustments – have relatively small effects on output and employment (namely on domestic stability).

The strong trade unions, the expansion of mass politics and the growing costs in terms of unemployment and output level of the adjustments generated by the gold standard prompted Western countries to revise the relationship between politics and national economic policies. As early as 1953, Milton Friedman pointed out – in his essay “The Case for Flexible Exchange Rates” – that in the heydays of the gold standard, namely up until the outbreak of World War One, when it came to choosing between freedom from government interference, including from government-dependent monetary policies, and domestic stability, understood as output and employment stability, Western countries opted for the former.

The moral foundation of the gold standard was altered once the view which claimed that the capitalist economy was inherently unstable (advocated first by Irving Fisher (1932, 1933), with minor success, and then by Keynes (1936) with resounding success) came to prevail. Consequently, Western countries opted for strengthening

the government's role in the domestic stabilisation of the economies. Since domestic stability was understood until towards the end of the 1980s exclusively in terms of employment and output, a new "moral" emerged, whose essence was – in stark opposition to the former moral of the gold standard – the disregard for competitiveness and hence for the level of inflation.

This shift in the attitude towards inflation was favoured by the spreading of "institutional democracy" after 1918 (Marshall and Jagers, *apud* Obstfeld and Taylor, 2003), with an extension of voting rights (Crafts, 2014), which in the run-up to the 1929 crisis gave a massive boost to the number of voters in Western countries, thus prompting ruling parties to focus more on the domestic stability of output and employment rather than on the adjustments in competitiveness (inflation) required by the gold standard.

The enhanced role of the government in the economy, combined with the increased power of trade unions and monopolies, led to wage and price stickiness, generating a ratchet effect on the labour market and on the goods market compared with the period when their power to obstruct competition was relatively low. This change rendered the price cuts required for restoring economic competitiveness increasingly costlier in terms of domestic stability of output and employment. Under the circumstances, in England, which had readopted the gold standard in 1925 at an overvalued pound, the money supply dropped under pressure from external deflationary forces, which reflected in the decline in output and employment. The response was a general strike and the shift to policies aimed at re-inflating the economy (Eichengreen and Jeanne, 1998), which resulted in the gold standard being abandoned in 1931.

The increased concern of policies for domestic stability was the beginning of the end for the gold standard. Turning domestic stability into the core objective, participating Western countries were preoccupied by the effects that a limited amount of gold might have on deflation and, hence, on employment. Against this background, countries started building up reserves in the key currencies of the era (Bernanke and James, 1990, pp. 7-8). These reserves weakened the link between the amount of gold and the quantity of money in participating countries, namely they weakened rule (iii), which guaranteed the common stance towards inflation of various central banks. Essentially, the strict discipline required by the gold standard with regard to the common attitude towards inflation came into conflict with the internal objectives of governments and central banks. In the end, between the discipline regarding adjustments in competitiveness required by the gold standard and discretionary fiscal and monetary policies, governments opted for the latter. This led to the obstruction of markets' capacity to impose their requirements regarding competitiveness in the economic policy parameters.

5. The Bretton Woods system and the attitudes towards inflation

In the beginning, the shift in policy focus towards the internal stability objective was revolutionary only in the sense that the preoccupation was there. Previously, under the gold standard, guided by the belief in freedom from government intervention, participating states had ensured compatibility between capital mobility and the sought stability of exchange rates by accepting, at policy level, the subordination of monetary policy to the exchange rate stability objective. Thus, the only *de jure* objective of the gold standard was the expansion of trade and of investment.

However, after the dismantling of the gold standard, the role that the internal stability objective had played was relatively minor compared with what might have been put into practice. When the gold system collapsed, there were in theory two options for countries to ensure the supremacy of the internal stability objective. One referred to the free fluctuation of exchange rates, in response to the free movement of capitals and to the independent monetary policy movements, dedicated to the internal stability objectives. The other option was for countries to maintain fixed exchange rates, which called for capital movements to be kept in check as well, in order to allow monetary policy to focus on ensuring domestic stability, understood as the stability of employment and output. After a while in the interwar period, when capital mobility hit a low and exchange rates were very volatile (Obstfeld and Taylor, 1997, p. 6), reflecting a disintegration of the world economy through protectionism, capital controls and currency wars (Eichengreen, 2013; Bordo and Schenk, 2017, p. 216), the latter solution was chosen in 1944 and it was institutionally transposed as the Bretton Woods system.

