

Dual Hegemony: France, Germany and the Making of Monetary Union in
Europe

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With the inauguration of the third stage of monetary union in Europe this year, the mighty D-mark has been replaced by the euro. The transition went smoothly, contrary to predictions that were being made by many analysts just a year ago. EMU's architects designed a central bank that not only mimicked but arguably improved upon and upgraded the Bundesbank's independence and price stability-oriented policies. Germany's leadership in European monetary cooperation has been documented by both economists and political scientists, with the arguments collectively known as the "German Dominance Hypothesis". These writings correctly note the impact that German monetary policy has had on the development of monetary integration in Europe. The success of the European Monetary System and plans for monetary union under the Maastricht Treaty depended upon the willingness of the member states to subordinate their interests to those of Germany and the Bundesbank. German monetary policy became a model for the rest of Europe to follow.

But this does not make Germany the sole leader of European monetary affairs. In this paper I will argue that the passivity of Germany regarding monetary cooperation has made it only a co-leader of monetary cooperation in Europe. In the absence of active German leadership in this area, it has been up to France to determine the pace of monetary union as well as wrest significant concessions in its form, leading to a system that I refer to as "dual hegemony." While Germany's dominance in the functioning of the EMS is unquestionable, France's critical role can be seen in the pace of the progress towards monetary union, its institutional design and its implementation.

The structure of the paper will be as follows: First, I will review the literature on the German Dominance Hypothesis. Next, I argue that European monetary integration progressed during a period of dual hegemony rather than straight German leadership. I demonstrate this through case studies of seminal events leading up to monetary integration: the inception of the European Monetary System in 1979 and its "maturing" in 1983; the negotiations leading up to the Maastricht Treaty and the 1992-93 currency crisis; and the controversy over the selection of the European Central Bank president.

The German Dominance Hypothesis: Defining Leadership and Hegemony

The German Dominance Hypothesis posits that German hegemony is responsible for the success and stability of European Monetary Cooperation.¹ This is an extension of the hegemonic stability thesis² in the international relations literature, which attributes economic cooperation to the presence of a hegemon.

There are two major strains of the hegemonic stability thesis. One characterizes the hegemon as being benevolent, or at least benign, in its exercise of power. The hegemon provides the international system with the following public goods: markets for distressed goods, countercyclical capital flows, and acts as lender of the last resort. In this conception of hegemonic stability theory, the hegemon is cast as a “leader” of the international economic system.³

The second variant of hegemonic stability theory portrays a coercive leader that uses its power to structure the system in a way that suits its own purposes and promotes its power.⁴ This strand of hegemony emphasizes the relative nature of power gains, and asserts that the stability that the hegemon provides the international system is not altruistic in nature but rather reinforces the dominance of the hegemon.⁵

When applied to European monetary affairs, some argue that despite Germany’s influence, it cannot be properly termed a hegemon in either sense. Its status as hegemon has been disputed for a variety of reasons, not least of all its failure to supply the aforementioned public good functions at a regional level. Germany does not provide a market for distressed goods, and it has only reluctantly intervened in the exchange

¹ Matthias Kaelberer, “Money and Power in Europe: The Political Economy of European Monetary Cooperation” (Ph.D. diss., Princeton University, 1996)

² This phrase was first coined by Robert Keohane in his article “The Theory of Hegemonic Stability and Changes in International Economic Regimes, 1967-1977,” in Ole R. Holsti, Randolph M. Siverson, and Alexander George, eds., Change in the International System (Boulder: Westview Press, 1980), chapter 6. For a review of hegemonic stability theory, see David Lake, “Leadership, Hegemony, and the International Economy,” International Studies Quarterly 37 (1993): pp.459-89. For an application of hegemonic stability theory to the European case, see Helen V. Milner, “The Political Economy of International Policy Coordination” in Michele Fratianni and Jürgen von Hagen, eds., The Political Economy of Macroeconomic Policy in Open Economies (Westport, CT: Greenwood Press, 1997), chapter 6

³ Charles Kindleberger, The World in Depression, 1929-1939 (Berkeley: University of California Press, 1973)

⁴ Robert Gilpin, The Political Economy of International Relations (Princeton: Princeton University Press, 1987)

⁵ See also Joseph Grieco, Cooperation Among Nations (Ithaca, NY: Cornell University Press, 1990)

markets to support other currencies. The Bundesbank has refused to allow Germany to serve as lender of last resort, and its participation rests on its freedom to withdraw when German price stability becomes threatened.

Therefore, what constitutes leadership and hegemony on the European level? The size of the German economy is larger than any other in Europe, but not overwhelmingly so.

[insert German-French GDP table here]

Germany did not actively seek monetary hegemony, unlike the United States after World War II, thus it has exercised its leadership more passively and serves more as a focal point for policy coordination than a leader. It is, in some sense, a reluctant hegemon. The coercive strand of hegemonic stability theory is also a problematic explanation for European monetary cooperation for this reason. German participation in European monetary cooperation has been marked by fits and starts rather than the deliberate design of a German-style monetary regime in Europe. Germany did not impose the conservative regime that we see in Europe today, it was the conscious policy choice of its partners. Germany has largely conducted its own monetary affairs and permitted the other European countries to follow its lead or not. Germany has appeared ready on several occasions to allow monetary integration to stall, thus calling into question hegemonic aspirations.

Rather than a premeditated strategy, the leadership position has been thrust upon Germany by virtue of the role of the mark as the anchor currency and its institutional influence in which other countries have attempted to replicate the success of German monetary policy by adopting similar policies and effectively delegating their policymaking autonomy to Germany and the Bundesbank. The mark, as the strongest currency in the region, has acted as an anchor currency, thus permitting Germany to act with more independence in making monetary policy than the other countries. Also known as the n minus one problem, in a fixed exchange rate regime only one currency is able to have an independent monetary policy and the other currencies must adjust to it.

This is problematic because the mark is often subject to different exchange rate pressures than the other European currencies. The mark is a primary recipient of

exchange rate changes globally; exchange rate changes in the dollar, for example, have a strong effect on the value of the mark, and when the dollar weakens, investors flock to the mark, driving up its value. This wreaks havoc on European monetary stability and gave rise to the various impetuses for monetary cooperation in Europe as the smaller countries banded together, seeking monetary stability on a regional level.⁶ Giavazzi and Giovannini have also pointed to the asymmetric effect that dollar fluctuations have on European currency values. They note that the timing of many of EMS realignments coincide with periods of dollar instability, corroborating their thesis that dollar fluctuations have different effects on the currencies, thus straining exchange rate cooperation. The strength and stability of the mark combined with its position as the anchor currency allow Germany more independence in policy making.⁷

Though the mark has served as the anchor currency of the system, does this necessarily mean that Germany is the hegemon? Econometric testing of this hypothesis has yielded inconclusive results. Some have argued that interest rates, for example, show asymmetric features that favor Germany.⁸ Others such as Fratianni and von Hagen⁹ show that the EMS countries together impact German interest rates.

Other measures such as intervention data indicate some asymmetry as most of the intervention activity inside the EMS was done by central banks other than the Bundesbank, while the Bundesbank only intervened when its mandatory intervention limit had been reached. Sterilization effects also suggest asymmetry.¹⁰ However, monetary aggregates demonstrate that the relationship worked both ways, in which Germany was influenced by changes in other countries as well as the reverse.¹¹ Weber has gone so far as to argue that for a period the EMS functioned more as a bipolar system

⁶ C. Randall Henning, "Systemic Conflict and Regional Monetary Integration: The Case of Europe" International Organization 52, 3 (Summer 1998): pp.537-573

⁷ Francesco Giavazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility (Cambridge: MIT Press, 1989)

⁸ *ibid.*; Michael J. Artis and Mark P. Taylor, "Exchange Rates and the EMS: Assessing the Track Record." CEPR Discussion Paper 250, 1988; Daniel Gros and Niels Thygesen, European Monetary Integration (London: Longman, 1998)

⁹ Michele Fratianni and Juergen von Hagen, "German Dominance in the EMS: The Empirical Evidence" Open Economies Review 1, 1 (1990): pp.67-87

¹⁰ Gros and Thygesen (1998): p169

than a hegemonic one, with France serving as the alternative. Gros and Thygesen note that Germany has been influential on the policies of the other EMS countries, but there was also weaker influence in the other direction.¹²

Political scientists concentrate on the hegemonic aspect of Germany that stems from the credibility other EMS countries have attained by following the lead of the Bundesbank. German economic policy-making, particularly the inflation-conscious Bundesbank, has become the model for Europe, turning Germany into the de facto leader of the regime. This is paradoxical in that the Bundesbank approached European monetary cooperation with considerable skepticism. The potential incompatibility of maintaining a fixed exchange rate with protecting price stability made the Bundesbank a formidable critic and obstacle to the formation of the EMS, and it has warily eyed monetary union for the same reason. Much of the Bundesbank's power and authority lie with its independence, and exchange rate cooperation and monetary union had the potential to compromise that.

