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1. The Mundell-Fleming trilemma and EMU

In a classic book and subsequent articles, Obstfeld and Taylor (2004) have shown how the broad contours of international financial history over the past century and a half can be well understood by appealing to the famous economic trilemma which emerges from the standard Mundell-Fleming model many of us still teach our undergraduates. In their words,

> the chosen macroeconomic policy regime can include at most two elements of the "inconsistent trinity" of three policy goals:
>
> (i) full freedom of cross-border capital movements;
> (ii) a fixed exchange rate; and
> (iii) an independent monetary policy oriented towards domestic objectives.

The proof of this proposition is straightforward: capital mobility vis-à-vis the rest of the world implies uncovered interest parity; uncovered interest parity combined with fixed exchange rates implies that domestic interest rates are pinned down by interest rates abroad. A country with open capital markets which maintains a fixed exchange rate system thus loses the freedom to vary domestic interest rates in order to pursue domestic policy objectives.

Confronted with this economic trilemma, governments have made very different choices at different moments in history. Major crises have typically been the trigger for fundamental regime shifts. Under the classical (pre-1914) gold standard, open capital markets and fixed exchange rates meant that central banks subordinated interest rate policy to the goal of maintaining gold reserves and staying on gold. Faced with a drain, a country would in principle raise interest rates, thus inducing capital to stay, while the resulting deflation would restore its competitiveness in the longer run. This approach to economic policy sat well with the liberal philosophy of the time, but was gradually undermined by the growing rigidity of product and labour markets, which meant that the unemployment costs of deflation rose, and by the extension of the franchise which meant that the political costs rose as well (Eichengreen 1992).

During the interwar period, the gold standard transmitted the contractionary impulses emanating from the United States worldwide, and made it impossible to combat the incipient Depression. The result was that one after the other, countries switched to prioritizing domestic policies, abandoning exchange rate pegs, open capital markets, or both. After the interwar disaster, a new regime was instituted at Bretton Woods, which prioritised domestic monetary policy autonomy and fixed exchange rates (since competitive devaluations were felt to have been a serious problem in the 1930s). The result was capital controls, which persisted for many years, but were eventually undermined by the markets. In 1973 fixed exchange rates were abandoned, and the world entered the era of capital mobility and floating rates which persists to this day. While capital mobility has proved troublesome on many occasions – especially when market participants have persuaded themselves that they did not need to concern themselves with exchange rate risk – there is no doubt that the floating rate environment was one reason why the policy response to the crisis of 2008-9 was so much more successful than the policy response of 1929-32 (Eichengreen and O'Rourke 2009, Almunia et al. 2010).

Within Europe, the move to floating was seen as a serious challenge because of the threat which sharp exchange rate movements might pose to the Common (and later Single) Market, and for technical reasons having to do, for example, with green exchange rates. Attempts to limit exchange rate fluctuations soon got underway, culminating in the creation of the EMS in 1979. Initially the system functioned fairly well, due to residual capital controls, and frequent exchange rate realignments. However, after 1987 the system became far more rigid, while capital controls were abolished as a result of the Single Market programme. In retrospect the collapse of 1992-93 can be seen as inevitable, since there was a limit to the extent to which national governments were prepared to subordinate national monetary policy to the requirements of a fixed exchange rate regime. The prior decision by a subset of EC members to move to EMU was another logical response to the challenges posed by the trilemma, in the context of capital mobility. Market doubts about the viability of a fixed exchange rate system in such an environment meant that in the long run the abandonment of separate currencies was a more stable solution. European Monetary Union has thus solved the economic trilemma in a particularly radical way: capital mobility combined with the complete abandonment of national monetary sovereignty.

2. The political trilemma and EMU

There is another way to tell the same story, which relies on another trilemma, which is political, and which has been developed by Dani Rodrik in a series of articles and his most recent book (Rodrik 2000, 2011). This "fundamental political trilemma of the world economy" argues that "we cannot simultaneously pursue democracy, national determination, and economic globalization. If we want to push globalization further, we have to give up the nation state or democratic politics. If we want to maintain and deepen democracy, we have to chose between the nation state and international economic integration. And if we want to keep the nation state and selfdetermination, we have to chose between deepening democracy and deepening globalization" (Rodrik 2011, pp. xviii-xix). The argument is that "deep globalization" involves a commitment to not just open commodity and capital markets, with the constraints that these imply, but also to a competition for mobile factors of production that makes it difficult for national governments to adopt regulatory standards or other interventionist policies, even when their populations want this. The solutions are either to allow popular opinion to manifest itself through supra-national mechanisms, or to ignore it.