There were three reasons for choosing the Bretton Woods system. First, the prevailing view after the Second World War was that the world economy could not self-regulate without enormous costs in terms of output and employment, which required keeping in place the controls on capitals and trade, instituted during WWII. In the Keynesian view, prevailing at the time, balance-of-payments disequilibria are done away with through adjustments in real output, not through prices. The second reason was the existence of the belief that the free floating of currencies would deter international trade and investment, while encouraging inflation, as proven by some hyperinflationary episodes during the interwar period. Even if floating rates had enabled greater independence of policies to attain internal goals, they would have deterred, by way of consequence, international trade and investment, which remained a major objective – although no longer the only one – of the global monetary system. Finally, capital and exchange rate control was consistent with the control over monetary policies of some government-dependent central banks.

The Bretton Woods system – a system with less strict international discipline than that contained in the gold standard – became operational on 27 December 1945, with the signing of the Articles of Agreement. I remind readers of this system to point out again the role that the attitude towards inflation plays in the functioning of a rule-based currency system – particularly rules that aim to ensure the stability of exchange rate parity. The Bretton Woods system was no surprise. It had announced *de facto* its presence the moment when countries still operating under the gold standard started to focus more on the internal stability of economies, especially by deviating from rule (iii), which established the clear link between the amount of gold and money.

In terms of adjustment mechanisms, the choice above stood midway between the gold standard – which it was replacing and which did not leave, *de jure*, room for internal goals – and the system based on the free float of currencies and the free movement of capitals, which accommodated internal goals to the maximum extent possible and insulated from other countries' macroeconomic policy shocks. Under the gold standard, as it functioned up until World War One, with mobile capitals and exchange rates pegged to gold, the main means for correcting balance-of-payments deficits was the deflation resulting from the decline in the quantity of money in deficit-ridden countries. If, after the Second World War, countries had opted for keeping in place the free movement of capitals and the free float of currencies, which ensured monetary policy independence, the main means for restoring the equilibrium of the balance of payments would have been the real-time depreciation of the exchange rate. In this case, a conflict between the internal (*de facto*) value of the currency and the external (*de jure*) one would have been averted, since the currency would not have had a *de jure* value, but only the value determined by internal policies (*de facto*). Since the choice was to ensure trade stability and macroeconomic stability by controlling capital flows and exchange rates and a discretionary monetary policy, the adjustment of balance-of-payments disequilibria could be done via exchange rates, which could be realigned among them occasionally, so that the external (*de jure*) value be aligned to the internal (*de facto*) value, determined by internal policies.

Consequently, the Bretton Woods system had two fundamental rules: (a) controlling capital movements over the short term and (b) maintaining fixed, yet periodically adjustable exchange rates (adjustable peg), provided certain conditions were met with regard to the balance-of-payments deficit and the intensity of currency market speculations, with IMF approval. The system was based, on one hand, on the US dollar convertibility to gold at an adjustable parity, through purchases and sales of gold by the US central bank, and – on the other hand – on the other currencies'

convertibility to dollars at an almost fixed exchange rate, fluctuations being permitted within a 1 percent band, through purchases and sales of US dollars.

The two rules of the Bretton Woods system proved weak anchors. On one hand, the structure of incentives allowed methods to be identified to circumvent rule a) on short-term capital control, which weakened the condition that real monetary policy independence hinged on to keep inflation in check. For instance, during 1960-1961 Germany witnessed an economic boom, with GDP rising 4.6 percent in 1961. The increase in interest rates in order to contain the boom led to massive build-up of reserves, costly, yet necessary to withstand the appreciation pressures of the Deutsche mark and to maintain parity with the US dollar.

On the other hand, rule b) on the exchange rate parity triggered numerous speculative attacks in the

1960s, after the current account convertibility had become broad-based and, because of administrative and political limits of controls (for example, as showed in Obstfeld and Taylor (1997, p. 37), on a political and administrative level, capital mobility rose with the signing in 1957 of the Treaty of Rome, which called for the progressive abolition of restrictions on the movement of capital belonging to persons resident in Member States). These attacks were generated, as Friedman (1953) pointed out, because exchange alignments occurred after problems were building up and also indicated the direction in which the exchange rate correction would necessarily take place. The speculative attacks were clear proof of the incompatibility between the rule on preserving fixed exchange rates and the internal goals regarding output and employment, in a context in which capitals were not under strict control.

It could be said that the Bretton Woods system had explicit rules regarding exclusively the external goals, without any mention of a rule concerning internal goals. In light of the scientific knowledge of the time on monetary policy issues, policymakers pursued full employment rather than price stability. By the time of the articles written by Friedman (1968) and Phelps (1968), which showed there was no trade-off between inflation and unemployment and highlighted what monetary policy could and could not do, it was too late for the Bretton Woods system. However, rule b) on exchange rate stability implicitly assumed that two hypotheses were fulfilled for it to be observed.

