

**Monetary Power, Bargaining Asymmetries and the Structural Logic of EU
Exchange Rate Cooperation**

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The conflict between strong and weak currency countries represents the major shaping force of European monetary bargaining. This is due to the fact that monetary cooperation involves a straightforward distributional question: Who should bear the burden of macroeconomic adjustment to establish exchange rate stability? Most importantly, how do member countries determine the system-wide inflation level of the monetary regime? I argue that governments use their structural power to answer these questions. The first section of this paper defines the terms “weak” and “strong” currency countries and analyzes the balance of payments positions of the EU member countries. It emphasizes Germany’s role as the primary strong currency country in the EU and explains the broad coalitional patterns that evolved over time among strong and weak currency countries in European monetary politics. The second section explains the logic of macroeconomic adjustment for weak and strong currency countries. Because they do not face a reserve constraint, strong currency countries have much greater freedom to choose their preferred adjustment option than weak currency countries.

Section three explains how this asymmetry in adjustment options shapes the logic of bargaining over the rules of monetary cooperation. Strong currency countries are often in a superior bargaining position and, therefore, tend to yield stronger leverage over bargaining outcomes. The bargaining strength of strong currency countries rests on two basic conditions. First of all, strong currency countries have a credible exit threat since their unilateral policy options are less costly than those of weak currency countries. Thus, they have a lower incentive to achieve cooperation through their own concessions. Secondly, weak currency countries lack a threat of exclusion against strong currency countries, since successful monetary cooperation is virtually inconceivable without the participation of strong currency countries. These two conditions imbue strong currency countries with powerful leverage: rules for monetary cooperation would either come largely on their terms - or they would not come at all.

Section four explains how this bargaining asymmetry has driven the choice of adjustment rules in European monetary cooperation. Being in a position to choose adjustment options under much fewer constraints, strong currency countries in the EU have consistently rejected monetary rules that would restrict their domestic macroeconomic adjustment options. Given this obstinacy of strong currency countries, questions of external adjustment, financing and side-payments had to become the only feasible area for bargaining compromises between weak and strong currency countries.

1. Definition and Significance of a Country’s Balance of Payments Position

What features characterize a country’s balance of payments position? For the purposes of this paper, a country’s balance of payments position consists of three interrelated elements: level of inflation, the strength of a currency’s exchange rate and actual payments balance. Low inflation serves as the most prominent - and for the case of European monetary cooperation, most consequential - definitional characteristic of a strong currency country. Low inflation is also correlated to the relative strength of a

¹ This paper represents a revised version of chapter two of my forthcoming book: Kaelberer (2001).

currency in financial markets and payments surpluses. Conversely, higher inflation represents the main attribute of *weak* currency countries. Relatively higher inflation also puts downward pressure on the value of the currency and helps to create balance of payments deficits.

Gathering data for the three definitional characteristics mentioned above, table 1 depicts the balance of payments positions of the EU member states. It summarizes the link between currency depreciation, inflation differentials and current account balances for EU member states from 1972 to 1992.² Clearly, the EU member states exhibited sharp differences in their respective balance of payments positions. Presenting accumulated data from two decades, the table is merely a static summary. It cannot illustrate the changes that have occurred in this period. Some of these changes will be addressed shortly. Nevertheless, the data collected in table 1 provide a useful first cut for analyzing the balance of payments position of the EU member states that existed prior to the adoption of the euro in 1999.

Table 1: Strong and Weak Currency Countries in the EU

	Depreciation against DM, 1972-1992	Accumulated inflation differential against DM, 1972-1992(CPI)	Accumulated current account balances, 1972-1992 (in bill. US \$)
Germany	0	0	248.3
Netherlands	11.5	18.9	83.5
Belgium*	47.6	42.0	21.6
Denmark	78.4	77.4	-24.1
France	114.6	80.8	-41.9
Ireland	186.8	133.9	-12.9
United Kingdom	209.7	124.9	-106.7
Spain	254.5	169.0	-88.9
Italy	406.3	167.2	-103.5
Portugal	965.4	289.9	-14.5
Greece	1,329.2	288.3	-34.4

Calculated on the basis of data in: Deutsche Bundesbank, "Entwicklung des Außenwertes der D-Mark: Pressenotiz der Deutschen Bundesbank." Frankfurt am Main, Dezember 30, 1992. In: BAP I, January 4, 1993: 18; International Monetary Fund, International Financial Statistics, various years; and International Monetary Fund, International Financial Statistics Yearbook, 1993.

*Depreciation value is for the Belgian-Luxembourg franc; inflation and current account data are for Belgium only.

² These years were chosen to allow for a starting point after the end of the Bretton Woods system compatible with the Bundesbank data series and to mark the year of the Maastricht Treaty ratification.

From table 1 Germany clearly emerges as the principal strong currency country in the EU for the period under investigation here. It was the low inflation leader within the EU, the deutsche mark was the EU's strongest currency, and the German economy produced the largest current account surpluses. The Netherlands enjoyed virtually the same balance of payments position as Germany. Thus, it comes as no surprise that the Dutch were consistently Germany's closest ally on all issues of European monetary cooperation. Like the Germans, the Dutch have rejected the efforts of weak currency countries to compromise on the macroeconomic standard that the strong currency countries have set in European monetary politics. Belgium and Denmark were in a slightly weaker position than the Netherlands. However, after their disinflationary successes during the 1970s and early 1980s, both countries shared very similar monetary conditions as the Germans and the Dutch. In general, they supported German positions on questions of European monetary cooperation, but their support was less firm and less enthusiastic than the Dutch.

These four countries formed the hard core of European monetary cooperation at least into the second half of the 1980s. During the later part of the 1980s, however, it became increasingly obvious that other EU member states were starting to catch up with this hard core. Inflation rates and ultimately also interest rates converged toward German levels. Moreover, German unification resulted in higher inflation, higher budget deficits and current account deficits, which in the medium term also meant a relative weakening of Germany's position. Not only did convergence erode some of the initial differences in countries' balance of payments positions, it was also the major precondition for the move toward monetary union in the 1990s. Without the improvement in particular of the French balance of payments position, German policymakers would have never taken the push for EMU seriously.

Nevertheless, the long-term differences in balance of payments positions were the basis for a country's bargaining leverage well into the negotiations over the Maastricht rules. Traditional distributional concerns of weak and strong currency countries continued to shape the rules of European monetary cooperation into the early 1990s. And the Maastricht process itself followed a pattern similar to earlier monetary negotiations in the EU. This argument allows for an intriguing interpretation of the Maastricht Treaty: strong currency countries adjusted to the narrowing gap between strong and weak currency countries by installing their preferred monetary constitution for the rest of Europe. In this sense, the Maastricht Treaty appears to be both an admission of narrowing gaps in countries' balance of payments positions and of the continued bargaining leverage of strong currency countries.