The Bundesbank's independence and the achievements of the German economy have been among the most vaunted aspects of the Germany postwar success story. In the late 1980s and early 1990s central bank independence was increasingly seen as a panacea to economic ills such as inflation. The literature on central bank independence argues that when a nonpolitical body forms monetary policy, it is not prone to political cycles and its policy promises are seen as more credible by markets. According to Alberto Alesina, the independence of the central bank from the political pressure found in systems dominated by a politically accountable Treasury allows for the following benefits to accrue: a reduction in the inflation bias; a reduction in the variability of monetary policy according to government partisanship; and a decrease of pre-electoral manipulation of monetary policy.¹³

¹¹ Fratianni and von Hagen, *op cit.*; Axel Weber, "Reputation and Credibility in the European Monetary System" *Economic Policy* (April 1991): pp.58-102; Charles Wyplosz, "Asymmetry in the EMS: Intentional or Systemic" *European Economic Review* 33 (1989): pp.310-320

¹² Gros and Thygesen (1998): p.177

¹³ Alberto Alesina, "Macroeconomic and Politics" in Stanley Fischer, editor, *NBER Macroeconomics Annual 1988* (Cambridge, MA: MIT Press, 1988): pp.13-52

The logic of such reasoning hinges on the assumption that there is some political reward (at least for some parties) for lax monetary policy, and that parties are differentiated by the degree to which they are inclined to exploit this. If this is the case, the independent central bank can serve as a guardian of monetary stability to the untrustworthy politicians who would sacrifice long-term stability for short-term political profit. The preferences of the government are presumably different (at least sometimes) from that of the independent central bank, the latter of which is more committed to monetary stringency.

In lieu of central bank independence (and more recently, supplementing it) some states have chosen to yield monetary policymaking decisions to a noninflationary source such as the independent central bank of a partner country (in the case of Europe, the Bundesbank). The reasoning is similar to that of an independent central bank: by “tying your hands” to noninflationary targets set by the Bundesbank via international commitments, the promise not to inflate becomes more credible. The international agreement and its accompanying entanglements and reputation form a type of bond that the governments offer markets. If the government reneges and foregoes the bond, presumably it will lose its accumulated credibility, and its international ties and commitments will fall into disarray. This method is imperfect, however, as seen by the interest rate differentials across countries that existed till shortly before monetary union commenced in January.

However, participating in an international arrangement like the European Monetary System could still strengthen the government’s commitment not to inflate because it combines elements of rules and discretion.¹⁴ Realignment decisions are made collectively, but ultimately success rests on the government’s ability to bolster its international commitment with domestic policy. The regime provides governments with rules and goals, but implementation is done at the discretion of the government. In that sense, participation in an international agreement is symptomatic rather than a causal force. If governments are unwilling to adjust domestic policy to suit the demands of the regime, it will quickly lose credibility and become meaningless. International

cooperation must be part of a coherent domestic policy and economic program if it is to be successful. As former German Bundesbank President Karl Otto Pöhl writes,

“necessary disciplines must be acceptable to all partners, they must all see advantages for themselves in abiding by them, and they must be willing to do so even though at times this may appear unpalatable. The necessary disciplines cannot be imposed upon countries from outside.”¹⁵

In summary, German dominance theories have rested on the following assumptions: the mark serves as the anchor currency, and the other countries of the EMS have delegated their monetary policymaking authority to the Bundesbank. They eventually created a European central bank that was explicitly modeled on the Bundesbank but is arguably even more independent. Thus, the weaker currencies gain credibility for disinflationary policy, and Germany benefits from the export of its stability to countries that peg their currencies to the mark. However, this credibility relies as much on the government’s willingness to follow the Bundesbank’s lead and enact restrictive monetary and fiscal policies as any sort of nominal commitment to exchange rate cooperation.

Dual Hegemony

Germany’s commitment to support its partner currencies, along with its enthusiasm towards monetary union, has been constrained, calling into question its ability to act as a leader.¹⁶ The reasons will be explained in more detail in the section on the origins of the EMS, but for now it is important to recognize the reluctance that Germany has exhibited from the start to play the role of hegemon. Germany’s willingness to act as hegemon and provide stability for the system (ie to intervene intramarginally to defend currency parities and change its interest rates to serve international goals rather than domestic ones) is severely circumscribed by the divided policymaking structure that makes both the government and the Bundesbank responsible for the upkeep of the

¹⁴ Miles Kahler, “Organization and Cooperation: International Institutions and Policy Coordination,” Journal of Public Policy 8, 3.4 (1989): pp.375-401

¹⁵ Karl Otto Pöhl, 1987, “The European Monetary System—a Model for a More Stable International Monetary Order?”, in Deutsche Bundesbank, *Auszüge aus Presseartikeln* 33 (May 1987)

¹⁶ Jacques Méhitz, “Monetary Discipline and Cooperation in the European Monetary System: A Synthesis” in Francesco Giavazzi, Stefano Micossi and Marcus Miller, eds., The European Monetary System (Cambridge: Cambridge University Press, 1988): pp.51-79

system. The German government is responsible for exchange rate policy, but the Bundesbank determines interest rate policy.

This has led some authors to question the German dominance hypothesis, given the objections of the German government to reflate its economy and lower its discount rate.¹⁷ For Germany's dominance to be the primary factor behind the EMS' stability implies that Germany is providing the credibility to the system. But its leadership is passive. Germany does not provide Europe with such public goods because this would run counter to the interests of the Bundesbank, which privileges domestic price stability over international currency stability. Germany has been unwilling to sacrifice domestic goals for monetary cooperation.¹⁸

Hegemony implies an active involvement in managing monetary affairs that is problematic in the German case because of the competing interests that run monetary policy. Kaltenthaler notes the inconsistencies of German monetary policy over the last two decades due to the numerous political and bureaucratic interests that shape policy.¹⁹ The domestic competition for control over European monetary policy has further hindered any possibility of Germany exerting a coherent leadership in the monetary sphere.

So rather than German hegemony being responsible for the success of the EMS, analysts have offered other reasons for the great strides that we have seen in European monetary cooperation. Some point to the emerging policy consensus surrounding the desirability of pursuing policies of low inflation.²⁰ Another explanation connects advancements in monetary cooperation with changes in the geopolitical environment, with European cooperation reacting to changes in the power distribution that

¹⁷ Kathleen McNamara, "Economic and Monetary Union: Do Domestic Politics Matter? Does Hegemony" Paper presented at the Annual Meeting of the American Political Science Association, New York 1994

¹⁸ Kathleen McNamara and Erik Jones, "The Clash of Institutions: Germany in European Monetary Affairs" *German Politics and Society* 14, 3 (1996): pp.5-30; Matthias Kaelberer, "Germany's Incentives for European Monetary Cooperation" *German Politics and Society* 14, 3 (1996): pp.31-53

¹⁹ Karl Kaltenthaler, *Germany and the Politics of Europe's Money* (Durham, NC: Duke University Press, 1998)

²⁰ Michele Fratianni and Jürgen von Hagen, "Asymmetries and Realignment in the EMS" in Paul de Grauwe and Lucas Papademos, eds., *The European Monetary System in the 1990s* (London: Longman, 1990): pp.86-116; Kathleen McNamara, *The Currency of Ideas* (Ithaca: Cornell University Press, 1998)

accompanied the end of the Cold War.²¹ Others find evidence of material interests of key sectors within the nation states.²²

All of these explanations naturally give Germany a central role in their explanation of why German monetary cooperation has succeeded to the extent that it has. As another large state within Europe and a major player in monetary integration, all of these accounts have also considered the incentives that France has had in promoting monetary cooperation. But these explanations do not consistently give France the same theoretical weight that is accorded Germany in these explanations regarding leadership. When this does occur, France either occasionally emerges during key moments to take advantage of unique historical circumstances, or France is one of several large European powers that, along with Britain and Italy, follow Germany's lead. Its leadership is either sporadic and dependent upon external events to be effective, or its leadership role is diminished to a second tier.