The first hypothesis was that monetary policy, which can be used to attain internal goals, was used primarily to preserve exchange rate stability. It is important, for the reasoning here, to underline that inflation has not been from the beginning a problem for exchange rate parity. Although monetary policy independence was not reined in by rules aimed at keeping inflation under control either explicitly or

implicitly (the likes of the Friedman rule or a Taylor rule), central banks were “excessively” conservative in the 1950s and the 1960s, which reflected in too much unemployment and excess capacity, especially in the US and the UK (Lanyi, 1969, p. 12). Most central banks resorted to interest rates to defend exchange rate parity, like in the gold system. This required a hostile attitude towards inflation.

The central banks’ attitude against inflation in the 1950s and the 1960s is all the more noteworthy in an environment where the majority opinion favoured expansionary policies. Lanyi (1969) shows that central banks “have been able to push through their point of view by appealing to the necessity of avoiding or correcting balance-of-payments deficits”. Moreover, Bordo and Eichengreen (2008) pointed out that one of the factors that kept inflation relatively low until 1965 in the US was that monetary policy had acted as if following the rules of the gold standard. In other words, the US monetary policy rose interest rates in response to the worsening of the balance of payments, with a view to preserving the dollar-gold parity.

The second implicit hypothesis ensuring the observance of rule b) on exchange rate parity was that system participants had the same attitude towards inflation. However, the conservative stance vis-à-vis inflation started to weaken in the Bretton Woods system at the very core of the system, namely in the US, the only country whose currency was backed directly by gold. The US monetary policy led to relatively high inflation starting 1965, which fuelled concerns over the dollar’s declining value in gold, and hence there were strong incentives for France and the UK, in the spring of 1971, to seek to convert their sizeable USD reserves into gold.

Bordo and Eichengreen (2008) argue that the shift in the attitude towards inflation started only when the US Treasury introduced fiscal measures the likes of quasi capital controls (such as the so-called interest equalisation tax, introduced in July 1963 as a temporary measure, but applied until 1974). Then, the US central bank deemed it appropriate to move on to monetary policy easing in line with internal objectives, without deteriorating the balance of payments and depreciating the dollar. Deviating from the rule which required it to maintain the exchange rate stable by altering interest rates in line with balance-of-payments changes, the US monetary policy was left without any rule, since – despite Friedman’s efforts – no rule on monetary policy conduct had been adopted.

Among the less obvious reasons why, after the Second World War, the macroeconomic policy trilemma was not solved in favour of capital mobility and floating exchange rates was the fear of inflation. Inflation picked up in the 1960s, entailing a *de facto* decline in the value of money, which – given the *de jure* parities – was tantamount to an appreciation of currencies in real terms.

These currency appreciations prompted the market to test repeatedly to what extent central banks were willing to defend their exchange rates. In the end, the countries' different attitude towards inflation led to the collapse of the Bretton Woods system. In the US, the increase in military expenses for the Vietnam War translated into higher inflation and into pressures for a devalued dollar. There were speculative attacks on the dollar. The system was completely abandoned in 1973.

6. The euro area and the mechanism whereby imbalances are perpetuated

Given its inbuilt structure, namely based on nation-states, the euro area has a dual solution to the macroeconomic policy trilemma. On one hand, at the union level, the solution to the macroeconomic policy trilemma was in favour of an autonomous monetary policy of the union, in which countries have open capital accounts (mobile capital) and the exchange rate is flexible with respect to the rest of the currencies. On the other hand, for the member countries, the euro area has a single currency, which is tantamount to an implicit fixed exchange rate among countries. With capital mobility, this meant that countries had to give up the right to determine their own monetary policy rates in favour of the ECB, which sets a common policy rate for all member states.

Unlike the central banks that operated during the gold standard or during the Bretton Woods agreement, the central bank of the euro area is not concerned with the fluctuations of the single currency vis-à-vis other currencies. Its monetary policy is aimed at price stability. However, for member countries, the single currency acts just like the gold standard or even more restrictively, because – unlike the latter – the euro area does not have a temporary abandonment clause. Under the gold standard, there was the ideology that exchange rates could be flexible only in extreme circumstances, for a while, then we would see fixed rates again. In the euro area, there is no such thing as national currencies. At the current juncture, were a country to return to its legacy currency or adopt a new one, that country would either boast economic soundness, like Germany, and the newly-adopted currency would appreciate, hurting exports and economic growth, or it would be extremely vulnerable, and the new currency would depreciate sharply, with implications in terms of financial instability. Either way, quitting the euro would be painful in the beginning.