On this reading of history, the pre-1914 gold standard could be sustained, despite the deflationary policies which it imposed on deficit countries, because of the limited franchise of the period: the system was based on nation states and globalization, because democracy was not much of a constraint. With the extension of the franchise, commitment to the gold standard – which was seen in those days as synonymous with commitment to the international economy – became unsustainable: in a world of nation states, democracy won out over globalization. In the 1930s this was pushed in an extreme direction, with not just the abandonment of the gold standard, but widespread trade and capital controls as well.

In 1944, a compromise was reached, with the Western countries committing themselves to open trade policies (subject to certain exceptions) but retaining the right to impose capital controls and maintain domestic monetary policy autonomy. Indeed, they reserved the right to intervene in their domestic economies in a number of other ways, including active agricultural and industrial policies. (What one thinks about such policies is not the point here.) With the deepening of globalization over the past two decades this 'Bretton Woods compromise' has been under attack, as nation states start to find their scope for domestic policy manoeuvring restricted. The result has been, on the one hand an anti-globalization movement focussed not just on jobs and wages, but on such traditionally domestic policy matters as environmental policies and consumer legislation as well; and on the other a move towards more global governance. The latter, however, has been technocratic rather than democratic in nature.

Viewed through the lens of Rodrik's political trilemma, the collapse of the EMS showed that one form of international economic commitment – that to a fixed exchange rate standard – was incompatible with democracy and national decision-making, since in the long run there was a limit to the unemployment price that elected politicians would be willing to pay in order to maintain their peg to the Deutschemark. It was the markets' understanding of this proposition that sealed the fate of Norman Lamont's attempts to stave off the inevitable. What makes European Monetary Union such a radical solution to the political trilemma is that it not only abandons national monetary policy-making, but delegates it to a technocratic Central Bank (in keeping of course with recent practice in the United Kingdom and elsewhere). Moreover, this has occurred without common Eurozone policies in complementary areas, notably financial and banking regulation; and it has occurred without a move towards a common fiscal policy, which most economists also regard as a desirable complement to a common monetary policy.

To see why this piecemeal and risky approach was adopted, it is necessary to take a closer look at the political economy of the European Union more generally, and again the political trilemma provides a useful lens through which to view this.

3. From the European rescue of the nation state to the crisis

The EU is notable both for the extent to which it has pooled decision-making, and for the extent to which this pooled decision-making is controlled by democratically elected politicians. The roots of this process can be traced back to the beginnings of the project in the 1940s and 1950s. 'Europe' was in those days not a constraint on the ability to engage in activist policy, but a way for nation states to achieve things jointly which they could not have achieved on their own: it was, in the words of Alan Milward, a "European rescue of the nation state."

As we have noted, post-war Europe saw the growing involvement of the state in domestic economies, and it also saw the widespread development of social welfare systems. The defeat of Churchill in 1945, and the election of a Labour government, symbolised the desire of ordinary Europeans, who had suffered so greatly during the war, to see their lives improve in its wake. Given the experience of the Great Depression, they were hardly going to be willing to leave it to the market: "embedded liberalism" (Ruggie 1982) was a logical consequence.

As Milward has pointed out, these heightened expectations on the part of ordinary people coincided in most of Europe with the feeling that traditional nation states had failed their people -- they had failed in providing economic security during the interwar period, and they had failed in providing physical security after 1939.[1] The most urgent need for governments was to restore the political legitimacy of the states which they governed, by providing ordinary citizens with the security that they craved. According to Milward, the three crucial constituencies which had to be placated were agricultural voters, whose

[1] Milward (2000).

disillusionment had led them to support extremist parties during the interwar period in many countries, workers, and those dependent on the welfare state. The solution was to provide workers with rising wages and full employment, to ensure rising living standards for the agricultural sector, and to establish modern welfare states.

