

***Europe in the Twentieth Century:
a commentary on events in the context
of finance and banking***

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Introduction

This conference on the evolution of banking - particularly central banking - in Europe in the twentieth century is not to be regarded as simply a retrospect - looking at the past in a 'rear-view mirror' (the historian's professional viewpoint, with hindsight as his only professional advantage). Retrospection, perceptively analysed, can also utilise the past as a perspective through which to assess the present and likely future. This is particularly so when considering the evolution of institutions. Short of the cataclysms of total war and revolution, institutions evolve gradually, being deeply structured into society, economy and government - unlike the history of events - *l'histoire événement* - which is largely imposed upon this institutional matrix. The evolution of institutions is greatly 'path-dependent' in this way. Historians can therefore, with professional legitimacy, use their long-term perspective of the past to reduce (but never eliminate) the indeterminacy masking the options for future change. Knowing the path by which existing arrangements have evolved widens the awareness through which we view the present and what is to come. Perhaps this is what an educated guess means. But there is Lenin's salutary comment that 'history is more cunning than any of us' while the same truth is encapsulated by the old story of the fortune-teller's shop, abandoned and boarded up, with a notice pinned on the door which read: 'closed owing to unforeseen circumstances'.

As we meet, the economic and political context is experiencing dramatic structural changes for Europe and the international economy: the great eastward expansion of the European Union (which is not just an aspect of the EU but a systemic change in the entire concept and actuality of Europe). With this comes the full operation of the European Central Bank and the common European currency as a main agency and symbol of the new Europe. This is not to mention the wider horizons: the faltering (or worse) of the United States economy after a decade of unfaltering growth at an unprecedented pace; with all the global consequences this will bring; the continuing question mark over the revival of the Japanese economy and its structural reform (with all that implies for S.E. Asia); China coming in from the cold through the World Trade Organisation; and what lies ahead immediately for Russia?

Clearly, immense changes are on the horizon as we traverse the millennium year. How much more then, in the long perspective of the twentieth century behind us, should we appreciate the seismic developments which have come to Europe within the international economy and to all its constituent parts, which are explored in this set of contributions.

The main papers of this conference will focus upon banking, and look outwards from banking institutions and their operations to the economic and political context within which the banks acted. By contrast this initial paper is designed to provide a general view of the main historical trends which shaped the evolution of banking systems and the central banks at their head. Given the enormous scope of historical change over such an eventful century (an accurate adjective!) the trends can only be sketched with a very broad brush.

The complexities are compounded by the fact that banking (both in the institutional sense and in the operation of banking activities) has to be construed in the operation of the economy as a whole, and in relation to the formulation of economic, financial and monetary policy (which gives the state an important, inescapable role). In anything except the shortest of short runs banking is integral with the 'real' economy: any presumed dichotomy between the workings of

an economy and its financial arm is false because, in the longer term and in the wider context, the financial dimension is not autonomous. Moreover, the interplay of forces between financial activities and economic activity more generally is complex, changing over time and dependant upon the specificity of context, both institutional and *éventuelle*.

The context shapes the relationships between the banking system (particularly the central bank) and the economy, powerfully influenced by the nature of the state concerned. Politics is never irrelevant to the dynamic produced in the interplay of finance and economics. To what extent is this momentum for change a product of the internal dynamics of the economy concerned? To what extent is it a reaction to forces being imposed from the international economy (perhaps political as well as economic and financial)? An autocratic state, wanting to control the levers of power, will have a propensity to exert its authority over the central bank, if not commercial banks, to seek financial ends through the exercise of political power. A small economy, with a large primary sector, its export earnings from primary produce being its main source of foreign exchange, will have little leverage to mitigate the impact of deteriorating terms of trade. This will be all the more so if the economy depends on a regular inflow of foreign capital (short or long-term), if extensive financial assets are held by foreigners, if overseas-based banks have a significant presence in its financial structure and if a high proportion of foreign-exchange earnings are mortgaged to service debt. Whatever the formal rules of the game (whether 'gold standard' conventions are in play by the central bank or not) by one route or another severe deflation and a fall in the level of economic activity, trade, investment and employment will ensue. Financial levers will be the means of imposing the necessary economic constraints in such a deflationary spiral, imposed by the external shock of deflating demand for primary product imports, contracting volumes in trade, falling prices and deteriorating terms of trade, the momentum for this sequence of contractions being primarily derived from the major players in the international economy - the advanced industrial economies.

For them the effects of a down-turn in activity (primarily internally generated) need not be so devastating. Their main trading flows will be internal, or with other advanced economies. A smaller fraction of their trading values (and purchasing power) will derive from trade with smaller, primary-produce exporters, which for them will be of much higher values in relation to their economies. In consequence, if America or Europe gets a cold, they will get double pneumonia.

Moreover the possibilities open to the larger advanced economies for taking remedial financial actions to counter deflationary forces (or to counter inflationary pressures in opposite circumstances) are much greater. Central banks can manipulate interest rates and monetary policy with much greater leverage upon events. A whole armoury of fiscal and other measures of financial policy can be brought to bear if the apparatus of government is effective. In such a context the decisions of the central bank, particularly if taken in co-ordination with the central banks of other powerful players in the international economy, can play a decisive role in stabilising the economy and placing it back on a path of sustainable growth after an imposed shock.

Of course, the dynamics of the nexus between the 'real economy' and the financial system can operate in the opposite direction. A stock market 'bubble' or a banking crisis - where inherent financial instability results from fraudulent, speculative or over-optimistic decision-making by banks - can radiate outwards to the wider economic community as losses are exposed, loans get called in, credit becomes restricted and interest rates rise. This was not just a phenomenon of small, unstable countries with weak institutional structures. An unstable internal banking system characterised the United States in 1914 and was instrumental in the creation of the Federal Reserve system.

It is counter-productive to elaborate further on the possible permutations in the relationships between banking and the economy. The main part of this text therefore aims to provide a chronological sequence of the main historical trends and the characteristics of the various phases of evolution of these relationships - in short to provide a framework within which the more specialised contributions which follow may be construed.

Before the Deluge: the European and International position before 1914

The context within which banking has to be considered in 1914 was that of the sustained expansion and transformation of the world economy, with relatively mild fluctuations, driven primarily by market forces, both internally and internationally, responding to the opportunities of advancing technology, rising population and incomes, effective governments and developing efficiencies in institutions embodying business and financial dealings. The evolution of banks, and their role in internal and international financing of economic activity is an important dimension of global developments. Financial assets were growing in all European countries (and other 'modern' economies) 2-3 times faster than the rate of growth of GDP. Financial institutions grew in numbers, range and scale as capital markets deepened and diversified.