In this case, even if a euro area exit clause did exist, the public would not accept this, because – unlike the gold standard – leaving the system would be tantamount to shifting from the euro to a former national currency, which could not be done without a massive depreciation of the latter for external deficit countries. Besides, the existence of such a clause would be like an “invitation” to speculative attacks,

similar to those manifest under the Bretton Woods regime. In rough times, investors would like to test some countries' determination to activate the exit clause just the same as they do when a country targets an explicit or implicit level of the exchange rate.

The differences set aside, the euro area bears a fundamental resemblance to the gold standard for member states, namely that countries have solved the macroeconomic policy trilemma – the same as in the case of the gold standard – to the detriment of monetary policy independence, opting for a single currency (the same as a fixed exchange rate) and full capital mobility.

This solution to the trilemma makes the euro area depend, just like the gold standard, on countries' different attitudes towards inflation. With a single nominal interest rate, different inflation rates in participating countries translate into a wide variety of real interest rates. Countries with an inflationary bias (and, hence, with relatively high inflation expectations) will have low *ex ante* real interest rates, enabling the emergence and widening of current account deficits. Countries with a bias towards low inflation rates (and consequently with relatively low inflation expectations) will have higher *ex ante* real interest rates, increased competitiveness and, hence, current account surpluses. In the end, the segregation of countries' attitudes towards inflation will widen the rift in terms of inflation rates (Walters, 1990, pp. 79-80) and compound the problems.

The attitudes towards inflation are embedded in the social networks of euro area countries and they will not be easy to change. Even if, prior to joining the euro area, an economy with an inflationary bias has a central bank oriented towards maintaining a low inflation, this objective can be missed due to other entities' systematically different behaviour towards inflation. Thus, inflation can stay relatively high as long as attitudes do not change. The same reasoning is also valid for countries with a bias towards relatively low inflation rates, so that these preferences will not change easily either. Hence, there will always be a segregation of countries depending on the attitudes towards inflation.

The same as in the case of the gold standard starting with the late 1920s, for the euro area as well, the countries' persistently different attitudes towards inflation will preserve a lingering segregation of the currency union between economies with current account deficits and economies with current account surpluses. This segregation essentially reflects the differences in competitiveness. Like the gold standard after World War One, the euro area as well lacks an adequate incentive structure to guarantee that surplus countries accept to diminish their competitiveness through higher prices so as to avoid the adjustment burden falling entirely on deficit countries.

Although there is a common currency, part of the EUR-denominated debt of euro area countries is external debt, since entities in different jurisdictions (countries) of the euro area lend and borrow from one another, yet do not have their own central banks to issue euro, but rather share one central bank. The fixed exchange rate encourages EUR-denominated borrowings, since there is no longer a depreciation risk. One feature of the euro area is that, generally, public debt runs high in most countries of the currency union. Before the 2008 crisis, some countries had relatively wide current account deficits, whereas others reported relatively large surpluses. In response to the crisis, most euro area economies reduced their current account deficits, but – as I am about to show – deficits will be restored relatively quickly, raising again the share of debt as a percentage in GDP.

The public and private sectors have different reasons to borrow. In the public sector, the public's impatience (low time preference rate) to have their needs for public goods satisfied now rather than in the future prompts political governments to compete in this direction. They will issue as much debt as possible to bring consumption from the future into the present so as to satisfy the public from which they hope to obtain votes (Croitoru, 2015b). This largely explains why public debt is relatively high in almost all EU countries and in other Western economies.

Firms and households borrow for business and for consumption. If inflation expectations are relatively high and, for this reason, real lending rates are relatively low, even firms with relatively low competitiveness can take loans or issue debt in order to increase imports. Thus, they contribute to the widening of current account deficits above sustainable levels. That is why, after the 2008 crisis, although euro area countries generally narrowed their current account deficits by cutting down investment and increasing savings in the private sector, their public debt rose, given that public deficits widened for several years after the crisis, before starting to narrow. These developments occurred in an environment in which, on average, output in the euro area remained below potential, requiring fiscal expansions to match the decline in private demand. However, once the potential has been reached and the euro area economy continues to grow, different attitudes towards inflation will again lead to an increase in current account deficits in countries with a preference for relatively high inflation.