In the long term historical perspective, however, all other large EU member states (France, Italy, Great Britain and Spain) were weak currency countries compared to Germany. Overall, France was the strongest among the weak currency countries in the EU. Its balance of payments position was significantly weaker than Germany's for most of the period under investigation here. While inflation rates converged to German levels toward the late 1980s and French franc - deutsche mark exchange rate stability became the center of French monetary policy after 1983, France remained the much weaker monetary player than Germany well into the 1990s. As the 1992/3 EMS crisis clearly underscored, French adjustment options were still confined by the domestic macroeconomic policies Germany pursued. In the summer of 1993, all rescue efforts

failed to lift the French franc from its ERM floor, despite a year-long explicit verbal and financial support policy from Germany and despite the fact that the real monetary and fiscal conditions in France were in much better shape than in Germany. Thus, while German monetary power no longer rested on a real policy advantage, its long-run low inflation record gave Germany a significant credibility edge in financial markets.

While weak compared to Germany, the French position was considerably stronger than Italy's and Great Britain's. Consequently, French governments were favorably positioned to become the primary advocate for weak currency country concerns during European monetary negotiations. Most importantly, this involved attempts to compromise the German macroeconomic standard. In particular, France advocated adopting a more symmetrical intervention system for the EMS and favored quick monetary unification under rules strongly at odds with German preferences.

France's balance of payments position was critical for the prospects of broader European monetary cooperation. As the operation of the Snake during the 1970s demonstrated, Germany, the Netherlands, Belgium, and Denmark faced fairly few obstacles to cooperation among themselves. However, because of its implications for the distribution of adjustment pressures, French participation in the EMS was essential to allow both Italy and Ireland (and then later, Great Britain, Spain, and Portugal) to join the arrangement. Without French participation, the EMS would probably have been viable only among the strong currency countries. Simultaneously, however, French governments also sought to avoid joining a European scheme for exchange rate cooperation if France would be its weakest member. The fact that Italy and Ireland had committed themselves to the EMS alleviated French concerns about participating in the EMS. Similarly, French officials pushed strongly for the participation of Italy or Spain in the common currency during the implementation of the Maastricht Treaty.

2. The Logic of Macroeconomic Adjustment

Strictly speaking, balance of payments disequilibria create adjustment pressures for both weak and strong currency countries. In the face of a balance of payments crisis, the government of a weak currency country may decide to let the exchange rate adjust through devaluation or depreciation, it may adopt monetary and/or fiscal austerity measures or it may decide to finance the payments imbalance for a while - to name the most common policy options. A strong currency country faces exactly the opposite choices. It can adjust to a disequilibrium through appreciation or revaluation of its currency, through expansionary domestic economic policies or through financing its surplus by intervening on behalf of a weaker currency and accumulating currency reserves.

Despite the fact, however, that both sides face adjustment pressure, the structural logic of adjustment is asymmetric. The primary reason for this asymmetry is the fact that a strong currency country is less constrained in choosing among its adjustment options. It could - if it wanted to - voluntarily reflate its economy through expansionary fiscal and/or monetary measures. Of course, Germany never considered this alternative seriously, but if the German monetary authorities had chosen to reflate at any point in time, no one could have prevented them from doing so. As a matter of fact, there are many instances

when almost everyone else would have applauded such a course of action – most visibly in the late 1970s and the early 1990s.

A strong currency country could also freely choose to finance its surplus through the accumulation of currency reserves. The most important advantage a strong currency country has over a weak currency country in this respect is that it can finance its payments disequilibrium without facing the danger of exhausting its currency reserves. A strong currency country does not face a reserve constraint. The inherent limit to this option in particular in the eyes of Germany's Bundesbank, of course, has been its potential inflationary impact. In other words, while a strong currency country does not face a reserve constraint, it may face a self-imposed "intervention constraint." However, this further underscores the asymmetry between strong and weak currency countries: the "intervention constraint" reflects a voluntary choice; the reserve constraint is externally imposed by the structural logic of monetary relations.

Despite these self-imposed limitations, however, financing a balance of payments surplus has been by far the preferable option over outright domestic deflation in the eyes of Germany's macroeconomic policymakers. Most importantly, the Bundesbank retained the option to sterilize interventions and, therefore, to contain the import of inflation.³ Similarly, the Bundesbank also preserved its option to stop interventions at any time to limit the danger of imported inflation. Interestingly, the intervention rules have received much more attention in the prevailing literature than the sterilization issue to explain EMS asymmetry. However, for the EMS to develop into a truly symmetric regime, it would have been equally important also to limit the ability of strong currency countries to sterilize their interventions (i.e. to prevent them from negating the impact of interventions on real economic conditions).

Finally as its third option, a strong currency country can choose to let its currency adjust upwards. German policymakers have clearly preferred this option over adjustments in domestic policy. The late Bretton Woods period and the various realignments in the Snake and EMS provide many examples of this. However, German policymakers have also continuously worried about the potential costs of revaluations, namely a loss in export competitiveness. In particular during the late 1970s, German policymakers perceived the danger of a "virtuous cycle" of low inflation and further revaluation in which the deutsche mark appreciated beyond inflation differentials, a situation that significantly strengthened German incentives to stabilize exchange rates and establish the EMS. The tradeoffs in adjustment costs meant that German policymakers were confronted with the need to balance rigidity (i.e. absence of exchange rate changes to obtain exchange rate stability) and flexibility (i.e. legitimacy of exchange rate changes to allow for orderly adjustment) of an exchange rate system - an issue that visibly shaped the rules for the EMS.

As opposed to strong currency countries, the currency reserves of a weak currency country are limited. If a weak currency country chooses to finance its disequilibrium, it can do so only as long as its reserves last. In other words, a weak currency country faces a reserve constraint. This situation obviously restricts the ability of a government to use the financing option in times of crisis. The asymmetry in adjustment is further enhanced by the fact that weak currency countries become

³ On the asymmetries introduced by the ability of countries to sterilize their interventions during the operation of the Bretton Woods system see: Obstfeld (1993).

dependent on the corresponding good will of strong currency countries to continue to intervene in financial markets or the willingness of multilateral institutions to extend financing aid. Strong currency countries can finance their surplus as long as they deem appropriate and they can stop their interventions at their own volition. Weak currency countries have little leverage to influence these decisions.

