British Exit, German Voice, French Loyalty: Defection, Domination, and Cooperation in the 1992-93 ERM Crisis

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For more than a half-year after September, 1992, the European Monetary System experienced a crisis unprecedented in its thirteen-year history. After having gradually evolved into a highly stable, even quasi-fixed exchange rate regime over the previous decade, the Exchange Rate Mechanism of the EMS suddenly found itself wracked by waves of speculative pressures that forced seven devaluations of member currencies, the departure of two currencies from the ERM, and the abandonment by three non-members of the European Community of the peg between their currencies and the European Currency Unit of the EMS, and threatened several of the remaining members of the ERM with devaluation.

As one currency after another was devalued or floated, and as one central bank after another raised interest rates to support their currencies, it became increasingly doubtful whether the ERM would provide the stable and inclusive foundation for Economic and Monetary Union assumed by the Maastricht Treaty signed in early 1992.[2] Indeed, not only did the Maastricht vision of monetary union seem increasingly implausible for all but the few members with currencies in the "hard" inner core of the ERM,[3] but the ERM itself seemed increasingly unlikely to endure through the several years of the transitional second stage of EMU.[4]

The most dramatic moment of the 1992-93 ERM crisis, and the one with perhaps the most lasting consequence, occurred on September 16, 1992, "Black Wednesday," when Britain suspended its membership in the Exchange Rate Mechanism of the European Monetary System and allowed the pound to float downward through its floor against the German mark.[5] The British decision to withdraw was not the first sign that all was not well in the ERM; it had been preceded by decisions to float the Finnish markka and devalue the Italian lira a few days earlier and, in fact, by an accumulation of evidence over the Summer that the ERM was badly in need of a major realignment.[6] But coming as it did at a time when Britain held the rotating Council presidency of the European Community, after several public declarations by the Prime Minister and Chancellor of the Exchequer that the pound would not be devalued and a massive, costly, and ultimately unsuccessful effort to keep the pound within its margins, the British exit represented a profound defeat for the government of John Major. And involving as it did the first departure of a currency from the ERM since the founding of the European Monetary System in 1979, and accompanied as it was by acrimonious exchanges between the British government and officials of the German Bundesbank, the British exit represented an equally profound setback for the EMS and for the Community's ambition to achieve economic and monetary union in the 1990s.

In marked contrast to the British government's decision to withdraw from the ERM, the French government conducted a sustained and successful defense of the franc's existing exchange rate, both in the immediate aftermath of "Black Wednesday" and in the weeks and months thereafter. European currency markets were highly unstable during that period as speculators and the anonymous actors in foreign exchange markets moved first against one currency and then another. Most of the currencies outside the "hard" core of the ERM fell toward their floors, requiring central banks to raise interest rates and intervene in foreign exchange markets, and several were forced to devalue (the Spanish peseta on September 17, and then on November 22, and then again on May 13, 1993; the Portuguese escudo on November 22 and again on May 13, 1993; the Irish punt on January 30, 1993), or to float (in addition to the pound, the lira on September 17), or, in the case of non-ERM currencies, to drop their peg to the ECU (in addition to the markka, the Swedish krona on November 19 and the Norwegian krone on December 10). (See Table 1.) Yet despite considerable downward pressure on the franc in the week after "Black Wednesday" and, later, after the November devaluations and again in early January, 1993, despite the high real interest rates and double-digit unemployment associated with the franc fort policy, and despite impending legislative elections, the French government remained firmly committed to the existing exchange rate.

Why did the two governments respond as they did? Why, in particular, did the British Conservative government--despite its commitment to price stability and a strong pound, despite the fact that it had just won an election and would not need to face the electorate for several years, despite the good reasons for remaining in the ERM, not least of which were the British occupancy of the Council presidency and John Major's carefully cultivated relationship with Helmut Kohl--nevertheless decide to exit? Why, on the other hand, did the French Socialist government--despite its presumed commitment to employment and growth, despite the high level of unemployment and low rate of growth produced by its franc fort policy, and despite the impending elections that threatened a landslide defeat for the government at the hands of the conservative parties[7]--nevertheless decide to remain inside the ERM, regardless of the cost?

In addressing these questions, I consider three alternative types of explanation. One involves a domestic politics approach that attributes the different responses in Britain and France to differences in their internal politics--for example, to differences in the economic preferences of government or the structure and influence of relevant political and economic actors. The second approach involves international politics and attributes the different responses to the structure of the international system within which the two countries are located--in particular, to the preferences and influence of Germany, the dominant actor in the European monetary regime. The third approach involves international regimes, viewed as polities, and attributes the different responses to the institutionalized interactions and norms within the European monetary regime--in particular, to the difference between the two countries in their roles within the institutions of the EMS, the extent to which they had internalized the norms of the EMS, and their involvement in transnational and transgovernmental relations within the regime.

In the course of examining these alternative approaches, I suggest that neither a purely domestic-oriented, 'comparative politics' approach nor a purely international-oriented, 'structural realist' approach adequately accounts for the somewhat counterintuitive policies adopted by Britain and France in the ERM crisis. Indeed, the former type of explanation, the one grounded in conventional domestic politics, seriously mispredicts the actual outcome insofar as it leads one to expect that it would have been Britain, not France, that would remain in the ERM and France, not Britain, that would exit. The latter explanation, on the other hand, the one founded on 'structural realism,' tends to underpredict the outcome; largely because of the conceptual ambiguity and analytic indeterminacy of the approach, it is difficult, if not impossible, to generate precise predictions a priori--for example, before "Black Wednesday"--about whether defection would occur and, if so, which country or countries would defect. And while the realist approach may be able to account for a particular outcome after the fact, its conceptual and analytic underdevelopment enable one to employ it to account for other possible outcomes as well--indeed, perhaps all possible outcomes. Realism does, as I shall suggest, offer useful insights into certain aspects of the ERM crisis. But even when modified to take account of the EMS as a monetary regime, its explanatory power is, at best, ambiguous; thus, it is by no means apparent that the different responses in Britain and France can be attributed to the preferences and "structural leadership" of Germany and the Bundesbank within the EMS.

Of the three types of explanation, the one which provides the best explanation for why Britain defected from the ERM and France remained a loyal member is the third, the one that emphasizes international regimes, viewed as polities. More than anything else, the story of the ERM crisis--especially as it relates to Britain and France--is a story about the institutions of the European monetary regime, the norms of the regime and the processes by which those norms have been, in varying degrees, diffused, internalized, and reinforced, the transnational and transgovernmental relations that occur within it, and, most of all, the patterns of cooperation that existed among some, but not all, members of the regime. In particular, it is a story about the difference in the extent to which the norms of the regime had been internalized in policymaking in Britain and France, and about the difference in the extent to which, because of that difference in internalization of regime norms, the governments of those two member states pursued and achieved cooperation with governments and officials of other member states--most notably, of Germany.

Antecedents of the ERM Crisis

Many factors contributed to the ERM crisis. Among the most important antecedents of the crisis were the following: 1) the evolution of the European Monetary System into a quasi-fixed exchange rate regime and the lack of any multicurrency realignment within the ERM since 1987; 2) the expansion and compositional changes of the foreign exchange markets within which European monetary authorities operated; 3) the economic and monetary policies pursued by the German government and the Bundesbank both before and after unification, and their impact on other ERM members; and 4) the uncertainty about the fate of the Maastricht Treaty and EMU created by Denmark's rejection of the Treaty in the referendum of June, 1992 and the possibility that the French electorate would likewise reject it in the September, 1992 referendum.

The European Monetary Regime. The European Monetary System was founded in March, 1979, in order to create what Helmut Schmidt, then the German Chancellor and one of its principal architects, called a "zone of monetary stability." Created in the wake of the demise of the Bretton Woods exchange rate regime, the OPEC price shock of 1973-74, accelerating rates of inflation and increasing exchange rate volatility among the currencies of the European Community, the EMS represented an effort to repair the defects of the "snake" that had been introduced in April, 1972.[8]

The new EMS retained several important features of the "snake." For example, it retained the "snake's" fluctuation range of +/- 2.25 per cent,[9] the bilateral parity grid of currencies, and the notional unit of account. But it altered the "snake" in several important ways, by creating an Exchange Rate Mechanism, limiting participation in the ERM to currencies of member states of the EC, creating a Community fund to facilitate joint intervention in foreign exchange markets when pairs of currencies reached their upper and lower margins, and assigning the task of monitoring the ERM and, if necessary, negotiating realignments to the already-existing Monetary Committee of the EC that grouped the principal deputies of the finance ministries and central banks. And no less important than these institutional changes, the EMS created an explicit expectation, a "proto-norm," that both weak-currency and strong-currency states would take appropriate action as their currencies approached and reached the margins--that is, altering interest rates, intervening in foreign exchange markets, and, if necessary, realigning their currencies.

When they proposed strengthening and, ultimately, replacing the "snake," Tindemans, Jenkins, Schmidt, Giscard, and the others who were involved did not intend to create a full-fledged exchange rate regime, much less one characterized by fixed bands and infrequent realignments.[10] The ambition remained more limited--as Schmidt described it at the Bremen meeting of the European Council in 1978, the creation of a "zone of monetary stabilty." Nevertheless, over the course of its first decade of existence, the EMS evolved into a quasi-fixed exchange rate regime as realignments--especially multicurrency realignments--became increasingly infrequent. Thus, whereas the EMS experienced seven realignments in its first four years, of which five involved two or more currencies, in its next four years, between March, 1983 and March, 1987, there were only four realignments, of which three involved two or more currencies. And in the five and one-half years between early 1987 and the September, 1992 crisis, there was only one realignment and it involved only one currency.[11] Indeed, realignments became so infrequent that the long-standing ambition of Economic and Monetary Union, marked by irrevocably locked exchange rates and ultimately a single currency, appeared to many in the late 1980s and early 1990s to require little more than an incremental extension of the EMS. (See Table 2.)

The evolution of the EMS into a quasi-fixed exchange rate regime undoubtedly had many salutary consequences for the European Community. By stabilizing exchange rates at a time when the Bretton Woods system had broken down and when two oil price shocks had made the values of currencies more volatile and unpredictable, the EMS contributed to a Community-wide deceleration in the rate of inflation in the early and mid-1980s as well as an expansion in trade and commerce among the member states.[12] In so doing, it may have provided the necessary monetary foundation for the effort to create a single internal market characterized by the free flow of goods, services, capital, and labor. And, together with the creation of the internal market, the evolution of the EMS into a quasi-fixed exchange rate regime may have constituted a necessary precondition for the decision, taken at Maastricht in December 1991, to move to EMU by the end of the decade.

For all its virtuous consequences, the development of the EMS into an exchange rate regime marked by narrow bands and increasingly infrequent realignments was problematic in one fundamental respect. One might take--as many observers did--the decreasing frequency of realignment as evidence of increasing stability in the exchange rates of the member currencies of the ERM. And extrapolating into the future, one could quite plausibly suppose that exchange rates within the ERM would not only remain stable but would become so stable as to allow them to be irrevocably locked without bands. In fact, however, the increasing stability of exchange rates within the ERM constituted a potential source of <u>de</u>stabilization. And paradoxically, the more <u>in</u>frequent the realignments, the <u>more</u> likely the ERM would sooner or later experience severe speculative pressures and perhaps multiple realignments and even forced departures.

The source of this paradox of an increasing potential for instability despite an appearance of increasing stability is, of course, the fact that the fiscal and monetary policies of the governments with currencies in the ERM could, in principle, diverge. To the extent that member countries accepted the norms of the regime--that is, adopted as their own the policy objectives of the dominant member or members--the policies would presumably converge and the stability of exchange rates would rest on a firm foundation. But to the extent that member countries' policies diverged--and, as we shall see, in some circumstances it might be quite difficult for all members to pursue policies that were congruent with the implicit norms of the regime--the cumulative effect of those divergent policies, as reflected in cumulative differences in rates of inflation and implicit changes in the relative value of the currencies, would require an adjustment in exchange rates. In such instances, the absence of a realignment of exchange rates would mask a growing discrepancy between the stated and the true relative values of the currencies and would, therefore, represent a source of disequilibrium and instability.