Accomplishing all three goals required an extension of government intervention in the economy. The welfare state reduced economic insecurity, while Keynesian macroeconomic policies helped stabilise economic fluctuations. As regards agriculture, after World War II all European countries experienced severe food shortages, at a time when governments wished to achieve food self-sufficiency for strategic reasons. The result was widespread agricultural intervention across Europe. For all these reasons, as Milward says, "in the long run of history there has surely never been a period when national government in Europe has exercised more effective power and more extensive control over its citizens than that since the Second World War, nor one in which its ambitions expanded so rapidly. Its laws, officials, policemen, spies, statisticians, revenue collectors, and social workers have penetrated into a far wider range of human activities than they were earlier able or encouraged to do".[2]

Another crucial part of post-war economic strategy in Europe was the dismantling of trade barriers between European countries, and between Europe and North America. This was essential to achieving the economic growth without which governments could not attain their other objectives. But how could this be reconciled with the widespread government intervention described above? In fact, governments of the time were deeply conscious of the need to reconcile

[2] p. 18.

domestic with international policy objectives, and of taking steps to ensure that the achievement of the latter did not undermine the former. In turn, this historical context helps explain why post-war European economic integration took on the unusually supranational form that it actually did, when looser intergovernmental structures (such as NAFTA, or the European Free Trade Area) might have sufficed to bring about trade liberalisation on its own. This is precisely what the political trilemma would predict.

In the case of agriculture, the answer was to replicate at a European level the government policies of nation states, by setting up a Common Agricultural Policy. The alternatives would have been agricultural deregulation, which was politically impossible, or a free trade agreement excluding agriculture, which the British favoured, but which would have been unthinkable for agricultural exporters such as France or the Netherlands. Such a policy required a great deal more intergovernmental cooperation than a mere free trade area. It required decision-making rules to set minimum agricultural prices facing farmers, and one can well imagine that the prices favoured by different countries would differ as well. It also required rules for financing the consequences of surplus production.

Governments during the 1950s also feared that their industries would be placed at a competitive disadvantage vis-à-vis industries in other countries whose social welfare systems were less well developed. The French in particular were concerned that their car manufacturers and other industries would suffer from the fact that French law provided workers with longer paid holidays than elsewhere; that it required (in principle) equal pay for men and women, whereas in other countries women's earnings were roughly a third lower than men's; and that it set a working week in France of only 40 hours, as opposed to 48 hours in Germany and Belgium (implying that high overtime rates accounted for a higher share of weekly pay in France). A particular concern for French industry was that social security costs were lower in Germany, where wages were also lower.

It was politically essential that the domestic social welfare systems which not only underpinned governments' political legitimacy, but their economic growth strategies as well, not be undermined by the development of Europe-wide free trade. As Milward puts it, "The problem genuinely was how to construct a commercial framework which would not endanger the levels of social welfare which had been reached…The Treaties of Rome had to be also an external buttress to the welfare state."[3] A logical response was to argue, as the French did, that a common market required common social policies. In order to develop such policies, a deeper institutional framework would then be required than would be the case under a simple free trade area. Common policies required common decision-making rules, and the pooling of sovereignty in particular policy areas.

The Treaty of Rome thus called for the (not yet realised) harmonisation of social policies and the development of a Common Agricultural Policy. The EU has since developed a range of other policies designed to deepen economic integration between members, while allowing governments to collectively retain the regulatory control they deem necessary. European governments have thus opted for deep economic integration, and from the beginning have tended to opt for joint policies, rather than accepting that political (i.e. democratic)

[3] p. 216.

considerations have no place in economic policy-making. In this context, we are today faced with two problems, one old, and the other newer.

The older problem is the issue of how such common policies and regulations should be decided, in the context of an association of democratic nation states unwilling to make the jump to political federalism. From the early days of the EEC, decision-making procedures have been mainly inter-governmental, and thus quite opaque. This in turn has fuelled widespread concerns about democratic deficits, which have been only partially dispelled by the directly elected European Parliament. In particular, the perception has been that ministers go to Brussels and engage in horse-trading behind closed doors, and then return to their countries presenting Parliaments with a *fait accompli*. In fairness, the Lisbon Treaty made several changes here: many Council meetings are now open, national Parliaments have a greater say on European matters, and the European Parliament is more powerful than before. On the other hand, the recent crisis has prompted an increase in inter-governmental decision-making occurring outside the normal Community framework, with consequences that remain unclear.

Attempts to strengthen the political and democratic nature of the EU thus have a way to go, and the reality is that national parliaments continue to enjoy greater legitimacy in the eyes of European citizens than the European Parliament in Strasbourg (not to mention the European Commission in Brussels). The more integration requires joint decision-making, the more resistant European voters may become.