As a result of its reserve constraint, a weak currency country faces the choice between external adjustment (depreciation or devaluation) or domestic adjustment (disinflation and austerity measures) much more severely than a strong currency country. While these two options sound equally plausible and feasible on paper, in reality there exists another fundamental asymmetry between them. Overall, it is extremely difficult for a weak currency country to avoid domestic adjustments. To counteract financial outflows and to reestablish confidence in private financial markets, a weak currency country is pushed toward adopting higher interest rates - i.e. domestic austerity measures. Moreover, the potential danger of setting in motion a vicious cycle of depreciation and inflation and the politicization of devaluation decisions further constrain the external adjustment options for weak currency countries. Thus, while strong currency countries may choose domestic adjustment on their own volition, domestic policy changes are often unavoidable for weak currency countries in the face of balance of payments problems. Whereas weak currency countries have hardly any chance to avoid disinflation, a strong currency country is much more likely to elude reflation. Internal adjustment is more or less voluntary for strong currency countries, while it may be inevitable for weak currency countries. In other words, the policy options of weak currency countries are much more confined than those of strong currency countries.

The different adjustment options explained above shape the logic of European monetary bargaining. A country's status as a "strong" or "weak" currency country has significant implications for its bargaining position and leverage. While weak currency countries seek generous conditions for the rules of financing and would like to shift domestic adjustment obligations to strong currency countries, their leverage to achieve these goals is severely constrained. In other words, balance of payments positions create power relationships. Unless it can bring in leverage from somewhere else through issue-linkage, a weak currency country has hardly any chance to force a strong currency country to adjust domestically. Ultimately, a weak currency country faces greater adjustment pressures within the international political economy but has fewer bargaining threats available to change conditions within its international environment. Before I specify this bargaining logic, I will address briefly two supplementary and intervening considerations, namely the influence of economic size and capital mobility.

Size

While the above discussion addressed certain power imbalances between states, surprisingly it did not pay attention to such traditional power indicators as economic "size" or "control over resources." There are essentially two arguments for this neglect. First of all, a country's balance of payments position is a significant measure of monetary power, no matter what other power resources are at a particular government's disposal. As I will demonstrate shortly, size is not completely irrelevant in determining a government's leverage in international monetary negotiations. However, the ability of states to influence the rules of monetary cooperation is clearly confined by their

respective balance of payments positions. Secondly, the EU offers a unique opportunity to study the impact of relative balance of payments positions on monetary bargaining in a fairly favorable environment. In terms of pure size, France, Germany, Italy and Great Britain are relatively closely matched - at least compared to the global monetary system with its significant size asymmetry between the United States and other players.

The United States certainly serves as the prime example for the influence of traditional power indicators on monetary bargaining. This is particularly noteworthy, since the United States developed more or less into a weak currency country during the 1960s compared, for example, to Germany. Nevertheless, traditional resources allowed the United States to create monetary bargaining leverage through issue linkage. First of all, as a large economy the United States was less vulnerable to external shocks and experienced less severe external adjustment pressures than smaller countries (Keohane and Nye, 1977). Larger countries can sustain balance of payments problems more easily. Moreover, during the Bretton Woods years, the United States was in position to use its security guarantee as a form of leverage to elicit favorable responses from strong currency countries - in particular Germany's restraint on dollar-gold conversions (Bergsten 1975: 329; Block 1977: 171-174; Strange 1976: 270-275). Similarly, the size of its internal market allows the U.S. to use threats of protectionism in international macroeconomic negotiations (Webb 1991). Also, the sheer magnitude of the U.S. economy and the continued role of the dollar as an international reserve currency and vehicle for transactions still lets the U.S. government exercise greater pressures on other economies than would otherwise be possible for a weak currency country. The willingness of foreigners to hold dollars reduces the costs of borrowing from abroad. All of these factors present an opportunity to the U.S. occasionally to use the dollar exchange rate as a tool to force adjustment on other countries - the so-called "dollar weapon" (Henning 1994: 253-308).

On the other hand, the United States example also points to the inherent limits of traditional power indicators for the explanation of monetary cooperation. This is, for example, visible in US-German macroeconomic relations. Despite their security dependence and smaller economic size, their strong currency country status often gave German policymakers sufficient leverage to resist U.S. demands for domestic adjustment through reflation on many occasions since the early 1960s. As the principal strong currency country in this relationship, Germany was able to choose its more preferred policy options of financing (including temporary capital controls) and external adjustment (revaluation and floating). In other words, American attempts to influence German domestic macroeconomic policies do not have an impressive track record. Moreover, capital mobility and U.S. dependence on capital inflows have more and more constrained the ability of U.S. governments to use the "dollar weapon" in recent years. The fact that the U.S. can borrow at low costs from abroad implies an obvious counter threat: competitive depreciation of the dollar is politically limited by the potential of capital outflows and the subsequent need for the U.S. to raise interest rates.

Within European monetary politics there exist no comparable asymmetries to the role of the United States on the global level. Rather, traditional power indicators would suggest a fairly balanced distribution of power among the bigger EU member states France, Germany, Great Britain and Italy. Indeed, a coalition of weak currency countries should have easily swayed the distribution of power heavily in their favor. Based on pure

“size,” a coalition of France, Italy, Great Britain and later Spain should have had the upper hand in a power struggle with a coalition of Germany and its small country allies. The core insight here is that the distribution of power in terms of “size” yields inaccurate predictions about outcomes in monetary negotiations. This situation enhances the validity of the argument advanced in this book. It is difficult to attribute any real asymmetrical bargaining outcomes to differences in size or control over traditional power resources. Causes other than “size” would have to explain imbalanced outcomes.

France represents a partial - albeit very limited - exception to the above arguments. French policymakers have been able on a few occasions to translate France’s political importance into leverage in the context of monetary politics. Most significantly, its status as one of the four allied powers in Germany allowed France to bargain for an acceleration of the EMU process by exchanging its approval of German reunification for German acceptance of a concrete timetable within the Maastricht negotiations (Baun 1996; Methfessel 1996). It is noteworthy, however, that even this bargaining exchange still did not involve German concessions on domestic adjustment issues, but merely on the timetable. Concrete bargaining over the rules of EMU remained as asymmetric as in previous episodes. In this sense the timetable represents one of the typical concessions of strong currency countries, namely a side payment.