To what extent did the increasing stability of the European monetary regime in the late 1980s and early 1990s mask a growing discrepancy between the stated and true relative values of the currencies of the ERM members? A simple means of ascertaining whether such a discrepancy existed and was increasing over time, and thereby foreshadowed a potential crisis or major realignment rather than continued stability, is to compare the rates of inflation in the countries that participate in the ERM. Table 3 presents the annual rates of inflation in the ERM members since 1985. By comparing the difference in rates of inflation, one observes that a significant divergence in economic and monetary policy existed after 1987, the date of the last multi-currency realignment, despite the stability in exchange rates after that date. For example, if one simply compares the rates of inflation in Germany to those in other countries, one observes a negligible cumulative difference after 1987 between the German rates and those in Belgium, the Netherlands, and Luxembourg. And one observes, also, a negligible cumulative difference after 1988 or thereabouts between the rates in Germany and those in France, Denmark, and Ireland. Monetary policy in those countries appears to have converged with the policy pursued in Germany. On the other hand, the cumulative difference between the German rates and those in Italy and Spain were considerable, indicating that the stability of the ERM masked a increasing overvaluation relative to the mark of both the lira and the peseta. The cumulative differential between the German and Italian rates since 1987 appears to be on the order of 20 per cent (of which only a small portion was eliminated by the devaluation of the lira by 3.7 per cent in 1990). And the cumulative inflation differential between Germany and Spain over the period after the peseta joined the ERM appears to be well over 10 per cent. And if one adds to the initial overvaluation of the pound when Britain joined the EMS at a rate of DM 2.95, the considerable cumulative inflation differential between Britain and Germany in 1990 and 1991, it would appear that ERM stability masked an overvaluation in the British currency as well. Clearly, the absence of a major realignment after 1987 masked a significant divergence in policy among ERM members, and ultimately a growing disparity in the true value of their currencies--a disparity that, sooner or later, would have to be remedied by a realignment.

Global Currency Markets: Size, Growth, Composition. If the increasing stability of exchange rates within the ERM--epitomized by the decreasing frequency and, indeed, virtual absence of realignment in the late 1980s and early 1990s--masked a potentially destabilizing divergence among the economic policies of its member governments, the potential for instability in the ERM was greatly increased by the enormous size, recent expansion, and changing composition of foreign exchange markets. By 1992, the daily global turnover on currency markets totaled approximately one trillion dollars. More than 620 billion of that was traded in London, New York, and Tokyo, the three largest markets, and London alone--by far the largest European market and, indeed, the largest in the world--accounted for more than 300 billion.[13]

The global currency markets are as large as they are today, in part, because they expanded so dramatically in recent years. Reflecting the accelerated processes of globalization and liberalization, or deregulation, of international finance in the 1980s, the global currency market increased more than three-fold between 1986 and 1992. Thus, roughly 190 billion dollars a day was traded in London, New York, and Tokyo in 1986, compared to the 620 billion dollars a day in early 1992. In London alone, 90 billion dollars a day was traded, on average, in 1986, compared to the 300-plus billion in 1992.[14]

Describing what happened on "Black Wednesday" in London, one currency trader said "the central banks were buying sterling and the rest of the world was selling. It was no contest."[15] Although oversimplified, there is some truth in this characterization of the crisis as a struggle between the central banks and the markets and, in particular, in the trader's implication that the resources of the two sides were not comparable. Thus, whereas one trillion dollars was traded each day in the currency markets in 1992--300 billion in London alone--the official currency reserves of the G7 nations (excluding gold and Special Drawing Rights) prior to the ERM crisis were equivalent to approximately 275 billion dollars. And not only was the global currency market much larger than the agggregate currency reserves of the G7 banks but the disparity between the two had increased dramatically in the few years since the last multicurrency realignment in the ERM. Thus, whereas the G7's official currency reserves of 150 billion dollars in 1986 were equivalent to approximately one-half of the daily turnover in the global currency market, to the combined turnover in the three largest markets, and to almost twice the daily turnover in London, by mid-1992 those reserves were equivalent to only one-quarter of the daily global turnover, to less than one-half the combined turnover of the three largest markets, and to less than the turnover in London.

In addition to the marked and growing disparity between the size of the global currency markets and the resources available to central banks for intervention in those markets, the ability of central banks to support existing exchange rates, should they choose to intervene, was diminished to some degree by a compositional change in the markets that became more pronounced in the 1980s.[16] Whereas currency markets traditionally had been dominated by commercial bank traders involved in spot trading and taking short-term positions in currencies that could be influenced by changes in interest rates and by central bank intervention, the processes of globalization and liberalization had opened up the markets to the managers of investment and pension funds who, typically, were more inclined to hedge their currency risks and/or speculate on the future value of currencies by buying and selling on forward markets. Contemplating not only current interest rates but the longer-run values of currencies, relative to current values, and the prospects and likelihood of changes in existing exchange rates, such actors are not only less susceptible to the interventions of central banks than spot traders but are likely to perceive such interventions as cues to act in precisely the opposite direction of the central banks--for example, selling short when the central banks attempt to prop up the existing exchange rate for an overvalued currency.[17]

The various changes in composition and size of currency markets--both absolute size and size relative to official reserves--were, by themselves, sufficient to destabilize any would-be fixed exchange rate regime. But their destabilizing effects were accentuated within the European Community by the decision, made in the late 1980s, to eliminate all exchange controls by the end of 1992.[18] An expression of the Community's commitment to the creation of a single internal market--and what Colchester and Buchan call "arguably the most important single directive of the 1992 programme"[19]--the agreement on a set of dates by which the member states with exchange controls would remove them meant that those states, and indeed all of the member states of the Community, would willingly relinquish use of an important instrument by which governments can moderate, if not control, fluctuations in the value of their currencies. Without those controls, the currencies of those governments, and of the ERM in general, were exposed to an even greater degree to the unimpeded ebb and flow of demand and supply in the markets.

German Economic and Monetary Policy. Taken together, the two developments already mentioned--the evolution of the European Monetary System into a quasi-fixed exchange rate regime marked by infrequent realignments despite divergent economic and monetary policies, and the growth and changing composition of currency markets and increasing disparity between the size of the markets and the resources of central banks--made it quite likely that the Exchange Rate Mechanism would sooner or later be subjected to speculative pressures in the markets and, perhaps, a full-fledged currency crisis. That such a crisis did in fact occur, however, resulted in no small part from the impact on the ERM of German macroeconomic policy--in particular, the German government's economic policies, both before and after unification, and the Bundesbank's response in the domain of monetary policy.

By the mid-to-late 1980s, the German mark had increasingly taken on the role of "anchor" currency in the ERM. As it did, the monetary policy adopted by the German central bank, the Bundesbank, became, in effect, the monetary policy of all the ERM members.[20] According to two knowledgeable observers, "Most of

Europe has been turned into a Deutschmark zone. The Bundesbank in Frankfurt has become Europe's de facto central bank. Other EMS participants have to ape a German monetary policy in which they have no formal say."[21] Put crudely, the Bundesbank Council adopted the monetary policies it believed appropriate for Germany and other ERM countries adapted their policies to those of the Bundesbank as necessary, in order to maintain the effective peg of their currencies to the mark.

One manifestation of the growing asymmetry of influence that occurred as the mark and Bundesbank became increasingly important was the tendency for German interest rates to set a floor for interest rates throughout the ERM. Under certain circumstances--for example, if the rate of inflation and interest rates in Germany were very low--the floor might be low enough to allow other central banks ample space to keep interest rates high enough to maintain price stability and keep their currency pegged to the mark without choking off economic growth. But under other circumstances--for example, if the rate of inflation and interest rates in Germany, and with them the floor for interest rates in the ERM, were increasing to relatively high levels--other central banks might be forced to choose between two unattractive alternatives. Either they would raise interest rates high enough to maintain the traditional spread with German rates, thereby reducing the rate of growth and causing the rate of unemployment to rise, or they would allow the traditional spread to narrow, thereby increasing the incentive for investors to move out of their currency and into marks. Regardless of which alternative was pursued, the ERM might be destabilized--either by demands for reductions in German interest rates despite the high and rising rates of inflation in that country, or by increased demand for and purchases of marks.

During the early and mid-1980s, the rate of inflation and interest rates in Germany decreased for several consecutive years, to such an extent that by 1986 and 1987 the rate of inflation was negligible and interest rates reached historic lows. (See Table 2.) Thus, in December, 1987, the German discount rate dropped to 2.5 per cent and the Lombard rate dropped to 4.5 per cent. In such circumstances, despite whatever concerns other member states might have had about the growing dominance of the Bundesbank within the EMS,[22] the German floor for interest rates in the EC was low enough that the other central banks were able to pursue price and exchange rate stability without incurring severe costs in growth and employment.

In the four years after 1987, however, the rate of inflation in Germany, and hence German interest rates and the floor for interest rates throughout the ERM, increased in each successive year. Thus, over the four years between mid-1988 and mid-1992, the German discount and Lombard rates were increased on ten successive occasions; by mid-1992, the ten increases in the discount rate had raised it to 8.75 per cent, and the Lombard was at 9.75 per cent. While the long-term upward drift in the rate of inflation and interest rates in Germany is often attributed to the economic decisions taken in regard to unification in early 1990, it is important to note that, in fact, it began well before the Wall came down. As Table 2 indicates, the rate of inflation in Germany increased from 0.2 in 1987 to 1.3 in 1988 and then to 2.8 in 1989, an acceleration that largely reflected the impact of the surge in demand and growth in those years.[23] During 1988 and 1989, the two most important rates manipulated by the Bundesbank--the discount rate and the Lombard rate--were increased six times. As a result, when the Wall came down and unification loomed on the horizon, German interest rates were already unusually high--the discount rate at 6 per cent (compared to 2.5 per cent less than two years earlier) and the Lombard rate at 8 per cent (compared to 4.5 per cent to years earlier). Even without the exogenous shock of unification, then, German interest rates--themselves a reflection of the adaptation by the Bundesbank to the government's fiscal policy and the acceleration of inflation--had increased dramatically in the two years prior to unification.

If German interest rates were on the rise well before unification, the economic decisions taken with regard to unification generated further upward pressure on German interest rates. For good political reasons--both to generate support in election of March, 1990 for the Volkskammer, the legislative assembly of the German Democratic Republic, and, later, in the post-unification Bundestag election of December, 1990, and to give citizens of the G.D.R. an incentive to support the CDU while remaining in the eastern territories and forsaking the option of migrating to the western states of Germany--Helmut Kohl, the German chancellor, pursued a course of rapid unification with generous economic terms. The decision to lock the two German exchange rates at a rate of 1:1 implied a four to five-fold <u>re</u>valuation of the <u>OstMark</u> vis-à-vis the mark and provided a windfall of considerable magnitude to those living in the G.D.R.[24] And subsequent to unification, the government acquiesced in the 1991 agreement between employers and labor unions that would grant workers in the former G.D.R. disproportionately large wage increases in order to achieve wage parity--despite large differences in productivity--by the mid-1990s between those workers and workers in western Germany.[25]

However understandable the currency conversion and wage parity decisions were from a political perspective, they were enormously costly both for Germany and for the ERM. By locking the exchange rates of two distinct economies at very different levels of development, the government gave up the exchange rate as an instrument of adjustment between the two economies. As a result, the burden of adjustment in the east could only be borne by production, employment, and income. Because the exchange rates were locked at a rate that implied a four to five-fold <u>re</u>valuation in the <u>weaker</u> currency, the price of exports from the east and the cost of investments in the east was grossly overstated, and the reductions in production, employment, and income were far greater than otherwise would have been the case. And because wages in the east were raised in large increments that did not correspond to gains in productivity, the government not only fueled a consumption binge but guaranteed that enterprises would incur losses and would be unable to compete for markets abroad (including in western Germany). As a result, the losses in production, employment, and income were further increased. Reflecting those losses, by 1992 the G.N.P. in the former G.D.R. had dropped to about 55 per cent of its 1990 level, and the rate of unemployment--taking into account those no longer in the work force--had risen from about 2 per cent in 1990 to about 45 per cent by 1992.[26]

The losses in production, employment, and income associated with unification were offset to some degree by transfer payments, infrastructure investments, and other forms of public funding. Just as the exchange rate and wage bargaining decisions greatly increased the magnitude of the losses in production, income, and employment in the east, so too the enormous magnitude of those losses, which were far in excess of most initial estimates, caused the public transfers to the former G.D.R. to far exceed most initial estimates. In the first two and one-half years of unification, more than 350 billion marks--more than $225 billion--was transferred by public authorities to the governments and citizens in the territories of the former G.D.R.[27] Although the government did put through a temporary 7.5 per cent surcharge on income and corporate taxes--the so-called "unification tax"--much of the expansion in public spending was financed by borrowing; as a result, the combined deficit of all public authorities in Germany in 1990, 1991, and 1992 averaged more than 100 billion marks a year and totaled close to the 350 billion marks transferred to the East in those years.[28]

As the government spending and deficits increased dramatically in the wake of unification, the money supply and the rate of inflation likewise increased. Whereas over the course of 1989 and the first half of 1990, the rate of increase in M3 had decelerated from more than 7 per cent a year to 4 per cent, it began to accelerate in the second half of 1990, to roughly 5.5 per cent per year, and by late 1991 and early 1992 was accelerating upward again, reaching the 8 to 9 per cent range by mid-1992. The rate of inflation, not surprisingly, accelerated also, increasing from 2.7 per cent in 1990 to 3.5 per cent in 1991 and then to 4.1 per cent in the first three quarters of 1992. As a result, the Bundesbank Council continued the periodic increases in interest rates that had begun in mid-1988. Thus, in the two years after unification, the discount rate and Lombard rate were each raised four times. By the Summer of 1992, the discount rate had risen to 8.75 per cent and the Lombard rate to 9.75 per cent--both historic highs.