The newer problem is that for a variety of reasons, 'Europe' seems in the past decade or two to have become less of a mechanism for 'rescuing the nation state', and more of a constraint on policy choices. The Single Market programme and EU competition policies, for example, rule out many policies which European governments have used in the past. This may be a very good thing from an economic standpoint, but it ultimately threatens the political legitimacy of the Union -- unless these new constraints reflect the policy preferences of European citizens. That this is so is far from clear: they certainly don't reflect the policy preferences of a sizable minority, at the very least. One frequently heard complaint during the 2005 French referendum on the Lisbon Treaty's predecessor was that the proposed treaty 'constitutionalised' various pro-market policies which ought properly be the subject of political debate between left and right. A convincing retort was that these policy constraints in fact reflected pre-existing European commitments and had nothing to do with the proposed 'Constitutional Treaty': but the more fundamental complaint that 'Europe' was now excluding politically legitimate policy options remained.

In terms of the trilemma, then, Europe is an uneasy halfway house. In part its embrace of deep economic integration has led to a shift to supranational politics, but this remains a work in progress. Policy-making is largely intergovernmental, and the emergence of a genuinely European democratic political process remains elusive – despite such remarkable exceptions as the electoral success of Daniel Cohn-Bendit on both sides of the Rhine. In part, it has led to a more technocratic style of politics, diluting the political element in economic policy making. Both responses have their critics, from different points on the political spectrum. As a result, the European Union finds it difficult to take bold initiatives which might respond to popular opinion, while at the same time it can sometimes impose constraints on the ability of individual governments to act on their own. (Sadly, it was unable to prevent Ireland's unilateral banking guarantees in 2008. On the other hand, 'Europe' is now restraining Ireland's new government from belatedly and partially rectifying this suicidal mistake.) Just as importantly, while some policy areas have been moved to the European level, others remain at the national level, and as suggested earlier it is unclear that this makes for a coherent institutional set-up in the context of EMU.

Schematically, the situation can be conceptualised along the lines of Figure 1. Taking as given the European commitment to deep integration (in certain policy areas), the political trilemma says that the choice is then between national policies, and shared policies. Where policies are nationally determined, the pressures of integration mean that they can suffer from not being sufficiently responsive to popular opinion. To take an obvious example, public opinion is

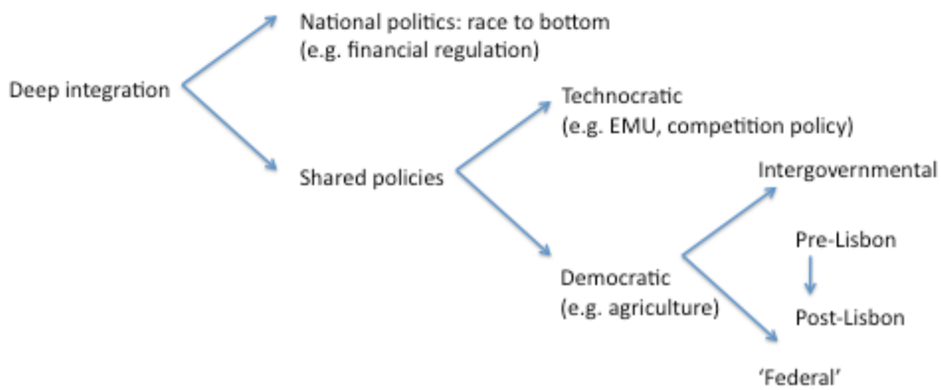


Figure 1. The political trilemma in Europe

overwhelmingly in favour of a variety of measures to regulate the financial sector, but national governments find it difficult to meet such demands in the presence of mobile financial companies. Alternatively, policies can be jointly determined. There is then a choice between delegating policies to a non-political entity, such as the European Central Bank or the European Commission, and having policies be determined by democratically elected representatives. Delegating policy decisions to technocrats may make a lot of sense economically, since rules are often superior to discretion, but democratic politics in national jurisdictions typically involves more than a series of decisions to replace political discretion with binding rules, and there are political risks in allowing European politics to become defined in this way. The alternative is to allow policies to be determined on an ongoing basis by elected politicians, either using intergovernmental means (which runs into the problems outlined above) or more fully-fledged 'federal' procedures. Europe is currently stuck somewhere between these two modes of governance, with the Lisbon Treaty having shifted the equilibrium modestly in the direction of a more 'federal' system.