Capital Mobility

Like size, increasing capital mobility could potentially be an important variable in the adjustment process. As asserted by Robert Mundell (1968: 233-271), governments cannot hope to achieve simultaneously the three objectives of 1) national policy independence, 2) capital mobility and 3) stable exchange rates - a logic now often referred to as “Holy Trinity” (or sometimes also as “unholy trinity”). Indeed, capital mobility has received a special explanatory status in many recent analyses of international monetary relations (e.g. Andrews 1994; McNamara 1997; Pauly, 1997; and Webb 1991, 1995). After the adoption of the Single European Act in 1986, the capital mobility argument increasingly became an intellectual rationale to warn about future instability of the EMS and the need to complement the single market with a single currency (e.g. Padoa-Schioppa 1994).

Clearly, the degree of capital mobility forms an important background variable for the discussion of monetary bargaining. However, capital mobility does not change the fundamental logic of adjustment pressures. If anything, it may actually strengthen the underlying asymmetries. Even under limited capital mobility, governments were not in position to defend an exchange rate forever (Obstfeld 1993: 216). The role that capital mobility plays in this process is that of acceleration. Rising capital mobility speeds up the problems of adjustment, because weak currency countries run out of currency reserves faster, and they are forced to find other means of adjustment more quickly.

A comparison of the exchange rate crises in the late 1960s and the 1992 ERM crisis illustrates this point. France and Germany debated the realignment of their currencies in 1968-9 for almost a year and in a very public fashion. In Germany, the question of a DM revaluation even became a hotly debated topic in the national election campaign of 1969. In 1992, however, capital flows forced much quicker decisions than in the 1960s. Great Britain and Italy did not have much time to debate the merits of a devaluation. Both governments ran out of options within weeks (if not days). Moreover,

Italy had to withdraw from the ERM despite a devaluation of the lira only three days earlier - indicating that external adjustment options become even more constrained under higher capital mobility. In other words, pegged exchange rate regimes are more difficult to maintain the higher the degree of capital mobility (Eichengreen 1994).

Notwithstanding these impressive changes induced by capital mobility, the causal relationships established by Mundell's "Holy Trinity" have different explanatory strength. A more direct causal link exists between policy independence and exchange rate stability. If macroeconomic conditions and policies diverge among countries, exchange rates cannot be expected to remain stable. Capital mobility, on the other hand, is not a direct cause but serves as a framing condition. While capital mobility arguably accelerates the dynamics of macroeconomic inconsistencies, the degree of capital mobility is not of causal significance in this relationship. As mentioned above, even under low levels of capital mobility it is impossible for governments to maintain a stable exchange rate in the long run if macroeconomic conditions diverge. While lower degrees of capital mobility or the imposition of capital controls allow governments to postpone adjustment - or to create breathing room until other adjustment measures take effect - they ultimately cannot prevent some form of real adjustment. Higher capital mobility speeds up the adjustment process, but does not change the basic asymmetry in the adjustment options between weak and strong currency countries.

3. Bargaining Asymmetry between Weak and Strong Currency Countries

The asymmetry in adjustment options identified above has significant implications for the logic of bargaining over the rules of exchange rate cooperation. If the macroeconomic policies of participants in an exchange rate regime are not in a "natural" lock step, policymakers must somehow create consistency through deliberate adjustment rules. This necessity has posed an obvious distributional question for European monetary politics - namely, who bears which adjustment costs?

Generally speaking, governments have an obvious incentive to advocate adjustment rules that would allow them to externalize costs and to maintain as much domestic macroeconomic autonomy as possible. While this incentive is common to all participants in monetary negotiations, their ability to achieve these goals is highly uneven. As argued earlier, in the case of weak currency countries, domestic adjustment may frequently be dictated by external constraints. Disinflation is often unavoidable. In contrast, even if strong currency countries also have to adjust to external imbalances, they have a greater latitude of choice among their various options. Reflation remains a voluntary option for them. This greater ability to pursue their own choices presents strong currency countries with the opportunity to exercise greater leverage in the design of the rules governing adjustment.

The connection between adjustment asymmetries and bargaining leverage is based on two presuppositions. First of all, the costs of the unilateral options strong currency countries face in the event of bargaining failure tend to be lower than those for weak currency countries. In other words, the intensity of their preference for successful cooperation is often lower than that of weak currency countries, a situation that strengthens the credibility of strong currency countries' exit threat and, therefore, their bargaining power (Dixit and Nalebuff, 1991; Moravcsik, 1998). Secondly, weak currency

countries do not have an effective threat of exclusion against strong currency countries, because participation of the strong currency countries is necessary to establish a successful monetary regime. They are essential as sources of financing facilities, for providing the macroeconomic focal point of the system or for establishing credibility in financial markets.

The logic of the exit threat is based on simple cost/benefit analysis. Strong currency countries often face lower costs from bargaining failure. They have less to lose from the breakdown of negotiations and are, therefore, less compelled to make concessions. Vice versa, governments facing higher costs from bargaining failure have weaker leverage. They tend to be more willing to make concessions in order to achieve their preferred outcomes.

Focusing on the trade-off between a country's reserve constraint and its access to financing facilities helps to illustrate these cost/benefit calculations. Downward pressure on its currency poses adjustment problems for a government both within a negotiated exchange rate regime as well as under floating exchange rates. While the advantage of floating in such a situation is the absence of a mandatory intervention rule, the government has to bear the full brunt of its reserve constraint. In other words, the core problem for a weak currency country is of a structural nature: it has simply no unilateral tool available to overcome its reserve constraint. On the other hand, monetary cooperation at least offers some prospect of relief from the impact of its reserve constraint by agreeing on financing facilities.

The French deliberations during the 1982/3 monetary crisis provide the most dramatic evidence for this contention. Pressure on the French franc following the Mitterrand experiment of expansionary policies and state interventionism triggered a divisive debate within the government about the future of French macroeconomic policy and participation in the EMS (e.g. Hall 1986; Loriaux 1991). Proponents and opponents of continued EMS membership both agreed that macroeconomic adjustment for France would be costly. While maintaining EMS membership at least promised further access to the regime's financing facilities, a floating French franc would have required similar rigid domestic adjustment with access to extended financing only through the IMF (Cameron 1996). Obviously, requesting IMF financing facilities would have been politically embarrassing, given U.S. dominance of that institution, and would have done little to safeguard French domestic priorities, because of the IMF's policy of conditionality. Thus, weak currency countries often face a choice between two unappealing options: that of asymmetric monetary cooperation or unfettered market pressures.