The cumulative effect of the ten increases in interest rates in Germany from mid-1988 until mid-1992 was to raise the floor for interest rates within the ERM by some six percentage points. As interest rates in the country with the "anchor" currency, and thus the floor for interest rates throughout the ERM, rose to unusually high levels, it became increasingly apparent that the ERM could be destabilized by any of four possible developments. First, the high rates in Germany--a country which had never devalued its currency after the currency reform of 1948--would attract more funds into mark-denominated instruments. Such an inflow would, of course, increase the money supply, thereby adding to the upward pressure on interest rates, which would in turn attract more funds into marks and drive other currencies toward their floors. Second, some members might, while maintaining their traditional interest rate differential with Germany, nevertheless attempt to exert pressure on the Bundesbank to lower its rates in order to lessen the rising costs in growth and employment imposed on their citizens by higher interest rates. Regardless of whether such pressure succeeded, it would send a strong signal to the markets that the country was unwilling to impose the costs necessary to remain in the ERM at the existing exchange rate. Third, some members might simply refuse to maintain the traditional differential and chart a course of monetary policy independent of that of the Bundesbank--for example, reducing their interest rates despite the upward drift of German rates. If by such a policy the interest differential was eliminated, funds would be likely to move from the country or countries with decreasing rates into marks, thereby increasing the upward pressure on the mark and the downward pressure on the currencies of those other countries. Fourth, as German interest rates rose to higher levels it became increasingly likely that they would surpass the rates in the major non-ERM countries and that, as a result, funds would flow out of those countries into Germany, thereby exerting additional upward pressure on the mark and pushing the other ERM currencies toward their floors.

By the end of the Summer of 1992, all four of these possible developments had in fact occurred. The higher rates in Germany were attracting funds from abroad that were contributing to an increase in the money supply, above and beyond the impact of the government's fiscal policy, and were simultaneously exerting upward pressure on the rate of inflation and interest rates in Germany and on the value of the mark vis-à-vis the other currencies in the ERM. In various countries outside the "hard" inner core of the ERM, the series of increases in German interest rates brought forth demands that the Bundesbank be forced to roll back its increases and, with them, doubts as to whether the governments in those countries would persist in their emulation of German monetary policy. And at least one country, Britain, simply refused to maintain the spread between its rates and those in Germany. Indeed, Britain--a late-comer to the ERM that, as Harmon has noted, refused to "play by the rules,"[29]--pursued a contrarian policy that led it to reduce its rates on nine consecutive occasions after its entry into the ERM in October, 1990. There were, of course, good economic and political reasons for the British policy; the country entered a recession in 1990 that was to be longer in duration than any other since the Depression of the early 1930s and the government faced a strong challenge in the election that would occur in the Spring of 1992. Nevertheless, by May, 1992, after the latest reduction of the base rate to 10 per cent, the British government had essentially eliminated the seven per cent spread between its minimum lending rate and the German Lombard rate that existed when it entered the ERM.[30]

Elsewhere, outside the ERM, in contrast to the convergence that occurred between British and German rates, the cumulative effect of the ten successive increases in German interest rates since 1988 was a widening spread between those rates and the rates in other countries. In both Japan and the United States, interest rates drifted downward after early 1991 and throughout 1992 while those in Germany increased. Thus, by mid-Summer of 1992, after the United States had followed the British pattern and reduced the discount rate for the seventh time since 1990 to 3 per cent, at a time when the Bundesbank was raising its discount rate to 8.75 per cent, a sizeable difference had opened between the interest rates of the major currencies. Those interest rate differentials, and the widening spreads between German and major non-ERM rates, only added to the inflow of funds to Germany, increased its money supply and rate of inflation, and thus added to the upward pressure that already existed on German rates. That, of course, made the mark even more attractive, further accelerated the inflow of funds, and added to the downward pressure that already existed on the other currencies of the ERM.

The Danish and French Referendums. The simultaneous evolution of the ERM into a near-fixed exchange rate regime and expansion and compositional change in currency markets, coupled with the financial consequences of the decisions made with regard to German unification, significantly increased the likelihood that some type of currency crisis might occur within the ERM. What actually precipitated the 1992 crisis, however, was the addition to this volatile mix of financial developments of a new-found and growing uncertainty over the ratification of the Maastricht Treaty and the future of EMU. That uncertainty derived, first, from the surprising defeat of the Treaty in the Danish referendum in June, 1992 and, subsequently, the increasing possibility that the Treaty would be defeated in the French referendum in September, 1992.

On June 2, 1992, 82.9 per cent of the electorate voted in Denmark's binding referendum on the Maastricht Treaty. Despite the overwhelming support for the Treaty in the Danish Folketing--in the parliamentary vote on May 12, 130 had supported the Treaty while only 25 had voted against it--and the apparent last-minute surge of support reflected in polls--the 'yes' vote had increased from 39 per cent to 41 per cent to 44 per cent in the last three Gallup polls conducted on May 20, May 26, and May 31 while the 'no' vote had dropped from 41 per cent to 39 per cent to 35 per cent--the electorate rejected the Treaty by a narrow margin of 50.7 per cent to 49.3 per cent.

In retrospect, what is perhaps most surprising about the Danish vote is not the fact that the Treaty was defeated but that the 'yes' vote was as large as it was, for the forces arrayed against it were unusually broad and diverse. Fishermen in Jutland who were opposed to the intrusions of EC fishing policy voted overwhelmingly against the Treaty, as did farmers opposed to the recent reforms of the Community's Common Agricultural Policy, environmentalists, feminists, left-wing academics, nationalists on the extreme Right concerned with increased immigration and the Maastricht concept of European citizenship, older voters who could remember World War II, and younger voters who, although lacking the memory, perceived in a unified Germany a threat of external economic and cultural domination. About 55 per cent of all women, concerned about possible rollbacks in social spending and programs as well as the possible development of a European defense force, voted against it, as did nearly two-thirds of unskilled workers and 60 per cent of white collar public sector workers. As support or opposition for the Treaty became conflated with support or opposition for the government, the lack of support for the latter--a minority coalition the members of which had received less than one-third of the vote in the previous election, that had been in power for ten years, and that had pursued economic policies that resulted in an increase in the rate of unemployment from about two per cent to eleven per cent--diminished support for the former. Not surprisingly, then, while most supporters of the Conservative and Liberal parties--the two parties that formed the government--said 'yes' in the referendum, more than 60 per cent of the supporters of the Social Democratic Party--the largest party in the country--and 90 per cent of the supporters of the smaller and more left-wing Socialist Peoples Party opposed the Treaty.[31]

The Danish vote greatly complicated the ratification process for the Maastricht Treaty and the prospects of an evolution of the ERM into EMU. On one hand, it was not immediately apparent how the Treaty could be ratified by Denmark since Danish law prohibited a second referendum on the same Treaty language and the other members of the Community were committed not to negotiating and drafting a new Treaty. On the other, it seemed quite likely that if Denmark did not ratify the Treaty it would not go into effect, since ratification required approval by all member states and, in particular, since it was possible that Britain would reject the Treaty if Denmark did.[32]

The uncertainty created by the Danish vote was compounded the day after the referendum when François Mitterrand announced that France would hold a referendum to approve the constitutional changes necessary to implement the Maastricht

Treaty.[33] At first, at a time when support for the Treaty surpassed a two-to-one majority,[34] Mitterrand's call for a referendum appeared to be a masterful political gambit--a means by which France, and Mitterrand, could appear as the saviors of Maastricht by rallying a large vote in favor of the Treaty, while simultaneously exacerbating the divisions that had appeared in the parliamentary debate of the Treaty within the two major opposition parties,[35] and increasing support for a government (and president) whose popularity was at record low levels. But as the Summer went on and popular support for the Treaty dropped below 60 per cent and then, for the first time in late August, below 50 per cent,[36] the decision to call the referendum increasingly appeared ill-conceived, politically motivated, and, perhaps worst of all, one that risked killing the Treaty--for it was obvious to all that if Maastricht might, by some sleight of hand, survive a second Danish rejection in a new referendum, it could not survive rejection by France. Thus, in the period from late August, when the first surveys reported a majority of the French electorate opposed to the Treaty, until the referendum on September 20, all of the other, financial sources of potential instability in the ERM--as well as the conundrum posed by the Danish result--were joined by a growing uncertainty about the French vote. As the uncertainty about the French vote was generalized to the Treaty itself and the future of EMU, the flow of funds out of the weak currencies of the ERM and into the strong ones accelerated, thereby further destabilizing the ERM.

Beyond the uncertainty about Maastricht and the future of EMU generated by the increasing uncertainty about the outcome as the French referendum drew near, the referendum had a further destabilizing effect on the ERM. As the outcome became increasingly uncertain, with poll results suggesting, at best, a petit oui,[37] it became increasingly apparent that the French government would resist a realignment within the ERM prior to the referendum--not only a general realignment that would change the existing parity of all currencies relative to the mark, including the franc, and that might be construed as acknowledgement of a failure or shortcoming in French government's franc fort policy but, also, a broad realignment that, even if it retained the existing franc-mark exchange rate, might expose the franc to speculative pressure as the next target for devaluation. France was not the only member state wedded to the status quo in the ERM, of course. But the potential embarrassment and loss of support in the referendum that might accompany either a realignment of the franc or any evidence of instability in the ERM effectively placed France in the days prior to the referendum squarely in the camp of those defending the status quo, no matter how urgent the need to negotiate a broad or general realignment[38]--something that could, paradoxically, only add to the destabilizing pressures within the ERM.

The Failure to Negotiate a Realignment: The ERM Crisis Begins

Taken together, the four factors described above--the evolution of the ERM into a near-fixed exchange rate regime despite the considerable divergence in policy that existed among its members, the expansion and compositional change of currency markets, the financial and monetary consequences of the decisions taken by the German government with regard to unification, and the uncertainty about the future of the Maastricht Treaty and monetary union that occurred after the Danish referendum and in the run-up to the French referendum--set the stage for the 1992-93 currency crisis in Europe. What actually provoked it, however, was the inability of the member states to agree to a pre-emptive realignment within the ERM during the late Summer or early Fall of 1992. To understand why "Black Wednesday," and all that followed, occurred, it is necessary to understand why the Community found itself, at a critical moment, unable to negotiate either a "broad" or a "general" realignment within the ERM--either of which might have pre-empted the markets and thereby headed off the looming crisis.

July-August, 1992: The Pound and the Lira in Trouble. While specifying a starting date for the ERM crisis is inherently arbitrary, many would probably agree that it began in mid-Summer when the Bundesbank and the U.S. Federal Reserve--both operating in response to domestic economic conditions--further widened the difference between interest rates in the two countries. Responding to the continued high rate of growth in M3--by 8.5 to 9 per cent, well above the target range of 3.5 to 5.5 per cent--the Bundesbank raised its discount rate for the tenth consecutive time since 1987, to 8.75 per cent and its internationally-influential Lombard rate to 9.75 per cent. Meanwhile, responding to Administration pressure to provide a monetary boost to a weak recovery, the Federal Reserve lowered its discount rate for the seventh consecutive time since 1990, to 3 per cent--the lowest level in 29 years.