The basic 'real' data of this unprecedented phase of modern economic growth - integral with the industrialisation of the main 'western' economies - need always to be borne in mind. In 1890-1913 western European countries experienced population growth of 0.8% p.a., real income growth of 2.6% p.a. (and per capita growth of 1.7%). Western European economies, with North America increasingly since 1850, were the main 'engines of growth', with industrialisation and urbanisation proceeding apace. In 1913 Western Europe had an average level of real GDP per capita of almost 700\$ (in 1960 prices) with North America almost twice as high and the Eastern European average just over 400\$. International trade values were expanding by over 4 per cent p.a. The gap with other world regions was widening. Expansion was enhanced by large flows of migrants moving to roles of 'higher value-added' than in the countries they had left: 34 million emigrants sailed from Europe between 1851 and 1910.

Britain remained by far the greatest trading nation and financial presence in this process of expansion and progressive integration of the world economy, although (by 1910) no longer the dominant industrial economy. Half of total European registered shipping of

35,000M. tons was British (the United States having only 5M. registered tons), and most had been built in British yards. Equally with long-term foreign investment, dominated by the savings of Western European countries: of 45,000M.\$ in such flows by 1914 (principally portfolio investment), 20,000M.S had come from Britain. The direction of British foreign investment was mainly extra-European (in contrast to France and Germany) which helps to explain the crucial global role of Britain in trade and finance in this period. The short-term credit market, financing international trade by the medium principally of bills of exchange, had centred on London. Credit balances from all over Europe and beyond, when given endorsement by London banks and discount houses, could be put to use in financing trade (not just trade based on the UK). This gave London a global role in the liquidity of world trade even more than in the long-term international capital market. But endorsement in sterling was critical; in these operational terms the world was trading on a 'sterling standard' as much as a 'gold standard', as one supported the other.

Foreign investment spurred the creation of infrastructures, underpinning the development of both 'old' and industrial countries and 'new' settled and colonised countries (for which exports of primary products and minerals were to be their main contribution to the world economy) - the railways (taking up the major part of foreign investment), port facilities, urban utilities, telegraph and telephone systems. This came at the initiative, and largely under the control, of business interests based overseas; and overseas banks and financial institutions, such as insurance, followed those business interests, handling the finance of their relations with the overseas markets which had created the momentum for development in the first place. This was not just a core-versus-periphery nexus, a primary-product-export-versus an import-of-industrial-goods dichotomy of trade. Britain was the largest exporter of a key raw material - coal - in the world and the United States, as well as becoming an industrial Titan by 1914, was also the largest western world exporter of foodstuffs and raw materials other than coal.

The financial networks and financial flows supporting this vast

expansion and restructuring of the world economy, led by European countries, have an importance of their own: financial arrangements in this period were such as to minimise constraints. The United Kingdom, as by far the greatest presence globally, had the prime responsibility for encouraging international liquidity - her institutions, notably the Bank of England, and her financial and trading policies, were the most important constituents of the system, and strongly influenced other participating states. Free trade (in particular the absence of import tariffs on almost all agricultural products) encouraged the growth of 'complementarity' in Britain's trading relationships. Britain was much the largest importer in the world economy, particularly of food and raw materials. The import bill increased 8-fold between 1850 and 1913, pumping sterling credits out into the world economy. The British economy ran a cumulative deficit on the balance of trade - this being converted into a massive surplus in the balance of payments by international earnings from services (shipping above all, other financial services, the repatriation of profits and earnings etc). This was not derived directly from industrial dominance but from trading and financial strength. Moreover, the context was of an open, multilateral trading and financial system, with few quota limitations on trade (but with some tariff constraints imposed by late industrialisers). Willingness to lend long and short term was also instrumental. From 1896-1914 prices, profits and the rate of growth of international trade recovered from late-XIXth century levels. European agriculture became prosperous again, and a surge of foreign investment ensued. At the outbreak of war more British savings were flowing abroad than were being invested at home.

The general adoption of the gold standard was a function of how the international financial system operated. This was diffused from the Bank of England's traditional practice from the eighteenth century - originally as a non-discretionary means of ensuring convertibility of the national currency; imposing discipline by way of convertibility on internationally trading firms and banks (and originally on provincial English banks). Other concomitant rules (whether formalised through the adoption of 'gold standard rules' or by other controls) aimed to

ensure constraints against the over-issue of currency (the prime early function of central banks was usually to regulate the currency by means of a national monopoly of issue), to prevent the operations of the bank from subsidising government expenditure (even where governments maintained the power to appoint the governor of the bank - which was never the case in Britain), to maintain the external value of the currency by regulating the rate of exchange, particularly by the movement of interest rates. Other functions, such as formal responsibility for regulating the private banking sector, acting as lender of last resort, handling government borrowing and the like, accreted over time in many national contexts. Often the central bank became responsible for functions as a result of a crisis. Adopting the gold standard became a necessary condition for participating in the trading, credit and investment opportunities of the global economy. Investors wanted security for the value and tradeability of financial and commercial assets (through a 'gold' or 'sterling clause' in contracts); as did traders and bankers generally when operating across the exchanges. The gold standard rules offered a general protection against such currency risks.

In the 1870's Germany, Holland, Denmark, Norway, Sweden, France, Spain, Belgium, Italy, Switzerland, Austro-Hungary joined the gold standard (most having had strict rules about control of circulation and *de facto* convertibility) with Russia 'going onto gold' in the 1890's - as a pre-condition for seeking large-scale inward investment and floating state bonds on western European markets to fuel a leap forward in industrialisation (and rearmament). This was a clear example of the leverage which creditor countries could exert on those needing international capital and credit. And as long as these flows were primarily organised and funded through the private sector in a market context, following 'gold standard rules' was virtually a necessity.

Western-based banks operating in foreign countries, colonial territories under western control and British Dominions where banking practices mainly followed UK precedents (with close financial and trading links) widened and consolidated the international financial system, primarily focused on London. Diplomatic influence (and

sometimes *force majeure*) was brought to bear on the economic and financial policies of countries within the western orbit to maintain conformity: dependency created opportunities for leverage.