A strong currency country may also have interests in stabilizing exchange rates. For example, it may want to limit problems of competitiveness due to its appreciating currency. This motivation played a role among German policymakers to pursue the EMS in 1978/9. However, the implications of this incentive for the monetary bargaining interaction have natural limits. A strong currency country can achieve reflation unilaterally, namely through domestic policy measures (e.g. expansionary macroeconomic policies or unsterilized financing of balance of payments surpluses). Thus, even if a strong currency country had an overwhelming interest in achieving exchange rate stability, it could attain this goal largely through its own means. It would not need cooperation to produce the desired effect. In other words, if a strong currency country seeks exchange rate cooperation, the very point of such collaboration would be to

unload a significant portion of the costs on weak currency countries. This greater latitude of strong currency countries raises the opportunity costs of agreement for them. With it, the credibility of their exit threat strengthens.

So far we have looked only at strong and weak currency countries in the abstract. Keen observers of the specifically German setting for macroeconomic policymaking may be tempted to construct a more cynical variation on this theme. For example, we could ask if Chancellors Schmidt and Kohl pursued their respective designs for the EMS and EMU in quasi-Machiavellian fashion to undermine the authority of the Bundesbank and to achieve reflation through the “backdoor” of international obligations?⁴ While there is undoubtedly some cursory and anecdotal evidence to support this claim, the overall causal connection is fairly weak. Except for a few flippant interview remarks, there is little direct evidence that Schmidt advocated German domestic reflation. In fact, his strong distaste for the Carter-administration’s macroeconomic policies and his resistance to what he perceived as American bullying tactics to achieve expansionary policies contradict this kind of interpretation. Attempts at fiscal expansion - an area over which the federal government indeed had control - remained timid at best under the Schmidt administration. The stimulus package of 1978 was modest and certainly not proof of a genuine desire for reflation. There is, furthermore, little evidence that Schmidt actively sought to construct a strong domestic alliance favoring reflation and supporting the demands of weak currency countries. Notwithstanding the personal animosity between Schmidt and Bundesbank President Emminger, Schmidt did not visibly resist Emminger’s demands for EMS rules. Schmidt’s memoirs (1990) also attest to his desire to use the EMS as a device for disinflation in the EU and to his fears over a lack of discipline in the EMS.

Similarly, Kohl’s pursuit of EMU does not appear to have many Machiavellian qualities. First of all, EMU became a goal before the German government pursued expansionary policies to finance reunification. Thus, the policy conflict between the Bundesbank and the federal government of the early 1990s has little to do with the adoption of the EMU goal. Moreover, it would appear to make little sense to disempower the Bundesbank by constructing an even more independent and possibly more obstinate European Central Bank.⁵ In summary, the bargaining asymmetry between weak and strong currency countries is structural. It consists of the inability of weak currency countries to overcome their reserve constraint unilaterally, whereas strong currency countries can achieve external adjustment (i.e. appreciation), internal adjustment (i.e. reflation) and financing through their own means. While all of these options involve costs even for a strong currency country, its main advantage is that it can choose more or less voluntarily where to pay the price of adjustment.

The relative opportunity costs of agreement, however, are not the only source of leverage at stake here. If the preferences for cooperation among strong currency countries are so low that weak currency countries deem their demands excessive and too costly, cooperation cannot take place between these two groups of countries. This situation certainly characterized the interaction between strong and weak currency countries during the Snake period. Both sides perceived the costs of their unilateral options as lower than

⁴ Heisenberg (1999) and Oatley (1997) come closest to this type of interpretation.

⁵ For a comparative evaluation of the status of the Bundesbank and the European Central Bank see: Teivainen (1997).

those of cooperation, with the result that the Snake functioned only among the strong currency countries. However, the Snake period provided two important lessons for the bargaining interaction in the EU. First, the continued existence of the Snake underscored that cooperation among the strong currency countries was indeed possible and credible - even if weak currency countries were not part of the regime. Secondly, the unilateral floating options pursued by France and Italy during this period turned out to be much more costly than anticipated, effectively increasing the urgency for weak currency countries to find some form of agreement during the EMS negotiations.

These examples demonstrate that the strong currency countries' exit threat at stake is supplemented by an insufficient threat of exclusion available to weak currency countries. Strong currency country participation is essential for the credibility of any eventual monetary regime. Cooperation only among weak currency countries was not viable in competition with a floating deutsche mark or deutsche mark bloc. Financial markets would have attached low credibility to the arrangement, and the source of the regime's financing mechanisms would have been an open question. For example during the EMS negotiations, the option for Germany to maintain a Mini-snake with its strong currency neighbors was much more credible than, say, a joint French-Italian exchange rate regime. Similarly, the Maastricht EMU had to include Germany in order not to doom the project from the beginning. Even a German-Dutch mini-EMU had more credibility than, say, a monetary union between France and Italy (which would have defeated the French political intentions in any case).

Thus, the need to secure participation of the principal strong currency country in any eventual exchange rate regime endowed Germany with additional bargaining leverage. German policymakers were in a position to determine the "bottom line" of the EMS and EMU negotiations and to present their partners with a "take-it-or-leave-it" proposition, because they could threaten exit and could not be excluded by other participants. This becomes even more revealing in contrasting the German with the British bargaining position. As its bargaining behavior visibly demonstrates, the British government certainly had an "exit threat," both in the EMS and EMU negotiations. The intensity of British preferences for cooperation was low, a situation that should have improved British bargaining power. If we were to disregard the causal significance of balance of payments positions, there would be no obvious explanation why Germany should have been endowed with more leverage than Great Britain. However, the British exit threat clearly did not translate into bargaining power. Some observers would even argue that in the British case exit threats may have been counterproductive to advancing British interests in the negotiations. Ultimately, the problem for the British bargaining position was that both the EMS and EMU were conceivable without British participation. German participation, however, was paramount in each case. Thus, the low perceived costs and the perceived necessity of German participation form the backbone of Germany's leverage. A weak threat of exclusion must accompany an exit threat in order to generate bargaining leverage.

Up to this point, I have treated the structural logic of bargaining asymmetry in a static fashion and isolated from other issue areas. There are, of course, situations in which other factors might offset or counteract the asymmetry explained here. For example, if a strong currency country would have an intense domestic preference to pursue expansionary policies it would certainly be more amenable to compromises. The crucial

causal shift in such a hypothetical scenario, however, would be toward greater congruence in interests between weak and strong currency countries, rather than toward a weakening of the strong currency country's bargaining position. It still maintains a credible unilateral option of reflation and would not need cooperation to achieve that goal. In any case, this situation did not exist in European monetary cooperation, given Germany's obstinacy on this point.