But France has done more than act as a receptacle to German ideas and influence. It has actively shaped the content and direction of monetary cooperation along with Germany. The internal conflict of German monetary policymaking has rendered it ineffective as a strong leader, it acts mainly as a model or example for others to follow. But cooperation does not simply emerge, it is either set in place by a hegemon or it exists through regimes whose rules and *raison d'être* were originally constructed by a hegemon.²³

In the case of European monetary cooperation, France has acted with Germany as a co-hegemon, leading to a system of dual hegemony. The development and institutionalization of European monetary cooperation was dependent on French as well as German leadership. French leadership determined the speed of integration and its institutional design during the course of monetary integration over the last two decades.

First, Franco-German cooperation has always been at the heart of the European integration process. Even the original Coal and Steel Community could have gone ahead without the involvement of any other country, and this remains true for all of the

²¹ Bernard Connolly, *The Rotten Heart of Europe* (London: Faber and Faber, 1995); Michael Baun, *An Imperfect Union* (Boulder: Westview Press, 1996)

²² Andrew Moravcsik, *The Choice for Europe* (Ithaca: Cornell University Press, 1998)

subsequent areas of agreement as well. Britain can drop in and out of agreements as it chooses, the prospect of Italy not making the first round of monetary union was acceptable, even desirable to many, but if France and Germany are not on board, cooperation stops. Period. There would be no European integration without France, there is no monetary cooperation without France. The timing of European initiatives rests on its appropriateness to both French and German situations.

Second, the content and scope of monetary cooperation has not slavishly followed German preferences to the extent that has often been implied. True, German ideas and institutions have heavily influenced the development of European monetary integration. But if a policy consensus did emerge about the usefulness of conservative monetary policies, at what point did this shift from being a German interest to a European interest? In other words, can this rightfully be pointed to as an example of German hegemony if the adoption of these policies and institutions was the consequence of a pre-existing policy change in the countries concerned? These new conservative institutions were not imposed upon the other EMS countries, they were willingly adopted.²³ Furthermore, the adoption of such policies were preceded by, not followed by, domestic changes in France. The consolidation of power by conservative economic factions in France were a precondition for the actual functioning of the EMS just as they were necessary for pushing through plans for monetary union.

Moreover, though the European Central Bank's charter and organizational structure does closely resemble that of the Bundesbank's, the German delegation was not entirely successful in forcing its EMS partners to comply with the exacting standards of the Maastricht criteria. The treaty offered various loopholes that would permit participation in monetary union even if all the criteria were not strictly fulfilled. Even the Growth and Stability Pact, instituted several years later to prevent a moral hazard problem from arising in the future, is not as unforgiving as it may originally appear. Such loopholes suited France's interests in keeping EMU membership less restricted and allowing for more of a balance in policy making.

²³ Robert Keohane, *After Hegemony* (Princeton: Princeton University Press, 1984)

Thus the impact of France can be seen in both the form that monetary union has taken and in the speed with which it has progressed. The next section will consider these points in further detail.

The Making and Maturing of the EMS

The original institutions of the EMS were hardly an homage to German institutions. They were designed to spread the responsibility of policymaking and adjustment across all of the countries so that Germany would not be privileged. France, as the weaker currency country, had a greater interest in seeing this symmetry institutionalized, though Germany did agree to the original principles. After the Snake degenerated into a D-mark zone in the 1970s, the European currencies were buffeted by the dollar's erratic movements. This had detrimental effects on the European economies which were already struggling with inflation and unemployment.

French President Valéry Giscard and German Chancellor Helmut Schmidt constructed the European Monetary System, which would create a "zone of monetary stability" in the wake of the large exchange rate fluctuations that followed the end of the Bretton Woods regime and the oil crisis of 1973-4.²⁴ These fluctuations exposed Germany to currency instability and the prospect of imported inflation from weaker economies with correspondingly weaker currencies. The instability also wreaked havoc with the Common Agricultural Policy, a treasured benefit of EC membership for the French.

The EMS offered France and Germany political and economic opportunities that they could not achieve on their own. For France, it was the chance to have a larger say over European monetary affairs than the strength of the French economy alone would allow it. It also provided the government led by Raymond Barre with a scapegoat for its austerity policies. For Germany, it was the opening it needed to exert greater influence and leadership in the monetary (and, hopefully political) sphere under the cloak of European integration. The strength of the German economy and the mark would no doubt make it a major player in the system, both in its institutions and day-to-day operations.

For Germany, however, there were additional risks, and the decision provoked controversy. From the very start the EMS divided Germany. There was general support among the public for regional monetary stability, but the banking community was split, and the Bundesbank was outright opposed to the idea. Industry, however, looked forward to exchange rate stability as the chemical and steel industries in particular had been losing market shares to its competitors because of the strong mark. Chancellor Schmidt argued that the EMS was a way to prevent excessive devaluation of the French franc and the Italian lira and promoted the issue vigorously.²⁵ From the beginning, it was clear that Germany would act as a reluctant hegemon, if it assumed any leadership position at all.

The Bundesbank, voiced its objections early on. Schmidt had reportedly threatened to revoke the Bundesbank's independence if it did not agree, pleading that the EMS was a matter of high politics. Monetary integration was an essential aspect of foreign policy, and Schmidt made its political significance clear from the beginning. He even attended a meeting of the Bundesbank Central Council in Frankfurt to plead his case, an unprecedented act for a German chancellor, but the political stakes were high.²⁶

Finally, the Bundesbank and the government were able to form a truce in the informal agreement which has become known as the "Emminger Letter": in exchange for not interfering with the establishment of the EMS, the Bundesbank retained the right to discontinue intervention if it threatened the German money supply. Schmidt had essentially agreed not to compromise the Bundesbank's independence for the sake of European integration.

This act set the tone for the rest of development of the EMS, as independence from political interference in the setting of monetary policy became seen as the key to credibility. With credibility, governments no longer needed to fear the periodic instability

²⁴ The most comprehensive account of this can be found in Peter Ludlow, The Making of the European Monetary System (London: Butterworth, 1982)

²⁵ Marcello De Cecco, "The European Monetary System and National Interests" in Paolo Guerrieri and Pier Carlo Padoan, eds., The Political Economy of European Integration (Savage, MD: Barnes and Noble Books, 19889): pp.85-99

²⁶ Randall Henning, International Monetary Policymaking in the United States, Japan and Germany (Washington: Institute for International Economics, 1993)

that occurred in the exchange rate markets during elections, for example.²⁷ Political transitions would no longer be tied to changes in monetary policy and currency stability, those decision would be made by independent bodies. First, decision-making would be delegated to the German Bundesbank, and later plans would be made for a European-wide version of the Bundesbank.

But these notions did not develop until several years after the inception of the EMS. The initial concern of the EMS was to correct what were seen as the mistakes of the Bretton Woods system and the European precursor to the EMS, the snake. The EMS would ensure cooperation between the European countries through the development of a strong regime and institutions to guide it over the rough spots. Not wishing to be captive to a hegemon as they were during the Bretton Woods system, the EMS' architects designed the ECU, a basket of the participating countries' currencies, to serve as the system's numeraire.