Many incipient difficulties had been built into the European financial system by 1914. The working of the gold standard imposed harsh deflationary pressures on the periphery at certain times. Little could be done to mitigate the effects of major downturns in their terms of trade. The gearing of international short-term financing on London - with much of the world's trade being financed by the 'bill on London' - meant that the resources of the Bank of England to control and influence the system were becoming progressively inadequate. With sterling as the major reserve currency, international liquidity - and the general governance of global financial flows - was more dependent on a single financial centre than at any time before or since. The Bank of England was beginning to have to 'box above its weight' in seeking to keep the system stable. Other financial centres were growing in importance - New York above all, Paris, Berlin, Vienna in Europe - but no regular mechanisms (least of all institutions) existed to coordinate responses to pressures in the international market. Of the largest 25 European banks in 1913, 11 were British, 7 German, 3 French and 3 Austrian. The Bank of France held the largest mobilised gold reserves in the world and occasionally, in emergency, the Bank of England benefited. These, however, were individual decisions depending on the personal confidence existing between central bankers. In retrospect it is remarkable that confidence in the reputation of the City of London, as a privately organised financial centre, should have carried the system so successfully for so long without state guarantees and provided the basis for its sustained expansion. The longer the historical perspective in which we can assess this epoch in European finance the more extraordinary it is seen to be.

The pre-1914 international financial system has been emphasised in this text as a historical 'norm'. Against it can be judged the fundamental disequilibria and structural changes which produced the collapse of the system subsequently in the two World Wars, the largely

unsuccessful efforts to resurrect it between the wars and the progressive restructurings which took place in the new phases of expansion and growth after 1945.

The Price of War and its Consequences 1914-25

The experience of the First World War was transforming for all aspects of the national life of the belligerent countries (social, cultural, political, economic, financial) - and neutral states also experienced profound change, if beneficial, economically, in their case. This was not just in relation to the impact of war at the time but its repercussions cast a long shadow over all the nations involved - and thus collectively the international economy together with international relations more generally - until the world was once more engulfed by war in 1939. In retrospect it is clear that so many of the discontinuities facing European countries in the longer term can be traced back to the war of 1914-18. The war accelerated underlying trends.

For European countries (Sweden, Switzerland and other neutrals apart) the effects were mainly prejudicial to their pre-war standing, unlike the United States and Japan. Apart from the physical and human destruction - more than 15M - mainly young men - were killed or maimed, perhaps up to twice as many, with as many civilian casualties from war-related famine and disease, the indirect effects were greater. The destruction of shipping, for example, was compounded by its diversion for war purposes. As freight rates rose tenfold (war has universally produced a shipping shortage) states moved to exercise control over their merchant fleets. The diversion of productive assets to non-productive use brought a run-down in investment (the armament industries excepted) in industry, agriculture and public utilities, a fall in productivity, a dramatic collapse in international trade. With food shortages the strength and well-being of peoples declined, with inevitable economic consequences.

The free-trade system lost its viability as the underlying flexibility of market-responses to potential shortages (expressed in relative price movements) collapsed. A world of state-control, licensing, quotas,

rationing ensued, where priorities were laid down and enforced by governments rather than by the market. The pre-war system was never recouped although quantitative controls gave way in the 1920's to tariffs, until revived in Germany and the German-trading bloc in Central and East Europe through bilateral clearing agreements after 1935.

Europe swung from creditor to debtor status in the international economy - at least relative to the United States which emerged from the war as the only major creditor but did not act in that role in the effective way that Britain had done before 1914. International assets had been liquidated as European states spent on war finance more than their income (either in terms of foreign exchange or tax revenues). The new regime in Russia after 1917 reneged on Tsarist debts, to the great loss of France, but this was just the largest case of bad debts that had to be liquidated. Germany lost most from such defaults, with the added burden of an impossible total of reparations. When successfully scaled down they were still set in April 1921 at 132 *billion* gold marks (more than twice the size of Germany's GDP) and a 20% tax on German exports to last over 40 years.

In the first years of peace loans to allied countries from the United States totalled £1,900M (£842M to the UK) while total loans to European allies from the UK reached £1,750M. Even with much written off, these huge sums produced distortions and instability in a liquidation of financial assets, the opportunity cost of which was significant in real as well as financial terms. The consequences of wartime debts and reparations dominated the post-war European financial scene.

The emergencies of war-time finance also overwhelmed the rules for financial prudence maintained by central banks nationally and the gold standard internationally. The transcendent obligation of central banks (mainly known up to this time as 'banks of issue') to maintain convertibility of notes in circulation as the core feature of national financial discipline was quickly abandoned (empirically if not always formally). Gold exports (except with official authorisation) were prohibited, overseas lending stopped. The 'gold standard rules' for maintaining exchange rates, setting monetary policy and interest rates

according to market principles went by the board as normal financial and commercial criteria were sacrificed. The essence of the matter was that central banks lost their operational autonomy from government and became creatures of state policy (which also included maintaining confidence in the financial system for ordinary transactions) forced to do all the things which violated the canons of being central banks under the old assumptions of keeping the predatory demands of the state at bay. Governments regarded central banks as institutions for directly supporting state policy with the transcendent priority of winning the war, deploying financial resources in an analogous way as mobilising manpower, production, shipping for the same ends.

The means whereby governments subverted the central banks were all too familiar. Essentially state spending had to rise urgently above the level of current revenues from taxation. Central banks could print currency directly to fulfil state spending needs and lend to the government in various ways - to pump out credits, to accept government paper, and valorise government debt by way of direct and indirect refinancing of public expenditure. Inflation became a key mode of war finance in many countries - as with wars long preceding 1914 - imposing a burden on the current generation through the attrition in the real monetary value of savings. Imposing a burden on future generations by the expansion of the permanent national debt was an alternative, or a shared means with inflation, for countries with a long tradition of public credit and 'honest money'. The permanent national debt in Britain rose more than tenfold (in current prices) between 1914 and 1920 (from £650M to £7,830M) with annual debt charges rising from £23M to £350M. This followed tradition from the late XVIIIth century: long-term public debt being created by war and then gradually retired in subsequent years of peace. In all belligerent countries the scale of war-time financial needs (in both the length of the conflict and the unprecedented mobilisation of resources for 'total' war) was unanticipated so only modest efforts were made to 'mop up' increased purchasing power, encourage savings and raise taxation. This lesson was learned in the second

world war when a higher percentage of expenditure in Britain came from taxation.