A more complicated countervailing scenario concerns the question of political issue linkage. If a strong currency country had very intense political preferences for monetary cooperation because it seeks goals in other policy areas, its costs of non-agreement would increase and weak currency countries would gain more room to solicit bargaining concessions.⁶ For example, there is obviously a connection between the overall goal of European integration and monetary cooperation. Indeed, later chapters will report evidence that certain aspects of European integration have helped to trigger initiatives in the monetary realm as well. If strong currency countries had significantly more powerful incentives than their weak currency country counterparts to safeguard other aspects of European integration – say the common market – their opportunity costs of non-agreement would rise and they would more likely make concessions in monetary negotiations. In other words, strong currency countries would be more accommodating to the demands of weak currency countries, in order to achieve other goals.

However, such a scenario rests on the theoretical assumption that issue linkage is more important for the strong currency country than the weak currency country. If issue linkage is roughly similar, these preferences simply offset each other and restore conditions of asymmetric monetary bargaining power. There is no doubt that European integration – in particular the customs union and the single market – has been an important political goal for Germany. However, similar things can be said of France. Both countries have had political interests in European integration and there is no evidence that these issue linkage goals would have been significantly stronger for Germany than for France. The same logic applies to the bilateral French-German relationship as well. Both countries have had similarly strong interests in preserving the special strategic ties between them.

Moreover, there is no evidence of any necessity for the EU to pursue monetary integration. The customs union, the Common Agricultural Policy (CAP) or the single market project all provided incentives to pursue monetary cooperation. However, the various decisions on monetary cooperation have been deliberate political choices and not mechanical consequences of any preexisting logic of European integration. The fact that neither the EMS nor EMU have encompassed all EU member states further underscores the absence of an automatic link between European integration and monetary cooperation within it. Monetary cooperation was never inevitable, but it allowed European policymakers to make explicit decisions and to exercise their relative bargaining strength to achieve their preferred outcomes.

4. Bargaining Asymmetry and the Choice of Adjustment Rules

While the previous section identified the differences in bargaining power between strong and weak currency countries, this section takes a more thorough look at the

⁶ For a broader treatment of German interests in exchange rate cooperation see: Kaelberer (1996).

choices and tradeoffs between the various adjustment rules that are at stake for strong and weak currency countries in negotiations over monetary cooperation. Generally speaking, bargaining over the rules of adjustment in monetary cooperation features three relevant areas: domestic or internal adjustment (such as interest rate changes or changes in fiscal policies), external adjustment (most importantly, exchange rate changes) and the financing of monetary imbalances.⁷ Technically speaking, financing is not an adjustment mechanism since it does not provide a durable solution to the underlying imbalances. However, financing is used as a means temporarily to bridge existing imbalances. As such, financing has always played a significant role in monetary negotiations. The bargaining asymmetry explained in the previous sections has visibly shaped the patterns of monetary negotiations over these issues in the EU during the past four decades. Most importantly, the choice among rules for macroeconomic adjustment options is constrained by the strong currency countries' ability to reject any compromises on domestic (or internal) adjustment. I will address the issue of domestic adjustment first, before I turn to questions of external adjustment, financing and side payments.

Domestic Adjustment

At the center of the domestic adjustment problem within the EU has been - for all practical purposes - the issue of inflation. The key question in this context is the standard that should serve as the common reference point for the exchange rate system. This situation obviously poses a cooperation problem for states. What would be an acceptable standard for the system and how can states establish such a standard? Most importantly, if inflation rates diverge, who should adjust - the high inflation country or the low inflation country?

Part of the problem is the fact that this requirement for domestic consistency is ultimately a relative (or perhaps arbitrary) category. For example, an exchange rate system could remain stable at a common inflation level of, say, 1% or 50%. Thus, the inflation target of a system reflects deliberate policy decisions, rather than any absolute criteria. Both the Snake and the EMS left the question of consistency - at least in terms of its explicit rules - unregulated. This necessarily led to a situation in which the strongest country (i.e. Germany) would set the standard for the system. In the cases of the Action Programme, the Werner Report and the Maastricht Treaty, rules for domestic macroeconomic consistency became the most important issue of the negotiations. In the case of the Action Programme and the Werner Report, the EU member states ultimately could find no agreement. The Maastricht Treaty, however, prescribed five convergence-criteria for membership in EMU, namely rules on inflation rates, interest rates, government deficit, government debt and exchange rate stability.

These convergence criteria, however, are in essence quite arbitrary. Following one line of thinking in the debate over monetary union, one may wonder why convergence criteria are theoretically necessary at all. As the so-called "monetarist" school of thought in European monetary debates has argued, irrevocably fixing exchange rates would automatically lead to convergence around the "average" macroeconomic

⁷ To zero in on the essential elements of European monetary bargaining, I will leave out a number of other options here, such as capital controls or trade policies. helpful discussions of adjustment issues can be found in: Cohen (1983) and Webb (1991, 1995).

standard for the group as a whole.⁸ Equally, one may point out that the German monetary union (GMU) of 1990 took place without explicit convergence criteria. The difference here is clearly that there was sufficient political will among (West) German policymakers to accept the adjustment costs of GMU - a situation that did not exist for EMU. Instead, one can interpret the Maastricht convergence criteria as an attempt to force some adjustment costs onto non-German participants of EMU.

Table 2: Inflation Differentials in the Early Snake and Early EMS (in percent)

	1971	1972	1973		1979	1980	1981	1982	1983	1984
Germany-France	0.3	0.7	0.3		6.7	7.9	7.1	6.5	6.6	5.0
Germany-Italy	-0.3	0.2	3.8		10.7	15.9	13.2	11.2	11.3	8.4

Data Source: International Monetary Fund, International Financial Statistics, October 1993.

In addition to this, the consistency requirement is a relative category also because every exchange rate system can tolerate some degree of divergence. A pegged exchange rate system allows participants to change exchange rates or to finance disequilibria. The EMS of the early 1980s underscores this point. It survived despite considerable divergences between the most important players. Table 2 illustrates the substantial differences in macroeconomic conditions among France, Germany and Italy in the first five years of the EMS. The survival of the EMS is even more remarkable if one compares the situation to the conditions that existed in the early Snake-period. During the early 1970s, inflation levels among these countries deviated much less significantly - although as a lagging indicator, inflation rates tell us little about the actual policies pursued in this period, and should therefore not be overinterpreted. Despite this caveat, however, table 2 does indicate that the difference in outcomes between the Snake and EMS is remarkable. The survival of the EMS constitutes a considerable political achievement against the odds. The experience of the EMS shows that a pegged exchange rate regime can survive large divergences, if the participants remain politically committed to it and maintain a consensus over the legitimacy of appropriate adjustment mechanisms - in the case of the EMS occasional realignments and the financing of balance of payments equilibria.