This was done so as to make the EMS a symmetrical system in which pressure would be exerted on both deficit and surplus countries to adjust their respective currencies. The French in particular wanted a more symmetrical system that would not place the entire burden of adjustment on the weaker currency country, as the snake had. Using a basket of currencies rather than bilateral exchange rates to determine intervention obligations would place pressure on the strong currency country to also intervene. Early on in the negotiations, Schmidt had also voiced his desire for a more symmetrical system that would avoid the problems that the Snake faced, though later on he would reverse this position in favor of a system that once again would oblige the weak currency countries to carry out the bulk of the interventions.²⁸

A compromise was reached in which the central bank interventions would continue to be determined according to bilateral exchange rates, but a divergence indicator would be created to show the movement of the exchange rate of each ERM currency against the (weighted) average movement of the other ERM currencies. The criterion used is the divergence of the actual daily rate of the ERM currency, expressed in

²⁷ Michele Chang, "Crisis and Credibility in the European Monetary System" Ph.D. dissertation, University of California, San Diego, 1998

²⁸ Kaltenthaler, 1997

ECU's, from its ECU central rate. Adjustments are made for those currencies contained in the ECU but not participating in the ERM and the wider margins observed by certain currencies. When the currency crosses 75 percent of its band width, it has crossed the divergence indicator, signaling the need for intervention. At least two currencies are always identified in this, the strong currency and the weak currency, and it was expected that the strong currency would purchase foreign currencies while the weak would sell. Thus, both the strong and the weak currencies would be adjusting.

In summary, the formation of the EMS was clearly a joint Franco-German initiative. Compromises were made that would incorporate both the concerns of the French for a more symmetrical system and the need for Germany to protect its price stability via the use of bilateral parity grids and the ECU and divergence indicator. In particular, Chancellor Schmidt would have to promise the Bundesbank that it would not be required to intervene if that would affect price stability.

The 1983 Crisis

As the EMS developed, it clearly did not evolve as its architects had originally intended. But this was neither an indictment of French leadership nor a clear case for the victory of German hegemony. It took several years for the EMS to get off the ground and get beyond the frequent realignments and uncoordinated monetary policymaking in the major countries. During this period there were some indications of the leading role Germany would take in monetary cooperation; for example, in 1982 the Federal Republic essentially dictated to France the terms of its realignment and the domestic adjustments that France should undertake in order to improve its economy. But there was little convergence among states on a German standard of policymaking, and price stability had not yet become a priority for the other member states.

[insert charts on inflation, interest rates, 1979-1982]

In practice, the institutional provisions that made the system more symmetrical played only a limited role.²⁹ The EMS has developed into an asymmetric system in

²⁹ERM countries have preferred to intervene intramarginally, before the currency reaches the divergence indicator. For more details, see Horst Ungerer, Owen Evans and Peter Nyberg, The European Monetary System: the Experience, 1979-82 (Washington: International Monetary Fund, 1983): p15. For a theoretical discussion of allowing currencies to move outside a narrow band within the permissible currency bands, see Andrew K. Rose and Lars Svensson, "European Exchange Rate Credibility Before the Fall", European

which the German mark plays the role of the anchor currency.³⁰ The divergence indicator did not play the role for which it was designed because several countries were unwilling to accept the flexibility in currency fluctuations in the margin for the divergence indicator to work. Instead, these countries chose to intervene intra-marginally to prevent the currency from ever reaching the divergence indicator, believing this was a better way to maintain overall stability. This prevented the strong currency country from having to intervene in the foreign exchange market to prop up the weak currency in many instances, and the burden of adjustment largely remained with the weak currency country.

Because of this preference for intra-marginal intervention, the EMS intervention system of very short-term financing in unlimited amounts did not play as great of a role as it might have otherwise. The central banks of the strong currencies were obligated to extend financing in unlimited amounts to defend bilateral margins when they crossed the divergence indicator. Settlements were to be made within forty-five days after the end of the month of the intervention, but extensions could be granted. Because countries by and large intervened before the currencies crossed their intervention rates, this played less of a role than originally envisioned.

Thus the EMS in its early years functioned much as the Snake did, promoting neither exchange rate stability nor policy convergence. It would not be until after France completed its U-turn in 1983 that the EMS would develop into a more credible institution as all of the participating countries adopted more conservative economic strategies that were broadly in line with one another. The policies that would be adopted would resemble German policies, but the success of the EMS hinged around French participation and willingness to transform its economic policy. Until the French U-turn, the EMS looked like it could go the way of the Snake. There was little discipline in policymaking or convergence in economic fundamentals during the first four years of

Economic Review 38, 6 (1994): pp.1185-1216 and Alun Thomas, "Expected Devaluation and Economic Fundamentals", IMF Staff Papers (1994)

³⁰Daniel Cohn, The European Monetary System and the Franc-Mark Asymmetry CEPR Discussion Paper No.245 (June 1988), Francesco Giavazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility (Cambridge: Cambridge University Press, 1989), Bernard Herz and Roger Werner, "The EMS Is a Greater D-mark Area" European Economic Review 36, 7 (October 1992): pp.1413-1425; for opposing arguments, see Michele Fratianni and Jurgen von Hagen, "Asymmetries and Realignment in the EMS" in Paul de

operation. The significance of the EMS was questionable because a zone of monetary stability did not appear to be a realistic goal.

The French decision to abide by the constraints imposed by the global economy as well as the European Monetary System allowed the EMS to avoid the fate of the Snake. Germany, on the other hand, did not take any initiative in trying to preserve monetary cooperation during this period, its primary focus remained domestic price stability. The U-turn and the consolidation of power with the conservative faction of the French Socialist Party heralded a turning point for the EMS.

The Socialist government and their Communist coalition partners had come to office in mid-1981 on a policy platform that would return France to policies geared towards growth and employment, going against the trend towards more austere policies in Germany, Britain and the United States. Their predictions of a worldwide economic recovery at the end of 1981 failed to materialize, and the economic situation of the country continued to decline as inflation and unemployment worsened, weakening the exchange rate and necessitating three realignments within two years of taking office.

The relationship between the Socialists and the Communists proved to be a rocky one. The Communists still wanted France to spend its way out of the recession and repeatedly called for reflation and rising wages, and there was open disagreement within the government and within the Socialist party itself. Some notables such as Jacques Delors and Pierre Mauroy favored an austerity plan out of economic necessity. Given the openness of the French economy, it was vulnerable to speculation and could not afford to pursue an economic policy that differed so greatly from its partners, particularly Germany. France's attempt to spur on economic growth when the rest of Europe was in the midst of recession led to a surge in imports because national production was not prepared to meet the high domestic demand. When the world economy did not pull out of the recession as predicted, there was not enough foreign demand to buy up the excess production. Growth stagnated, unemployment rose, the balance of payments went further into deficit, and the pressure on the franc necessitated a second devaluation in June 1982,

Grauwe and Lucas Papademos, eds., The European Monetary System in the 1990s (London: Longman, 1990): pp.86-116

as well as high interest rates. This faction believed that France must conduct its economic policy so that it is in line with its major trade partners.

Others such as Pierre Bérégovoy and Minister of Industry Jean-Pierre Chevènement wanted the government to return to its earlier expansionary policies. They advocated that France withdraw from the EMS so that it would no longer be forced to shadow the D-mark, and then interest rates could be lowered. This more traditional Socialist policy was known as *l'autre politique*. The issue was not definitively decided until after the municipal elections of 1983.³¹

The municipals were scheduled for March 6. They were the first national elections since the Socialists took power two years ago, and they were widely viewed as a referendum on the Mitterrand government. Although the municipal elections would not affect the composition of either the cabinet or the National Assembly, most Frenchmen believed a Socialist defeat could send a message and force the government to reevaluate its economic policies: "if you lose in the municipals, you declare that it will have no affect whatsoever on your political program and then you change it" according to a French public relations executive.³²

The Conservatives swept the first round of the municipal elections, which were interpreted as dissatisfaction with the Mitterrand government. Several prominent Socialists were forced into the second round, such as Mauroy, Delors and Chevènement. The evening before the election, Mauroy had promised his resignation should the results of the election be definitive, as it would be interpreted as a personal repudiation of the Prime Minister and his policies.³³

After the first round, Mitterrand had privately decided to withdraw from the EMS and seek a policy of growth that would be unencumbered by the necessity to keep high interest rates, as the government was obliged to do in the EMS to defend the currency

³¹For more on the internal debate within the Socialist party, see Peter Hall, Governing the Economy, (Oxford: Oxford University Press, 1986); Peter Gourevitch, Politics in Hard Times (Ithaca, NY: Cornell University Press, 1986); David Bell and Byron Criddle, The French Socialist Party: The Emergence of a Party Government (Oxford: Clarendon Press, 1988); David R. Cameron, "Exchange Rate Politics in France, 1981-1983" in Anthony Daley, ed., The Mitterrand Era (New York: NYU Press, 1996): pp.56-82

³²Wall Street Journal, March 1, 1983

³³Thierry Pfister, La vie quotidienne à Matignon au temps de l'union de la gauche (Paris: Hachette, 1985): p.238

rate. He was convinced that “By staying in the system, we are condemned to the policy of a dead dog drifting in the water. For the sole profit of Germany.”³⁴ France was very close to rejecting the German model altogether in favor of *l'ature politique* and policy autonomy.