As the German and American central banks continued to move their rates in different directions in July, 1992, Britain witnessed a growing public debate over its exchange rate and interest rate policy. In mid-July, the Chancellor of the Exchequer, Norman Lamont, addressing concerns from industrialists, Conservative backbenchers, and some academic economists that the pound was overvalued and that high interest rates were preventing an economic recovery, argued that devaluation of the pound would only increase interest rates, that a revaluation of the mark was not on the agenda, and that no other ERM members were willing to sacrifice their credibility by pursuing devaluation. The next day, the Prime Minister, John Major, backed up his Chancellor and he too ruled out a British devaluation, despite the fact that the existence of a current account deficit, a Minimum Lending Rate stuck at 10 per cent, and a rate of inflation of 4 per cent after two years of recession were sure signs of an overvalued currency.[39]

The increasing divergence between rates in the U.S. and Germany, coupled with the increasing convergence between rates in Germany and the U.K., accelerated the flow of funds out of dollars and pounds and into marks. The dollar dropped against the mark and, within the ERM, the demand for marks moved it upward, thereby pushing weaker currencies--especially the pound and the overvalued lira--toward their floors. Thus, as early as mid-July, the pound had dropped to DM 2.85, 10 pfennigs below its entry rate and only 7 pfennigs above its floor, and the lira had come under intense pressure that forced the Bank of Italy to raise its discount rate to 13 per cent.

By late August, the dollar was close to its all-time low against the mark of 1.4 DM, provoking several coordinated interventions by central banks to buy dollars with marks. Within the ERM, both the pound and lira were close to their floors against the mark. Thus, for example, in the last week of August the pound dropped to DM 2.7875, less than one pfennig above its floor, and the Bank of England was forced to make its biggest intervention in years in the currency markets, buying one billion pounds with marks. Meanwhile, in Italy, the lira fell through its floor against the mark of DM 765.4.

In discussions among officials of the central banks of Germany, England, Italy, and Spain, a consensus had developed by late Summer, as the lira continued to come under pressure, that Italy would have to devalue. And indeed, officials of the Banca d'Italia did not dispute that conclusion. They did, however, insist that Italy not be the only country to devalue--that is, that there be a "broad" realignment that would include other weak currencies as well (e.g., the pound). But the British government had made its position clear, and in any event refused to discuss devaluation unless France was also prepared to discuss devaluation of the franc. France, facing an increasingly uncertain outcome in the Maastricht referendum, and in any event convinced that the "fundamentals" did not call for devaluation of the franc, adamantly refused. Britain therefore refused to consider a realignment, and hence Italy did likewise.

By early September, with the pressures on the pound and lira continuing, but with Britain, France, and even Italy resisting suggestions by Bundesbank officials that a realignment was in order,[40] both Britain and Italy had to resort to arranging new credit facilities in order to defend their currencies. On September 3, Britain announced that it had arranged a three-year, multicurrency revolving credit from international banks for 10 billion Ecu ($14.5 billion), 5 billion of which was in marks, to defend the pound. In announcing the Ecu loan, Lamont restated the "government's clear determination and ability to maintain sterling's position in the ERM at the existing rate," The next day, the Bank of Italy drew on the short-term, unlimited EMS credit facility, borrowed marks from the Bundesbank and the Belgian central bank to purchase lira, and raised its discount rate 1.75 per cent, to 15 per cent. Despite these measures, however, both currencies remained near their floors.

The Bath Meeting of Ministers and Governors. On September 5, 1992, the Ministers of Finance and Governors of the central banks of the member states of the Community met in Bath, England for one of their semi-annual "informal" meetings. Included on the formal agenda for the two-day meeting were such topics as the GATT negotiations and Eastern Europe. But Lamont had not included the ERM and the problems within it that were, by then, apparent to all. On the morning of the first day of the meeting, Horst Köhler, the State Secretary in the German Ministry of Finance, attempted to persuade Lamont to include realignment on the formal agenda. But Lamont refused, to the chagrin of several participants; Ruud Lubbers, the Dutch Prime Minister, undoubtedly expressed the view of many when he said that, in retrospect, the failure to prepare a realignment at Bath was a "black page in the book of 1992."[41] As Rudiger Dornbusch has said, a creative response to the tensions within the ERM would have been either a large devaluation of all the ERM currencies against the mark, or a large appreciation of the mark, or a combination of the two.[42] However, neither a "general" realignment, involving a change in the value of all of the ERM currencies vis-à-vis the mark, nor a "broad" realignment, involving a devaluation of the lira, pound, escudo, peseta, and perhaps even the punt and krone, against the "hard" currencies of the ERM, was extensively discussed, much less approved, at Bath.

At the meeting, ministers and governors of several countries--most notably, Lamont, sitting in the chair, but also Michel Sapin, the Minister of Economy and Finance of France, and others as well--rejected a broad realignment. When Piero Barucci, the Italian Minister of the Treasury, suggested that Italy might consider a devaluation if accompanied by others, Sapin immediately excluded a broad realignment on the grounds that it would jeopardize the outcome of the French referendum and could well have a domino effect on other currencies, including the franc.[43] Instead, Lamont and Sapin, and others, suggested--some explicitly, others implicitly--that the source of the recent instability was the Bundesbank and its high-interest rates. According to Helmut Schlesinger, the Bundesbank President, Lamont turned to him and insisted on four occasions that he commit the Bundesbank to lowering its rates.[44] Reportedly, Lamont's pressure tactics so angered the Bundesbank President that he had to be restrained from walking out of the meeting by Theo Waigel, the German Minister of Finance.[45] Waigel countered that the problem stemmed from the low American rates and the attempt of the weaker currencies to stay with the mark that was being pushed up by the American-German rate differential. Schlesinger raised again the issue of realignment and linked it to the issue of interest rates, by suggesting that it might well be possible for the Bundesbank to reduce its rates as part of a broad realignment in the ERM.[46] But the ministers, led by Lamont, rejected any realignment and the meeting simply concluded with a commitment to maintain existing exchange rates and to intervene as need be in the currency markets. As Lubbers said, realignment did not occur because of "political motives": "England had its pride and France said it couldn't be done because it was facing a difficult referendum and they couldn't discuss it, and the English said then that the Bundesbank should do something first, and so the discussion went."[47]

In his concluding public statement at Bath, Lamont not only implied that the participants supported the existing parities but that they had secured a promise from the Bundesbank that rates would not be increased. Schlesinger, mindful that he could not commit the Bundesbank Council on such a matter, had not in fact promised not to increase them and, furious with Lamont, insisted on setting the record straight, not only in private but in public as well. He did so several days later, during and after a meeting of the Committee of Central Bank Governors of the EC in Basle on September 8. And as he did, there could be little doubt, from the tone of his comments, that the Bundesbank felt that a realignment was a necessity and that it might well formally request one in the near future.[48]

<u>The Lira Devaluation.</u> Given that nothing emerged from the Bath meeting (other than friction between Schlesinger and Lamont), it is hardly surprising that the lira and the pound remained near their floors within the ERM. Despite the fact that sterling closed at DM 2.7875 on September 10, less than a pfennig above its floor, John Major continued to defend the status quo, telling the Scottish Confederation of British Industry the same day that "There is going to

be no devaluation, no realignment" and that a realignment would be "a betrayal of our future."[49] Meanwhile, in the week following the Bath meeting, the lira came under intense speculative pressure and, indeed, by the end of the week, had fallen through its floor against the mark--despite the fact that the Bundesbank had spent some 24 billion marks ($16 billion) during the week in support of the lira.[50]

The magnitude of the Bundesbank's intervention, and its apparent inability to lift the lira above its floor, led the Bank to ask for a meeting with the Chancellor, Helmut Kohl, the Minister of Finance, Theo Waigel, and the State Secretary of the Finance Ministry, Horst Köhler.[51] At the meeting, held in great secrecy at the Bank's Frankfurt headquarters in the evening of September 11, Schlesinger and Hans Tietmeyer, the Bank's Vice President, presented the case for an ERM realignment, based largely on the magnitude of the Bank's intervention to that point, the likely magnitude of future required interventions,[52] and the effect continued intervention would have on the German money supply. Although all the participants knew that John Major was strongly opposed to devaluation of the pound and that the German Chancellor was under intense pressure from François Mitterrand to persuade the Bundesbank to lower its rates before the French referendum without forcing an embarrassing devaluation of the franc, Schlesinger and Tietmeyer persuaded Kohl and Waigel to support a broad realignment. In return, they indicated that the Bank would be prepared to link a reduction in its interest rates to a realignment, with the understanding that the extent of rate reduction would depend on the breadth of the realignment.

Köhler and Tietmeyer were dispatched to Rome the next morning, via Paris. In Paris, they met with Michel Sapin, the French Minister of Finance, and Jean-Claude Trichet, the Directeur du Trésor in the Ministry and current chair of the Community's Monetary Committee. Köhler and Tietmeyer, the German representatives on the Monetary Committee, apparently indicated that Germany desired a substantial realignment within the ERM but did not formally request a meeting of the Committee, the forum within which such a realignment would be negotiated. Trichet, apparently treating the information as confidential and the visit as a courtesy, did not canvass the other members about convening the Committee (the Secretary of the Committee, who normally canvassed members prior to a meeting, was away for the weekend) and did not contact the other members of the ERM until after the Germans and Italians had worked out their agreement. And when he did contact the other members of the Committee that evening and the next day, he apparently did not inform them that the Germans had wanted a broad realignment.[53]

Whether it reflected a failure of German and Italian officials to articulate their preferences clearly or to make a formal request for a Committee meeting, or deliberate subterfuge by the French who feared that any consideration of a realignment might threaten the existing parity of the franc and fuel the 'no' vote in the Maastricht referendum one week hence, or simply the shared knowledge of the French and German officials that, despite the preferences of the latter, a broad realignment would be blocked by the British, the meeting in Paris did not result in a convening of the Monetary Committee. As a result, the German-Italian problem within the ERM was left to bilateral negotiation and Köhler and Tietmeyer proceeded on to Rome, where they negotiated a 7 per cent devaluation of the lira, in return for which the Bundesbank reduced its discount rate by 0.5, to 8.25 per cent, and its Lombard rate by 0.25, to 9.5 per cent.

There still was a slight chance that the Italian devaluation might be broadened into a multi-currency realignment within the ERM, for since all members had to approve the devaluation, there was still an opportunity for other currencies to join the lira in a devaluation. Indeed, on Sunday morning, when Lamont and the top officials of the British Treasury met to discuss the German-Italian agreement, the Permanent Secretary of the Treasury, Sir Terry Burns, asked Lamont whether Britain should join in the devaluation. But Lamont said no. And later Sunday morning, when the Italian Prime Minister, Guiliano Amato, called John Major to tell him of the devaluation and ask whether Britain would join in, Major, too, said no.

British Exit, German Voice, and French Loyalty: The ERM Crisis Unfolds

The 1992-93 ERM crisis began immediately after the failed efforts to negotiate a broad realignment of exchange rates. Those efforts, led primarily by German officials and resisted primarily by the British and the French, resulted in nothing more than a modest devaluation of the lira that left the Italian currency still overvalued and, with the pound, at the floor of the ERM. It was only a matter of time before both currencies would come under attack in the markets. And indeed, within days, and prompted largely by the failure of the members to agree to a broad realignment, the lira and the pound, and eventually other currencies, and the ERM itself, came under attack, and one currency after another was either forced out of the ERM or forced to devalue after speculative attacks. But not all currencies succumbed to the pressure of the markets. One currency in particular--the franc--did not. That it did not, when most of the other currencies were being forced to exit or devalue, may be not only the most intriguing but the most consequential aspect of the crisis. Why it did not, in marked contrast to the fate of the pound, and others, is the question to which we now shall turn.