Recovery Depression, and Changes in Direction 1925-1939

The European economies struggled to overcome the human, material and financial costs of the war - and the immense opportunity costs which were involved - and the fruits of this recovery were seen in the renewed growth of the years 1925-9. Most countries had regained internal financial stability, convertibility of currencies and a re-adoption of the gold standard by one means or another (the United States had not departed from gold). This followed total collapse in the value of the German currency in 1923, the postponed nemesis of war finance and the added burden of reparations, which wiped out financial assets and brought a new beginning where imposed financial discipline was at its strictest. The national memory of this disaster spanned the traumas of the second world war and made the German central bank the most conservative in Europe up to the arrival of the Central European Bank in 1999.

The impetus of renewed growth did not survive the next, greater crisis of 1929-32, which revealed structural distortions and a change of dynamic which can also be traced back to the trends set in train by the first world war. The pursuit of national self-determination, endorsed by the Versailles settlement, brought into existence small, weak, indebted and unstable states in Eastern Europe. The Austro Hungarian Empire (next only to the Ottoman) was a ramshackle structure but the financial role of Vienna provided coordination and a certain coherence to the region. The successor central banks were much subject to destabilising practices, political influence and foreign pressures, compounded by inherent political instability, which was maximised as the new national frontiers created powerful disaffected minorities. Can the economic costs of this nationalism ever be quantified? The new Soviet regime, meanwhile, largely withdrew from the international economy, setting quite new rules for operating its own centralised system.

The great depression of 1929-32/3 exposed more long-standing weaknesses temporarily masked by the post-war boom of 1919-20 and the revival of trade, credit and investment in 1925-28. The momentum of the old export industries was failing, imposing harsh restructuring for iron, coal, shipbuilding and some textiles (particularly for the UK), while new industrial growth came primarily from home markets and trade between the advanced economies. Direct investment by American firms gave a boost to industrial modernisation in Europe, but international trade suffered from the retreat of the United States as the main creditor now at the heart of the international economy. The stock-market boom of 1929 absorbed American savings and the subsequent crash in the autumn set off a rush for liquidity with a collapse of credit which reverberated through the system. Prices of primary products fell by 10-20% in the autumn of 1929 setting off a global contraction in purchasing power. Most Western European countries protected their agriculture but the main exporters in Southern and Eastern Europe suffered (except for the Scandinavian countries where the prices of paper, pulp and wood-products held up). These trends were apparent before 1929 but were intensified by the world-wide slump of 1931, for which the American financial turmoil of 1929 was a herald but not the main structural explanation. Debt-servicing costs in the primary producers world wide (including Europe) doubled or tripled as a percentage of their export earnings between 1926 and 1931/2 causing financial reserves to dwindle, preventing further borrowing, and forcing retrenchment in their purchasing. In 1929-32 the value of world trade fell by 60% (35% in volume) and was still below the level of 1928/29 in 1938. The foreign trade of European countries was lower in 1932-3 than in 1900. Growth rates followed down from 2.5% p.a. (the volume of GDP per capita) in 1925-9 to 0.8% p.a. in 1929-38. In the latter decade the economies of Austria, Belgium, France and the Netherlands experienced absolute decline (as did the United States).

In Europe the financial dam broke with the revelation of bankruptcy of the Credit Anstalt Bank of Vienna on 11 May 1931 which rocked the entire banking system in many continental countries.

Creditors (local and international) withdrew their funds from the banks in the rush to liquidity and fled. Gold and foreign exchange reserves of 18 European countries fell by half in 1930-31. In the scramble for liquidity the main demands eventually fell on France (still with the highest gold reserves in Europe) and then Britain. After a run on sterling in July 1931 the Bank of England went off gold. With the domino-effect operating powerfully the gold standard collapsed in all the main European economies save France, and American lending on the financial markets disappeared. Much debt was repudiated; reparations were finally abandoned.

A major bank crisis had been waiting to happen, given the weakness and uncertainty of the time. Apprehensions of the wider consequences for Europe existed ahead of the debacle which explains the desperate international efforts made, without success, to prop up Credit Anstalt - by the central bank, the Rothschilds (major creditors), the League of Nations coordinating seven national governments, the Bank of England putting together a syndicate, even the recently formed Bank for International Settlement (the forum for central bankers) - the first incipient international institution for financial cooperation. This was quite ineffective at the time but a faint herald for the new world of central banking after 1945.

The tradition of 'mixed banks' on the continent, whereby main banks became long-term creditors and promoters of large-scale utilities, transport undertakings, industrial and mining companies, had been a force for industrial expansion in the long term but now multiplied defaults and illiquidity. British banks, not taking up equity or promoting long-term investment in the normal course of business, remained largely unscathed. Where the Bank of England was drawn into industrial reconstruction schemes this was in response to crisis, not its cause.

With the discipline of fixed exchange rates and convertibility into gold abandoned (Britain had suffered constraint by returning to gold in 1925 at too high a parity for post-war trading conditions) the crisis (or crises) unwound, but did so under new policy regimes. Interest rates could fall and devaluations proceed. Tariffs became universal - Britain, the bastion of free trade, adopted import tariffs in 1932, with

imperial preference as an aspect of the fundamental change. Preferential trading advanced in various 'blocs' as the economic frontiers were re-grouped, almost in parallel with political groupings. The 'gold bloc' centred on France and associated economies (including the remains of Empire); the 'sterling area' essentially comprised Britain, the Dominions, India and smaller colonies - consolidating links between the main trading partners with sterling as the reserve currency. In the north, Scandinavian countries drew together, while the most important regrouping centred on Germany. Here the 'reichmark bloc' formalised trading patterns through a series of bilateral clearing agreements which became instruments of German trading, banking and investment dominance in the Balkans, Central and Eastern Europe. Could this be called an 'economic Munich'? In continental countries new economic fiefdoms were consolidated through state initiative and state-inspired institutions. Exchange controls proliferated as another dimension of market relationships became subordinate to political influence. Central banks became instruments for politically-driven policies, and not only in the newly emerging 'fascist' states of Italy and Germany, which led the way in internal reconstruction.

