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"British accession to the exchange rate mechanism: the politics of the strong currency option"

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PRECIS:

This study provides a multi-dimensional analysis of the decision of British policy makers to join the exchange rate mechanism (ERM) of the European Monetary System (EMS) in October 1990. British monetary authorities are obliged to function within several different spheres simultaneously: the marketplace, the international state system, and the British political economy. Each of these spheres has its own distinct dynamics with respect to monetary policy. In This study emphasizes the structure of the policy problem posed by changes in international markets, the role of multilateral bargaining within the European Community, and the linkage between domestic politics and British international monetary policy. Comparisons are drawn between the British experience and the adoption of the strong currency option by the French government in March 1983.

Market forces, particularly the effects of integrating capital markets on the British balance-of-payments and consequently on the pound's exchange rate, provided certain constraints and incentives for British policy makers during the 1970s and 1980s. On the whole, these changes in the international financial markets resulted in pressures to adopt the so-called "strong currency option:" pegging the British currency to a relatively non-inflationary standard.

During the first ten years of the EMS, however, these pressures were effectively resisted by British monetary

authorities intent on remaining outside any regional exchange rate arrangement that might restrict Britain's formal monetary autonomy, preferring instead to pursue a nationalist monetary strategy. This resistance to regional monetary cooperation collapsed when the rest of the European Community, and especially France and Germany, threatened the British with exclusion from the benefits of further regional monetary integration to be negotiated at the proposed intergovernmental conference (IGC) on European monetary union scheduled for December 1990. Believing both that this threat was credible and that British input on the shape and speed of further integration efforts was essential, the government accepted participation in the ERM as the "price of admission" to fruitful participation in the IGC.

Having formally entered the ERM, realizing the desired economic benefits of adopting the strong currency option--allowing the force of international trade competition to combat domestic wage and price inflation--depends critically on the British government's ability to convince both labor and industry of the credibility of the pound's peg to the German deutschmark. As a rule, when domestic interests groups become convinced that their currency's value on international markets has become a foreign policy issue, they respond by modifying their demands on the government (for devaluation or lower interest rates) and on each other (for wage and price concessions) accordingly. The credibility of the British

government's commitment to the strong currency option was initially weakened by a drop in base rates virtually simultaneous with the announcement of entry into the exchange rate mechanism. In recent months, the rise of the dollar (and, to a lesser extent, the pound sterling) against the deutschmark on foreign exchange markets has provided British monetary authorities with an window of opportunity to reduce interest rates still further while maintaining the pound's position within the exchange rate mechanism. As a consequence, the government's will to sustain the peg in the face of tough market conditions and political pressures is still largely untested.

1. MARKET FORCES: BRITAIN'S EXTERNAL FINANCIAL POSITION

Britain's postwar industrial decline has been well documented elsewhere (e.g. Hall 1986). The slow demise of Britain's capital goods industries has resulted in an increasing reliance on the British service sector, as well as capital inflows, to balance habitual trade deficits, reduce balance-of-payments pressures, and protect sterling's value on foreign exchange markets. Capital inflows substantially increased beginning in 1986 with the deregulation of British financial services, since these regulatory changes made investment in British markets relatively more attractive and helped reinforce the City of London's position as an international financial center. However, deregulation and the increased mobility of international capital also increased potential risks for

the pound sterling: the integration of international capital markets increased the capacity of speculators on the foreign exchange markets to punish any substantial divergence between British monetary policy and international trends by quickly transferring funds offshore.

In short, the further integration of international financial markets reinforced Britain's reliance on its capital account in order to maintain a balance-of-payments' equilibrium. Absent rigorous capital or exchange controls, maintaining a capital surplus depended on a stable pound sterling in order to attract and to maintain foreign investment; and in an environment of highly mobile international capital, stabilizing the pound meant pursuing a non-inflationary domestic monetary policy--at least relative to Britain's competitors for international investment. While other options were available to policy makers, the elements of this situation resulted in considerable and continuing incentives to follow the example of the French and Benelux states in opting for the so-called "strong currency option:" pegging sterling's value to the German deutschmark through the exchange rate mechanism of the EMS, conducting domestic monetary policy in a fashion intended to support this peg, and allowing the force of international trade competition (unmitigated by the possibility of a devaluation of the pound) to combat domestic wage and price inflation, with the ultimate goal of bringing these in line with levels in Britain's EC

trading partners.

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Britain's balance-of-payments:

The United Kingdom's annual trade balance was in deficit for the whole of the 1960s and all but once during the 1970s; increasingly the British were relying upon the export of services (so-called "invisible" exports) to keep the current account (the trade balance plus the balance on other goods, services and income, and private and official unrequited transfers) from collapsing entirely. Fortunately, the balance between invisible exports and imports was in continual surplus throughout the 1960s, 1970s and 1980s. The net result was that until the late 1980s, the British current account deficit never exceeded $7.5 billion (1974); with the exception of the years 1973-1976, the current account deficit never exceeded $1 billion (peaking at $875 million in 1979).

This changed dramatically in the late 1980s, when the current account fell from an annual surplus in 1986 to successive deficits of $7.4 billion in 1987, $26.7 billion in 1988, and $34.1 billion in 1989. Exports were expanding during this period but were unable to keep pace with the rise in imports: the trade balance, which had been in surplus as recently as 1980-1982 (during the British recession), fell to historical deficits of $12.8 billion in 1986, $17.9 billion in 1987, $37.0 billion 1988, and $38.0 billion in 1989. (Previously, the highest annual British trade deficit had been $12.2 billion in 1974.

Meanwhile, the British capital account, which had been in deficit from 1978 to 1985, returned to a net positive position in 1986 and showed massive surpluses in 1988 and 1989 ($25.6 and $19.7 billion respectively). This capital account surplus was sufficient to soften the blow of the current account deficits of 1987 and especially 1988; in that year, despite running a current account deficit of $26.7 billion, the overall balance (current plus capital accounts) was only $1.2 billion in deficit. By 1989, however, with the capital influx slowing and the current account deficit still climbing, the overall balance fell to a $14.3 billion annual deficit.

The Big Bang and London's capital markets:

The switch in Britain's capital account from a deficit to a surplus position was caused in large measure by the deregulation of Britain's financial sector, and especially of the London securities market. Beginning on October 27, 1986, a veritable revolution in British finance (the "Big Bang") resulted in a deepening integration of London's capital markets with those on the continent, in the United States, and in Japan. The City reasserted itself as a leading center of international finance, thanks in part to the low costs of doing business on the London exchanges as well as their well-developed trading structure and liquidity.

In addition to these market qualities, the City's increased attractiveness to foreign investors was a

function of two additional variables: the government's commitment (as demonstrated by the Big Bang) to have London remain a leading, dynamic financial center, and Britain's emergence as a central EC player since the passage of the Single European Act (see below, "International bargaining: the trilateral EC dynamic"). These political factors helped reduce perceptions within the markets of the risk that the British government might someday choose to pursue policies inimical to international capital. Consequently, London has consolidated its position as the financial center of Europe and the world's premier market for international capital. Indeed, recent figures released by the Bank of England indicate that despite adopting similar financial reforms, Germany, France and the Netherlands have not yet effectively challenged the City's dominance as a financial center; in 1990, two-thirds of all reported trading of equities outside their countries of origin took place on the London Stock Exchange (Financial Times, 13 May 1991).

The tradeoff between monetary autonomy and exchange rate stability:

While financial deregulation resulted in a tremendous turnaround on Britain's capital account, much of the influx of foreign capital after 1986 reflected a long term, one-time only relocation of foreign assets. Such transfers eased Britain's balance-of-payments problems on a short term basis, and provided some protection from the impact of

rising trade and current account deficits on sterling. Britain's reserve position declined only negligibly in 1988 and actually improved in 1989 (-$2.4 and +$9.3 billion respectively).

However, because much of the inflow was on a one-time only basis, policy makers recognized that the capital account could not be counted on for continuing relief to the balance-of-payments in the longer term. Britain could not rely on huge capital account surpluses to finance its declining current account position indefinitely; the United Kingdom remained in a state of industrial decline, even relative to its major OECD trading partners. Furthermore, officials at HM Treasury and the Bank of England recognized that financial deregulation represented a two-edged sword. While the Big Bang had ushered in massive quantities of foreign capital, the increasing degree of international financial integration meant that Britain's capital account would in future be subject to equally sudden and broad instances of speculative capital flight--should financial conditions in Britain ever deviate negatively from global trends.

A well-known problematique is formed by the conjunction of financial integration, stable exchange rates and independent national monetary policies. [1] In brief, high and increasing levels of international capital mobility place strains on attempts to achieve national monetary autonomy and exchange rate stability simultaneously. Financial deregulation in 1986 represented

a happy marriage of two elements of Thatcherite ideology--the primacy of markets and the independence of sterling--but guaranteed the second only in the short term. After the one-shot gains in Britain's capital account had been realized, any future decisions by British monetary authorities to induce financial laxity could be punished with alacrity by investors seeking to protect the real rate of return on their capital.