Similarly, a currency union can also survive macroeconomic divergences if the participants have sufficient adjustment mechanisms at their disposal - for example, factor mobility, changes in domestic economic policies, price and wage flexibility or fiscal transfers. Theoretically and practically, large divergences are possible. As mentioned earlier, German Monetary Union (GMU) is an example of an exchange rate regime with significant divergences among its "member states."⁹ Arguably, in economic terms GMU is a much more divergent entity than EMU. However, GMU could survive because the partners were politically committed to enduring the costs associated with these divergences.

⁸ For the distinction between the economist and monetarist approach to monetary integration see: Tsoukalis (1977): 91-93; Kruse (1980): 63-70.

⁹ To recall the sequence, GMU went into effect before the exact timetable for political reunification was known. At the time, it was thought that reunification would come only several years later. favorable international developments - in particular the Soviet-German agreement of July 16, 1990 over united Germany's NATO-membership - allowed German reunification to proceed much faster.

The conceptual problem in evaluating the requirements for consistency here is that optimum currency area theory does not specify precise thresholds for the formation of a monetary union or a fixed exchange rate system.¹⁰ This situation limits the theory's predictive and prescriptive value. Economists remain uncertain as to whether the EU constitutes an optimum currency area (e.g. Eichengreen 1992b). However, optimum currency area theory would more likely have predicted a monetary union between (West) Germany and the Netherlands than between East and West Germany. Thus, the determination of what constitutes consistency or inconsistency of macroeconomic policies and conditions depends in the end on the political assessment of the participants. The convergence criteria of the Maastricht Treaty for EMU reflect the political character of the consistency requirement. While optimum currency area theory can be read in general terms as an argument in favor of some form of convergence criteria, economists are often hard pressed to justify the economic rationale for the EMU-rules set in the Maastricht Treaty (e.g. Eichengreen 1993 and Kenen 1995). Instead, it seems more compelling to understand these rules as a result of political necessities, most importantly the need to accommodate Germany's concerns over the costs of EMU (e.g. Padoa-Schioppa 1994: 198-200).

All of these considerations result in the same conclusion: If there is no preexisting, quasi-"natural" agreement on an appropriate common standard, the problem of consistency somehow needs to be politically resolved among the negotiating partners of an exchange rate regime. Indeed, domestic adjustment has remained the most important obstacle for European monetary relations due to its distributive implications: should a low inflation country bear the costs of establishing consistency by inflating its domestic economy? Or, vice versa, should the high inflation country adjust through a policy of disinflation? Or can the participants meet somewhere in between? Or, finally, can they devise other strategies to deal with divergence among them - for example realignments? These questions describe the central conflict among the EU member states over exchange rate cooperation during the past forty years.

So far, Germany has always refused to make significant concessions on its macroeconomic priorities to solve these questions. Both in the Snake and the EMS, German macroeconomic policies effectively served as the reference point for the exchange rate system. Despite their explicit efforts, weak currency countries did not succeed in negotiating policy rules that would force domestic adjustment upon the strong currency countries. The Maastricht rules for EMU membership, institutional design and the pursuit of macroeconomic policies also largely follow German preferences.

These examples demonstrate that the patterns of bargaining also depend on the type of exchange rate regime being negotiated. Pegged exchange rate systems in general are often flexible enough to exist without explicit rules for domestic adjustment. The negotiations over the rules for the Bretton Woods regime, for example, featured significant differences between Great Britain and the United States over the appropriate rules for domestic adjustment, exhibited, for example, in the Keynes- and White-plans for the post-war monetary order (e.g. Gardner 1956). Ultimately, the Bretton Woods System recognized the need for domestic macroeconomic flexibility and did not stipulate explicit

¹⁰ For an overview see: Ishiyama (1975), Kawai (1992) and Blejer, et al. (1997).

rules for internal adjustment.¹¹ The same pattern characterized the negotiations over the Snake and the European Monetary System. Recognizing the fact that no consensual agreement existed on an appropriate standard, neither one of these systems established any explicit rules for domestic policy adjustment. Instead, rules for external adjustment and financing have been the primary features of pegged exchange rate regimes.

In contrast, currency unions do not require rules for external adjustment or financing. This puts the issue of internal adjustment into a different light. Indeed, the Maastricht Treaty contains explicit rules for domestic policy objectives for the potential members of EMU. In other words, monetary unions do not allow member states to shift disagreements over internal adjustment to negotiations over external adjustment and financing. In the end, rules for domestic adjustment had to become part of the Maastricht negotiations in order to satisfy German concerns over a potential inflationary bias in the monetary union.

External Adjustment

Exchange rate changes are the most important form of external adjustment to restore equilibrium in a country's balance of payments. Before explaining the significance of exchange rate changes, however, it is necessary to mention briefly other forms of external adjustment. This refers to trade policies as well as capital controls. Both types of policies allow governments to influence the flow of goods, services and capital across borders. Deficit countries, for example, are tempted to restrict imports to take pressure off their current account. France and Italy at various times during the 1960s and the 1970s introduced trade restrictions during balance of payments crises - mostly in violation of EU rules for the common market. Similarly, capital controls can allow governments to restrict the outflow of capital. Deficit countries have at various times introduced these controls to alleviate balance of payments deficits. This happened as late as the 1992 currency crisis, despite the abolition of capital controls under the single market project. For surplus countries, the logic has worked the other way around. Germany has often been asked by deficit countries to implement policies that increase imports - although it has rarely heeded these requests. And it has on occasion, although reluctantly, introduced controls on capital inflows.

As indicated earlier, the significance of these two means of external adjustment has declined within the EU over the past few decades. Although trade restrictions and capital controls may provide temporary relief, they are ultimately inefficient. And more importantly, the member states have increasingly lost control over these two policy areas within the EU. Unilateral trade restrictions violate the idea of the customs union, and the single market project prohibits now the use of capital controls. Thus, exchange rate changes were the only means of external adjustment left to the EU member states until the creation of EMU removed even this last instrument of external adjustment. Here, exchange rates are permanently fixed. In other words, participants of EMU completely forgo the possibility of external adjustment. Instead, adjustment will take place automatically through capital flows.

¹¹ In this sense, Germany's rejection of compromise is typical for strong currency country behavior. As Eichengreen (1992a) demonstrates, the United States - believed to be the principal strong currency country in the post-World War II period - rejected any meaningful restrictions on the options of surplus countries during the Bretton Woods negotiations.