German Voice: The Handelsblatt Interview. The devaluation of the lira and the small decrease in German rates negotiated by Tietmeyer and Köhler in Rome on September 12, provided a brief respite for the pound and the lira in currency markets, and the pound, in particular, closed up slightly, at DM 2.8125, on Monday, September 14, the first day after the weekend devaluation. However, the 7 per cent devaluation of the lira did not alleviate tensions within the ERM for long. For one thing, on the basis of the cumulative difference in inflation rates in Germany and Italy, the Italian currency was still overvalued by at least 10 per cent after the devaluation. And the pound remained near its floor vis-à-vis the mark and appeared, more than ever after the markka float and lira devaluation, to be the next likely target of speculative pressure.

Whatever downward pressure on the lira and the pound existed in the markets was greatly accentuated by the comments of the President and Vice President of the Bundesbank immediately after the lira devaluation. In their press conference on Monday, September 14, outlining the Bank's view of the events of the past several days,[54] Schlesinger and Tietmeyer said that the Bundesbank had pressed the government to request a realignment of the ERM. And on the same day, unnamed officials in Bonn and Frankfurt told reporters that the Bank had offered its ERM partners a rate cut for more than a week in exchange for a realignment and that the Bank had wanted a broad realignment that included a devaluation of sterling. Lest the message be missed, Schlesinger repeated it the next afternoon in an interview with the Wall Street Journal and Handelsblatt, the German business weekly. Following German custom, a summary of the Schlesinger interview was immediately released to news agencies, prior to publication of the full text a few days later. According to the summary, the Bundesbank President had said that "the problems had not been completely solved" and that "the situation in the EMS could have been further eased if there had been a more comprehensive realignment."[55]

The summary of the Schlesinger interview immediately reached London, where the pound had fallen to a new low of DM 2.7800, only one-fifth of a pfennig above its floor, and had actually fallen through its floor in after-hours trading. The Prime Minister had cancelled his trip to Spain, and the Treasury and Bank of England were preparing their plans for the intervention that would surely be required in the next day's trading. By late afternoon, word of Schlesinger's remarks had traveled to the Bank of England and then quickly up the hierarchy to Robin Leigh-Pemberton, the Governor of the Bank, who was then meeting with Lamont and their top officials. At Lamont's request, Leigh-Pemberton called Schlesinger in the evening at his home, twice, to clarify the report. When Schlesinger, rather than denying the report, said that the interview was not yet authorized, that he had not yet approved the quotes for the interview, and that he would not have approved the comments attributed to him in the summary, the British knew they could expect only the worst in the currency market the next day.[56] Which, more or less, is what happened.

British Exit: "Black Wednesday," September 16, 1992. "Black Wednesday" witnessed the largest intervention in currency markets ever conducted by a single central bank--and, indeed, the largest coordinated intervention ever conducted by any group of central banks. During the day, the Bank of England spent approximately 15 billion pounds in support of sterling, which represented roughly 50 per cent of the total reserves available to it.[57] Other central banks--most notably, the Bundesbank and the Bank of France--bought an additional 5 billion pounds. But by the end of the day, the intervention had failed, the pound had fallen well below its floor against the mark, the central banks had lost billions to the speculators, and the British had been forced to "suspend" sterling's participation in the ERM.

"Black Wednesday" began early and continued well into the next day.[58] At 7:30 A.M., the Bank of England's currency dealers were authorized to spend about two billion pounds of reserves in three separate interventions. By 8:00 A.M., the pound was still on its floor against the mark and Lamont soon ordered that additional reserves be committed. At 10:30 A.M., with the pound threatening to drop below its floor in trading, Lamont called the Prime Minister and obtained authorization for an increase in the Bank lending rate from 10 to 12 per cent. Announced at 11:00 A.M., the increase had no effect on the pound and by 11:30 Lamont, Leigh-Pemberton, and their top officials decided they would have to tell the Prime Minister the exchange rate could not be defended. Meanwhile, more reserves were committed to the battle. The Prime Minister, meeting with the most important members of the Cabinet, decided to authorize an additional increase in the bank rate, to 15 per cent. Announced at 2:15 P.M., it too failed to attract support for the pound. In mid-afternoon, Major called Helmut Kohl, the German Chancellor, and Pierre Bérégovoy, the French Prime Minister, to tell them that the pound would be withdrawn from the ERM and the Bank likewise informed the other central banks of the decision. The Cabinet was summoned for a 5 P.M. meeting and agreed to the plan for withdrawal, and at 7:30 P.M. Lamont announced that the pound had been "suspended" from the ERM.

The Monetary Committee was called into an emergency session in Brussels that evening. After an all-night meeting, the Committee "took notice" of the British decision, announced that the Italian government--after a day in which the lira had fallen well below its new floor against the mark--had decided to "abstain temporarily from intervention in foreign exchange markets," and announced, also, that the Spanish government had decided to devalue the peseta by 5 per cent. Thus, by the time trading opened the next day, the ERM--from which no currency had ever withdrawn in its thirteen-year history--had lost two of its major members in the past twenty-four hours and had experienced its second devaluation in five days.

The exit of the pound from the ERM represented a defeat of the first order for the British government. That such was the case was apparent not only in the business press, which spoke of an "extraordinary political crisis, undercutting the central plank of the prime minister's economic strategy," one that "seriously undermines PM's authority,"[59] but, also, in the acrimonious exchange that soon followed between British and German officials. In reply to a question about when Britain might rejoin the ERM, Lamont stated that German policy had produced many of the tensions in the ERM and Britain had to be satisfied there would be changes in Germany policy that would lead to a more stable environment. Kohl, in Rome, responded that Lamont's comments were "inappropriate for a minister."[60] Major defended Lamont in parliament by saying that Britain would not return to the ERM until it had been reformed and its "faultlines" repaired.[61] And in a quite extraordinary departure from the typical discretion of central bankers, Schlesinger prepared a lengthy statement to the British Treasury that was released by the German embassy in London, claiming that he had not undermined sterling in his Handelsblatt interview and describing in detail, and defending, the actions of the Bundesbank in the period before "Black Wednesday" and in the interventions undertaken that day.[62] No less extraordinary was the British reaction. The Treasury attacked the embassy's release of the document as a breach of confidential communications and said Schlesinger "misses the point." And the Bank of England stated that it "did not entirely recognise" the Bundesbank President's version of the events and, in any event, "very much regretted" the release of his statement. Capping off the exchange, the British Foreign Office called in the German ambassador for consultations--the first time ever that such a summons had been issued between two member states of the EC.

French Loyalty and German Voice: The Defense of the Franc. Immediately after "Black Wednesday," with the pound and the lira out of the ERM and the outcome of the French referendum very much in doubt, the franc came under pressure and appeared to be the next target in what Schlesinger would later call "an unfriendly game of dominoes."[63] By the end of the week of "Black Wednesday," the franc had fallen to within one centime of its floor against the mark and a devaluation of the franc appeared imminent. But that did not happen. Instead, over the next several days, the French and German finance ministries and central banks mounted a well-publicized, coordinated, sustained--and successful--defense of the existing mark-franc exchange rate. Compared with the failed defenses of the pound, the lira, the punt, the krona, and others, and the politically humiliating devaluations or floats governments were forced to accept, the Franco-German defense of the franc in late September, and later as well, is notable not only for its success but for the means by which that success was achieved.

The first evidence that the Bundesbank would play a public and vocal role in the defense of the franc came two days after "Black Wednesday," when Hans Tietmeyer told Agence France Presse that "the franc is in no way at risk. The franc is a very strong currency which has achieved inherent stability. On the contrary, it is a candidate for appreciation."[64] Behind the scenes as well, the Bundesbank began to play a significant role in defending the franc against speculative attacks; by the end of trading on Friday, September 18, the Banque de France had bought 56 billion francs (more than $10 billion), borrowing not only from commercial banks but from the Bundesbank. Despite that, however, the franc remained within a centime of its floor, the Banque had begun to spend its own reserves, and devaluation threatened.[65]

A meeting of the finance ministers and central bank governors of the G7 had long been scheduled for the weekend of September 19-20 in Washington, D.C. in connection with the Fall meeting of the International Monetary Fund. It was at that meeting that French and German officials began to prepare a concerted defense of the franc. On Monday, September 21, after the result of the referendum had become known and with the franc only a half-centime above its floor against the mark and the Banque continuing to intervene heavily in the markets, Michel Sapin, the Minister of Finance, Jean-Claude Trichet, the Directeur du Trésor, and Jacques de Larosière, the Governor of the Banque de France, met in Washington with Theo Waigel, Horst Köhler, Helmut Schlesinger and Hans Tietmeyer, their German counterparts. Negotiating in English, the French and German officials worked out the details of a coordinated intervention by the Banque and the Bundesbank as well as the outlines of a joint statement by the two governments that would be released on Wednesday.[66] In public, the German officials attempted to "talk up" the franc; speaking to reporters in Washington, Schlesinger pronounced the franc "healthy and stable,"[67] Tietmeyer denied that there would be any further realignments, and Waigel, speaking at a plenary session of the I.M.F. meeting, said there was no further need for realignment.[68]

On Tuesday, September 22, as the franc, the peseta, the escudo, the krone, and the punt all came under pressure, several central banks, including the Bundesbank and the Banque, intervened heavily in the markets. In Paris, Helmut Kohl and François Mitterrand held a "mini-summit" to reiterate their support of the Maastricht Treaty in the wake of the British exit and the French petit oui. Nothing was said publicly by the two leaders about the negotiations in Washington and the tensions in the ERM, although immediately after the meeting the French Finance ministry reiterated that there would be no change in the franc-mark rate.[69] Meanwhile, Sapin and Köhler left the I.M.F. meeting early and returned to their capitals to prepare the announcements of the Franco-German agreement and plans for their intervention in the markets.

On Wednesday, September 23, at 8:15 A.M., the Banque de France announced an increase in its 5 to 10 day repurchase rate on short-term borrowings (often used for currency trading) from 10.5 per cent to 13 per cent. At 8:20 A.M., a rare joint statement of the French and German ministries of finance and central banks was issued, stating that the existing central rates for the franc and mark "correctly reflect the real situation of their economies" and that there was no justification for a change in rates.[70] At 8:30 A.M., after a rhetorical flourish alluding to how speculators were treated in the French Revolution, Michel Sapin announced that "France and Germany will fight this speculation, which is based on no economic fundamentals," and that both the Banque and the Bundesbank were committed to intervening "massively" in currency markets in support of the franc.[71] Soon thereafter, both banks began to intervene heavily in the currency markets.

In its interventions in the market on September 23, the Bundesbank supported the franc at levels above its floor and did so openly. It was one of the few times the Bank had intervened intramarginally in support of another currency. And it was the first time since the founding of the EMS that the Bank had revealed it was doing so at the time of the intervention. Sapin was later to single out the "very good cooperation" of the Bundesbank as the key to winning the battle of the franc in September--in particular, the fact that the Bank's intervention, because it occurred before the franc hit its floor against the mark, was "voluntary and all the more appreciated by the markets for that."[72] By early afternoon the franc had moved off its floor against the mark and soon thereafter it had risen several centimes above the floor, where it was to remain for the better part of the next two months.[73]

The magnitude of the coordinated Franco-German intervention in late September in all likelihood exceeded the combined central bank intervention on "Black Wednesday." Some time later, de Larosiere revealed that the Banque had spent 160 billion francs (more than $30 billion) of foreign currency in defense of the franc in late September.[74] The Banque spent approximately 80 billion francs of its reserves--more than eighty per cent of its total reserves--in the seven days after "Black Wednesday,"[75] implying that it may have drawn funds of a comparable magnitude through credit tranches denominated in marks and swap credits from the Bundesbank.[76] Meanwhile, the Bundesbank--which according to Schlesinger spent a total of 92 billion marks (roughly $60 billion) in support of weak ERM currencies in September[77]--was estimated to have spent between 10 and

30 billion marks ($6.7 to $20 billion) in support of the franc in the week after the Washington agreement.[78]

After the turmoil of September, the ERM enjoyed a period of relative calm in October and early November, 1992. The franc remained well above its floor, the Banque de France reduced its key interest rates and repaid its borrowings for the September defense, and the threat of continued speculative attacks and possible devaluations within the ERM abated. But the calm was illusory. The events of September had not diminished the need for a general or broad realignment, and it was only a matter of time until the weak currencies of the ERM would come under renewed attack. In late November that happened, triggered, paradoxically, by an attack on a non-ERM currency, the Swedish krona, which had been pegged to the Ecu since May, 1991 and which, in the September crisis at least, had been strongly defended by the government.[79]

By Friday, November 20, pressure was mounting on the escudo and peseta. Spain had spent some $3 billion in reserves to support the peseta during the week. Aware of the enormous loss of reserves in Sweden over the past week and fearing a speculative attack that would require it to throw away reserves in support of an overvalued currency--and perhaps force it to leave the ERM altogether--Carlos Solchaga, Spain's Minister of Finance, decided to move quickly and devalue before a devaluation was forced upon Spain.[80] Late on the 20th, Spain requested a meeting of the Monetary Committee and on November 22, after a ten-hour meeting in Brussels, the Committee announced that both the peseta and the escudo had been devalued by 6 per cent.[81]

<u>The Defense of the Franc: Round Two.</u> The November devaluations immediately increased pressure on the remaining "non-hard" currencies of the ERM that had not yet been devalued or floated. The Irish punt fell through its floor against the Belgian franc and close to its floor against the guilder and the mark, and it remained at those levels despite the Bank of Ireland's increase of the three-month rate from 14.5 per cent to 20 per cent and of its overnight rate to 30 per cent and then to 100 per cent. Despite a similar increase in short-term rates and an increase in overnight rates to 50 per cent, the Danish krone

dropped toward its floor against the mark. And despite three increases in interest rates in three days, the French franc dropped sharply against the mark and reached its lowest level since October. Yet another round of forced devaluations seemed inevitable and imminent.