The German parliamentary elections were also held on March 6. Speculators predicted a revaluation of the D-mark once Chancellor Kohl emerged victorious. A victory of the conservative Christian Democrats would signal a strict budget which would be favorable to investment and buoy Germany's economy, which boasted 1 percent inflation. This fueled speculation for a realignment of the EMS. The Bundesbank was required to intervene heavily in the foreign exchange markets to prop up the Belgian franc, Danish krone and French franc, all of which threatened to reach their floor during this period. The Banque de France spent considerable sums of money to prevent the franc from falling below its floor. The week of February 24, for example, the bank spent approximately 6 billion francs, or \$700 million dollars.³⁵

The Socialists rebounded during the second round on March 13, causing analysts and politicians to describe the municipal elections as a warning to the government, a point acknowledged by party leader Lionel Jospin.³⁶ Still, Mitterrand viewed this as a positive sign overall, interpreting the results as a criticism of his policies rather than an outright rejection.³⁷ The Communist party fared the worst during second round, losing sixteen of the seventy-three major towns they controlled since 1977. This is more detrimental than the Socialists' loss of fifteen towns because the party's financial base is wrapped up in their control of important municipalities, signaling the weakening of Communist influence on government policy.

The time seemed ripe for another French devaluation, but Germany was initially against an EMS adjustment. German Finance Minister Gerhard Stoltenberg argued that the currency unrest was the result of “momentary political observations”. Furthermore, Germany believed it had fulfilled all of its obligations regarding its contribution towards monetary stability. This was in response to France's demands

³⁴ Serge July, *Les Années Mitterrand* (Paris: Grasset, 1986): p.96

³⁵ *Le Monde*, March 3, 1983, p35

³⁶ *Wall Street Journal*, March 8, 1983, p38

that the Germans behave like “good Europeans” and “take significant measures” to save the EMS.³⁸

The 1983 realignment negotiations was the biggest crisis the 4-year-old EMS had faced to date as the Monetary Committee was unable to reach an agreement over the weekend, forcing foreign exchange markets to close on Monday as well. France was pushing for a massive mark revaluation, maintaining the problem for the past two weeks rested with the mark, not the franc. A compromise was finally reached in which the German mark revalued while all the other currencies devalued against it, marking the first general realignment of the EMS. Stoltenberg noted that the meeting was unusually difficult because the participants seemed prepared to exit the system. Finance Minister Jacques Delors actively used the threat of French exit from the EMS to gain favorable terms for the franc.

However, Stoltenberg emphasized that countries could not be complacent with the realignment and must implement domestic policies which support the new exchange rates and promote sound economic fundamentals. With this warning, Germany had stated its intention to continue its brand of economic policymaking, and if the other countries of Europe wished to share in its success, it would require changes at the domestic level, not German handouts. Germany was not the EMS’ benefactor, and sound economic fundamentals required sound (German-like) policies. Support that might be considered a public good could not be expected from Germany, not in 1983 and not a decade later in 1993. It would be up to the other countries to determine their own path.

The realignment negotiations were successful as the Germans agreed to revalue by 5.5 percent and France would devalue 2.5 percent and remain within the EMS. Days after the conclusion of the realignment negotiations, Mitterrand announced a series of austerity measures that would complete the U-turn begun in 1982. The municipal elections tolled the death knell for the Communists as the cabinet was restructured to reflect the results of the internal struggle of the government. The advocates of *l’autre politique* and the Communists had lost, and the victorious faction

³⁷ July, p.90

embarked on a new policy era for France and a new life for the EMS.³⁹ The *franc fort* policy became a staple of French monetary policy over the subsequent years, and Germany's low-inflation/strong currency model became the standard.

In summary, the 1983 realignment marked the end of the EMS' growing pains and the beginning of a regime whose success would eventually lead to monetary union. The degree to which Germany can claim responsibility is circumscribed, however. Germany could not save the European Monetary System alone, nor was it willing to do so. Germany was not willing to sacrifice its own internal stability for the sake of monetary cooperation, thus negating the possibility that it would provide a public good in the form of reduced interest rates or strong revaluations of the mark unless France were willing to change its domestic policies. France did so, but these moves should not be viewed as orders from Germany but rather the consolidation of power within France of a faction whose goals were in sync with Germany's goals. The Mitterrand government could have withdrawn from the EMS, and this threat was taken seriously by the Germans during the realignment negotiations. It was France's decision to remain within the EMS, a decision that was made at the end of a power struggle within the government following an election, a decision that allowed the EMS to continue and to flourish. Once the French government followed stability-oriented policies, the EMS took on a whole new life marked by increased stability and policy convergence.

The increased convergence after the 1983 French U-turn, however, did not mean that all the states became exact replicas of Germany. There were "escape valves" available that other states could use to ease the constraints imposed by the regime, namely capital controls and the continued possibility of realignments.⁴⁰ But the asymmetry of the system was apparent in that realignments that did not fully account for inflation differentials between the countries, thus reflecting the deflationary bias.⁴¹

³⁸ *Frankfurter Allgemeine*, March 15, 1983

³⁹ David Cameron, "Exchange Rate Politics in France, 1981-1983: The Regime-Defining Choices of the Mitterrand Presidency" in Anthony Daly, ed., *The Mitterrand Era: Policy Alternatives and Political Mobilization in France* (New York: New York University Press, 1996): pp.56-82

⁴⁰ Fratianni and von Hagen, 1990, p.102

⁴¹ Loukas Tsoukalis, "The Political Economy of the European Monetary System" in Paolo Guerrieri and Pier Carlo Padoan, eds., *The Political Economy of European Integration* (Savage, MD: Barnes and Noble Books, 1989)

As the EMS succeeded in its goal of creating a zone of stability in Europe, cooperation in other aspects also received a new lease on life, giving rise to further efforts at integration. For example, the move towards monetary union seemed a natural one after the plans for the Single Market had been agreed upon. How can Europe truly have a single market if over a dozen currencies were used? The Single European Act even had a reference to monetary union within it. But the nature of the negotiations points to deeper concerns than economic efficiency.

The Maastricht Treaty and European Monetary Union

Less than a decade after the inception of the EMS, the participating governments began negotiations for monetary union. In this section I will demonstrate how the rapid pace of monetary union was the result of French negotiating tactics that overcame the division within Germany over the desirability of monetary union. During this period Germany would equivocate on making any firm commitments to monetary union as France would strongly press forward with its agenda until reaching its goal. Once monetary union was accepted as inevitable, Germany concentrated on the content of monetary union, eager to make it resemble German policymaking as closely as possible and prevent the German economy from being sabotaged by weaker members.

The Pace of Monetary Union

Some argue that geopolitical concerns played a decisive role in determining the timing of the plans for monetary union.⁴² German unification and the end of the Cold War made the need to tie Germany to Western institutions greater than ever in order to placate its neighbors who were concerned about “the German question”. For Baun and Woolley, German participation in monetary union was also a means of furthering EC political integration.