Deregulation meant that funds could easily and almost instantly be transferred out of the London markets to New York, Frankfurt, or Tokyo; in such an event, Britain's current account difficulties would no longer be masked by capital account surpluses but instead exacerbated by net outflows of capital. Faced by the resulting substantial deterioration in the balance-of-payments, the government would be forced to choose between two ills: rectifying the divergent monetary policy (effectively abandoning policy autonomy) in order to protect sterling and maintain balance on the capital account, or allowing sterling to depreciate significantly in order to correct the current account deficit by improving the international competitiveness of British industry.

Yet the experience of Britain and other middle-sized, inflation prone economies in the 1970s, and especially of the French Socialist experiment with reflation in the early 1980s, had left policy makers dubious as to the merits of the latter course. A wide intellectual consensus maintained that under conditions of international capital

mobility, the intended beneficial trade effects of depreciation are generally more than offset by capital outflows spurred on by depreciation itself. Furthermore, substantial depreciations were just as likely to result in domestic price instability as sustained competitive advantage. Depreciations were regarded as tending to beget future depreciations, with the overall balance-of-payments position continuing to deteriorate at any given value of the currency--the so-called "vicious circle" of inflation and depreciation. By the end of the 1980s, capital was substantially more mobile than it had been during the trying years of the European currency snake; the negative consequences of a depreciation strategy were consequently regarded as greater than ever. (Hall 1986, Petit 1987)

Rejecting the "Portuguese" option:

The only way that a depreciation strategy might plausibly result in long term payments equilibrium was in conjunction with the reinstatement and reinforcement of capital, exchange, and possibly even trade controls--in other words, by using the power of the state to insulate the British economy from the forces of international markets. But while this option was feasible in terms of economic theory, it was quite out of the realm of political possibility. The British government had already committed itself to financial deregulation--indeed, securing the City of London's place as Europe's financial center demanded that Britain be a leader in this arena--as well as

liberalizing its trade relations within the EC in conjunction with the dictates of the Single European Act. Implementing the so-called "Portuguese option" (after the left-wing of Mitterand's Socialist government) was an alternative that most Tories rejected on principle and that the reformed Labour center and right regarded as impractical. Only the Labour left, characterized by increasing political isolation and intellectual incoherence, pressed for such an approach. Whereas Mitterand toyed with this isolationist strategy before ultimately and definitively rejecting it in 1983, the Portuguese option was anathema to the mainstream of the British policy community throughout the ERM debate.

It is important to note, however, that British political commitments rather than economic determinism made the Portuguese option unacceptable to policy makers. Consequently, external pressures mounted to abandon practical autonomy over British monetary policy. By the late 1980s, Britain's political commitments to liberal trade and financial deregulation, in conjunction with the British external payments position and the necessity of maintaining sterling's value in order to protect the capital account, significantly constrained British monetary authorities from pursuing any monetary policy that diverged substantially from global trends. Importantly, these constraints on a genuinely autonomous monetary policy existed independently of the existence of the formal institutions of the EMS.

<u>Strategies for constricted autonomy:</u>

While British monetary authorities recognized that their ability to pursue a monetary policy based on autonomously chosen objectives was severely constrained by the confluence of the government's political priorities, the structure of international financial markets, and Britain's perennial trade deficits, there still remained important choices to be made regarding policy strategy. Here it is useful to distinguish between the practical autonomy and the formal strategy of British monetary authorities. The practical autonomy of British monetary authorities vis-a-vis global markets can be conceived of behaviorally and, as explained above, was quite limited given British political commitments. Nevertheless, there were a number of alternatives monetary strategies that were each compatible with this absence of practical autonomy. In other words, practical monetary autonomy--the capacity of monetary authorities to pursue autonomous objectives, understood behaviorally rather than juridically--can be compromised in a number of different and distinctive ways.

Significantly, practical monetary can be compromised by (1) accepting the jurisdiction of some supranational institution to determine national monetary policies (as is contemplated by the ongoing IGC on EMU); or by (2) making official commitments to international partners that the state's central bank will support a pegged currency value (as with the exchange rate mechanism of the EMS); or by (3)

unilaterally establishing an unofficial, de facto peg, lacking regulatory or normative authority (as with Lawson's experiment in shadowing the deutschmark, or with most G7 agreements); or by (4) simply determining to pursue domestic policies that will match international competitors' rates of inflation, thus keeping domestic investment opportunities competitive, and allowing foreign exchange markets to determine the national currency's price in this context. (See Figure 1.)

Figure 1:

"Institutional strategies for coping with constricted monetary autonomy"

Internationalist

1: Supranational authority
2: Formal multilateral targeting by domestic authorities
3: Informal external targeting by domestic authorities
4: Domestic targeting by domestic authorities

Nationalist

It is significant that under conditions of advanced financial integration, none of these alternative institutional strategies (different as they are) represents a purely autonomous approach to monetary policy. Each alternative implicitly recognizes that the interdependence of national economies prevents monetary authorities from pursuing domestically generated preferences without regard to the influences of international markets; each alternative strategy represents a form of behavior that has been modified by this recognition. Nevertheless, despite this common recognition and consequent modification of

behavior, the differences between these alternative monetary strategies are extremely important--because of the relative effectiveness of each in achieving a myriad of policy objectives relative to international markets, the implications of each for the international relations of the state, and the economic and political consequences of each domestically.

Britain under Thatcher: a nationalist monetary policy

The preferred strategy of HM Treasury for dealing with the constraints of interdependence during the bulk of Thatcher years was the fourth option cited: the pursuit of domestic policies designed to match international levels of inflation while permitting the pound to float. British monetary authorities during the Thatcher years aggressively targeted monetary aggregates in order to pursue a rigorously anti-inflationary policy, which in turn served as an indirect defense of the pound and of the current account. This particular response to restricted behavioral autonomy can be called "nationalist," since it focuses attention on both national instruments and goals. With the exception of the shadowing episode, this was the consistent policy of the Thatcher governments until ERM entry; unlike pegging, domestic monetary targeting preserved the appearance of practical policy autonomy as well as underlining the importance of national will in the fight against inflation.

Nevertheless, this proved ultimately to be a high risk strategy, especially once deregulation under the Big Bang was completed. British monetary authorities were able to maintain the illusion of practical autonomy only so long as they were successful in protecting Britain's capital account by maintaining competitive real rates of return for foreign capital. Thus the return of high levels of price instability to the British economy in the late 1980s was a doubly crushing blow to the state's monetary authorities. First there were the economic consequences: price instability had already been driven out of the system once already, at substantial social cost. Now, with the further integration of Britain's capital markets into the global system and the downward convergence of inflation rates among Britain's major EC partners, the external costs of even temporarily diverging from global inflation trends were going to be higher than ever; absent a return to tight money policies that was both swift and sure, Britain's payments position would rapidly be in jeopardy.

Furthermore, the erstwhile successful fight against inflation had not only been a centerpiece of the government's economic agenda but of its domestic legitimacy as well. Thatcher had made a point of associating an (at least nominally) independent pound sterling with British sovereignty; the former was proving increasingly difficult to sustain. The failure to control domestic price instability resulted in steadily mounting financial pressures to abandon Britain's nationalist monetary policy

and to reconcile the practical effects of financial interdependence with an appropriately internationalist monetary strategy.

<u>Summary:</u>

British monetary autonomy was already limited in practical terms by the structure of international financial markets, the government's political commitments, and its payments position well prior to ERM entry in 1990. The unwillingness of political authorities to reverse commitments to financial deregulation and trade liberalization meant that Britain's external position was now entirely exposed: any sustained deviation from global policy trends that resulted in relatively high rates of domestic inflation would doom sterling to cyclical depreciations until either inflation was brought back into line (difficult under the best of circumstances) or the commitment to international capital mobility was abandoned.

The failure of domestic efforts to contain inflation in the late 1980s provided fuel to the fire pushing for ERM entry. It was in this market environment that British monetary authorities eventually switched their approach, abandoning the nationalist approach to policy they had exercised with mixed success throughout the 1980s, and linked sterling with the deutschmark through the exchange rate mechanism of the EMS in October 1990. However, the switch from a nationalist policy to ERM membership represented a shift in monetary strategy rather than a

relinquishment of practical autonomy. The latter was already a casualty of Britain's commitment to the integration of global financial markets.