The greatest momentum was given to industrial recovery in Germany, followed by other states, after 1935 by rearmament which inflated demand once more from state orders, breathing new life into depressed capital goods industries and the proliferation of construction and engineering activities. Unemployment levels finally retreated again, having been above 10% of the labour force since 1921 in most countries. Rearmament was the culmination of economic policies dictated by political imperatives. An economic impetus derived from this source led - in retrospect inevitably - to an even greater cataclysm which engulfed Europe and the world in the six years after 1938. Never was this phase of economic recovery bought at a higher price.

War, recovery and sustained growth, 1946-1973

The human and material destruction in Europe during the second world war was on an even greater scale than in 1914-18. If the

slaughter in trench warfare on the western front in the first world war was not matched in the second, the carnage and the terrible consequences of occupation in Poland, Eastern Europe and Russia in the east were much greater. Mass bombing added a new dimension of destruction and terror for all the belligerents, but more particularly for Germany in the latter stages of the European war. Western Europe experienced over 6M military and over 8 M civilian deaths (including 6-7 millions in the holocaust); while over 15M died in Russia. The fighting left behind tides of penniless, homeless refugees while indirect casualties from starvation, malnutrition and disease which followed the breakdown of organised society in the aftermath of the military campaigns added to human misery and the costs of reconstruction. Almost half of residential accommodation in Germany was destroyed or damaged; while in major English cities the percentage of property damaged did not fall far short of this. As before, industries were run down, worked to maximise immediate output without due maintenance or investment. Immense deterioration took place in public utilities, transport, mines, the urban fabric and all aspects of the material environment, quite apart from physical destruction. By 1945 physical output in Europe (including agriculture) was less than half the level of 1938.

Financial assets were also ruthlessly exploited by governments: overseas investments liquidated, currencies debauched in inflation as central banks acted as agents for supporting war expenditure. All this was a replay of war-time experiences in 1914-8 and its aftermath but with variations.

Financial strains could not be avoided, however well managed wartime economies might be, but lessons had been learned in Britain. Increased taxes, 'forced' savings absorbed much of excessive purchasing power (helped by the development of national-income accounting quantifying economic and financial flows in the economy); modifying current inflation, slowing the rate of growth of the national debt compared with 1914-20 and hence lowering the financial burden on future generations, while enabling a more orderly return to peace-time finance. Over 45% of total state expenditure in Britain

during the war came from taxes. The sale of foreign assets and the growth of external debt meant that the balance of payments became critically dependant on exports, on which post-war policies were focused. "Export or die" became the national slogan

Systematic exploitation, financial, human and material characterised the occupation of Western Europe. Savings were forcibly mobilised. Perhaps 12% of the Reich's total wartime expenditure was extracted from occupied countries; with Germany taking two thirds of the total French budget in 1943. Before the final collapse, 20% of the workforce in Germany were foreign (8M workers) and 30% of the industrial labour force. Between a quarter and a third of Germany's war production came from the occupied territories. The 'new order' was not so much a considered plan analogous to the integration of Western Europe in the EEC/European union, with an industrial heartland and peripheral agricultural economies in complementarity, as a ruthless means of exploiting resources for Germany's benefit, however they could be extracted.

With this traumatic impact of war and occupation from 1939 to 1945 the common expectation was that the post-war experience of the European economies would be even more dire than after 1918. In fact, the opposite occurred, once the immediate dislocations of 1946-7 (with its terrible winter) had been overcome: peace ushered in a generation of unprecedented growth and prosperity, which in most respects has continued to the present.

How did this 'miracle', which characterised the international economy as a whole and was led by the United States, come to pass? The experience of the inter-war years gave governments, central bankers, economists and policymakers in general clear awareness of what had to change and produced the political will to bring this about. International institutions to coordinate macro-economic policy, provide liquidity and agreed procedures to cope with disequilibria were of the essence - with the essential backing of the United States, now the only major creditor in the international economy and the dominant partner in trade and finance in the post-war context. Anxious, in her own interests to restore the international economy (quickly

supplemented after 1947 by the political imperatives of the cold war), but with generous altruism in addition, America acted boldly. The contrast with post-1918 was fateful for European recovery.

The declaration of intent for restoring the multilateral trading system came as early as 1941 in the signing of the Atlantic Charter. Before the war ended representatives of 44 countries signed the Bretton Woods agreement, which set up the institutional framework of the international monetary system with the International Monetary Fund, the International Bank for Reconstruction and Development (the Bank for International Settlements remained complementary to the 'Bretton Woods System'). Ambitions for a World Trade Organisation had to be scaled down until 1995 with the General Agreement on Tariffs and Trade but the norms were set: no discrimination, the removal of quantitative restrictions and quotas, the reduction of tariffs. Convertibility of currencies into gold and/or dollars (the United States having the main reserves of both) was another norm but disequilibria proved too great for this to be achieved at the first attempt in 1947 (when British convertibility lasted only 6 weeks). By 1958, however, convertibility and fixed exchange rates with the dollar (save only in circumstances of 'fundamental disequilibrium') characterised the Bretton Woods system until 1973.

In the first years the reconstruction of the trading system and economic regeneration of Western Europe countries was the priority for the new institutions (the I.M.F. was funded by participants with 10bn.\$ and given access to the capital markets) but as years passed, with this objective successfully accomplished, the main tasks lay elsewhere in the world (with occasional short-term rescues in Europe).

However, in the immediate aftermath of war, aid - with emergency loans - was critical. Other United Nations agencies focused help upon European reconstruction: the International Refugee Organisation, the World Health Organisation and - particularly - the Relief and Rehabilitation Administration which, in 1945-6, provided 20M tons of food, medical and other supplies, with 1bn.\$ in aid. In 1945-7 the United States supplied 4bn.\$ in aid to Europe and an emergency loan of 5bn.\$ to Britain. The initial priorities were food supplies and

agricultural output, to restore nutritional levels as a pre-condition for economic rehabilitation, and then raw materials and industrial reconstruction. The regeneration of exports was urgent if foreign exchange was to be won to pay for vital imports and to service loans, but, even so, economic and financial controls were widespread until the 'dollar gaps' were closed in the later 1950's.

The emergency response to Europe from the United States then became consolidated in the Marshall Plan (announced on 5 June 1947) implemented in the European Recovery Programme of the following year which continued until 1952 through the organisation for European Economic Co-operation, set up to coordinate the scheme. No less than 13bn.\$ in loans and grants flowed from the United States to Europe under the ERP.