With relatively high debts, with the currency union segregated between countries with current account deficits and those with current account surpluses, alongside the lack of adequate incentives for surplus countries to partake in the adjustment burden, when a future crisis strikes, deficit countries will have to enhance their competitiveness. To the extent to which this is done by cutting wages and prices, the debt of deficit countries will rise in real terms, entailing a renewed temporary

segregation of the euro area between countries with high real debt and countries with relatively low real debt.

To sum up, the mechanism currently at play in the euro area – and which I will hereinafter refer to as mechanism (a,b) – is the following: the single monetary policy rate makes it so that real interest rates are low in countries with a bias for relatively high inflation. In these countries, the relatively low cost of money encourages the widening of current account deficits and the build-up of debt. Countries with a bias towards relatively low inflation, reflecting deeper preferences for increased competitiveness, see current account surpluses emerging. The segregation between countries with current account deficits and those with surpluses steps up as the differences in the attitudes towards inflation lead to increasing differences between inflations. In the same direction of widening imbalances and increasing debt acts the fixed exchange rate, which – by eliminating the currency depreciation risk – stimulates business in good times. Since the exchange rate is fixed, in these countries, deficit adjustment takes place by reducing wages and prices (internal devaluations, deflation), which increases debt in real terms, compounding difficulties in bad times.

Because debt as a share in GDP is high, the fiscal policy cannot help relaunch economic growth either. High public debt diminishes the response of output to a positive shock in government spending (Perotti, 1999). Several recent papers corroborate this finding. Auerbach and Gorodnichenko (2012, pp. 89-90) showed that, if public debt is high as a percentage of GDP, government spending multipliers are close to zero not only during an economic upturn (which is an outcome predicted in theory), but even when the economy is in a recession. Moreover, Ilzetki *et al.* (2010) pointed out that fiscal multipliers are negative in countries with high degrees of indebtedness. Nickel and Tudyka (2013) showed that the cumulative effect of a government spending shock on the debt-to-GDP ratio is non-linear, being positive and significant at moderate ratios, but turning negative as the ratio increases. Huidrom, Kose and Ohnsorge (2016) showed that, although multipliers are higher during downturns, they are relatively low when public debt is high. Finally, Arin, Koray and Spagnolo (2015) pointed out that spending multipliers are higher in times of low economic activity, while the magnitudes of tax multipliers are larger during periods of high economic activity.

In conclusion, the mechanism (a,b) described above is at work because, although their attitudes towards inflation differ, euro area countries decided to solve the macroeconomic policy trilemma in favour of the fixed exchange rate (a single currency) and capital mobility, to the detriment of monetary policy independence. This solution is compatible only with similar attitudes towards inflation and, hence, towards competitiveness. In the euro area, however, these attitudes differ, which

makes the aforementioned mechanism yield, during recessionary periods, two unavoidable results: (a) the systematic placement of the adjustment burden on deficit-ridden economies, through wage and/or price deflation in countries with a preference for relatively high inflation; (b) lower fiscal policy effectiveness or even the loss of this policy altogether, amid public debt as a share in GDP soaring and exceeding relatively high levels.

7. The euro area and the illusion in the political trilemma of the world economy

In the section regarding the gold standard, I showed that, during the interwar period, the different attitudes towards inflation emerged for two reasons in particular. One was circumstantial, related to the fact that some countries readopted the gold standard at undervalued exchange rates, whilst others – at overvalued rates. But, much more importantly, after 1916, nation-states made a momentous change: they gave up the freedom from government interventions in the economy and made the stabilisation of output and employment the central goal of their economic policies.

Under the gold standard, during which time they were guided by the objective of maintaining freedom from government interventions, countries took care to keep the conditions in place for the market to ensure the best possible economic results. Practically, the rules of the gold standard ensured that markets transferred relatively quickly their requirements in the macroeconomic policy parameters, which guaranteed countries' convergence in terms of competitiveness and hence in the attitudes towards inflation. At least monetary policy sufficed in meeting market requirements entirely. Under these circumstances, the gold standard was a mechanism whereby the convergence of attitudes towards inflation and, more deeply, the convergence of attitudes vis-à-vis competitiveness were ensured.