But plans for monetary union predated the fall of the Berlin Wall. France had been advocating monetary union for several years. In 1987 French Finance Minister Edouard Balladur began actively promoting plans for monetary union. That same year French and German negotiators were working on a draft treaty that would commit France

⁴² Baun, 1996; Collette Mazzucelli, *France and Germany at Maastricht* (New York: Garland Publishers, 1997); John Woolley, “Linking Political and Monetary Union: The Maastricht Agenda and Domestic

and Germany to coordinating economic and financial policy. These plans were killed by the Bundesbank and German business interests, which were still concerned about the threat the monetary union could pose to price stability.⁴³ Nevertheless Mitterrand launched a proposal for the creation of a European central bank in October 1987. In January 1988 Balladur proposed a single currency and at the Hanover Summit in June of that year, a committee chaired by EC Commission President Jacques Delors was formed to draw a plan for monetary union. Some attribute France's eagerness for monetary union to its desire to finally wrest control from the mark and the Bundesbank.⁴⁴

Thus most of these plans resulted from French initiatives rather than German ones, and despite the benefits that Germany had enjoyed as the result of monetary stability brought about by the EMS, monetary union was a different matter. Though some industrialists and exporters may benefit from monetary union through greater exchange rate stability and lower interest rates, the "hard" EMS period in which no realignment occurred after 1987 indicates that these objectives were already largely achieved. Exchanging the Bundesbank for a European central bank that may not control inflation as well as its German predecessor presented German interests with a risk, despite the potential gains that a truly single market with a common currency could offer. German business only weakly supported monetary union; as Moravcsik writes, "the EMS status quo was also relatively attractive, perhaps even more so than EMU was."⁴⁵

Though Germany did not object to the principle of monetary union, the pace moved too rapidly. In 1988 the Bundesbank's annual report stated that monetary union was unnecessary because "the EMS in its present form would then provide sound underlying conditions for the internal market to function smoothly," contradicting arguments on the necessity of monetary union to complement the Single Market.⁴⁶ In 1989 Kohl argued against setting a firm date for the beginning of EMU in a letter to Mitterrand several days before the December Strasbourg summit. Just hours before the

Politics" in Barry Eichengreen and Jeffrey Frieden, eds, The Political Economy of European Monetary Integration (Boulder: Westview Press, 1993): pp.67-86

⁴³ Kaltenthaler, 1998, pp.63-5

⁴⁴ Connolly, 1995; David Marsh, The Bundesbank: The Bank that Rules Europe (London: Mandarin, 1992)

⁴⁵ Moravcsik, 1998, p.391

⁴⁶ Dorothee Heisenberg, The Mark of the Bundesbank (Boulder, CO: Lynne Rienner, 1999): p.105

summit, a compromise was reached in which the Germans agreed to an EMU conference in the second half of 1990, after the German parliamentary elections. Though this may not indicate a fundamental lack of German support for the project, it does point to a division within Germany that had the potential to prevent Germany from taking a leading role in monetary union, if not derail the process altogether.

In September 1990 the Bundesbank issued its own paper on monetary union that essentially demanded that the Bundesbank's anti-inflationary priorities be superimposed on the rest of Europe. There would be a tough series of convergence criteria before the second stage of EMU, all members would have to relinquish their capital controls, inflation must be reduced along with budget deficits, and the European Central Bank would be modeled after the Bundesbank.⁴⁷

When the conference on monetary union in Maastricht began, the French came in with the following priorities: establishing an intergovernmental forum by which the European Council would set economic and monetary policy for the Union; creation of the European Central Bank and the beginning of Stage 2 of monetary union in January 1994; and that monetary union follow a series of progressive steps with a fixed timetable. Germany, on the other hand, was primarily concerned that candidates for monetary union adhere strictly to the convergence criteria that would limit inflation, budget deficits, public debt and interest rate differentials. Germany also opposed monetary union which would automatically come into force during specified dates but rather it should occur after economic integration had occurred and the member states came to a unanimous agreement.

The Germans made some significant concessions at the Maastricht summit. First, the treaty allowed for a multistage EMU despite Germany's formal rejection of it. Second, the German delegation acquiesced to requests to establish dates for progression to the third stage of monetary union. If a consensus was not reached in 1996 on the beginning of the third stage of monetary union, in 1998 the decision would be taken by the European Council and made by a simple majority.⁴⁸ Such demands illustrated the political rather than economic/technocratic nature of monetary union. By insisting that

⁴⁷ Kaltenthaler, 1998, p.80

major decision be taken at the level of the European Council and not by central bankers or finance ministers, monetary union is more likely to occur with a larger number of members.⁴⁹ Therefore a possibility existed that political decisions could override any obstacles to monetary union posed by participants not strictly meeting economic convergence criteria.⁵⁰

In summary, in order for Germany to be termed the hegemon or leader in the monetary union process, Germany would have to have taken a leadership role in the initiation of the agreement and in its design. Germany, in particular the Bundesbank, can claim the latter but not the former. France took the lead in determining the pace of monetary union, both in pushing for an agreement within the EU that committed the organization to the ultimate goal of monetary union and in lobbying for a timetable that would allow for political considerations to override technical factors. Thus, the French delegation largely determined the pace of monetary union.

The Content of Monetary Union

The content on the convergence criteria and the statutory independence of the European Central Bank obviously reflected German priorities. The traditional camps that have been labeled “monetarist” versus “economist”, with the latter preferring strong currencies, low inflation versus the monetarists who favored less austere policies, even at the expense of higher inflation and weaker currencies, once again battled over the terms of monetary union. By the early 1990s, however, there had largely been a convergence of preferences regarding the desirability of strong currencies and exchange rate stability, even at the expense of growth. What was at stake was a matter of degrees more than basic principles.

Controversy did emerge over the imposition of objective criteria that had to be fulfilled before monetary union could take place, one of the Bundesbank’s primary concerns and one that was echoed by German business interests that wanted to safeguard the stable economic environment the Bundesbank traditionally provided. These measures included a convergence of inflation rates, budget deficits, and public debt and exchange

⁴⁸ Mazzucelli, 1995, p.114

⁴⁹ Mazzucelli, 1995, p.121

⁵⁰ Kaltenthaler, p.82

rate stability. The inflation rates of the EMS countries had been steadily converging in the late 1980s, making this criterion unproblematic. The lack of realignments since January 1987 made the exchange rate stability criterion also seemed like it would be readily achieved, though during the 1992-93 crisis the significance of this would be questionable.

Other necessary objectives included capital mobility and independent central banks in the other countries. The former would have far-reaching consequences in terms of the ability of markets to speculate against the currencies, and these would not be fully realized until the 1992-93 crisis. The latter condition on central bank independence seems largely cosmetic at this point, as the other European countries had been setting their interest rate policies in line with the Bundesbank's for years. But the existence of convergence criteria seemed to be non-negotiable in order to secure German participation, and given the convergence that had already occurred across Europe, particularly in inflation, Germany's conditions were acceptable.

What is considered less often, however, are the various safety valves built in despite the rigorous criteria. First of all, it was agreed that the ECOFIN Council would be responsible for exchange rate policy while the ECB would handle daily interventions on the exchange rate market and interest rate policy. This would potentially provide a political counterweight to the independent central bank that could permit the consideration of political issues when determining policy. Its significance is still uncertain, however, and a true political counterweight to the ECB has yet to be established, though the informal group of finance ministers, the Euro-X club, is the most likely contender.

More significant is the matter of the loose interpretation of the convergence criteria of the Maastricht Treaty in order to allow more members to participate. This ultimately benefited both the strong countries, including Germany, as well as the weaker countries that the criteria were designed to keep out. For example, according to Article 104(c) of the Maastricht Treaty, a country's budget deficit would be evaluated on its ability to meet the stated numerical criteria unless "the ratio has declined substantially and continuously and reached a level that comes close to the reference value." As for

government debt, participation was permissible if the country was approaching the 60 percent cut-off “at a satisfactory pace.” In addition, France and Italy were able to engage in short-term solutions that would qualify their economies (payment by France Télécom and a repayable euro tax, respectively). These measures did not go against the letter of the Treaty, but they did go against its spirit if the intent was to ensure fiscal austerity.⁵¹

This is in contrast to the draft treaty on monetary union that Germany proposed at the IGC in February 1991 which demanded strict compliance with the convergence criteria. Delors warned that such rigid interpretations could endanger EMU altogether.⁵² As early as 1994 members of the Bundesbank expressed concern that the convergence criteria were being softened when Ireland’s government debt was still 90 percent of GDP and was nonetheless approved by the Monetary Committee as satisfactory. These fears were repeated in 1996 when the EU failed to reprimand Denmark for excessive deficits when its debt ratio was 71.9 percent.⁵³

[insert Maastricht Convergence ratios here]