Russia had declined to participate in these international, dollar-financed schemes under American initiative, so Western Europe drew apart, on a quite different path of growth from the USSR compounded by the strategic and political confrontations of the cold war. In 1948, meanwhile, the Erhard Plan established the framework for free-market institutions in Western Germany, which rapidly became re-integrated into Western Europe once the three allied zones allowed political and institutional unity to be reestablished under western precedents. The deutch mark became the most stable currency in Europe following this. The new German central bank, however, modelled on the Federal Reserve System, did not take over from the regional Lander banks until 1957 when, reflecting the economic and industrial power of resurgent Germany, it became the most powerful central bank on the continent.

American credit and lending fuelled the revival of international trade, which centred on the renaissance of European economies, supported by direct American investment (which aided technological transfer in the modernisation of European industry) and payments for the American forces still stationed in Europe. With equilibrium returning in European economies, as export performance recovered, the ERP gave place to the European Payments Union after 1952 through which a free-trade zone was successfully instituted for EEC countries.

A back-log of innovations in the 'high-tech' industries of their generation, boosted by war-induced innovations gave a continuing impetus to industrial expansion. Aeronautics and the aircraft industries, automobiles, oil, proliferating engineering industries, electricals and electronics characterised the growth points in the changing industrial structures. Coal and steel still determined the basic industrial infrastructure. Not least remarkable in the European recovery was agriculture, which defied precedent in not giving way to post-war depression. Agricultural protection (and support prices in the case of Britain where imports remained at world price in this period) brought prosperity to the rural sector, while massive transfers of labour away from low-productivity agriculture in France, Italy, Germany, Spain and other countries to sectors with higher value-added gave a strong impetus to growth, urbanisation and the process of industrialisation.

The results collectively were remarkable. During the 20 years between the ending of ERP and the collapse of the Bretton Woods system in 1973, the average rate of growth of world trade - with the trade of Western Europe countries at its heart - was 8% p.a. (an unprecedented level it can be seen in retrospect). The European GDP growth rate per capita averaged 4-5% p.a., with unprecedentedly low rates of unemployment. With structural change away from agriculture the lower-income countries grew faster in a 'catching up' operation with the earlier leaders of industrialised economies (per capita growth in the UK - one of the slowest growing countries in Western Europe - reached only 2.2% in these years). But the momentum was much more deepseated than that of 'catching up' or a 'bounce back' effect from the depredations of the war. Europe had embarked on a new path of growth based on a new dynamic. Newly emerging European institutions were central to the process.

After Bretton Woods, 1973-

The American leadership, which had ushered in and sustained the resurgence of European economies, bringing in 'the Golden Age' from 1952, may be seen in retrospect as coming to an end in 1971-3

when the Bretton Woods 'system' of fixed exchange rates and convertibility based on gold and the dollar collapsed in 1971. Disequilibria leading to differences in purchasing-power parities between different countries had exacerbated tensions in the system (in some respects known access to liquidity in a crisis encouraged the relaxation of monetary and budgetary policies) but, behind this, lay the recovery of trading success in Western Europe. In Germany, Italy, Austria and the Netherlands the compound annual rate of growth of exports was over 10% by volume in 1950-73, while that of Belgium and France was 8-9%. This was, of course, rapid growth from a low base. The UK export performance, by contrast, was much less impressive at 3.9% p.a. which produced successive balance of payment crises, 'stop-go' economic policies and devaluation.

As the world dollar shortage dissipated and its value declined relative to western currencies so its role as a reserve currency faltered. Exchange controls had ended so, as willingness to hold dollars was called into question, speculative tides of short-term capital (growing much faster than the values in international trade) surged across the exchanges. It was impossible for the United States to continue to provide dollars and gold at fixed exchange rates any longer. In May 1971 the Reichbank let the German Mark float; in August a run on the dollar began and Federal Reserve stopped convertibility into gold. A new, much less expansive phase of European development ensued, bringing into the open forces of constraint - quickly dubbed 'Eurosclerosis' which the momentum of rapid growth had been masking. The OPEC cartel quadrupled oil prices in 1973, with a further shock in 1979-80, at a time when European economies were moving rapidly from coal to oil as a basic fuel and when North Sea oil had yet to come on stream. Oil prices increased more than 10-fold between 1970 and 1980. This imposed a heavy burden on costs, working right through economies, slowing growth. The discontinuity was apparent: rates of growth of Western European countries halved from 4.8% p.a. in the 'golden years' 1959-1973 to 2.1% p.a. in 1973-96 (with per capita rates down from 3.6% p.a. to 1.8% in the same period) The rate of growth of European exports fell comparably from 8.6% p.a. to 4.2%

p.a. and with this constriction unemployment rates - the most sensitive of indicators of prosperity for ordinary people - rose inexorably: from 2.8% of the labour force in the 1960's, 5.1% in the 1970s to 9.2% in the 1980s. To complete the record of woe, inflation rates rose to over 9% p.a. in the decade after 1973.

Slow growth was itself responsible for certain of these unfavourable trends but their impact was compounded by structural change. This was occurring within sectors as technological change and differential productivity movements altered relative prices and market opportunities. Old heavy industries, traditional textiles and mining were in decline across Western Europe, led by Britain where they had attained a greater size relative to the economy than in other countries, maximising social dislocation when in decline. Wherever such industries faced the full weight of attrition through market forces, as 'liberalisation' measures took effect the pace of restructuring increased. The same tale was told in Eastern Europe after the collapse of centralisation. Agriculture was no exception, despite the defences of the Common Agricultural Policy of the EEC/EU from its foundation, erected to protect producers from world prices (and thereby penalise consumers and taxpayers). The prosperity of farmers (at least in comparison with their experience in the inter-war period and in the last quarter of the nineteenth century) eased the economic transition of Europe until the 1990's, but did not halt the process. Upland rural regions of poor soil a long way from urban markets suffered depopulation (to the advantage of richer urbanites looking for second homes).

Structural change was most visible in inter-sectoral redistributions, with the contraction (absolute and relative) of employment in agriculture, coupled with the relative (but not quite absolute) decline in agricultural production. Mechanisation, fertilisers, pesticides, greatly intensified agricultural productivity per worker and per acre. In a reversal of a centuries-old pattern the cereal harvest, which once brought entire villages out into the fields, was now a job for one combine-harvester operator on a farm and a couple of tractors hauling grain to the silos.