4. Public opinion before and after the crisis

The current crisis has demonstrated the need for a common European approach to banking regulation and resolution. This is the major reform that EMU needs if further crises are to be avoided, although there is no doubt that a centralised budget which could help smooth asymmetric shocks would also be helpful. Will the current crisis lead to integration moving forward along these lines, or will it lead to greater reliance on national policies, and maybe even to an unravelling of EMU?

Public opinion will ultimately be crucial here, and so it is worth digressing briefly to discuss popular attitudes towards the EU in general, and EMU in particular. The first point to note is that the Euro project started with less public support than the Single Market project enjoyed in 1992 (Figure 2). Even worse, it started out with negative net ratings in Germany, its most important member, and this imposes constraints on what the German government is able to do to maintain Eurozone stability. In particular, it is hard to see any real progress towards anything approaching a fiscal union.

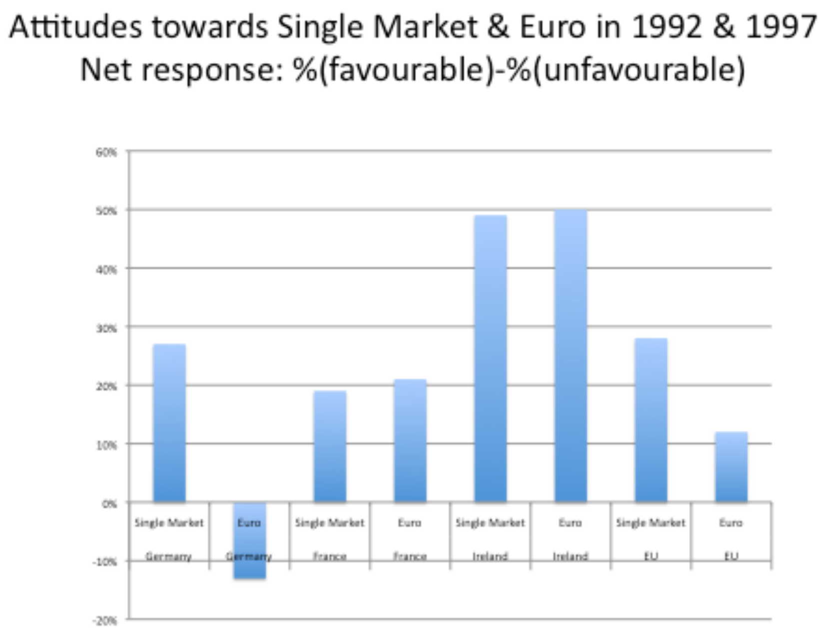


Figure 2. Attitudes towards the Single Market and the Euro in 1992 & 1997

Source: European Commission (Eurobarometer surveys)

Second, there is a major class cleavage as regards attitudes towards the European Union, which emerged strongly in the French and Irish referenda of 2005 and 2008: the better educated, the more highly skilled and the more affluent were significantly more likely to vote in favour of the proposed treaties than the less well-educated, the less skilled and the poor (Brouard and Tiberj 2006, Sinnott et al. 2009). One somewhat self-serving interpretation of these findings is that the less well-educated are more anti-EU because they are not sufficiently well informed about the benefits of the European project. Another interpretation, which is not necessarily incompatible with the first, is that these class differences reflect different interests, real or perceived. In particular, the unskilled in rich countries, and the less mobile everywhere, may have less to gain from international economic integration than the skilled or the mobile – whether this integration takes the form of Polish plumbers, *délocalisation*, or trade. On this reading, attitudes towards European integration reflect broader concerns about globalization in rich countries (Mayda 2006, Mayda and Rodrik 2005, O'Rourke and Sinnott 2001, 2006).

Attitudes towards EMU might also be expected to reflect other economic preferences, regarding unemployment and inflation for example. Given the inflation-fighting mandate of the ECB, one might expect to see less support for EMU among the unemployed, and more support among groups which like low inflation, such as pensioners. This is in fact what the data indicate: Table 1 gives the results of a preliminary multivariate probit analysis of attitudes in the Eurozone towards globalization, the European Union in general, and European Monetary Union, allowing for the possibility that these attitudes may all be correlated with each other.[4] The results show that support for EMU is positively correlated with support for both globalization and the EU, and that it is higher among the better educated, white collar workers, and retirees. On the other hand, it is lower among the unemployed, and those who consider themselves to be on the right politically.[5] Interestingly, pensioners are not significantly more