A pegged exchange rate system, on the other hand, allows for alterations of parities. Thus, participants of a pegged exchange rate system negotiate with each other the particular rules and procedures for exchange rate changes. For example, they have to determine if a country can alter its exchange rate unilaterally or if it needs the cooperation of its partners. Similarly, they must determine the central rates of currencies as well as their fluctuation margins. In this area, Germany accepted a number of bargaining compromises with weak currency countries during the EMS negotiations.

Table 3: Number of Devaluations of the British Pound Sterling, French Franc and Italian Lira against the Deutsche Mar kin the Snake and EMS

Number of devaluations against DM	“Snake,” 1972-1979**	EMS, 1979-1983	EMS, 1984-1987	EMS, 1988-1991
British pound sterling***	0	-	-	0
French franc	2	4	2	0
Italian lira	0	5	3	1*

Notes: * This devaluation on January 8, 1990 is often seen as a more or less technical adjustment for the lira to narrow its fluctuation bands from +/-6% to +/-2.5%.

** all three countries withdrew from the Snake at various times to avoid devaluations.

*** Great Britain participated briefly in the Snake after its entry into the EU; it did not participate in the EMS until 1990.

Source: Hellmann 1979; and Gros and Thygesen 1992: 68.

The absence of agreement on internal adjustment and the ability to shift bargaining to questions of external adjustment indicates that the stability of the EMS as an institution must have rested to some degree on the legitimacy of realignments as a form of adjustment. On the one hand, a revaluation of the deutsche mark was consistently the only formal obligation of real adjustment Germany would be willing to impose on itself. On the other hand, in the absence of German reflation or full disinflation of the weak currency countries, periodic devaluations had to become a legitimate tool of adjustment for the weak currency countries if the EMS as an institution was to survive. Table 3 illustrates the striking difference between the Snake and the early EMS in this respect. Although the particular conditions for realignments have always remained subject to political controversies and the question as to which realignments were justified or not continued to instigate squabbles among the EMS-members, there existed a consensus among them that realignments were an appropriate means of adjustment. Both, Italy and France used devaluations vis-à-vis the deutsche mark frequently until 1983 and somewhat less frequently between 1983 and 1987 to adjust for macroeconomic divergences. This consensus on realignments got lost toward the later part of the 1980s, a fact that aggravated the severity of the EMS-crisis in 1992/3.

Financing

As in the case of external adjustment, financing rules can become subject to bargaining only in a pegged exchange rate system and not in a monetary union. To some degree, a monetary union represents the ultimate form of financing. Balance of payments disequilibria cease to have any real meaning, in the sense that regional central banks

cannot run up against a reserve constraint. Financing facilities are not to be confused with structural aid - an issue that has gotten linked to both pegged exchange rate systems and monetary unions. Financing facilities are an inherent element of the intervention procedures to deal with balance of payments disequilibria. The purpose of structural aid is to support the real convergence in the targeted countries. I will address this issue subsequently under the heading of side-payments.

The typical financing issues for which countries need to find rules are the following: Under what conditions can governments ask for balance of payments assistance? How much assistance will countries be allowed to borrow? Are the financing mechanisms bilateral or multilateral? What are the repayment conditions? These issues are much more conducive to compromise. Indeed, strong currency countries have shown some willingness to make concessions on the amounts, lending periods and repayment conditions of financing facilities.

The key point here is that these types of compromises on financing facilities do not hurt the domestic policy priorities of strong currency countries. Through sterilization, their central banks are in a position to minimize the impact of their interventions in the system, and they can stop interventions when they become too large. The duration of borrowing periods or the conditions for repayments also have little relevance for their domestic economy. Ultimately, these items are relatively painless to agree on, if strong currency countries are sufficiently motivated to overcome bargaining impasses.

Side Payments and Issue-Linkage

As indicated earlier, pegged exchange rate systems allow participants to shift bargaining from the intractable question of internal adjustment to the issues of external adjustment (i.e. exchange rate changes) and financing. A monetary union, however, precludes such a tradeoff between negotiable and non-negotiable issues. As indicated earlier, in a monetary union the two issues subject to bargaining - namely rules for external adjustment and financing - simply disappear. Since exchange rates are permanently fixed, partners cannot bargain anymore over the rules for parity changes. And since they are subject to a common central bank, there is no longer a need for the participants of a monetary union to quibble over the financing of balance of payments disequilibria.

This implies a severe political problem for negotiations over a monetary union. Given Germany's uncompromising position on domestic adjustment issues, only side-payments and issues somehow linked to monetary negotiations can become subject to bargaining. One of the issues repeatedly linked to European monetary negotiations was the question of structural aid. While Italy and Ireland were successful on this question already in the EMS negotiations, weak currency countries also attached the creation of the so-called "cohesion fund" to the Maastricht accord. The Maastricht negotiations also saw a number of other side-payments. According to many observers, the most important concession at Maastricht was Germany's acceptance of a definitive timetable for moving to stage three in the EMU process. However, this concession follows the same logic described earlier. Germany's traditional position to declare its own macroeconomic preferences as non-negotiable did not logically preclude a binding timetable. France and Italy had already accepted Germany's conditions for convergence and central bank independence. In addition to the timetable issue, German policymakers made concessions

on a number of more or less symbolic issues at Maastricht. All of these concessions were possible because ultimately none of them hampered Germany's ability to protect its own domestic priorities.

5. Conclusion

The relative balance of payments positions of EU member states are important indicators of the leverage they can bring to the bargaining table. Strong currency countries face no reserve constraint and are, therefore, much less confined in choosing their preferred option for adjustment to balance of payments disequilibria. The costs of pursuing their policy options unilaterally tend to be lower than those of weak currency countries. At the same time, their participation in an exchange rate regime is necessary to provide credibility to the regime. Strong currency countries are endowed with a powerful exit threat, while weak currency countries do not have a correspondingly strong threat of exclusion. These conditions are the basis for the leverage of strong currency countries in monetary negotiations. As a result, the German refusal to compromise domestic macroeconomic priorities has introduced a visible pattern for European monetary negotiations. While Germany and its strong currency allies were able to keep internal adjustment issues off the bargaining table in the EMS negotiations, their macroeconomic priorities served as the architectural blueprint for the Maastricht EMU. In exchange, German policymakers were willing to make concessions on questions of external adjustment, financing and side-payments in the EMS. The logic of bargaining over the rules of EMU, however, allowed for concessions only on side payments, such as structural funds or the timetable.

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