2. INTERNATIONAL BARGAINING: THE TRILATERAL EC DYNAMIC

The previous section discusses the mounting financial pressures to adopt the strong currency option during the late 1980s. Yet for the ten years following the formation of the EMS in 1979, British authorities had effectively resisted any commitment to the ERM that would limit the formal autonomy of the pound sterling, preferring instead to pursue a nationalist monetary strategy. However, given that monetary autonomy was already greatly constrained on a practical basis, the return of price instability in the late 1980s greatly undermined confidence in the government's ability to successfully defend the British balance-of-payments absent an external discipline in the form of a pegged target for sterling.

Official resistance to adopting the strong currency option via the ERM, already weakened by the failure to maintain control of inflation, finally collapsed when Britain's European Community partners, and especially France and Germany, threatened the British with exclusion from their plans for further monetary integration. Formal negotiations on EMU were scheduled to begin at one of two December 1990 intergovernmental conferences; ERM membership was informally understood to be the "price of admission" for fruitful British participation at this forum. The

British government regarded this threat of exclusion from the dialogue as credible and furthermore considered the prospect of a "two-speed" European unification process, with Britain on the outside looking in, as unacceptable. With the November Rome summit only a matter of weeks away, the primary business of which was to prepare for the December IGCs, the formal announcement was finally made that Britain would join the exchange rate mechanism.

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<u>Bargaining within the EC: the shift to trilateralism</u>

The essence of European Community politics for the thirty years following passage of the Treaty of Rome was a bilateral bargain struck between France and West Germany: the French opened their borders to German exports in exchange for a net transfer of funds through the EC budget to French farmers. This Franco-German understanding remained at the center of EC politics and periodically remanifested itself, as in the creation of the EMS in 1979. Even after Britain finally entered the EC in 1973 (after periodic rebuffs from the French), the British generally remained an "awkward partner" at the periphery of EC bargaining, a condition due in no small measure to continuing ambivalence by a succession of UK prime ministers as to the utility of Community membership.

The Franco-German relationship proved the axis around which Community politics consistently revolved until the passage of the Single European Act (SEA) in 1986.

Negotiations concerning the SEA marked the beginning of a shift in the EC's core relationship from a bilateral Franco-German partnership to a trilateral association that included Britain; this shift has coincided with the passage from a relatively static period in EC development to a far more dynamic evolution recently. (For more on this changed dynamic see Moravscik 1991; Sandholtz and Zysman 1989; Wallace 1986.)

One of the important and continuing characteristics of this trilateral EC relationship is that any two partners can generally coerce the third into accepting an outcome on a major policy issue regarding integration if they can credibly threaten to exclude the third from the initiative's potential benefits. The key to this coercive strategy is twofold: first, the threat must be credible. The two colluding states must convince the third that they will proceed with the initiative regardless of the latter's participation. Second, exclusion must be expensive, "both because the nonmember forfeits input into future decision making and because it foregoes whatever benefits result.

> "If two major states can isolate the third and credibly threaten it with exclusion and if such exclusion threatens the substantive interests of the excluded state, the coercive threat may bring about an agreement at a level of integration above the lowest common denominator." (Moravscik 1991:26; see also Wallace 1986)

This is precisely the set of conditions that obtained during the negotiations of the Single Act in 1986, with historic consequences; it is also the dynamic that prevailed in the build-up to formal EMU negotiations in

1990.

British commitment to the Single European Market:

The dynamic of trilateral bargaining brought Britain to the negotiating table at the 1986 IGC because British officials recognized that remaining outside a unified European market would be extremely costly. In order to understand how these costs were perceived, it is important to understand the nature of British commitments first to the principle of a reformed European marketplace and second to participating in the process of European economic integration more generally. A dramatically liberalized internal market was regarded by many as the triumph of Thatcherism on a regional scale, and "a logical extension of the vision of the Community that had prevailed in Britain since the start of the 1960s." (George 1990:166) The practical appeal of liberalizing European trade was considerable as well. Influential elements of the government and the private sector felt that British entrepreneurs, unlike their continental counterparts, were both accustomed to and adept at competing "on a level playing field;" consequently, it was believed by many that British companies would on the whole gain at the expense of firms that had been long sheltered against international competition.

Above all, the threat of exclusion from the benefits of European economic integration was a genuine concern. Deindustrialization was far more advanced in Britain than

in France or West Germany; consequently, British interests in integration were somewhat different. For example, there was a growing perception in the early 1980s among European businessmen and governments that the US (because of SDI and related military R&D projects) and Japan were outstripping the EC in technological development. (Sandholtz and Zysman 1989) These fears were especially acute in France and Germany, which (unlike Britain) still had internationally competitive capital goods industries. Because British policy makers had already by and large accepted the demise of major sectors of British industry, they were not especially keen to participate in joint European research and developments ventures such as the EUREKA (the European Research Co-ordinating Agency).

Nevertheless, while Franco-German worries about the declining technical prowess and international competitiveness of European industry were not generally shared by the British government, these concerns came to have an important indirect effect on British policy. The desire of the French and Germans to improve their competitive position manifested itself in support not only for joint research but also for a unified European economy. Precisely because British industry was not internationally competitive, non-participation in regional market integration was out of the question. To a much larger extent than the French or West Germans, Britain had come to rely on serving as a conduit for international capital seeking access to European markets. The integration of

continental markets without including Britain could have potentially devastating effects on the balance-of-payments picture; an exodus of offshore companies and capital might well result.

In concert, these three forces--the internal market's ideological appeal, confidence in British entrepreneurial skills, and fear of exclusion from a successfully integrated Western European marketplace--combined to create an enormous and continuing enthusiasm for the project in London among both policy makers and industrialists. It was as a consequence of this appeal that the sustained Franco-German threat of pursuing integration "a deux vitesses" was so effective. (Taylor 1989, Moravscik 1991) The British commitment to financial market integration has already been discussed ("Market forces: Britain's external position"). But British policy makers were ultimately committed to participating in the full panoply of European economic integration, or at the very least unwilling to reject participation in those initiatives which might plausibly proceed without them. It was this bargaining dynamic which caused London to agree, however reluctantly, to the convocation of intergovernmental conferences in 1986 and again in 1990.

The debate over EC institutional reform:

As Helen Wallace wrote in 1986, "The internal market is important not only for its own sake, but because it is the first core Community issue for over a decade (as

distinct from EPC) which has caught the imagination of British policy-makers and which is echoed by their counterparts elsewhere.

> "Among its other effects, an internal market policy would redress the balance against the all-engulfing claims of the CAP. The pursuit of a thoroughly liberalized domestic European market has several great advantages: it fits Community philosophy, it suits the doctrinal preferences of the current British Conservative government, and it would draw in its train a mass of interconnections with other fields of Community activity." (Wallace 1986:590)

It was, however, precisely this "mass of interconnections with other fields of Community activity" that the British government (and especially the British prime minister) wished to avoid. Thatcher was unwilling to link progress in negotiations towards liberalizing EC trade with dramatic institutional reforms (including monetary reform) of the Community.

Sterling's non-participation in the ERM was symptomatic of a more widespread disagreement between Britain and its EC partners as to the ultimate role of the Community's institutions. Whereas many of the original EC members looked to substantial institutional reforms of the EC in order to realize their substantive ambitions, the British adopted a position they characterized as pragmatic: limited institutional reforms on an as-needed basis to address substantive difficulties only as they arose. The forceful presentation these ideas in the discussion paper tabled by the British delegation at the 1984 Fontainebleau summit represented a serious attempt by the government to persuade its European partners of the correctness of the

British approach of limited and practical steps; this position stood in sharp contrast with major institutional reform "which was the preferred path of progress of Italy and the Benelux states, and to which the French and West Germans paid intermittent lip-service...

> "The Fontainebleau paper was the first of a series of attempts by the British Government, not to take over directing the Community, but to get a hand on the steering wheel to guide the vehicle away from the institutional quagmire, which most British officials felt that their partners also really wished to avoid. Unfortunately, the British appear to have severely underestimated the genuine commitment of some of their partners to such institutional reform..." (George 1990:177,167)

One area in which this commitment was long abiding was monetary policy. The EMS was a genuinely successful multilateral institution and was regarded with pride by most European officials. Britain's failure to participate fully in the EMS was understood not simply to represent technical difficulties associated with the pound sterling, but to imply resistance or even rejection of the goal enunciated at the 1969 Hague conference of a common European monetary policy and eventual European monetary unification. As such, the independence of sterling from the regional exchange rate arrangement constituted a continuing affront to European sensibilities and a continuing reminder of Britain's ambivalent relationship with the Community.