Indeed, had the convergence criteria been strictly enforced, monetary union would look very different. Belgium and Italy, for example, suffered from debt to GDP ratios that are double the Maastricht criterion’s 60 percent of GDP. The Bundesbank and the Dutch central bank attacked Belgium’s debt/GDP ratio, which is not expected to meet the 60 percent convergence criteria until at least 2011, and demanded that the Belgians make some sort of “binding commitment” on debt reduction. Foreign Minister Erik Derycke took the criticisms in stride and issued reassuring statements about the positive effect that the state’s budget surplus of six percent would have on its debt. Nonetheless, Dutch politician Frits Bolkestein, parliamentary leader of the free-market Liberals (VVD), voiced his concern that the convergence criteria was not followed for political reasons, complaining “I voted for an economic euro and I’m getting a political euro,”⁵⁴ The Dutch Central Bank Governor, Dutch Prime Minister Wim Kok and Dutch Finance Minister

⁵¹ Even Germany tried to engage in creative accounting by revaluing the Bundesbank’s gold reserves and applying it to the 1997 deficit. The Bundesbank refused to allow Germany to sidestep the criterion and the revaluation was to be applied to the 1998 deficit. See *New York Times*, June 4, 1997

⁵² Mazzucelli, 1995, p.112

⁵³ Heisenberg, 1999, p.156

⁵⁴ www.reuters.com/emu

Gerrit Zalm echoed this disapproval of admitting countries that did not seem ready for monetary union, based on the Maastricht criteria. In addition, the vote taken to determine which countries would participate in monetary union were taken in the European Council. The decision to have the heads of state and government take the vote rather than central bankers or even finance minister underscores how politicized this process was.

Even the Stability and Growth Pact, which imposes fines on countries whose budget deficits exceed 3 percent of GDP, is not as stringent as it initially appears. The fines are not automatically imposed, they must first be approved by a majority of the euro members. Once the euro members approve the penalty, the country has at least two years to pay it, and if the country enters a recession, it need not be paid at all, rather automatic fiscal stabilizers come into effect. Prominent economists have already dismissed the Stability Pact as a serious threat to profligate countries.⁵⁵ In addition, at the Edinburgh summit in 1992 the European Council agreed to increase the structural funds in order to ease the fiscal adjustment process for the weaker countries.

Implementation

1992-3 Crisis: How it did not derail EMU

The 1992-93 crisis threatened to derail monetary union altogether. The series of crises that began with the ejection of the Italian lira and British pound from the exchange rate mechanism of the European Monetary System and ended with the widening of the exchange rate bands has been dealt with in some detail in numerous other sources.⁵⁶ In this section I simply note the dual role that France and Germany played in preserving the EMS and keeping Europe on track towards monetary union.

The British exit from the ERM in September 1992 resulted in the souring of relations between Britain and Germany. British Prime Minister John Major spoke publicly of the “fault lines” in the ERM and placed much of the blame on Germany for not doing more to prevent the crisis. Major contrasted the role the Bundesbank played in

⁵⁵ Barry Eichengreen and Charles Wyplosz, “Stability Pact: More Than a Minor Nuisance?” Economic Policy (April 1998): pp.67-113

⁵⁶ See, for example, Barry Eichengreen and Charles Wyplosz, “The Unstable EMS” Brookings Papers on Economic Analysis 1 (1993): pp.51-124; David Cameron, “British Exit, German Voice and French Loyalty”, Paper presented at the Annual Meeting of the American Political Science Association, Washington, DC 1993

the British crisis with its staunch, vocal support of the French franc. The franc also came under speculative pressure in the run-up to France's referendum on the Maastricht Treaty, and the German government and the Bundesbank made the unprecedented moves of publicly supporting the franc's exchange rate on the basis of the country's sound economic fundamentals. Even more surprising was the Bundesbank's decision to intervene intramarginally in support of the franc, an action that the Bundesbank had not undertaken since the EMS was founded in 1979. There was the recognition of the special relationship between France and Germany and the necessity of both countries participating in monetary union, if it were to happen at all.

The crisis continued until the following summer, resulting in the devaluation of the Spanish peseta, Portuguese escudo, and the Irish punt. The crisis reached its most critical stage in late July 1993 after the Bundesbank failed to lower its key interest rates in order to provide relief for the rest of Europe. Speculation resumed, and the tumult threatened to destroy the EMS. The Bank of France was forced to spend \$32.5 billion of reserves over the last week of July, after having already exhausted its reserves after nearly a year of recurring speculation. The Monetary Committee met on August 1 in order to determine the proper course of action.

France objected to any talk of devaluation and wanted Germany to reduce interest rates. Germany refused to reduce interest rates without an end to its intervention in the foreign exchange markets in sight. Balladur suggested that Germany exit the ERM temporarily so as to reduce pressure on the rest of the currencies. The Netherlands, Denmark and Belgium opposed this proposal and were unwilling to sever their links with the mark. Germany posed the idea of widening the band for the franc in exchange for an interest rate cut, but this went against French insistence for no devaluation. Ultimately negotiators reached a compromise that would widen the band for all of the currencies to +/- 15 percent.

This crisis and its resolution demonstrates the significance of the Franco-German axis in monetary integration. Germany undertook unprecedented steps to keep France in the EMS, knowing that the survival of the franc was critical for the success of monetary union. When the currency crises threatened the integration process, the widening of the

bands effectively eliminated the meaningfulness of the convergence criteria regarding exchange rate stability within the European Monetary System. Though the French would decline to take advantage of its newfound flexibility, the widening of the bands demonstrates the extent to which the convergence criteria can be manipulated in order to fulfill political ends. Both Germany and France benefited from the widening of the bands. The Bundesbank no longer had to intervene in the foreign exchange markets to support the weaker currency countries. France was also freed from its intervention obligations without suffering from an embarrassing devaluation.

In December 1994 the EU finance ministers even endorsed the European Monetary Institute's proposal to allow countries what had not been in the narrow EMS bands for two years prior to entry (the original Maastricht convergence criterion) to participate in EMU. This agreement was finalized on December 6, 1994 and would make it easier for more countries to be in the original EMU group, which France had supported all along.

Selecting a Central Bank President⁵⁷

In regards for the Presidency of the European Central Bank, it had long been a foregone conclusion that the position would go to Wim Duisenberg, the Dutch central banker who had presided over the European Monetary Institute. Duisenberg's original acceptance of the position at the EMU had been on the condition that he would be the first ECB president, an arrangement that all countries except France and Italy agreed upon.

In November of 1997, however, just six months before the final decision would be made, the French nominated its own candidate, Jean-Claude Trichet. French President Jacques Chirac sought this position for a Frenchman to temper the Germany-influenced institutional structure of the European Central Bank, which will also be located in Frankfurt.⁵⁸ This demand is primarily symbolic. Duisenberg is not even German, he is Dutch. Furthermore, Duisenberg and Trichet enjoy similar reputations and credentials as independent central bankers, and neither markets nor analysts expressed concern regarding any substantive differences in monetary policy the selection of one over the

⁵⁷ A detailed account of this process can be found in the Financial Times, May 5, 1998

other would make. The conflict turned into a political dogfight between Germany and France.

In May 1998 a compromise arose in which Duisenberg would assume the presidency of the ECB, but would “voluntarily” step down mid-way through his term, allowing Trichet to helm the bank for the remainder of the term. Rumors also floated that this was part of a package deal that would give a German, Horst Köhler, the presidency of the European Bank for Reconstruction and Development.⁵⁹ Köhler did become the EBRD’s president, but it is unclear whether or not Chirac actually wrested his concession. Since the compromise was made, the German press and various German politicians expressed their dissatisfaction. Finance Minister Theo Waigel even publicly confirmed that there was nothing to legally block Duisenberg from refusing to step down during his term.⁶⁰ And in an interview with a French newspaper, Duisenberg himself confirmed that he would not step down.⁶¹

Whether or not Duisenberg will keep the political commitment he made in May 1998 remains to be seen. But the choice of central bank president was largely a symbolic one, and by achieving the commitment that a Frenchman would share the position of the first ECB President in the first place reaffirmed France’s role in monetary union. Chirac extracted this concession after Duisenberg’s candidacy was already considered a “done deal”, underscoring France’s ability to renegotiate or possibly subvert German hegemony.