4 The data are taken from the Spring 2010 Eurobarometer Survey.

5 The regressions are estimated with Stata using mvprobit; robust standard errors are clustered by country. Country dummies are included in the regression, but the coefficients are not reported here. Respondents were categorised as either manual workers, white collar workers, the

likely to favour EMU in Germany, but are very significantly more likely to do so in France.[6]

VARIABLES	(1) Pro-globalization	(2) Pro-EU	(3) Pro-EMU
Right wing	-0.0115	-0.0168*	-0.0252***
	(0.00830)	(0.00873)	(0.00864)
Age	-0.00275	-0.00762	0.00835
	(0.00419)	(0.00726)	(0.00662)
Age squared	1.96e-05	0.000107*	-6.27e-05
	(4.19e-05)	(6.19e-05)	(6.01e-05)
Male	0.134***	0.179***	0.139***
	(0.0289)	(0.0312)	(0.0422)
Years of schooling	0.0456***	0.0745***	0.0729***
	(0.0105)	(0.00749)	(0.00726)
Manual worker	0.0303	0.0238	0.0893*
	(0.0432)	(0.0418)	(0.0499)
White collar worker or self-employed	0.183***	0.205***	0.239***
	(0.0441)	(0.0321)	(0.0510)
Unemployed	-0.0434	-0.144**	-0.168***
	(0.0500)	(0.0622)	(0.0591)
Retired	0.0541	0.0705	0.140***
	(0.0382)	(0.0570)	(0.0540)
Constant	-1.060***	-1.393***	-0.460
	(0.248)	(0.324)	(0.304)
Correlation between (1) and (2)	0.400***	0.400***	
	(0.0183)	-0.0183	
Correlation between (1) and (3)	0.377***		0.377***
	(0.0289)		-0.0289
Correlation between (2) and (3)		0.598***	0.598***
		(0.0254)	-0.0254
Number of observations	12,488	12,488	12,488
Robust standard errors in parentheses			
*** p<0.01, ** p<0.05, * p<0.1			

Table 1. Attitudes towards globalization, the EU and EMU (multivariate probit analysis)

Source: author's estimates, based on European Commission (Eurobarometer) data.

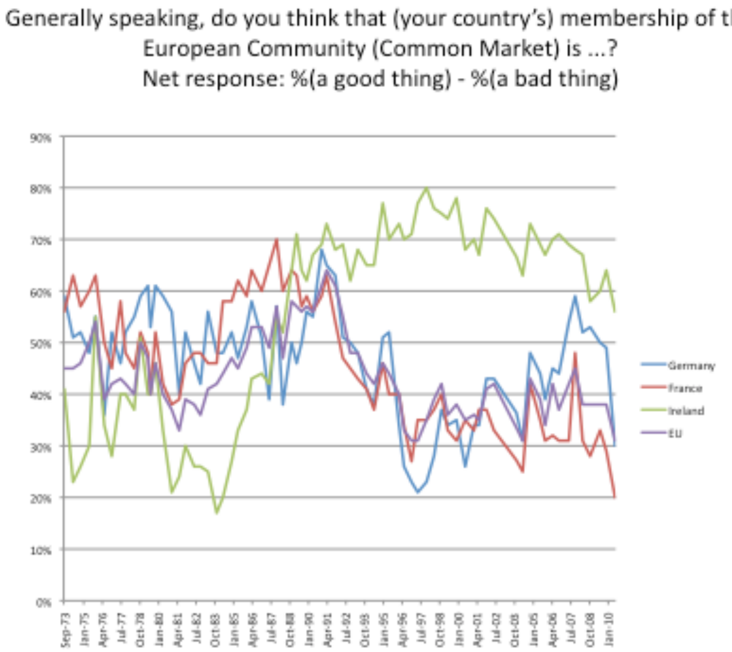
Third, attitudes towards the European Union have become more negative during the current crisis (Figure 3). Respondents are less likely to report that EU membership is a good thing, for example. Ireland has for a long time been one of the most Europhile countries in Europe (by a happy coincidence, it is also the one country whose Constitution obliges it to hold referenda on all major

unemployed, retirees, and those still in education. The latter is the excluded category in the regressions.