EMU: Thatcher and Delors

Until 1988, Thatcher was able to quietly resist the

pressure applied by several of her senior ministers to reconsider British policy towards the EMS; the almost mystical position adopted by the Treasury, that Britain would enter the exchange rate mechanism "when the time was right," had proved adequate to resist continental overtures. But Geoffrey Howe and Nigel Lawson, the foreign and finance ministers respectively, were increasingly prepared to challenge the prime minister on this subject. In their view, developments in both international economics and interstate politics were indicative that the time for entry was already right, and had been so for some time; further delay would only endanger Britain's material interests and its authority within Europe. This cabinet level debate, while often suspected by political observers, was tightly masked for a number of years by the principle and practice of cabinet unanimity. The tense standoff between Thatcher and her appointees was ultimately undone, disturbed first by a domestic political scandal and then by events in Europe and especially at the European Commission in Brussels.

In February 1988 Nigel Lawson was obliged to reveal that, in connection with his duties as Chancellor of the Exchequer, the Bank of England had been shadowing (at his direction) the movement of the ERM member states' currencies, making the pound a _de facto_ if not yet _de jure_ member of the exchange rate mechanism. Thatcher was infuriated by this admission and, when the pound came under upward pressure in March, she intervened directly to quash

this insubordination of her policy. In remarks before the House of Commons, she reiterated that the government's chief priority was to fight inflation, and that "excessive intervention" by the Bank of England to resist market forces was incompatible with this objective. On this news, sterling promptly exceeded its unofficial ERM margins. Much the same episode was repeated in May, and it was widely assumed that Lawson would soon step down.

However, foreign minister and former Chancellor of the Exchequer Geoffrey Howe came publicly to Lawson's support with an announcement of the Foreign Office's support for the EMS. This extraordinary public split between the prime minister and her senior colleagues took place with the next EC summit scheduled to take place in just one month, and seemed to promise new dialogue and perhaps even compromise by the Iron Lady. This was not to happen. A week before leaving for the summit, Thatcher argued before the House of Commons that the necessary corollary of a European bank was a European government; that Britain's EC partners were, truth be told, equally reticent about that possibility as she was; and that forging the internal market and creating a monetary union were entirely separate and unrelated objectives. Her summit partners at Hanover did not agree; instead, they authorized a committee to investigate strengthening the current EMS and to recommend "pragmatic steps" towards the goal of further European monetary integration. European Commission president Jacques Delors was appointed as chair.

While the summit communique omitted all reference to either a European central bank or a common European currency in deference to the British position, Delors' mandate was clear. As Lord Cockfield put it in October, "no one need have any doubt about what is intended or where we are going." Indeed, Thatcher herself entertained no such doubts, and was unreserved in her condemnation of what she considered a federalist scheme. Later that same month she told reporters that "I neither want nor expect to see such a bank in my lifetime, nor, if I'm twanging a harp, for quite a long time afterwards...

> "A European central bank in the only true meaning of the term means surrendering your economic policy to that banking system that is in charge of the maintainence of value of the currency and must therefore be in charge of the necessary economic policy to achieve that...So..what I suspect they will attempt to do is to call something a European central bank which it isn't and never can be." (cited in George 1990:192)

Meanwhile, Delors made a series of public remarks which further irritated the British prime minister. In a speech before the European Parliament in July 1988, he predicted that eighty percent of economic legislation would be directed from the Community rather than the individual members states in as little as ten years. Thatcher responded in an interview with the BBC, characterizing the Commission president's remarks as "over the top" and intended to frighten people. Delors raised the stakes in a speech before the annual conference of the TUC in Bournemouth, where he argued that "it is impossible to build Europe only on deregulation...The internal market

should be designed to benefit each and every citizen of the Community." He went on to outline his conception of the "social dimension" of the 1992 program, based on principles of protection of social security benefits, improved health and safety standards, Europe-wide collective bargaining, guaranteed rights to work and protections of temporary workers.

Thatcher regarded Delors machinations as nothing less than a socialist plot: leftist planks that had been defeated at the polls were being introduced covertly through a European bureaucracy. She explicitly argued as much at the October CP conference in Brighton. But before that, she used the occasion of a September address before the students of the College of Europe in Bruges to deliver her most damning indictment of the Commission and of European federalism to date. The texts of the two speeches are similar in tone and content, and amount to a declaration of war on Delors' vision of an integrated Europe. Thatcher warned that Delors statements were at odds with the spirit of the Treaty of Rome, which (in her view) enshrined liberal economic values. "Today, that founding concept is under attack from those who see European unity as a vehicle for spreading socialism. We haven't worked all these years to free Britain from the paralysis of socialism only to see it creep through the back door of central control and bureaucracy in Brussels."

The Bruges speech was immediately notorious; Jenkins writes that Thatcher supervised composition of the speech

herself, authorizing the use of language that was against both the advice of officials "and what ought to have been her own better judgement."

> "When the Foreign Office had submitted notes for the speech they went straight into the waste paper basket. When the Foreign Office saw the next version it was considered way over the top; she considered it too wet by half. What she eventually said...was, I am told, considerably toned down from what she would like to have said. She was restrained from delivering a speech which, instead of merely distressing and depressing our European partners, might have done lasting damage to our national interests." (The Independent, 22 September 1988)

Even so, Britain's EC partners were genuinely troubled by the prime minister's remarks, which occasioned an immediate counterattack by several heads of government supportive of Delors and the work of the Commission.

The intergovernmental conference threat:

It is important to recognize that the British position on the EMS, while admittedly awkward, had proved remarkably sustainable during the institution's first ten years of existence. The British were official members of the System, depositors to the European Monetary Co-operation Fund, and sterling was an element of the ECU; on the other hand, sterling was not a member of the exchange rate mechanism and hence not subject to any regional commitments regarding its value. The official position of the government--that sterling would enter the exchange rate mechanism "when the time was right"--imposed no substantive preconditions or deadline for entry: only the government would determine when the right time had arrived. In

contrast, any threat by its European partners to convene an intergovernmental conference on monetary union, to the degree that the threat was credible, would provide an external incentive and an exogenous deadline for the government's decision making process; otherwise, Britain's failure to accept present levels of EC monetary integration would threaten to exclude it from both the inner circle of the IGC as well as from whatever potential benefits might emerge from the process there agreed upon.

Following Thatcher's Bruges speech, just such a threat was forthcoming. The prime minister's remarks ignited a storm of protest in Europe, culminating in a joint declaration by the leaders of four center-right EC governments. Helmut Kohl of West Germany, Wilfried Martens of Belgium, Ruud Lubbers of the Netherlands, and Jacques Santer of Luxemburg used the occasion of the annual European conference of Christian Democratic parties to repudiate the British leader's position and publicly express their support for Delors. Their communique called for a European central bank, a common security policy, and EC guidelines for the Single Market's social dimension. This remarkable demonstration of support by the leaders of four of the original EC six--none of them leftists--further isolated the British prime minister and undermined her characterization of European institutional reform as a socialist plot.

Importantly, the joint declaration by the Christian Democratic leaders called for an intergovernmental

conference to consider the reforms necessary to the Treaty of Rome in order to achieve their stated policy aims. This was an alarming development in the view of the Foreign Office, since IGCs, the European equivalent of an American Constitutional convention, are potentially wide-open affairs that might threaten the status quo generally. Britain had unsuccessfully resisted an IGC associated with the Single European Act, but had managed to keep those proceedings focused on the internal market--an objective that London wholeheartedly endorsed. An IGC on monetary union threatened to extend itself well beyond British control, particularly since the British objections to further integration were definitely in the minority and perhaps even unique.

Nor was the British government's position entirely singleminded. Thatcher's isolation within her cabinet was once again underlined by a November speech by Sir Geoffrey Howe to a meeting of MEPs. Howe had already expressed his support of the EMS, following the row over sterling shadowing the ERM; here he took the opportunity to reiterate his position. The meeting was occasioned by the retirement of Lord Arthur Cockfield as British minister at the European Commission (Thatcher, unhappy with Cockfield's increasingly pro-EC positions, had him replaced in July by Sir Leon Brittan). In a meeting to honour the retiring minister, Howe expressed support for Lord Cockfield's efforts at the Commission and endorsed his conception of the internal market as but one element of an ongoing

process of European integration. In other words, Thatcher's foreign minister once again publicly, if politely, repudiated the prime minister's well-known views on the proper future of Europe.

<u>The Madrid summit: the beginning of the end</u>

The "Report on Economic and Monetary Union in the European Community"--the so-called Delors report on EMU--was scheduled for presentation at June's EC summit in Madrid. Britain's EC partners ended up conditionally endorsing Delors' vision of future European monetary integration while temporarily postponing the potentially divisive issue of formally planning an intergovernmental conference; it was understood, however, that this was merely a pause in order to more fully absorb the committee's recommendations. Remarkably, the British delegation does not seem to have been especially well-prepared for events in Madrid (interviews); while there had been quite a bit of dialogue within the government on the subject of EMU prior to the summit, the eventual policy declaration seems to have been a product of the moment. (One informant describes this as typical of European Council meetings, in which "white heat" generates joint declarations that are quite beyond the expectations of individual member states prior to arrival. Certainly this has been the British experience.) This spontaneity may have actually been the intention of Howe and Lawson, who together with the prime minister ultimately hammered out

the text of the Madrid conditions at the meeting itself. (Sir Alan Walters disputes this, but no one seems to take him seriously; see The Economist 9-15 March 1991:21.)