The shift, however, to the goal of stabilisation of output and employment led to the differentiation of institutional regimes needed for the development of the market economy. Capitalism models diversified, coming to include liberal capitalism (UK), Latin capitalism (Spain, Portugal, Italy), German capitalism, Scandinavian capitalism, and state-dependant capitalism in Central and Eastern Europe (Crum, 2013). Much more importantly, within each of these institutional regimes there was a sequence of different national political preferences regarding the distribution of importance coefficients attached to various economic and social objectives: economic growth, social solidarity, and the sustainability of economic and social policies. The Western countries' economic policies and developments have been anchored since the 1929-1933 crisis in this social and economic context. The 2008 crisis broke out against this background which, although somewhat altered in the

euro area, as I am about to show immediately, has retained its nature: in each country, the specific structure of preferences regarding the aforementioned goals (growth, solidarity, sustainability) remains the main filter for transmitting market requirements on competitiveness within the economic policy parameters.

Prior to the 2008 crisis, the economic architecture of the euro area essentially consisted of three components: a single interest rate, a stability and growth pact (SGP), and a growing number of national (autonomous) economic policies, each reflecting the hierarchies contained in each country's social and political networks regarding such values as economic growth, social solidarity, and the sustainability of economic policies. Particularly these hierarchies at the deep levels, reflected in the diversity of national policies, are important for the differentiation of attitudes towards inflation. The diversity of autonomous economic policies and their quality have a big potential to lead to the segregation of attitudes towards competitiveness and, hence, towards inflation, which in the end lie at the root of mechanism (a,b), entailing the outcomes (a) and (b) mentioned in the previous section. Consequently, given the policy rate set by the ECB and the constraints imposed by the new SGP, the sustainability of the single currency has come to depend on the national (autonomous) economic policies and on their coordination across the euro area via intergovernmental procedures. The coordination process has constantly required enhancements, a need enshrined officially in the Barre Report as early as 1969.

Up until the 2008 crisis, there was no essential change in this architecture of the euro area. The cumulated inflations during this period reflect the segregation of the European currency union depending on the attitudes towards inflation. The HICP inflations cumulated for the 1999-2008 period in Greece, Spain, Ireland and Portugal stood at 35.6 percent, 34.3 percent, 35.7 percent and 30.3 percent respectively. In Germany, Austria, France and the Netherlands, the inflation rates were merely 17.4 percent, 20.0 percent, 20.2 percent and 24.0 percent respectively.

The euro area reform measures taken after the 2009 crisis sought – while keeping the single policy rate in place and enhancing the SGP – to reduce the diversity of national economic policies. *Ex post*, the developed measures seem to have been two-pronged: introducing “procedures” in the drafting of national policies and establishing the entities that control the design of procedures.

The scope of procedures included the setup of common frameworks for designing and implementing fiscal, financial and economic policies and the assignment of enhanced supervisory tasks to European bodies, particularly the European Commission and the European Central Bank. The common economic policy frameworks and the strengthening of supervision were aimed especially at tightening fiscal discipline (through the measures included in what came to be

known as the two pack, six pack, Fiscal Compact) and creating the banking union, a project that needs a common deposit guarantee scheme to be complete. These measures are described in detail by Dăianu *et al.* (2016, pp. 65-74). As regards the control of the overall policy frameworks and the surveillance procedures, it has remained with the governments (self-government exerted by nation-states). Crum (2013) shows that such a solution has three major implications: the control process circumvents close parliamentary scrutiny of the economic policy frameworks and of the supervision conducted by technocratic authorities such as the European Commission and the European Central Bank; the decision-making process is run by creditor states, rather than by the principles of equality of Member States; and, finally, since national governments cannot control each other's economic policies, they delegate supervision to technocratic authorities, after having provided them with quantitative objectives and technical guidelines for conducting supervision.

Habermas (2011) coined this solution – the federalisation of economic policy frameworks and of supervision – “executive federalism”, a regime that, in his view, “would make it possible to transfer the imperatives of the markets to the national budgets without proper democratic legitimation.” It seems the right solution in terms of Rodrik's “trilemma of the world economy”, in the sense that democracy has been sacrificed in order to keep in place, on one hand, the nation-states entitled to self-government and, on the other hand, monetary integration. Another choice might have been the other goods: self-government, by keeping nation-states, and democratic politics. This solution to the political trilemma would have meant in the end the dissolution of the euro area. For this reason, some economists (e.g. Crum, 2013) believe that the chosen solution is a trade-off, which avoids the break-up of the euro area.