While 'industrialisation' brought a relative, as well as absolute, expansion to the industry/mining/construction sectors in the 1950's and 1960's, contingent with the 'contraction' of agriculture, 'de-industrialisation' subsequently brought a contraction in industry and mining (absolute with the labour force; relative in output) while both employment and value-added expanded in the services sector (a most heterogeneous category for such analyses). This was characteristic of the evolution of all advanced economies, including the United States, and had been identified in Britain from the interwar period (with a temporary reversal in 1939-60). Growth and prosperity have certainly characterised 'post-industrial' economies but rates of growth for output and productivity were slower, while jobs were not being created in services as fast as they were being lost in industry and agriculture. The agricultural periphery of Western Europe gained in industrialisation in the 1960s-70s (Italy, Spain, Ireland, E. Europe) but the process of structural change was being intensified by the rapid industrialisation and growth of manufactured exports from Japan and other S.E. Asian countries; which was altering the 'balance of power' economically and financially in the world economy, intensifying the problems of transition for Europe (as well as creating opportunities - as the growth of wealth internationally will do).

Structural change was not a short-term phenomenon: the trend continued. By 1998 agriculture was employing only 4.8% of the labour force in European Union countries, industry 29% and services 66%.

Even though American growth rates were slower than the European average after 1973, the economic performance of Japan became the new mark by which to judge the slackening growth rates in Europe. Heart-searchings and post-mortems characterised the 1970's, with particular intensity in Britain seen then as the 'English patient' (GDP per capita grew in Britain at 1.5% p.a. in the 1970's compared with 2.1% in Western Europe). Most new 'high-tech' industrial growth seemed to be concentrated in the United States (not then having a large enough share of GDP to influence the national aggregate), with a 'technological gap' apparent with European industry, analogous, it seemed, to that of the late nineteenth and early twentieth centuries. This was further evidence of 'Eurosclerosis'.

The popular diagnosis for the condition was institutional and policy-derived. Dynamism came from the private sector under the drive of market forces, which were blunted in Europe by national institutional protection of various kinds, which survived the legislation which had produced freedom for international trade and capital movements. Welfare systems throughout Western Europe created inertia against the necessary responses to market pressure - the short-run political and social imperative of blocking longer-term gains - while imposing rising burdens of state expenditure. Public sector expenditure in Western Europe countries had risen inexorably from 31.2% of GDP in EEC countries in 1960 to over 50% by 1982. By 1995 the EU average for public expenditure relative to GDP was 49.2% (64% in Sweden; 59.7% in Denmark; 50.9% in France; 42.3% in the UK), while only 34.3% in USA. Social security transfers (an indefinite category for comparisons) were 13.1% of GDP in USA and 20.4% on average in the EU countries with similar national variations (15.4% in the UK). Comparisons of growth rates with the United States had greater statistical validity in the 1990's when the American economy enjoyed a sustained boom, with industrial renaissance in new sectors, in contrast to Europe. This confirmed the earlier diagnosis of European sclerosis, just as the comparison with Western European growth rates had produced much self-examination in Britain during the 1970's.

From the troubled performance of the British economy - following similar diagnoses of the predicament - was born a new right-wing political philosophy championing the much freer reign of market forces, to which political action should be orientated. This broke surface as the new Tory ideology in Mrs Thatcher's government after 1979 and subsequent conservative administrations. The rhetoric of neo-classical economics of the 'Chicago School' and Schumpeter proved more resonant than the reality (the welfare system proved resistant to financial economies) but institutional, policy changes ensued. The trend was exceptional in that political ideology had always been a characteristic of left-wing politics in Britain, conservative thinking traditionally seeking empirical solutions for practical problems; without benefit of an ideological schema. The 'enterprise

culture' had to be revived; entrepreneurs cultivated. Marginal rates of direct taxation were dramatically reduced, with a major switch to indirect taxes on expenditure, to promote incentives (over-all levels of taxation did not fall). Market forces were let loose through de-regulation of financial institutions in the city of London; trade-union legislation circumscribed the right to strike; an extensive programme of denationalisation in transport and public utilities was set in train. The trend has not been halted or reversed since but much copied.

The consequences were generally invigorating: tests of 'value for money' and monitoring of performance were imposed on public-sector institutions, as free-market disciplines and incentives were to enhance performance in the widened private sector. In response, GDP per capita in Britain grew by 2.2% p.a. in 1979-89 while OECD countries averaged only 1.7% p.a. and all Western European countries except Italy were under 2%.

From this experience came the assertion that paths of evolution in Europe were diverging into two groups. Britain was following 'American capitalism', more ruthlessly accepting the consequences of market forces, more receptive to international trends (which meant American in the main), more determined to press ahead with deregulation, while in European Union countries, capitalist relationships were more mitigated by social controls. Perhaps the slogan 'the third way', adopted for the 'new labour' election campaign of 1997, is receptive on the continent in this respect, but important policy differences remain.

From EEC to EU

Up to this point nothing has been said directly of the evolution of the institutional integration of Europe - political and economic - which began in 1956 when the 'six' signed the Treaty of Rome to form the European Economic Community, still remaining at the heart of the much enlarged European Union after 1986 (now 15 members and about to rise further with the 'march to the east'). It is much easier to plot the institutional developments than to isolate the effect of the

progressive economic integration upon economic performance, apart from plotting the rising share of intra-EEC/EU trade amongst its members, which rose from 30% in 1958 to 52% in 1972 and is rising. Currently c. 60% of UK exports go to EU countries. Disentangling the specific economic effects of the EEC/EU on growth rates and changes of economic structure from wider influences (shared by European countries) is impossible to quantify. The 'counter-factual' is too complex to construe - as comparisons with the economic performance of non-EEC/EU countries reveals. But their economic performance, in turn, was powerfully influenced by the EEC/EU. Notionally, however, it has been claimed that (by 1997) the single market had increased GDP in the EU by up to 1.5% and helped to reduce inflation. This is too modest an assessment of the general importance of the European Union, and ignores its political dimensions, which were instrumental in creating a truly common market quite apart from wider objectives.