The "Madrid conditions" to Britain's ERM entry reflected Howe's views on Europe and the necessity of constructively engaging Britain into the EC integration process more closely than those of the prime minister. Together with Lawson, Sir Geoffrey seems to have at last convinced Thatcher that more than just a credibility gap but an "incredibility barrier" had developed around British policy towards the exchange rate mechanism. By enunciating the principles that would guide the government's assessment of when "the time was right" for entry, Britain could smash this barrier while still remaining in charge of the actual assessment; Howe and Lawson stressed that this was the minimum price that could be paid in order to retain "a voice at the table" regarding the future shape of EMU. Thatcher, cornered at last and on unfamiliar ground, consented reluctantly and issued the policy statement. (interviews)

The "Madrid conditions" were announced as five necessary preconditions that would serve as guidelines for eventual British accession to the exchange rate mechanism: liberalization of the regulations affecting capital movement within the Community; "real progress" towards completion of the Single Market; freedom of financial services across borders; a strengthened EC competition policy; and a UK inflation rate convergent with the

Community average. Significantly, all the conditions save the final one involved concessions or reforms by other countries or institutions; only convergent inflation represents a concrete domestic objective. During the winter of 1989-1990 a mass of Community agreements were reached in each of these first four areas. Indeed, in early 1990 France unilaterally rescinded its remaining regulatory barriers to capital movement, six months ahead of the schedule laid done in the SEA. Only British inflation remained to be conquered.

Perhaps even more significant than their fulfillment, the very fact of the formal enunciation of the Madrid conditions marked the beginning of the end of the Thatcher government's policy of continual postponement of any decision regarding entry to the exchange rate mechanism--a postponement that amounted to a tacit rejection of the EMS. The threat of exclusion from an intergovernmental conference on monetary union proved to be sufficient to convince leading members of the government that ERM entry was not only appropriate but now urgently necessary.

It is true that the Madrid conditions themselves did not oblige the government to join the ERM at any particular time, any more than under the previous regime of joining "when the time was right;" in both cases the government itself was the ultimate arbiter of whether the principles embodied in the conditions for entry had been met. Rather, the significance of the Madrid conditions is that they represented a shift in the balance of power and especially

persuasion within the government itself: the threat of exclusion from a meaningful role at the IGC was sufficiently credible that senior ministers were willing to risk their political careers in order to achieve what they considered to be necessary changes in British policy towards the EMS and towards Europe more generally.

From Madrid to Rome: accession to the ERM

Thatcher herself quickly sought to redress this shift in internal power by punishing both Sir Geoffrey and Lawson for their role at Madrid. Howe was demoted from his position as foreign minister in July and replaced by the relatively unknown John Major. Lawson at last resigned in October after yet another public display of prime ministerial pique at his performance (the Sir Alan Walters scandal). He was replaced, as Howe had been, by Major; the latter's tenure as foreign minister lasted only three months before his transfer to the Treasury and replacement at the FCO by Douglas Hurd. This rapid reshuffling of appointments was intended both to serve as a demonstration of the prime minister's continued control over her government, and to delegitimize the Madrid declaration that she had come almost instantly to regret.

But to a significant degree, the die had already been cast; events were already in motion in Britain and on the continent demonstrating that for Britain's monetary policy, the status quo was no longer a politically viable option either internationally or domestically. The two men who

took over at the the Foreign Office and the Treasury were careful not to repeat the mistakes of their predecessors by crossing Thatcher, either publicly or privately. But both were decidedly more pro-Community than the prime minister, and both were skilled at structuring their presentation of situations such that Thatcher was drawn into a series of incremental decisions with precisely the ultimate effects intended by Howe and Lawson. (interviews) Furthermore, both headed ministries at Whitehall whose senior mandarins favored ERM entry well prior to the IGC deadline.

It is significant that the Bank of England and to an increasing degree the Treasury had came to the view that ERM entry was both desirable and inevitable. The inevitability was regarded as political and especially diplomatic, and therefore not openly discussed. However, Treasury and Bank officials made little secret of their envy of the performance of the West German economy under the disciplinary leadership of the Bundesbank. Whereas the successful efforts of the early Thatcher years to control domestic inflation had once tempered this envy, the resurgence of inflation in the late 1980s (and especially the fall in interest rates in the months leading up to the general election of 1987) provoked wistful remarks not only about the ERM but also a more independent Bank of England.

For its part, the Foreign and Commonwealth Office has taken a long standing and consistently internationalist position on the conduct Britain's monetary policy--and in particular on the protection of sterling. While the FCO

nominally gives way to Treasury's expertise on these matters, in fact there is close coordination on policy between these two ministries. Official interest by Britain's diplomatic ministry in the exchange rate mechanism should be seen as part of a recurrent pattern rather than as an aberration.

Interest at the Foreign Office intensified once the dispute between Thatcher and Delors took on its increasingly ugly and public character. Particularly following Thatcher's Bruges speech, the FCO was deeply concerned that the prime minister's running feud with the Commission president was further isolating from Britain's EC partners. The fall 1988 threat by Europe's Christian Democratic leadership to convene an IGC on both political and monetary issues underlined this fear and had bells ringing: Thatcher's personal antagonisms were increasingly regarded as threatening Britain's long standing interests and policy objectives with regards to Europe. Moreover, whereas Treasury officials were reluctant to acknowledge that the December IGC loomed as a political deadline for ERM entry, Britain's diplomats well understood that full and active participation in the EMS was imperative in order for Britain to have an effective voice at the negotiating tables of the two conferences.

The December EC summit in Strasbourg took the expected step of officially calling for an intergovernmental conference on EMU to be convened in one year's time, despite Thatcher's objections. As the IGC

deadline approached, the British position on EMU took an interesting turn. Early in the summer of 1990, the semi-official British Invisible Exports Council (BIEC) published a report by Sir Michael Butler calling for the establishment of a "hard ECU" as an important reform paving the way to eventual EMU. Butler's report had been reviewed by Treasury officials prior to publication, and an official paper calling for much the same thing soon emerged from Whitehall.

Paradoxically, the logic of the proposal appealed to both supporters and detractors of EMU within the British government. The prime minister endorsed it in part because it was congruent with market ideology but especially because it promised to alter the very meaning of EMU: the goal now became a "common" (thirteenth) European currency, which investors could employ if they so chose, rather than a "single" and imposed currency replacing sterling. Many Tory backbenchers and Conservative Party activists openly welcomed the notion of a hard ECU (and eventually ERM entry as well) as a ploy by the Thatcher government, first to gain access and then to obstruct any continental schemes for a _dirigiste_ European monetary policy hatched at the EMU negotiations.

The response of Britain's EC partners to the hard ECU proposal was, however, tepid at best. Delors and others welcomed it as a sign of increased seriousness on the part of the British, but recognized that it did not respond to the central ambitions of either of the continent's leading

EMU proponents, Paris and Bonn. The French government hoped to use EMU to gain some degree of influence over the _de facto_ European currency, the deutschmark. For its part, Germany's central bank was decidedly unenthusiastic about the prospect of muddying the foreign exchanges with yet another currency. Officials at HM Treasury appreciated these concerns, but regarded the proposal as a genuinely pragmatic solution to certain real problems associated with implementing the Delors Report. Their position was an awkward one, as most anticipated a change in the government's policy towards both the ERM and and EMU; in the meantime, loyalties were confused. While acknowledging that the proposal had the quality of stalling maneuver, many Treasury officials genuinely hoped that the hard ECU would serve as the basis of a compromise solution should fast-track EMU talks break down.

One effect of the proposal was clear: it provided the prime minster with political cover for participation in the intergovernmental conference, and hence indirectly for entering the exchange rate mechanism. While the intergovernmental conference itself was not scheduled to begin until December, the Italian presidency of the European Council had called for a November summit in Rome in which the general mandate for the IGC would be determined. Major and Hurd, together with Whitehall's most senior officials, patiently explained the inescapable logic of the IGC deadline, and Thatcher finally authorized ERM entry for October 8, 1990. The central domestic condition

laid down at Madrid for British entry, an inflation rate converging on the Community average, was still markedly absent; but Treasury officials finessed this issue by declaring that levels of British price instability were now in the process of converging (that is to say, they were heading in the right direction). Greatly relieved, Treasury and FCO officials set about preparing their briefs for the November EC summit in Rome, unaware that it would be the prime minister's last.