By early December, and despite large interventions by the Banque de France, the franc had fallen to within two centimes of its floor against the mark. In a reprise of its coordinated defense of the franc in September, the Banque and the Bundesbank intervened together in the currency markets in the first week of December. And in another echo of the September defense, immediately after another Kohl-Mitterrand summit, Michel Sapin, the French Minister of Finance, reiterated the Franco-German commitment to the "ultimate stability" of a common currency and monetary union and, in the short term, continued defense of the franc. Invoking the "solidarity" of the two finance ministries and central banks in that defense, Sapin stated that the two countries would do everything necessary to preserve the existing rate between the franc and the mark.[82] And Waigel, Sapin's German counterpart, reiterated once more his support for the franc.

On Friday, December 11, the day after the Norwegian government had abandoned its peg of the krone to the Ecu and the Bundesbank Council had again decided not to lower its rates,[83] the franc fell once more to within two centimes of its floor against the mark. And once more, the Bundesbank intervened openly on behalf of the franc, buying francs with marks not only in European trading but in the afternoon fixing and after-market as well. Equally important, it publicly announced that it was doing so. And again Waigel stated that there was no need to devalue the franc. But the franc remained under pressure and, indeed, by the end of the following week it had fallen to within a centime of its floor against the mark, despite the public statements by President Mitterrand and Prime Minister Bérégovoy that the franc would not be devalued and by Schlesinger that there was no reason to change the existing parity,[84]

Only the light trading in currency markets over the holidays allowed the franc to remain a couple of centimes above its floor over the last two weeks of

1992. In the first trading days of the new year the selling pressure returned, and the franc again fell, closing only slightly more than one centime above its floor. Once again, however, the French and German authorities intervened in support of the franc. The Bundesbank revealed that it spent DM 3.5 billion in support of the franc in the first trading day of 1993. And as that support was being made known, the French and German ministries of finance and the central banks of the two countries issued another joint statement. As in the September statement, in their statement of January 5, 1993 the two ministries and banks reiterated their belief that "the actual central rate of the two currencies is fully justified on the basis of their economic fundamentals." And making their commitment to defend the existing rate more explicit than they had in September, the two ministries and central banks announced that they "will pursue their close cooperation in order to ensure the proper functioning of the ERM."[85] In the face of that reiteration of the French and German commitment to the defense of the franc, the French currency strengthened and moved several centimes above its floor, and once again avoided a forced devaluation.

In subsequent weeks and months, speculative attacks on the franc gradually subsided, as the markets came to understand that in challenging the franc they were challenging the Bundesbank. Except for a flurry of activity around the time of the legislative elections in March, the markets turned their attention away from the franc to more vulnerable targets such as the Irish punt, the Danish krone, and the Spanish peseta. Thus, after Britain had reduced its Minimum Lending Rate for the fourth time since "Black Wednesday," to 6 per cent in late January, the Irish punt--increasingly overvalued as the currency of its largest trading partner floated downward after "Black Wednesday"--was driven to its floor against the Dutch guilder, the Belgian franc, and the mark. Despite its low rate of inflation (2.7 per cent) and current account surplus, and despite the government's arrangement of a 4 billion DM loan to support the punt, its willingness to raise interest rates to very high levels (the overnight rate went to 100 per cent in late November, 1992 and again in early January, 1993), and its willingness to tolerate high levels of unemployment (18 per cent), even at the cost of a sizeable electoral defeat, Ireland was forced to devalue, and on January 30, 1993 the Monetary Committee announced a 10 per cent devaluation, the maximum permitted in the EMS and the largest ever implemented in its history.[86] Soon thereafter, the Danish krone fell to its floor against the mark, the now-devalued punt, and the guilder, and only the Bundesbank's long-awaited, but unanticipated, reduction in interest rates in early February--its first reduction since the Italian devaluation in September--saved it from the fate of the punt. Throughout the late Winter and early Spring, the Spanish peseta came under sporadic speculative pressure, and in mid-May, after the government had called an early election for June 6, the markets calculated--correctly, as it turned out--that the Spanish government, facing possible defeat in the election and presiding over a rate of unemployment in excess of 20 per cent, interest rates in the range of 15 per cent, a rate of economic growth below 1 per cent, and a hemorrhage of its reserves, would be forced to devalue for the third time since "Black Wednesday"--which it did on May 13, 1993.[87]

British Exit and French Loyalty: Contending Explanations

In retrospect, the ERM crisis was avoidable. As Wim Duisenberg, the governor of the Nederlandsche Bank and chairman of the EC's Committee of Central Bank Governors said, "We should have had the foresight to encapsulate all the five months of realignments into one weekend. We must never let this happen again."[88] Again quoting Duisenberg, the crisis was "one realignment that lasted four months."[89] But if it was one long realignment, the crisis was also a manifestation of a failure to cooperate in collective action--specifically, the failure of the ERM members to negotiate a preemptive general or broad realignment. That being the case, it is perhaps not surprising that as the crisis unfolded the members responded in a variety of ways, some upholding the norms and rules of the EMS and others deviating from them.

Among all the varied responses of ERM members during the 1992-93 crisis, those of Britain and France stand in sharpest contrast. In Britain, the government had reduced interest rates several times, while German rates were increasing, and had ruled out a devaluation of the pound within the ERM, although one was warranted by the "fundamentals." And when the inevitable day came, on "Black Wednesday," it withdrew from the ERM just as it had entered in 1990, unilaterally and without consultation in the Monetary Committee. In France, on the other hand, the government kept interest rates well above those in Germany and raised them on several occasions, despite the fact that the "fundamentals" were better in France than in Germany, and it kept the franc in the ERM at its existing parity, despite an impending election and calls for a devaluation or float.

Why did Britain and France respond in such different ways during the ERM crisis? What accounts for the British decision to leave the ERM, on one hand, and the French decision, on the other, to remain within it at the existing exchange rate? In particular, what accounts for the British decision not only to leave the ERM but to do so in a manner that resembled a forced retreat and implied that, in addition to being costly, the defense of the pound had been ill-conceived or mismanaged (or both)? And what accounts, on the other hand, for the French decision not only to remain within the ERM and at the existing franc-mark rate but, also, to arrange an unprecedented cooperative arrangement with Germany in order to maintain that rate?

The very different decisions of Britain and France can not be attributed simply to differences between the two countries in economic "fundamentals"--for example, to the fact that the pound was overvalued and a reasonable candidate for devaluation while the franc was, if anything, undervalued and therefore unlikely to leave the ERM. The fact that the pound was overvalued does not explain why the government resisted devaluation so adamantly and refused a broad realignment prior to "Black Wednesday," why it refused to devalue within the ERM when pressure mounted on the pound, and why it committed only a portion of its reserves to defending the pound and then withdrew from the ERM, creating the impression that the pound had been driven out of the ERM and incurring for itself considerable political humiliation both within Britain and in Europe. Likewise, the fact that the franc was possibly undervalued vis-à-vis the mark does not explain why the French government insisted on retaining the existing parity between the mark and the franc and refused to contemplate a general realignment within the ERM, why it rejected any alteration in the existing franc-mark rate in the weeks and months after "Black Wednesday," and why it was willing to embark, with Germany, on a sustained defense of that rate that could only impose high costs on the economy, in terms of interest rates, production, and employment, and on itself, in terms of popular and electoral support.

If economic "fundamentals" can not explain the dramatic difference between the British and French responses, can it be explained by differences in the domestic politics of the two countries, conventionally understood--for example, differences in the economic priorities and electoral incentives of government or in the structure of economic interests in society? Can it be explained, or explained better, in terms of forces and factors that derive not from the domestic political environment of the two countries but, rather, from the international structure within which the two countries are embedded--for example, the impact on each of the distribution of power and influence in the European monetary regime and, specifically, the impact on each of the dominant actor in that regime? Or does an explanation of the difference in the two responses require some other analytic framework--for example, one that does not concentrate exclusively on either domestic politics or international structure but, rather, links and bridges the two domains?

The Domestic Politics Explanation. If the decisions of the British to leave the ERM and the French to remain can not be attributed solely to the difference in economic "fundamentals," neither can they be attributed to the domestic politics of the two countries. If one knew only the domestic politics of the two countries prior to September 16, 1992, one would most likely have predicted that it would be Britain, not France, that would remain in the ERM and France, not Britain, that would devalue or defect. Put differently, an explanatory model constructed exclusively in terms of domestic politics would mispredict the actual outcome.

Consider the likely prediction regarding exit from or loyalty to the ERM that might be drawn from a Downsian view of parties as vote maximizers operating in anticipation of forthcoming elections.[90] One could plausibly assume that continued membership in the ERM at existing parities in late 1992 would require maintaining interest rates at high levels that, in turn, would reduce, or at least not improve, investment, production, and employment. Knowing that one of the two countries would hold elections in a few months that threatened the governing party not only with a significant loss of support but a loss of office as well, and that the other country had just had elections that renewed the government's mandate for several more years, which country might be expected to devalue or defect altogether from the ERM and pursue, instead, a strategy of growth and job creation fueled by low interest rates? Obviously, the former. And yet, of course, it was the latter country, the one in which the government was relatively immunized from electoral sanction, that left the ERM, while the former, the one in which government faced imminent electoral retribution for its economic policy, retained its commitment to the ERM and the existing exchange rate.

If, in attempting to account for the different exchange rate policies of the two countries, one were to turn from a Downsian to a Kirschenian perspective and consider not the electoral calendar but the partisanship of government,[91] one would confront a similar discrepancy between prediction and reality. Assuming, quite plausibly, that membership in the ERM and the retention of the high interest rates associated with continued membership would tend to dampen demand and promote a higher degree of price stability than would non-membership, assuming also that, all else being equal, conservative governing parties tend to favor price stability, even at the cost of unemployment, while left-wing governing parties tend to be more averse to unemployment than to inflation, and knowing that one of the two countries was governed by a conservative party while the other was governed by a socialist party, which country might be expected to remain in the ERM in order to achieve its objective of stabilizing prices, even at the cost of high unemployment? Obviously, the former, the one governed by a conservative party. Yet, of course, it was the latter, the country governed by a socialist party, that in fact remained in the ERM, continued to espouse price stability, and accepted the high rate of unemployment that accompanied the pursuit of price stability.