6 Regressions available on request.

European treaties), and its voters are still overwhelmingly likely to view EU membership in a positive light (Sinnott and McBride 2011). Net sentiment is still comfortably positive elsewhere in the Union as well (if much less so), but still there has been some deterioration everywhere. More dramatic has been the deterioration in trust in the European Union, the European Central Bank, and (albeit less so) in the European Commission. This has been sharp and rather general. Net trust in the EU is negative in both France and Germany, which is not that unusual, and almost zero in Ireland, which is unusual. Importantly, these data only go as far as Spring 2010, and thus do not take into account the impact of the bailout which occurred in November of that year. What that will do to Irish attitudes towards the Union is a major unanswered question with potentially large ramifications. More generally, the interaction between a sharp economic crisis in several countries, and underlying class-based or national hostility to EMU, could be a potent one.

EMU was a technical response to the economic trilemma, but it would have been a better response if there had been shared banking and fiscal policies among Eurozone members. The problem is that the political trilemma makes any moves towards adopting such common policies extremely difficult: the combination of democracy and the nation state are winning out here, implying that we are stuck with a monetary union with serious design flaws. German voters (among others) don't want a 'transfer union,' and Irish voters (among others) don't want tax harmonisation. Powerful interests are making it difficult to agree on shared banking regulations, let alone shared bank resolution frameworks. Whether EMU can survive in the long run if it remains stuck between these two trilemmas is an open question. On the one hand, as Rodrik puts it, "When globalization collides with domestic politics, the smart money bets on politics." On the other hand, no-one should underestimate the political capital that has been sunk into EMU, or the economic and political damage that could be done if EMU unravels.



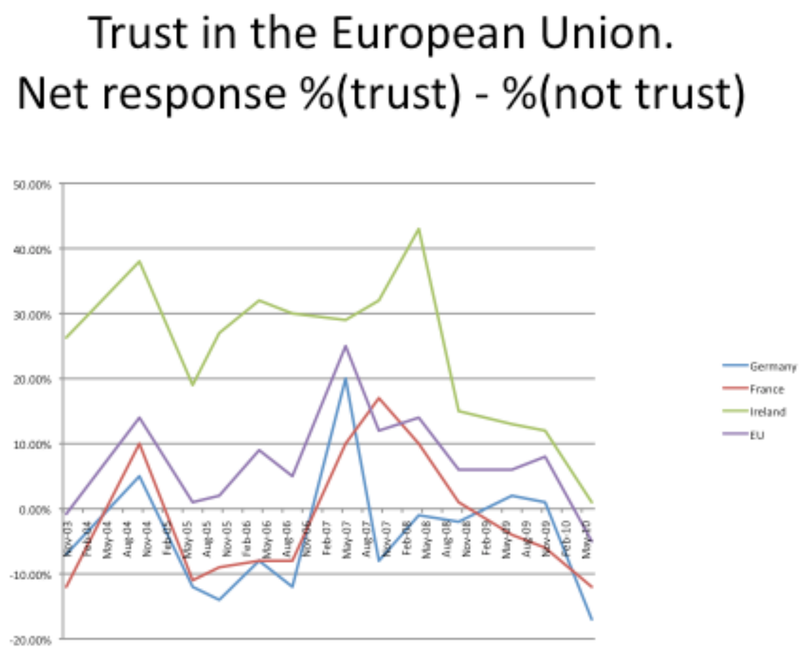
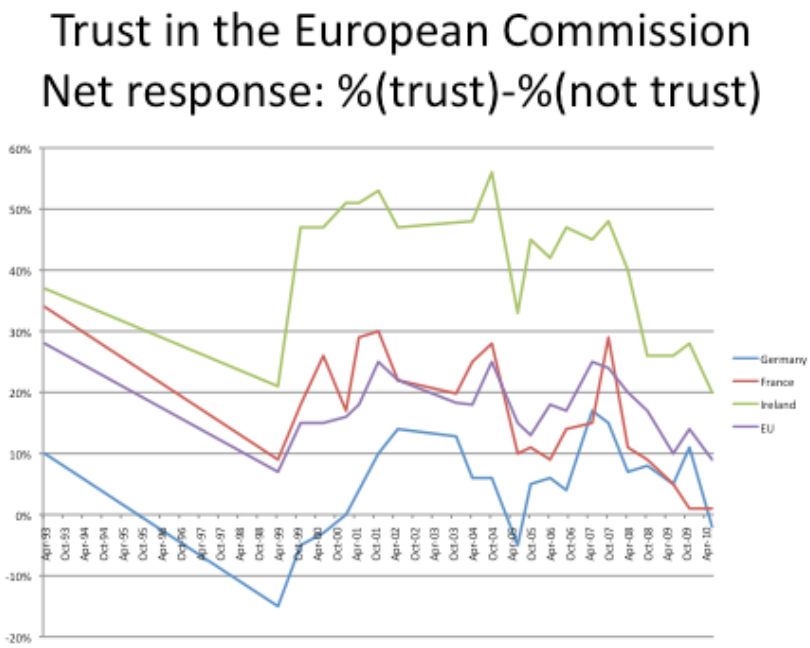