Summary:

British monetary authorities had chosen to cope with the limited autonomy left them, given the government's dual commitments to financial deregulation and maintaining the pound's value, with a nationalist monetary strategy: achieving a competitively low inflation level through the practice of rigorously controlling the expansion of the domestic money supply. This strategy eventually left something to be desired in terms of its effectiveness, as discussed in the first section of this study; but it also constituted an affront to Britain's major EC partners, which had since 1979 participated in a regional exchange rate arrangement which had both successfully stabilized intra-European currency values and resulted in a downward convergence of national inflation levels.

Britain's refusal to participate in the exchange rate mechanism of the ERM was transformed from a sore spot in EC relations to the central focus of European political

attention when British prime minister Margaret Thatcher challenged both the authority and the intentions of European Commission president Jacques Delors regarding his advocacy of eventual European monetary unification. Britain had long been at odds with its EC partners as to the need for major reform of the Community's central institutions, but Thatcher's vicious attacks on Delors at Bruges and elsewhere prompted a coalition of EC voices to express their support for the Commission president and to call for an intergovernmental conference to authorize some version of his vision.

This threat effectively linked both the British commitment to the success of the Single Market and even more importantly British resistance to being shut out of the inner core of EC integration with some sort of compromise on the issue of a common European monetary policy. Thatcher resisted this linkage to the last, hoping to use ERM entry and the Treasury's hard ECU proposal as a means to sabotage any efforts to create a single European currency. But the balance of power within her own government had changed, as manifested by the rebellion of her senior ministers at the Madrid summit and later by her own fall from power. The credibility of the Franco-German threat to proceed with monetary unification without the British--or with the British in a secondary position--proved sufficient to bring the government to the EMU bargaining table and to exact ERM entry as the price.

3. DOMESTIC POLITICS: TRANSFORMING BRITAIN'S POLITICAL ECONOMY

Having formally entered the ERM, realizing the desired economic benefits of adopting the strong currency option--allowing the force of international trade competition to combat domestic wage and price inflation--depends critically on the British government's ability to convince both labor and industry of the credibility of the pound's peg to the German deutschmark. In other words, the success of the strong currency option depends in large part on assessments made in the private sector: assessments of the government's political will to sustain the peg in the face of pressures to abandon it, as well as the likely impact of party competition and possible changes in government on ERM policy.

The key here is for the monetary authorities to convince these groups that staying in the ERM is a critical foreign policy goal of the state. As a general matter, when domestic interest groups become convinced that their currency's value on international markets has become a foreign policy issue, they are likely to modify their demands on the government (for devaluation or lower interest rates) and on each other (for wage and price concessions) accordingly.

The credibility of the government's commitment to the strong currency option was initially weakened by a drop in base rates simultaneous with the announcement of entry into the exchange rate mechanism. In recent months, the rise of

the dollar (and, to a lesser extent, the pound sterling) against the German deutschmark on foreign exchange markets has provided British monetary authorities with an window of opportunity to reduce interest rates still further while maintaining the pound's position within the exchange rate mechanism. As a consequence, the government's underlying will to sustain the peg in the face of tough market conditions and political pressures is still largely untested.

...

The strong currency option and the externalization of policy:

The strong currency option consists of pegging the value of sterling to some external, relatively non-inflationary target and conducting monetary policy with the objective of maintaining that peg. The economic logic of the strong currency option is relatively straightforward. With the possibility of a devaluation either reduced or eliminated, the force of international trade competition can be expected to combat domestic wage and price inflation. Since British producers can no longer look forward to having the monetary authorities intervene to improve the international competitiveness of their products, rising production costs associated with wage inflation above global trends will result either in a squeeze on profits or, if the costs are passed on to foreign consumers, the loss of international market shares.

Producers therefore have every incentive to take a harder line in wage negotiations, rather than expecting to be "bailed out" by future devaluations. Labor will likewise eventually recognize that wage increases beyond productivity levels will result in reduced foreign sales and ultimately reduced jobs; consequently, trade unions will reconcile themselves to more modest and internationally competitive wage demands.

Achieving these desired economic results, however, hinges on labor and industry accepting the government's commitment to the peg as irreversible. What are the shared perceptions of industry and labor of the government's will to maintain the peg in the face of domestic pressures to abandon it? Herein lies the political logic of the strong currency option. Importantly, a politically credible peg can result in the externalization not only of policy targets but of policy accountability. As a consequence, a credible peg can limit the government's domestic political accountability for what may well be unpopular monetary policies; monetary authorities are "liberated" to pursue sometimes restrictive policy preferences that would otherwise prove politically impossible.

The political credibility of the peg can be either a self-reinforcing or self-destructing phenomena. To the degree that the link between sterling and the German deutschmark through the ERM remains credible (or, put differently, politically certain), societal actors will accommodate a situation they regard as irreversible and

invulnerable to domestic pressures by moderating their demands on policy (specifically, their demand for lower domestic interests rates and/or a devaluation of sterling) and on one another (in terms of wage and price concessions). Conversely, as the credibility of the sterling-mark link is challenged, this accommodation of policy will diminish; monetary issues will become repoliticized in the domestic context. Effective depoliticization is a consequence of convincing societal actors that policy divergence will cost the state dearly in its foreign relations--in other words, that monetary policy should be treated as a unifying foreign policy issue rather than as a potentially divisive domestic matter.

The significance of the political logic of the strong currency option--the externalization not only of policy but of accountability for policy--has been generally underestimated in most accounts of the successful convergence of ERM member states' inflation rates during the past eight years. Beginning with the reversal of French monetary policy in 1983, convergence must be understood at least in part in terms of a successful strategy of externalizing accountability for unpopular policy decisions: the opportunity to blame the Bundesbank for tight money policies in France and Italy, for example. The EMS, which raised the international political costs of monetary policy divergence by associating the same with a highly visible EC institution, at the same time lowered the domestic political costs of pursuing restrictive policies

by externalizing and depoliticizing monetary policy altogether in the non-German countries of the ERM.

The critical matter facing the British government, as with any other government hoping to reap the disinflationary benefits of the strong currency option, is to persuade major societal actors and political associations to moderate their demands (for devaluation, lower interest rates, higher wages and higher prices) and to accommodate the government's external objectives. In effect, the state is attempting to reform the very bases of Britain's political economy: to alter both the sectoral sources of the policy preferences of the national monetary authorities and the domestic political constraints these authorities face in the pursuit of policy objectives. To be successful in the long run, this reformation process must convince societal actors of two things: that the government's will to sustain the peg is indefatigable, and that a change in government will not result in a change in policy.

British monetary policy: tactical maneuvering since ERM entry

The credibility of the government's commitment to the strong currency option was initially weakened by a full point drop in base rates simultaneous with the announcement of entry into the exchange rate mechanism. Sterling quickly fell to near the bottom of its ERM bilateral parity grid with the deutschmark, and there was a political furor

about the high entry rate of 2.95 DM. In general, there was widespread unwillingness by the financial markets to take the British commitment fully seriously; the timing of the announcement with the last day of the annual Labour Party conference underlined this cynicism. Thatcher's performance at the Rome summit, far from assuaging doubts, underlined the credibility gap of the British commitment.

Within weeks, however, Thatcher was gone--and replaced not by Michael Heseltyne but by John Major. He succeeded both in consolidating his position within the CP and almost instantly in forging stronger political connections with the rest of Europe. Major was fortunate in that he was widely known to be Thatcher's personal choice for succession and because he inherited ERM membership from her; these facts tended to mitigate efforts by the Tory right to reverse the Europeanization of monetary policy, despite their misgivings about Major centrist leanings.

More important for sterling than Major's solidifying position, however, was a renewed enthusiasm in the foreign exchange markets for the dollar. When the blockade of Iraq began in the summer of 1990, the dollar was notably passed over as a safe haven currency in favor of the deutschmark. However, the spectacular conclusion to the war in early 1991, combined with increasing fears about the economically destabilizing consequences of German unification and the apparent bottoming out of the U.S. recession, resulted in a belated surge in dollar values. The effect of the dollar's

rise against the deutschmark was to further strengthen sterling's position within the ERM. Britain's close links with the American economy resulted in relative gains against the German currency, which itself tends to be polarized against the dollar.

Consequently, the rise of the dollar (and, to a lesser extent, the pound sterling) against the deutschmark on foreign exchange markets has provided British monetary authorities with an window of opportunity to reduce domestic interest rates still further while maintaining the pound's position within the exchange rate mechanism. Bank base rates were cut from 15 percent when Britain joined the ERM in October to 12 percent in April, including four half-point cuts in a two month period. The regularity and cumulative depth of these cuts were made possible by sterling's sudden and unexpected strength within the ERM; they were legitimized by apparent progress in the statistically confusing fight against domestic inflation.