It is, of course, the case that the Downsian and Kirschenian perspectives greatly simplify the electoral and partisan politics that influence the policy choices of governments. That being the case, perhaps domestic politics can account for the British and French responses, provided one employs a more context-sensitive, and complex, perspective--one that does not reduce domestic politics to simply the pursuit of reelection and equate the preferences of government with a simple left-right dichotomous view of political parties and their assumed preferences.[92] For example, perhaps governments are sensitive not only to the schedule of legislative elections but to other electoral issues that bear upon their ability to govern. For the French government in September, 1992, the immediate concern might not have been its fate in the elections of March, 1993 but, rather, the referendum of September 20 (the results of which would, of course, affect those later elections). Likewise, although the British government had won reelection in April, 1992, its greatly-reduced majority in the House of Commons may have made it sensitive (especially with a battle pending over ratification of the Maastricht Treaty) to the preferences of the Thatcherite, "Euro-sceptic" wing to the Conservative Party. Perhaps, also, an aversion to inflation and devaluation is not confined to governments of the right, and a willingness to promote growth and employment through competitive devaluation to governments of the left. For example, the evolution of the ERM into a quasi-fixed exchange rate regime, the more than five years that had passed since a multi-currency realignment in the ERM, and the shared commitment to build EMU on the basis of a stable ERM may have created such an expectation of stable exchange rates that governments--even those formed by left-wing parties--were averse to exchange rate realignment and feared electoral retribution if they devalued their currency. That might explain why--however painful its franc fort policy--the French government was unwilling to contemplate any change in the franc-mark rate prior to the referendum of September 20. Likewise, notwithstanding its pronounced aversion to inflation, the British Conservative government may not have been altogether hostile to devaluation--not because it was overly concerned about creating jobs (although a portion of the Party, the more moderate "wets," were probably so concerned) but, rather, because many in the business community--especially those in export-oriented industry--saw the virtues of a large devaluation to fuel a recovery from a prolonged recession.

A more context-sensitive view of electoral and partisan politics is less likely to mispredict the British and French responses in the ERM crisis than hypotheses drawn from Downsian or Kirschenian views of the electoral calendar and the partisanship of government. On the other hand, such a view seems to rest, to some considerable degree, upon a prior knowledge of the outcome. That is, knowing only what was known prior to September 16, 1992, it is by no means obvious that a context-sensitive observer would have predicted that the French government's fear of electoral sanction in the referendum would have been sufficient to cause it to avoid a "general" realignment--even if such a realignment might have alleviated or eliminated altogether subsequent pressures on the franc and the other currencies in the ERM. Nor is it obvious that a context-sensitive observer of British politics would have predicted that the narrow Conservative majority in the House of Commons and the government's dependence on its "Euro-sceptic" wing, and the appeals of British industrialists, would so weaken its traditional commitment to price stability and its new-found commitment to the ERM that it would exit. Nor is it obvious that a context-sensitive observer would have predicted that Britain would exit in the way that it did--through what appeared to be a forced retreat after a costly but futile defense--and that France would remain loyal in the way that it did--through the arrangement with Germany of an unprecedented, joint intervention and through a disavowal of any negotiated devaluation.

If one turns from the domain of electoral and partisan politics to the structure and organization of interests within each country and the relations of those interests to government, one finds that, as with electoral and partisan politics--at least in the most simplistic formulation of those politics--the differences between the two countries do not accurately predict the different responses of government in the ERM crisis. Consider, for example, the differences between Britain and France in the size, organization, and collective preferences of the financial sectors of the two countries. As Zysman, Hall, and others have noted,[93] the financial sector in Britain is large, both in absolute terms--the capital market in London, for example, is the largest in the world--and in relative terms, compared with the industrial sector. That size is, of course, a legacy of London's preeminent role for three centuries as the financial center of the Empire, and both its size and its origins in the Empire give British finance an international orientation.[94] Moreover, it is dominated by privately-owned firms with which the government has, at best, an indirect and arm's-length relationship. In comparison, the financial sector in France is smaller, both in absolute terms and relative to the industrial sector. While the largest French banks and financial institutions operate globally, the sector as a whole is, arguably, less international in orientation than the British sector. And unlike the situation in Britain, a large portion of the sector is publicly-owned, thereby affording government a close and authoritative relationship with it.[95]

One might quite reasonably infer that the size and strategic importance of the financial sector in Britain, coupled with its autonomy from the government and its international orientation, would endow it with considerable political influence in international monetary matters and make it a powerful advocate of exchange rate stability. Supporting that view, Hall argues that:

> British macroeconomic policy, both before and after the war, was dominated by the pursuit of a relatively high exchange rate and was consequently more deflationary than it might otherwise have been....[T]he experience of empire left Britain with financial institutions that were heavily oriented toward overseas lending....Therefore the City became a powerful lobby against devaluation (which was widely expected to weaken international confidence in British financial markets) and a proponent of deflation....[T]he banks themselves were insulated from government control by the powerful Bank of England....Because Bank officials saw themselves as spokesmen for an internationally oriented financial community, custodians of the exchange rate, and financiers for the public debt, they tended to oppose devaluation, alterations to the financial system, and expansionary

> measures.... Therefore, they acted as a powerful force for fiscal conservatism.[96]

In contrast, one might infer that the financial sector in France would be less powerful than its British counterpart, both because of its smaller size in absolute and relative terms and the government's more extensive and more direct control of it. And one might infer that, because of its lesser international orientation, it would be a less forceful advocate of exchange rate stability and would be less averse to devaluation than British finance.

Applied to the ERM crisis, the contrast between the British and French financial sectors, in terms of their size, structure, presumed preferences, and relations to government, might lead one to expect that, all else being equal, the British sector--larger, enjoying greater autonomy from government, oriented to the international financial community, and committed to exchange rate stability and avoidance of devaluation--would be a stronger supporter than the French financial sector of the existing European exchange rate regime and its rules and norms. And more important, the contrast would lead one to expect that the British financial sector would ultimately be more successful than its French counterpart in having its preferences incorporated in policy. Thus, even if Britain had indeed postponed a devaluation too long (something that was quite predictable given the preferences of finance), one might have expected it to act "responsibly" when faced with a crisis of the magnitude of "Black Wednesday"--that is, raise interest rates, negotiate a modest devaluation, remain within the ERM, and pursue a restrictive macroeconomic policy. Conversely, if one of the countries were to pursue a "strategy for growth" marked by a defection from the ERM, a substantial depreciation of the currency, and a reduction of interest rates well below the levels found elsewhere in Europe, one might have expected it to be France rather than Britain. But as we know, however plausible these expectations, they are contradicted by the actual responses of the two countries; it was France, not Britain, that adhered to the principle of exchange rate stability and the existing regime, and Britain, not France, that ultimately opted for a large devaluation and an expansionary fiscal and monetary policy.

The International Structure Explanation. If the responses of Britain and

France in the ERM crisis can not be explained by differences between the two countries in such aspects of domestic politics as the electoral calendar, the partisanship of government, and the size, strength, and preferences of the financial sector, perhaps they can be explained by invoking an alternative approach, one that is far removed, analytically, from the internal politics of the two countries. One such approach involves international politics--in particular, the structure of the international system within which the states are located and the impact of that structure on the states. If an explanation of the contrasting responses of Britain and France in the ERM crisis can not easily be extracted from the domestic politics of the two countries, perhaps it is to be found, instead, in the structure of the international system--specifically, in the ways by which, in Waltz' words, "the structure of the system affects the interacting units and...conditions the behavior of states and affects the outcomes of their interactions."[97] If it is true, as Waltz claims, that the international system is "anarchic" (his "ordering principle") and therefore a "self-help" system in which states interact by "force and competition," that "the state's interest provides the spring of action," and that "the necessities of policy arise from the unregulated competition of states" which vary in their "capabilities,"[98] perhaps the different responses of Britain and France can be attributed to differences between the two in "state interest," the impact on each of the "unregulated competition of states," "capabilities," or some combination of all three.

To what extent, if at all, does 'structural realism' provide an analytic framework through which one can understand and explain why Britain left and France remained in the ERM? To what extent did international structure condition the behavior of the two states in the ERM crisis and affect the outcomes of their interactions? Without entering the on-going debate between realism and institutionalism,[99] at least some aspects of the ERM crisis appear to lend credence to the realist perspective. As noted earlier, the crisis itself was, in the first instance, provoked by a failure to cooperate, manifested by the inability to negotiate either a "general" or a "broad" realignment prior to

"Black Wednesday." That failure to cooperate occurred despite a high degree of institutionalization of the EMS, the wide diffusion of norms about expected and appropriate behavior, and an extensive record of past cooperation. That a cooperative solution eluded the members at a critical moment, despite the institutions, norms, and history of the EMS, supports Grieco's assertion that the barriers to cooperation may be greater than institutionalists often assume.[100] Moreover, the fact that the failure to cooperate can be understood in terms of "defensive positionalism" and a concern for "relative gains"--Britain refused to devalue unless France also devalued, France refused to devalue against the mark, etc.--offers further support for the realist perspective.[101]

If the origins of the ERM crisis appear, in some respects, to confirm the realist perspective, it is more difficult to attribute the difference in the responses of Britain and France <u>within</u> the crisis to the international structure and their position within it, or to differences between the two in "state interest," the "conditioning" impact of the "unregulated competition of states," or "capabilities"--in part, because of the generality and ambiguity of realist terminology. It is difficult, for example, to conceive of "state interest" in a manner that is not post hoc--that is, defined retrospectively in order to explain the policy in question; relativized--that is, conflated with the preferences of the government of the day (which can, of course, change from day to day); or reductionist--that is, defined by attributes, structures, and interests within the state that derive from internal politics rather than international structure. Similar conceptual ambiguities attend other Waltzian terms such as "unregulated competition," "conditioning," and "capabilities."

As serious as the conceptual and analytic problems within structural realism are, it is nevertheless possible to modify the approach in ways that extend and enhance its analytic and explanatory utility. For example, the rationality and unitary actor assumptions inherent in the approach can be relaxed. As noted above, state interests can--albeit with some difficulty--be treated as exogenous and taken as given, or can be read from government preferences that can be specified. The assumption that the "unregulated competition" among states that vary in "capabilities" has a "conditioning" impact on their behavior can be relaxed--not by denying that the competition among states affects them or that they vary in "capabilities" but, rather, by recognizing that the competition among them may be "regulated." Relaxing the assumption in that way allows one to apply the structural realist approach to instances of regulated competition among states, such as occurs among the members of an international regime. That application of realism is, of course, entirely unproblematic if regimes are conceived, as they often are, as the creations and instruments of "hegemons," for in that case the regulation manifest in cooperation among the members would simply reflect the domination of the hegemon and the submission of the other members in the face of that dominance. But it is also possible to apply the realist approach to regimes that have no "hegemon" and in which cooperation is not reducible to the interests and influence of the "hegemonic" member--that is, to regimes viewed as mutual-benefit joint ventures or partnerships designed to facilitate cooperation among the members.[102] For a modified structural realist perspective to be applicable to such systems, it is only necessary that--notwithstanding the cooperation among them--the members of the regime also be competitive and that they vary in "capabilities."

Employing a suitably modified structural realist approach, one might seek to explain the different responses of Britain and France in the ERM crisis as the product of differences in the preferences of the two countries and other influential members of the ERM, and differences in the competitive positions and capabilities of the two countries, relative to each other and to those other influential actors.[103] Assuming, as most do, that Germany--whether or not "hegemonic"--is the most influential actor within the regime,[104] one might attribute the different responses of Britain and France to the extent of congruence or divergence of their preferences with those of Germany, and to Germany's ability to achieve its preferences through its exercise of "structural leadership."[105] The different responses of the two countries might have reflected, for example, a divergence in German and British preferences--in contrast to a congruence of German and French preferences--regarding economic policy and, as an element thereof, appropriate behavior within the ERM, combined with Germany's greater ability to convert its "structural power into bargaining leverage"[106] and, ultimately, its preferences into policy. Thus, the different responses--British exit and French loyalty--might have reflected Germany's desire, on one hand, to sanction Britain for violating the norms of the Bundesbank-dominanted regime (as when it refused to raise interest rates or devalue prior to "Black Wednesday" and thereby destabilized the regime), and its desire, on the other hand, to reward France for upholding the norms of the regime. Perhaps, in order to uphold and reinforce the norms of the regime, Germany was willing, if need be, to expel Britain from the ERM--not by overt expulsion, of course, but, rather, by creating the conditions that would make it impossible for Britain to remain within the ERM. Perhaps, on the other hand, in order to maintain the regime and reinforce its norms, Germany was willing to publicly reward France for adhering to those norms and toward that end was willing to arrange and participate in an unprecedented and coordinated defense of the franc. If that was the case, the British and French responses in the ERM crisis share a common attribute: they did not reflect the preferences, interests, and internal politics of the two countries; rather, they reflected the preferences and interests of another state--Germany--that, through its exercise of "structural leadership," converted <u>its</u> preferences into policy and, in so doing, caused Britain to leave the ERM and France to remain a loyal member.