Conclusion

In Barry Eichengreen’s study of monetary hegemony during the classical gold standard, interwar period and Bretton Woods, he evaluates the impact of monetary hegemony in terms of the genesis, operation and decline of monetary cooperation. He concludes that even during periods of hegemony, some type of cooperation with other countries is necessary. For example, during the height of American power, Britain was able to extract significant concessions during the Bretton Woods negotiations.⁶²

⁵⁸ *Financial Times* May 2, 1998

⁵⁹ *La Libération*, May 2, 1998

⁶⁰ *Financial Times* May 5, 1998

⁶¹ *Le Monde*, December 30, 1998

⁶² Barry Eichengreen, “Hegemonic Stability Theories of the International Monetary System” in Richard N. Cooper, Barry Eichengreen, C. Randall Henning, Gerald Holtham and Robert D. Putnam, eds., *Can Nations Agree?* (Washington, DC: Brookings, 1989): pp.255-98

The genesis of European monetary cooperation has also rested not just on the actions of the anchor currency country. In fact, its consistent partner in monetary leadership has been France. Germany has never sought the role of hegemon, nor has it unilaterally advanced monetary union within the EC. Instead, the development and content of monetary cooperation has often displayed elements of French priorities as well as German ones. France did not have the same type of influence in the functioning of the EMS as the mark, but it played a critical role in the origins of monetary cooperation, both in the European Monetary System and plans for monetary union. The French interest in a more symmetrical monetary cooperation did not come to pass in the EMS, but the French were able to secure a relatively rapid monetary union despite such obstacles as the German Bundesbank and the 1992-3 currency crisis.

I have argued above that the pace of monetary union has largely depended on French efforts at least as much as German ones. France was an integral part of both the making of the European Monetary System as well as the launch to monetary union. The latter required a convergence in European policymaking that was only possible after the consolidation of power by the conservative wing of the Socialist party, not by German pressure. After the 1983 realignment, the *franc fort* policy represented a fundamental shift in French policy-making that would be supported by both governments of the left and right; there would be no turning back to the 1981 Socialist experiment. Since then, the French have actively pursued monetary union.

By virtue of its economic and political significance in Europe, France was able to take a leadership role in making monetary union happen. Though Germany also had some interest in monetary union, its divided institutional structure, in particular the hostility of the Bundesbank to monetary union, rendered it unable to exert such leadership despite the mark's status as the anchor currency.

France could not change the mark's anchor currency status, but it could help direct the future. Though many of the terms of monetary union conform to Germany's interests in price stability and fiscal rectitude, the French ensured that monetary union could happen even if countries found themselves unable to meet these high standards. The vagueness of the treaties and the acknowledgment that the decision would be a political

one rather than economic enabled France, with the cooperation of Germany, to make monetary union a reality for most of the EU's members.

The 1992-3 currency crises vividly illustrated the problems that could arise when the anchor currency's economy underwent different stresses than its partners. Under monetary union, however, monetary policy could be set for the entire region, not simply the country of the anchor currency. As Wim Duisenberg explained, "We had to shadow Big Brother. Now we will not shadow but we co-decide. So we got our voice back."⁶³ It was this desire that prompted France to exert its influence and, along with Germany, change the course of European monetary history.

⁶³ Financial Times, May 8, 1998

**Figure 1 Annual
GDP 1979-1995**

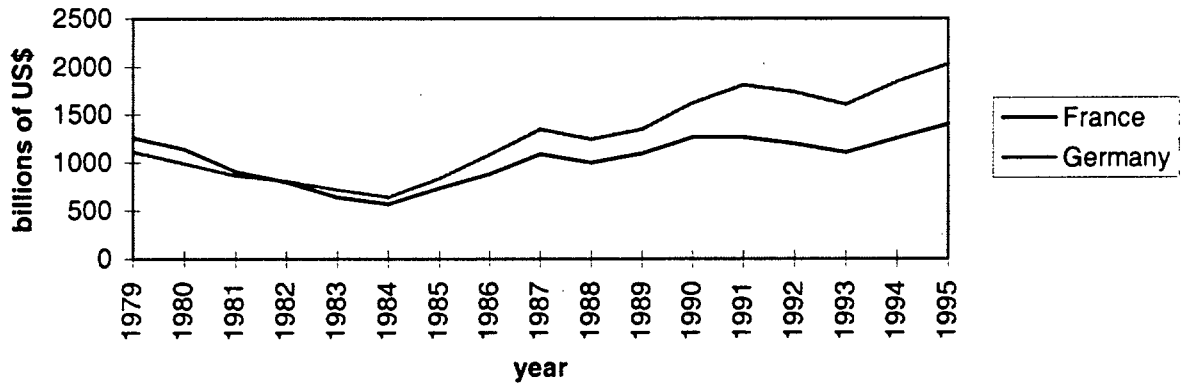


Figure 2 Monthly Eurointerest rates, 1979-1983

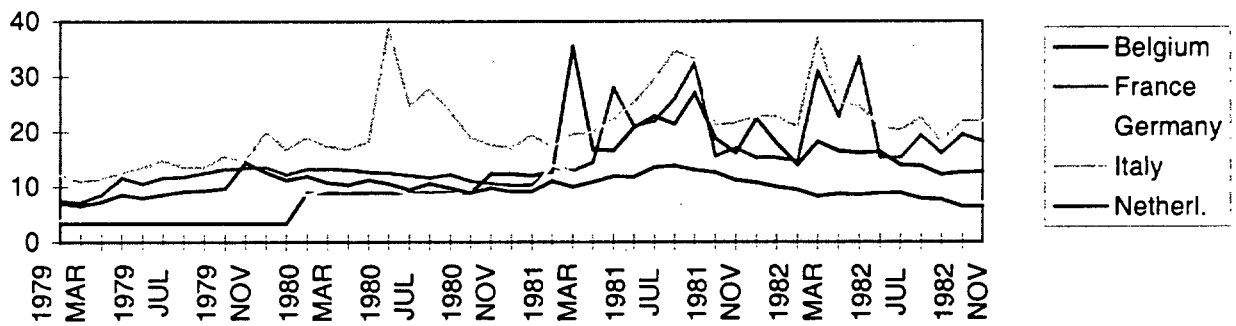


Figure 3 Monthly Inflation Rates 1979-1983

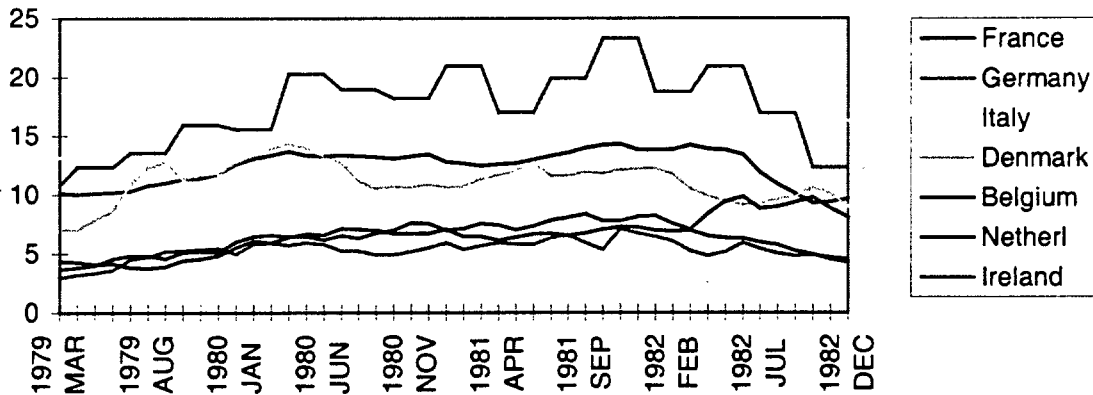


Table 1 1998 Maastricht Convergence Ratios, Commission Findings Based on 1997 Statistics, Reprinted from Heisenberg 1999, p168

Country	deficit	debt	inflation	interest rate
Austria	-2.5	66.1	1.1	5.6
Belgium	-2.1	122.2	1.4	5.7
Finland	-0.9	55.8	1.3	5.9
France	-3	58	1.2	5.5
Germany	-2.7	61.3	1.4	5.6
Ireland	0.9	66.3	1.2	6.2
Italy	-2.7	121.6	1.8	6.7
Luxembourg	1.7	6.7	1.4	5.6
Netherlands	-1.4	72.1	1.8	5.5
Portugal	-2.5	62	1.8	6.2
Spain	-2.6	68.8	1.8	6.3