The problem now faced by the government has been to take advantage of this window of opportunity without weakening market perceptions about the long term commitment to hold the line on inflation. The opportunity to lower interest rates while tackling inflation AND holding against the mark is an extraordinary one, and especially fortuitous for the Conservatives with a general election mandatory within the year. However, it is precisely the perception of political opportunism that the government wishes to avoid: the credibility of the long-term commitment of the

Treasury to pegging sterling rigorously to an external, low-inflationary target depends on it. For this reason, monetary authorities have resisted pressures for yet another cut in base rates since the last drop in April despite the existence of enabling technical conditions.

In short, the government has exercised a degree of restraint in its pursuit of the politically opportunistic goal of lowering interest rates prior to a general election. However, sterling's strength in the ERM (largely inherited from the dollar's post-war boom) has reduced the degree of discipline that was expected to accompany participation in the EMS, at least in the short run. While the government's political commitment to the ERM seems sound, it remains for the most part untested; furthermore, the very meaning of ERM membership in terms of inflationary expectations is unclear, given the unknown impacts of German unification and the imminent departure of the Bundesbank's president. Market expectations of future inflation in the long term--the gap between nominal and expected real rates of return reflected in the price of index-linked gilts--remain around six percent annually, well above the Treasury's stated goal of a four percent annual rate by year's end. Likewise, British labor and industry seemed to have taken a cautious approach to the ERM: they have moderated their inflationary expectations, but not as deeply as their government would like.

Party competition and the ERM: Labour's reformation

The second critical factor in private expectations about future inflation and the credibility of the sterling's peg within the ERM, after assessments of the standing government's political will on the matter, is the market's estimation of the likely impact on monetary policy that a change in government would produce. What would a Labour government mean in terms of Britain's commitment to the ERM? Here the analyst of political risk must evaluate the recent and evolutionary reversal of Labour's longstanding objections to Britain's further integration with the rest the European Community by the party's leadership. Labour's motives in this regard can been seen as both opportunistic and principled. The policy reversal was certainly tactically advantageous as an attack on a perceived weakness of Margaret Thatcher's Conservative Party. However, Labour's new views on Europe and the economy seem to reflect a genuine change in philosophy as well, as a new generation of Labour MPs have come to reject major elements of the party's traditional tenets.

The Labour Party's reversal of official policy on such central matters as the direction and goals of macroeconomic policy brings to mind the experience of the French left in the early 1980s. Despite certain parallels, important differences exist: for one thing, the French Socialists were in power when they underwent their change of heart. Labour's commitment to free market economics,

either at home or abroad, has been untested in the crucible of practice. But unlike the French in 1983, the Labour Party leadership in 1991 has the benefit of examining the effects of eight years of deflationary convergence on the continent-- political as well as economic effects. There is considerable evidence that important figures in the party have taken certain of these lessons to heart. The emerging intellectual consensus within the Labour Party has important implications for the future of British macroeconomic policy generally, and bears close examination.

The success of the Thatcher experiment in delegitimizing the principle, if not the practice, of an expansive state is astounding. This is especially important, given the lessons that the Labour Party leadership would draw from the Thatcher experience. Like the Conservatives, Britain's Labour Party is institutionally predisposed against dynamic state intervention--except on behalf of organized labor itself. More than most leftist parties in Europe, the British Labour Party has been linked almost exclusively with the trade union movement. This has had important consequences for party strategy; most notably, Labour's attempts to produce high levels of employment and to increase wages have remained unmitigated either by association with other interests or by a more comprehensive ideology. Consequently, despite its traditional support for nationalization of industries, the LP has been

ideologically opposed to many other forms of state intervention.

If Labour governments are not known for advocating a comprehensive and <u>dirigiste</u> industrial policies by continental standards, the party is nevertheless associated with a combination of fiscal laxity, weakness in dealing with union demands, and a willingness to time economic growth with the political cycle. Truth be told, CP and Labour governments had similar postwar records in each of these regards; but Thatcher's effective demonization of the Heath government (see Young 1990) and other accommodationist experiments as a rejection of true Conservatism had resulted in a new set of public expectations. Labour governments, Thatcher insisted, were not to be trusted with policy generally and with monetary policy in particular.

Labour's traditional policy towards Europe was also suspect, and once again associated with a bygone era. Until October 1983, the Labour Party had been resolutely opposed to almost any form of European integration. The eventual reversal of this policy was tied in no small measure to Labour's declining electoral fortunes. Labour's influence in British politics has been in consistent decline since the 1975 referendum (called by the Wilson government) on the renegotiated terms of UK membership in the European Community. Labour's forthright opposition to the Community over the years may have been in concert with the leadership of the trade union movement, but it has

increasingly diverged from public opinion--including opinion within the working class. "Since 1975," writes Rogowski, "and even more so since Margaret Thatcher's rise to power, Labour's left wing has continued to repudiate Europe and indeed has moved into open endorsement of protection. This policy, almost self-evidently suicidal to workers in so labor-rich a country as Britain, makes sense only as a last-ditch defense of the various rents that privileged groups within British labor have long been able to extract and that cannot withstand international competition: it is Decazeville on a grand scale," referring to the 1961-62 strike by protectionist French miners. "Labour runs every risk of joining the French Communists on the ash heap of history." (Rogowski 1989:104)

The decline in Labour Party influence has coincided with the rising popularity of the EC within Britain, as revealed in Table 1. Notably, by 1989 an absolute majority of Britons regarded EC membership as "a good thing," as against only one out of every six opposed. The extent of this shift in public opinion (especially after plans for the Single Market were announced) went largely unnoticed by opponents of the EC on both the left and right (interviews); only weeks before Thatcher's resignation they were still inclined to repeat the familiar chant, "nobody ever lost any votes by being opposed to Europe." Remarkably, the Labour Party chose to resist this growing tide of popular support for the EC by adopting a series of

anti-EC stands: the referendum of 1975 and then opposition to EC membership in the party platforms of 1979 and 1983.

While opposition to the EC may have been Labour's official policy, a majority of the party--mostly from its center and right--privately favored continued membership as early as 1979, and many openly regarded the 1983 anti-EC platform plank as an anachronism and an embarrassment. (interviews) Consequently, among Neil Kinnock's first actions after taking over the party leadership following the disastrous election results of 1983 was to insert language in an October party statement quietly reversing Labour's longstanding opposition to the EC. Since that time the Labour leadership has been trying to develop a strategy that would outflank or at least pressure the Conservatives on Europe without completely alienating the party's left.

Central to this strategy has been incrementalism: avoiding a public reversal of longstanding positions and pledges, while slowly distancing the party from their effects. By the time of the 1987 party platform, exiting the EC was no longer even serious debated; the moderate position that the leadership had assumed in 1983 was solidified. Buoyed by that internal victory, Labour's new leadership has since become increasingly assertive on the European front, no longer limiting themselves to passive acceptance of EC membership. Following the 1987 election, the party initiated a comprehensive two-year policy review. The review process culminated with formal discussions

between senior party members and leaders of the European Commission in Brussels, the West German SPD, and the French Socialist government; a conscious effort was underway to reformulate party policy along the more progressive lines of these continental counterparts.

A critical moment during this period of introspection came with the 1989 Europarliament elections. Labour's victory in this campaign cemented the leadership's notion that Europe had become a weak issue for the Tories and was an opportunity waiting to be exploited. Labour Party strategists point to this election as "Thatcher's only loss," despite the fact that she was not running; nevertheless, the event galvanized the party's imagination. Following Labour's victory in the Euroelections, the split within the party over the EC was increasingly characterized by a generation gap rather than a left-right cleavage: older Labour MPs continued to resist the notion of a Britain ensconsed in Europe. (Tony Benn expressed genuine disbelief in October 1990 that a majority of Britons favored closer relations with the Community.)

Policy towards the exchange rate mechanism eventually became a pivotal feature of Labour's European campaign. As early as 1986, Kinnock gave an interview in _The New Statesman_ in which he gave a heavily qualified approval of the mechanism; it was hardly a ringing endorsement of British participation in the EMS, but the Labour Party leader succeeded at least in sounding vaguely positive and in countering the Thatcher government's formula for entry

("when the time is right"). But it was the Madrid summit that provoked a decisive turning point in Labour's internal councils regarding Europe generally and the ERM in particular.