However, seen from the perspective of the analysis I have proposed in this article, namely that of the differences in the attitudes towards inflation, the chosen solution is not right in terms of the political trilemma of the world economy and cannot rescue the euro area. Essentially, the adopted solution seeks to mitigate the diversity of national policies, which is in itself difficult, because national policies reflect the hierarchies of each country's deep preferences regarding the objectives of economic growth, solidarity and sustainability, lying at the root of different attitudes towards inflation. Some might argue that executive federalism could be a mechanism leading to the convergence of attitudes towards inflation. However, this is not a solid argument. Since the self-government of nation-states remains a key value of the adopted solution, despite the fact that “nations [...] are not natural givens” (Habermas, 2011), the “enhanced coordination” of policies at a central level or, as Riet (2016) put it, the “collective governance instead of a central government” will not be able to reduce the diversity of the deep preferences that national economic

policies reflect. There is always enough room for national policies to weigh differently the importance of objectives regarding economic growth, solidarity and sustainability within the single currency area, no matter how deep the “collective governance”. Be it for this reason alone, attitudes towards inflation will remain segregated, activating mechanism (a,b) that I have sketched in the previous section, which widens the welfare discrepancies and the imbalances across member states, leading to the dissolution of the economic order.

Now we can say that solving the “political trilemma of the world economy” depends on the solution to the macroeconomic policy trilemma and on attitudes towards inflation. When the exchange rate and the interest rate are given and capitals are mobile, as in the case of euro area countries, then it depends on the attitudes towards inflation if the political trilemma of the world economy has accurate predictions. If the attitudes towards inflation are similar (which is possible for a relatively small number of countries that decide to form the union precisely because of these similar attitudes, but is not possible for any group of countries), then economic (monetary) integration can sustainably coexist with either of the other two nodes of the trilemma – nation-states or democratic politics – allowing the single currency to survive.

However, if the countries’ attitudes towards inflation are segregated (for example, because this criterion was overlooked when setting up the currency union), as it happens in the euro area, then economic (monetary) integration and nation-states cannot be sustained over the long term. Sooner or later, the divergent attitudes towards inflation will set in motion mechanism (a,b) described in the previous section, thus leading to the dissolution of the economic order for the countries concerned. When he postulated the idea that nation-states are compatible with economic integration, Rodrik (2000) assumed that governments “actively compete with each other by pursuing policies that they believe will earn them market confidence and attract trade and capital inflows: tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around”.

Indeed, were this “straightjacket” to be put on by all countries with fixed exchange rates among them or with a single currency, then we might see the convergence of attitudes towards competitiveness and hence towards inflation, reflecting the countries’ success in insulating economic policies from political influence. I have argued, however, that there are social, cultural, economic and political reasons why not all countries can put on the “straightjacket”, by virtue of the divergent deep preferences across countries regarding the goals on output, solidarity and sustainability. Even under the gold standard, which ensured for a while the proper insulation of macroeconomic policies from government intervention, the

emergence of the latter objectives (which I have called “external objectives” of the macroeconomic policy trilemma in this paper) eventually led to the disruption of mechanisms whereby markets imposed, to a sufficient extent, their requirements in the economic policy parameters.

The segregation of attitudes towards inflation is what fundamentally distinguishes the euro area from the gold standard in its heydays and equates it to the gold standard’s interwar period, when the attitudes vis-à-vis inflation were already segregated. Within the gold standard up until World War One, similar attitudes towards inflation allowed economic (monetary) integration and nation-states to be a sustainable solution to Rodrik’s trilemma. Then, the countries could put on the “straightjacket”. What ensured the convergence of countries’ attitudes towards competitiveness and inflation was their choice for the objective of keeping economic policies free from government intervention rather than for the objective on the stability of output and employment. The euro area does not have this luxury, at least not to the same extent. Rodrik’s political trilemma of the world economy was not available to inform on the possibilities in which the gold standard might have been saved after its reactivation in 1922, through democratic federalisation. But, just like the euro area nowadays cannot be rescued with nation-states and different attitudes towards inflation, the gold standard could not be saved in the 1930s by preserving nation-states, which were already fuelling divergent attitudes vis-à-vis competitiveness and inflation.

In the euro area, there will always be room for diversity, which is good from many points of view, but which – with nation-states in place – generates policies that will preserve different attitudes towards inflation and will maintain the segregation between deficit countries and countries with current account surpluses. This will eventually lead to political segregation. Surplus countries are creditor nations and are hence capable of imposing their policies. The segregation in terms of attitudes towards inflation will reflect in the permanent alteration of the political autonomy of deficit countries. Preserving a relatively high autonomy of national states’ economic policies will permanently be accompanied by the segregation of the currency union between countries that make the rules and those that accept them. This will be a perpetual reason for contesting any fiscal policy rules. In addition, they undermine another solution, namely democratic federalisation.