Figure 3. Attitudes towards the EU and its institutions
Source: European Commission (Eurobarometer)



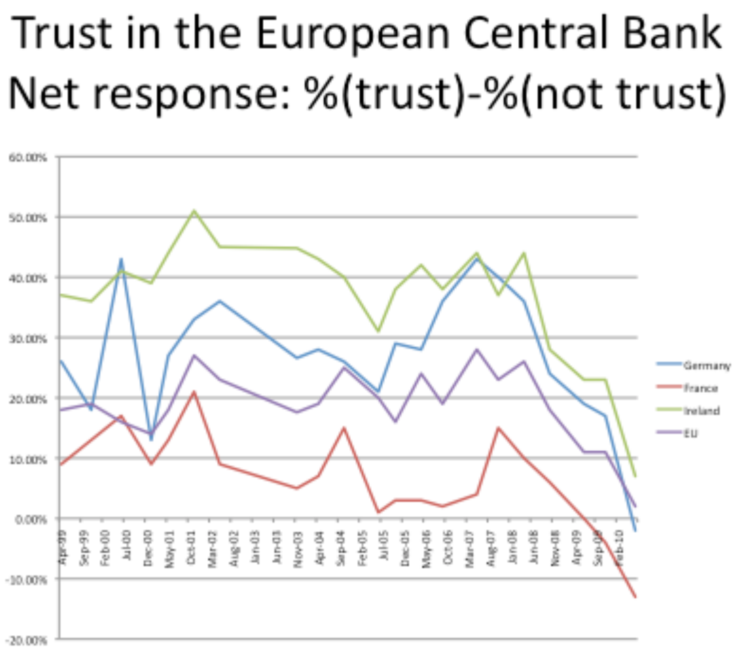


Figure 3 (cont.). Attitudes towards the EU and its institutions
Source: European Commission (Eurobarometer)

5. After the crisis: stuck between trilemmas

In many ways the economic crisis of 2008-9 offered the European Union with a golden opportunity to make itself more relevant to the public. There is strong popular support for Europe-wide initiatives to regulate banks and bankers. More broadly, with old growth models based on global imbalances, debt, and private or public consumption running into difficulty, the opportunity to develop alternative strategies based on investment – inter alia in energy and transportation infrastructures, which will be required going forward anyway – seemed obvious. Such a strategy would, in the European context, surely be largely cross-border in nature.

What we have seen instead is a series of ineffectual moves on financial regulation, and now a complete unwillingness to confront the European banking crisis head-on. Rather than promoting pan-European growth strategies, the institutions of the Union have been enthusiastically promoting pro-cyclical fiscal adjustments in the periphery, even as they insist that heavily indebted governments repay private creditors of private banks in full. Not only is the policy incoherent, making sovereign default more likely on the one hand, while preaching austerity on the other; the insistence that taxpayers rather than investors pay for bank losses is also setting the stage for a potentially very damaging confrontation between core and periphery taxpayers. The political consequences of this are unknowable, but in Ireland, just three months after the troika's intervention, the political party that had been dominant since the 1930s was annihilated at the polls, with the radical and Eurosceptic Sinn Féin now sniffing at its heels: and this in one of the most conservative, and Europhile, countries in Europe. What three or four years of the current policy mix will do is anybody's guess.

At one level, this can be regarded as a damning indictment of Europe's political leadership. At another level, the political trilemma suggests that it can be seen as proof of the primacy of politics, the problem being that it is national politics which are currently dominant, and that are making an effective common response impossible. If the nation state remains dominant within the Eurozone, then the trilemma suggests that there are two logical possibilities. Either public opinion is successfully ignored in countries like Germany, Greece and Ireland; or European Monetary Union will come under threat in the longer run. Something has got to give.

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