An official report on the October 1988 party conference had been scheduled for publication in May 1989; it was to include a series of tough conditions associated with ERM entry. Publication was delayed when the events leading up to the Madrid conference, and finally the enunciation of the so-called "Madrid conditions" themselves by the prime minister, intervened and provided Labour with the opportunity to at last assume an offensive posture on the European front. At the weekly meeting of the shadow cabinet's economic subcommittee, it was decided to replace the conditions that had been earlier agreed with an expression of Labour's eagerness to negotiate British entry into the ERM. Only Brian Gould, shadow Trade and Industry minister and a long-time Euro-sceptic, objected; the proposal was subsequently presented to the full shadow cabinet and adopted. (interviews)

It was following the elections to the European Parliament that the decision to launch a high level tour of European capitals was taken; ranking members of the shadow cabinet left for Paris, Brussels, Frankfurt and Bonn during the week of October 15-22. Shadow Treasury minister John Smith was at Berlayemont meeting with Jacques Delors when Alan Walters' scandalous anti-ERM remarks were making the press in London, which provided Labour with just the sort

of publicity they had been looking for: the Sunday Times reported that while Nigel Lawson's future in the cabinet was in doubt, Smith was well-connected in Europe.

Labour's advocacy of entry to the exchange rate mechanism was in some sense merely a policy of opportunity: it distinguished Labour policy from the Tory government's position and allowed Labour MPs to exploit divisions within Thatcher's cabinet on the issue. Indeed, since the prime minister herself was known to be adamantly opposed to entry, support for the ERM was for some simply a means of expressing disapproval of Thatcher. The range of objections raised in Parliament by Labour MPs to the government's ERM policy was so broad and sometimes self-contradictory as to suggest little intellectual cohesion within the party.

This observation should not obscure, however, an emerging intellectual consensus at the highest levels of the Labour Party leadership regarding the complex relationship between domestic politics and international economics. While the Party's old guard and extreme left continue to resist Kinnock's reformations, Labour's series of sad showing at the polls has largely robbed these groups of significant influence within the party or even self-confidence. Meanwhile, the rising generation of Labour MPs and their associated brain trusts have developed a still nascent but discernable understanding of European monetary integration and its significance for British politics. Here are the major elements of that consensus:

1. Labour Party economic strategists had come to believe by the late 1980s that there was no long-term trade-off between unemployment and inflation; in other words, the Philips curve (at least in its simplest form) was intellectually discredited. Party strategists generally recognize, with varying levels of sophistication, that the demise of the Philips curve is a function of the integration of national financial markets; they regard this process as irreversible. This means that Labour's habitual willingness to tolerate inflation in order to pay for full employment is no longer to be taken for granted. (interviews)

2. Based on the Tory experience of the 1980s and the French Socialists' tenure in power, Labour's political strategists have concluded that whatever painful policy prescriptions need to be applied ought to enacted very early in the government's term of office, well before the next election. "Pain first, pleasure later" is the maxim. As a consequence, in the event of a Labour victory, the party leadership does not intend to reward its core constituencies immediately ("there will be no pot of gold"). Insiders concede that that this will result in some disaffection among backbenchers during the months following a victory, but they remain cautiously optimistic about the leadership's capacity to resist these pressures. (interviews)

3. The externalization strategy implicit in the EMS regime is especially attractive to the Labour Party, given the propensity of their core constituencies to push for expansive fiscal and monetary policies. The leadership believes that a credible Labour commitment to the ERM will produce two important and related effects. First, it will reduce pressure from Labour political allies for lower interests and a devaluation of sterling. Second, because a Labour government can be expected to insulate itself from any remaining such demands, the party can expect to make inroads into swing constituencies normally suspicious of the Party's inflationary tendencies in the next general election. (interviews)

These three points (discrediting the long term trade-off between inflation and employment, associating electoral rewards with cautious macroeconomic policies, and recognizing the potentially liberating effects of externalizing accountability for monetary policy decisions through the EMS) are mutually reinforcing and constitute the intellectual bedrock of Kinnock's "new look" Labour

Party. Each point represents a change in the party leadership's causal beliefs--about the economy, the electorate, and the EMS respectively. And, as anticipated, the leadership's consensus is winning praise from figures in the economic and political mainstream. For example, as a result of its early and sustained support for ERM, Labour has regained considerable credibility among market and political elites. John Smith, the shadow Treasury secretary, has been especially well received in business circles, taking some of the laudatory financial press normally reserved for leading CP market enthusiasts. This has raised eyebrows, both among the Tories and the Labour left.

In brief, the recent revolution in Labour Party policy seems both to be relatively secure and to have secured public and market approval. Of late, party competition between Labour and the Tories has taken the form of trying to outdo one another in terms of responsible management of the economy (read fiscal conservatism), commitment to the ERM, and good relations with the EC generally. The prospect of returning Labour to power does not seem to significantly worry the financial markets; Britain's ERM commitment, and the necessary monetary policy to back it up, seem relatively secure under either party.

<u>Summary:</u>

The key to realizing the potentially disinflationary benefits of the strong currency option is the credibility

of the peg. Politically credible pegging can result in the externalization of political accountability for restrictive monetary measures, thus liberating monetary authorities to pursue measures that might otherwise prove unacceptable. But all of this hinges on the government's ability to convince market actors that the peg is secure and invulnerable to domestic machinations.

Market actors assess credibility in terms of demonstrated governmental commitment to sustain the peg, plus estimations about the effects that any change in government might have on policy. With the decline of the deutschmark on international markets, the British government has experienced no difficulty in lowering domestic interest rates while defending sterling's value within the ERM. However, Britain's monetary authorities have so far been careful not to endanger the credibility of their long-term commitment to inflation; fully exploiting every opportunity to lower rates might well reduce this credibility. Instead, the authorities have recently resisted several opportunities to lower base rates still further. The critical matter before the government is to guide the British economy out its recession while convincing actors in the private markets that there will be no unjustified tampering with Britain's recovery just prior to the next general election.

In the longer term, Major is committed to good relations with Europe; no Tory is in a position to challenge Major; and Labour, following the path of the

French Socialists before them, have become model citizens of financial respectability. While maintaining these credentials in office may prove more difficult than in opposition, markets no longer fear Labour; they regard Britain's commitment to the ERM as reasonably secure under either party. Given the self-reinforcing political logic of the strong currency option, they are probably correct.

4. CONCLUSIONS: ASSESSING BRITISH ACCESSION TO THE ERM

The ambition of this study has been to assess British accession to the ERM: the conditions that prompted eventual entry into the exchange rate mechanism and the dynamics of Britain's ongoing experiment with the strong currency option. It should be stressed that the characteristics of British participation are still in their developmental stages and are likely to evolve further.

The analytical framework here employed has emphasized three important dimensions to Britain's monetary policy: the marketplace, the international state system, and the domestic political economy. The framework has not treated these spheres as mutually exclusive theoretical paradigms, but rather as three distinct spheres within which British monetary authorities must act. The central dynamic of each sphere as regards Britain's ERM membership is identified and described. These dynamics and the spheres in which they take place should be thought of as coexisting and interactive, rather than as alternative views of a single problem.

In the sphere of the marketplace, the state is a powerful actor. However, this power derives primarily from the state's resources and its willingness to employ these resources to achieve desired ends rather from its privileged status as a sovereign entity. Especially in an environment of international financial deregulation, the state's power is not in the first instance derivative of its authority but instead of its ability to employ resources in an effective manner in order to achieve specific objectives. The central dynamic of the marketplace for British monetary policy has the tradeoff between exchange rate stability and practical monetary autonomy in an environment of capital mobility. Given Britain's commitments to financial deregulation and to free trade, the state's monetary policy options are, practically speaking, profoundly restricted.

The international state system, in contrast, is an exclusive club of mutually recognized sovereign entities; this association is characterized by the absence of any centralized and supreme authority. Britain is an important actor in this anarchical society, but only one of many. In the bargaining that takes place between EC states, the central dynamic since 1985 has been the combined Franco-German threat of excluding Britain from the benefits of future integration efforts and using this threat to extract incremental concessions. This dynamic first appeared during the SEA negotiations, and has since reasserted itself in intergovernmental bargaining about the future of

European monetary unification. The bargaining process between Britain and its EC partners resulted in considerable pressure on the former to join the ERM prior to November 1990 in order to be able to constructively participate in December's intergovernmental conference on EMU.

In the domestic sphere, the state sits atop a hierarchy of organized interests. The relationship is authoritative; the state arbitrates between these interests while simultaneously seeking to impose its own will on them. However, despite its position of authority, the state is not omnipotent even within the domestic sphere; rather, it must bargain with important elements of society and try to convince them to accept official goals and implement official programs. By adopting the strong currency option, the British state is attempting to reform several central features of the British political economy. In order for this reformation to be successful, market actors must be convinced that the state's commitment to a tough external target for sterling is irreversible. If this is accomplished, the result will be the depoliticization of monetary policy and its effective transformation into a foreign policy issue. Today, this process is incomplete but underway in Britain.

ENDNOTE:

1. This conundrum was first described by Mundell (1968); it is referred to as the "Unholy Trinity" by Cohen and the "inconsistent quartet" by Padoa-Schioppa (1988), who includes liberal trading relations as an element in his analysis.

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