The political motives for subsequent developments were apparent in the European coal and steel community four years in advance of the Treaty of Rome - with the intention of locking together the basic industries of France and Germany to preclude a future war as much as to provide a basis for industrial cooperation. While the governance of the ECSC instituted a supranational authority which presaged the institutions of the EEC, Britain remained apart. This set precedents for the future, with reverberations still present over the Euro and the European Central Bank which reveal a common theme of disparity in objectives between Britain and the EEC/EU, a difference in concepts and vision about Europe. The second world war set the experience of Britain apart from continental Europe. She had always faced outwards to the world economy, to the United States, to Empire and Commonwealth in cultural affinity, links through emigration, investment, financial and trading flows, more than to the Continent. Policy envisaged a central UK role as mediator and nexus between the United States and Europe rather than as a political constituent of a united Europe. Joint membership of a multi-lateral trading area - a truly common market in industry, commerce, financial services, with

reservations about the extent and the mechanisms for subsidising agriculture - was one thing; a political union and a supra-national authority progressively absorbing national sovereignties was quite another. Successive British governments underestimated at the least, at most were misled, and then deceived the British public, about the political implications of the sequence begun with the ECSC and the Treaty of Rome, whereas they were plain for all to see in Europe itself, in the United States and the Soviet Union.

The issue of 'sovereignty' thus became the public shibboleth for Britain's opposition to progressive coordination of national policies within the EEC/EU. This ranged from the legislative independence of Parliament and the autonomy of the judicial system to the 'economic sovereignty' of monetary and fiscal policy being determined at Westminster. Political advocacy at the 'slogan level' continued despite progressive compromise following Britain's accession to the Treaty of Rome in 1973 and acceptance of the Maastricht Treaty (with permitted exceptions) in 1991, and with judicial supremacy passing to the European court. In fact the most fundamental attribute of national sovereignty - defence - had long been breached through membership of NATO in 1949. The same objections continue to be levied in principle, the operational line being drawn in different places. Currently the freedom to set monetary policy-interest and exchange rates symbolised by 'keeping the pound' is the objective being used to argue against Britain joining the ECB and accepting the Euro.

The sequence followed by Britain in the successive stages of European integration tended to be: to seek to block developments (either from outside, as by setting up the European Free Trade Association to counter the Treaty of Rome; or by organising opposition from within after 1973). The first stance would be to say that the treaty would not be signed; then that it would never be ratified. When ratified, the argument was that it would not work. When patently working the assertion took over that Britain would be better off outside the grouping and finally came the awareness that the new arrangements were so important that Britain could not afford to remain out in the cold. I expect that we are now living through the penultimate

stage of this sequence with the Euro and the ECB, as in 1963 came recognition that Britain's future lay within the EEC.

Slow growth in European economies during the 1970's, inflation, monetary confusion and the collapse of international coordination produced a determination to press ahead with European integration. Opening internal markets would revive the momentum for growth, removing institutional and regulatory barriers would break down the inertia causing 'European sclerosis', while a trading and financial block comparable in scale to that of the United States would give Europe equivalent bargaining power in diverse international organisations and negotiations in the World Trade Organisation in particular. This was certainly the 'big idea' consistently promoted by Jacques Delors after his appointment as head of the commission in 1985.

It is impossible to plot in short compass the twists and turns, advances and retreats which have marked the evolution of the EU since then. Priorities were given to producing a unified common market (with the free movement of people, goods, capital and services) from the customs union which had evolved from the Treaty of Rome, partly in recognition of the much greater resistance which would face proposals for the integration of social policies, tax coordination, and - above all - a common currency and central bank. Margaret Thatcher's vigorous objections were much in mind. The main argument for the Single European Market came with the single European Act of July 1987 agreed in principle at the Milan summit in 1985. The extension of 'qualified majority voting' was a pre-condition for this; as for the widening of membership now proposed.

Despite bonfires of regulations previously covering intra-EU trade, the attainment of 'SEM' unity has been patchy with lags in cross-border freedoms in financial services, public utilities, and transport, telecommunications, legal systems, excise duties and taxation more generally, business mergers and takeovers (where essential national interests are still held to be paramount). All countries fight for their own corner but resist changing their systems to accommodate the interests of others.

The approach to monetary union has proved more fraught than any other aspect of European union - but recurrent setbacks underlined the fact that this was the most strategic area of all for the erection of a truly European entity. Convertibility failed in 1947, it failed again in 1971-3 following the break up of fixed exchange rates with the dollar (despite a declaration of intent of the six in 1969 to a prospective monetary union), and agreement to limit the deviations in exchange rates. The United Kingdom, Ireland, Italy and France abandoned the system as the weakest monetary members. Devaluations studded these years, even when the Bretton Woods agreement was operating.

The European Monetary System, (this time with a joint 'money of account', the Ecu) launched in 1979, again sought to stabilise currencies within narrow limits by establishing an 'exchange rate mechanism' analogous to the 'snake' of 1972. Britain joined the ERM in 1990 but, again, within two years, financial pressures forced Britain and Italy to withdraw, while France also effectively devalued the franc - to the immediate benefit of their economies. Such set-backs meant either pressing forward to a more complete monetary union, which was implicit in the implications of the European Single Market, or abandoning the efforts to create a 'monetary dimension' of the EU, which would have signalled a structural weakness in the whole endeavour. Hence the EMS of 1979 led forward to the European Monetary Union set up following the Maastricht summit of 1991 with more widely embracing rules demanded of countries applying to enter the system - exchange rate stability, a low upper limit in inflation, the budget deficit and public debt relative to GDP. Escape routes which had sabotaged the ERM were closed - provided that the rules were enforced. Such were the attractions of the new club for most existing and aspirant members of the EU that harsh policies were accepted in the efforts to join. The central banks of wayward governments now acquired leverage for inducing conservative rules over monetary policy.

Once the run-in to monetary union had started, the slope steepened and progress accelerated. In 1994 the incipient central bank

of the monetary union was launched as the European Monetary Institute, followed by the bank itself in 1999. In the dawn of that year came the real 'act of union' with the currencies of the then 11 members being locked together at fixed exchange rates, and by its end the 'Euro' had become the official currency of the member-states.

We stand at the beginning of a new era for Europe. Monetary union, if successful, will create great pressures (and incentives) for completing other aspects of union: competitive forces in the market economy will be greatly enhanced when operating through the agency of a common currency.

But will it succeed? And will Britain, as the largest European economy presently outside the ranks, come round to joining? Jean Monnet once concluded that the EEC was 'condemned to succeed'. Once beyond the point of no return - short of a total general cataclysm - we might argue that the trends of history are working in favour of strengthening and consolidating the union. But, as historians, we must acknowledge the indeterminacy of the future - the salutary thought with which this text began.

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