For the euro area, with attitudes towards inflation segregated among countries, the political trilemma of the world economy becomes a certainty: sustainable monetary integration is only possible with democratic politics, i.e. by creating a new country, with a single constitution, with a single government democratically elected by all currency area citizens, with a significant federal budget, capable of conducting fiscal transfers. It is the solution foreseen by Röpke (1959). Nation-states would not

disappear, since “there should be a balance” between them and a supra-national organisation (Röpke, 1959, p. 44), but would merely see their role diminished and, as Rodrik puts it, they would no longer “interfere with arbitrage in markets for goods, services or capital”, while politics would not have to shrink, but merely relocate at the central level. This new country, which Romania should be part of, could be called the United States of Europe. Unlike executive federalisation, democratic federalisation leads to the adoption of another solution to the macroeconomic policy trilemma compared with the existing one from the perspective of each member country. If it leads to political union, fiscal union etc., then democratic federalisation will automatically give the same response to the trilemma for member countries of the union as the one the European currency union has towards the rest of the world: flexible rate, monetary policy independence and mobile capitals.

The problem with this solution is the lack of demand for such a new euro area on the part of citizens. But this conclusion is not defeatist. Demand can be educated. The efforts made so far in this direction seem to have been fruitless also because they have not been strong enough. However, they should intensify as soon as possible. From the perspective of this paper, Romania should do two things: (i) understand well what attitudes towards inflation are imbued in the social, economic and political fabric of the society and decide whether they need to be changed. This effort is required not so much in order to gain faster access to a euro area dominated by executive federalism, but because the attitudes towards inflation are, in the end, attitudes vis-à-vis competitiveness; (ii) undertake all possible efforts to set up the United States of Europe and to become a founding member of this new country.

In this section, I have showed that, in a context of segregated attitudes towards inflation, executive federalism and the dissolution of the euro area (the latter being the equivalent of the sustainable, yet unwanted solution in which nation-states and democratic politics would have coexisted) are governance models yielding the same result (i.e. dissolution), but at different moments. Can it be said, from this perspective, that the euro area lost time focusing on building executive federalism? The answer is: it depends! If executive federalism had and still has as a purpose buying time for finding a way to build democratic federalism, then the past decade has not been lost. But, if executive federalism is considered to be the solution, then we can talk about a lost decade of the euro area and about how different attitudes towards inflation could thwart the European dream.

8. Conclusion

In this paper, I have showed that the world economic order depends on the solution chosen by governments to address the macroeconomic policy trilemma (the

impossible trinity). What determines over time the shift from one economic order to another is the change in solutions to the trilemma. Governments have to change the solution to the trilemma because no solution can be sustained indefinitely over time, given that the two goals chosen to be upheld are not only incompatible with the discarded (ruled out) objective, but they also have “external incompatibilities” with other objectives not covered by the trilemma. When these incompatibilities make it so that the benefits provided by the chosen solution to the trilemma are more than offset by costs for the large majority of participants, then another solution is picked out of the three possible ones and a new economic order is shaped.

What leads eventually to the abandoning of a solution to the macroeconomic policy trilemma is the segregation of countries’ attitudes towards inflation, which is nothing else than a way of manifestation of segregated attitudes vis-à-vis firms’ competitiveness. The deep causes of segregated attitudes towards competitiveness and hence towards inflation are primarily socio-political. The shift from the gold standard to the Bretton Woods system and then on to the current system, in which Western countries have flexible exchange rates, independent monetary policies and mobile capitals, is consistent with the explanation provided in this paper.

The differences in the countries’ attitudes towards inflation are accountable for the main dissimilarity between pre-1916 gold standard and the euro area. In the period up until World War One, the gold standard contained a mechanism that guaranteed the convergence of countries’ competitiveness and, hence, of countries’ attitudes towards inflation. By contrast, in the euro area, the attitudes towards competitiveness and hence towards inflation are segregated among countries, which entails the emergence of a mechanism splitting countries into economies with current account deficits and economies with current account surpluses, the same as it happened in the interwar period of the gold standard, when inflation expectations segregated across countries.

Through the mechanism they set in motion, the segregated countries’ attitudes towards inflation invalidate one of the predictions of Rodrik’s political trilemma of the world economy, namely that monetary integration is compatible with nation-states. Thus, monetary integration is not compatible with the executive federalism developed in the euro area after the 2008 crisis, putting its future into discussion. The only solution possible in theory to preserve the currency area consists in its democratic federalisation. Unfortunately, this solution has yet to be embraced by the public, which points to the need for a major effort to explain the singularity of the solution. Without this effort, the euro area might be left with no sustainable solution.

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