A modified structural realist explanation of the British and French responses such as the one sketched above is by no means implausible. Few would contest the assumption that an asymmetry of power and influence existed within the EMS at the time of the crisis that advantaged Germany, and presumably that asymmetry was especially marked vis-à-vis Britain, which at the time had been a member of the ERM for less than two years. Few would deny, also, that German and British preferences were widely divergent in the period immediately before "Black Wednesday;" for example, whereas British leaders had sworn they would not devalue and had urged the Bundesbank to lower its rates without an accompanying realignment, the Bundesbank had defended its rates on economic grounds while offering to lower them in exchange for a broad realignment that would include the pound. And the acrimonious exchanges between Schlesinger and other German officials, on one hand, and Lamont and other British officials, on the other, at Bath over interest rates, and later--and in public--over what the British perceived to be the Bundesbank's role in bringing on the crisis and its failure to support the pound on September 16 are telling indicators not only of the divergence of preferences but of the intensity with which those divergent preferences were held. Indeed, the tone of the British comments immediately after "Black Wednesday" and at the end of September, after Schlesinger's comments were released to the public, might well be taken as evidence that the British endorsed the structural realist explanation sketched above.

As plausible as a modified structural realist account of the British and French decisions may be, such an account depends on more than the existence of divergent preferences and structural asymmetry within the EMS. For the modified realist explanation to be credible, one must be able to demonstrate, also, that the outcomes were the product of the <u>exercise</u> of structural power--that is, what Young calls "structural leadership." Unfortunately for the theory, it is difficult to demonstrate, except by rather tortuous post-hoc reasoning, that Germany exercised such leadership in the ERM crisis. Did Britain leave the ERM and France remain in it because of Germany's exercise of "structural leadership?" Did Germany wish to drive Britain from the ERM? Did Britain wish to remain in the ERM? Did Germany, exercising "structural leadership," force Britain out of the ERM against its wishes? It is obvious that British and German preferences diverged, and few would deny that the German Bundesbank was the most influential central bank within the EMS. And it is possible to argue, retrospectively, that Germany's interest was served by driving Britain out of the ERM--either by reinforcing the norms of the Bundesbank-dominated regime or, conversely, by so damaging the regime that its evolution to the later stages of EMU (when the Bundesbank would be integrated into the European System of Central Banks and subordinated to the European Central Bank) would be delayed or halted altogether. But it is by no means evident that Germany wished, prior to "Black Wednesday," to force or induce Britain to leave the ERM. Nor--although this is perhaps a controversial point--is it apparent that Britain in fact wished to remain in the ERM and left only because it was forced to leave.

Consider, first, German preferences as they appeared prior to "Black Wednesday." By all accounts, what Germany preferred, prior to September 16, 1992, was not that Britain leave the ERM but, rather, that it forsake its rejection of devalution and participate in a broad realignment that would reduce tensions within the ERM. There is little, if any, evidence--except by post hoc reasoning--to support the assertion that Germany wished to drive Britain out, either to punish it for violating the norms of the ERM or to derail the move to EMU. Consider British preferences: Implicit in the modified realist account is the assumption that Britain wished to remain in the ERM and left only because it was forced to leave. This, of course, is the widely-held view of what happened on "Black Wednesday." Perhaps Britain _did_ wish to remain in the ERM and _was_ forced out against its wishes. However, when looked at _prospectively_, rather than retrospectively, it is no more obvious that Britain wished to remain in the ERM than it is that Germany wished to drive Britain out. And it is not obvious that Britain could not have remained within the ERM had it so desired. As noted earlier, Britain _never_, during its short membership in the ERM, raised its interest rates (until mid-day on September 16), and it rejected on several occasions the pre-emptive broad realignment proposed by Germany (and several other members) prior to September 16. It could have raised interest rates earlier than it did, and it could have raised them to higher levels than it did on September 16th. Whether or not it raised interest rates, it could have devalued prior to September 16. It could have devoted more reserves to a defense of the pound on that day. It could have negotiated a devaluation within the ERM rather than defecting from it. It could have returned to the ERM after its temporary "suspension." In other words, the British exit resulted from _its_ choices, not from the coercive pressure applied by Germany in support of its divergent preferences. That is, _Britain_, not Germany, decided it would leave the ERM, and it could have decided otherwise.

Consider, finally, the assertion or presumption that Germany exercised "structural leadership" within the ERM in the days and weeks before "Black Wednesday" and that Britain's exit reflected the exercise of that "leadership." It is certainly true that Germany exercised "structural leadership" in the domain of monetary policy throughout 1991 and 1992, with the Bundesbank's decisions about German interest rates effectively setting the floor for rates in other countries. And it is certainly true that German officials, both in the central bank and in the government, were not reticent to express their preferences both before and after the ERM crisis erupted, and that they repeatedly voiced their opinions about the performance of the ERM and various currencies within it. On the other hand, "voice" is not necessarily synonymous with "structural leadership" and the expression of one's preferences not equivalent to their domination over the preferences of others. As Horst Köhler, the State Secretary in the Ministry of Finance had put at the time of the Maastricht meeting, in regard to German advocacy of Economic and Monetary Union, "we are ready to bring the D-Mark into a currency union. We don't want to dominate. We think it is in our interest...it is not a question of domination."[107] More important, at the critical moment when the crisis might have been averted, in early September of 1992, Germany did <u>not</u> exercise "structural leadership." Recall, for example, the response when Schlesinger and other Bank officials offered immediately before the Bath ministerial to reduce rates in exchange for a broad realignment. Recall the response when Köhler asked Lamont to put realignment on the agenda of the Bath meeting. Recall the response when Tietmeyer and Köhler, on their way to Rome on Saturday, September 12, told Trichet, the chair of the Monetary Committee, that they were seeking a broad realignment. The ensuing crisis occurred, it would seem, in large part because Germany was, at several critical moments, <u>unable</u> to exercise "structural leadership." Indeed, had there been German "structural leadership," the crisis and subsequent turmoil in currency markets might well have been avoided. For that reason, and also because there is little reason to think that Germany wished to force Britain out of the ERM and that Britain wished to remain in it and was forced to leave against its wishes, it is necessary to look elsewhere than structural realism for an explanation for why Britain and France responded as they did in the ERM crisis.

The International Regime-as-Polity Explanation. The difference between the British and French responses in the ERM crisis can not be attributed to differences in the domestic politics of the two countries. Indeed, if anything, a domestic-politics approach tends to mispredict the actual responses of the two countries. Nor can the difference in response be attributed, following realist logic, to the divergent interests and capabilities of the two states and the influential role of Germany within the EMS. For all its insights regarding the tenuous nature of cooperation in a regime, and the importance it assigns to the divergence of preferences and asymmetries of power within the EMS, the modified structural realist account tends to attribute the British exit to German "structural leadership" rather than to the choices made by the British government. On the other hand, as noted earlier, those choices do not appear to have emanated from such aspects of British political life as the electoral calendar, the partisanship of the government, and the structure and preferences of important economic actors such as the financial sector. How, then, are we to account for the British decision to leave the ERM? And, more generally, how might we explain why the British and the French governments pursued such diametrically opposed policies after the onset of the ERM crisis?

Having concluded that neither a domestic-politics approach nor an international-structural approach provides a satisfactory explanation for the different responses of the British and French governments in the ERM crisis, we turn to a third approach, one that combines some elements of the other two. For lack of a better name, we shall call this the regime-as-polity approach. This approach draws upon certain aspects of the large literature on international regimes,[108] as well as the long-established study of transnational relations and more recent efforts to understand the role of ideas and norms in international politics.[109] In essence, this approach views a regime--for example, the European monetary regime--as a complex political system within which the members pursue their particular interests through collective action and engage in politics in order to further those interests. Rather than treating a regime as the creation and instrument of a hegemonic or dominant member, this approach views a regime as a partnership by which its members pursue their interests through collective action that, in principle, is mutually beneficial. Rather than viewing politics within a regime simply as the process by which the preferences of a dominant member become endorsed by the other members, this approach emphasizes the process by which regime norms are created, diffused, and internalized so that they become, in varying degrees, the preferences articulated by the members. And rather than viewing the end product of regime politics as the triumph of the dominant member's interest, this approach views the political process within a regime as inherently indeterminate, with the outcome dependent upon the process itself. Thus, to understand why particular forms of collective action occur in a regime, one must investigate politics <u>inside</u> the regime--that is, the alliances and coalitions, divisions and disagreements, and patterns of cooperation and opposition among members through which they articulate and contest various definitions of the collective interest and, ultimately, act in the name of that collective interest.

Conceiving of a regime as a polity is altogether compatible with standard conceptions of international regimes. Such a regime undoubtedly includes among its attributes the "procedures, rules, or institutions" by which "governments regulate and control transnational and interstate relations," the "sets of governing arrangements that affect relationships of interdependence," the "networks of rules, norms, and procedures that regularize behavior and control its effects" that, according to Keohane and Nye, define international regimes.[110] And, following Krasner, it no doubt includes "implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations."[111] However, a regime, when viewed as a polity, consists of <u>more</u> than institutions, rules, norms, and procedures, important as all of those are. It comprises, also, the <u>interactions</u> among its members. That is, it consists not only of <u>static</u> attributes such as institutions, rules, and norms, but, also, of <u>dynamic</u> characteristics as well--

most notably, the ongoing interactions among the participants as they bargain and negotiate, influence and persuade, ally and oppose one another in defining and pursuing the collective interest. Politics within such a regime, then, is not simply about how a particular member establishes dominion. Nor is it simply about the institutions, rules, procedures, and norms that define the regime. Rather, it is about how the members interact within a complex institutional system, how they participate in the on-going definition of the collective interest, and how they coalesce and ally, contest and oppose each other in the pursuit of their particular interests and the collective interest.

If the heart of a regime, viewed as a polity, involves interactions among its member states, the politics within such a regime can not be conceived, as some would imagine, solely in terms of intergovernmental relations. While intergovernmental politics--that is, state-to-state relations--are surely important and, in fact, in some regimes are highly institutionalized, transnational and transgovernmental relations may be pervasive and influential as well. This may be especially true when, as with the European Monetary System, one is concerned with a regime that exists within a densely institutionalized supranational organization in which non-governmental as well as governmental actors meet in a wide range of fora on many different issues, for there can be little doubt that transnational and transgovernmental relations proliferate, above all, within organizations that are marked by an exceptionally high degree of complex interdependence.[112]

Transnational and transgovernmental relations are likely to be especially influential, moreover, when the regime in question involves actors which can not be treated simply as the agents of governments and whose relations can not, therefore, be considered simply as manifestations of intergovernmental politics. Such is the case, of course, in the European monetary regime; not only do the central banks of the members play an essential role that is often independent of government instruction but the most influential of them--the German Bundesbank--is constitutionally independent of government, and its officials can and often do take positions different from those espoused by government ministers.[113]

Moreover, the heads of the central banks interact routinely and frequently without government representatives, as in the monthly meetings of the Committee of Central Bank Governors. And even when the principal deputies of the central banks meet, in the Monetary Committee, with the principal deputies of the ministries of finance, it is not necessarily the case that the positions advocated and adopted are synonymous with the preferences of the governments.

The concept of a regime-as-polity assists one in understanding why Britain and France responded as they did in the 1992 ERM crisis. If the ERM is viewed as a regime within which members interact repeatedly over time, in which transgovernmental and transnational, as well as intergovernmental, interactions occur under the umbrella of the regime's institutions, in which norms are diffused and internalized, and preferences thereby transformed, and in which members may agree or disagree, and ally with or oppose each other, as they define the collective interest, the different responses of the two countries--in particular, the unilateral defection of Britain and the unprecedented cooperation between France and Germany in defending the franc--become comprehensible and, indeed, even predictable.

When the ERM is viewed as a polity, one observes a marked contrast in the roles within it of Britain and France, a contrast that makes their responses in the 1992 crisis intelligible. Although both were members of the ERM prior to "Black Wednesday," their past relationship with the ERM could not have been more dissimilar. Whereas France participated in the ERM since its inception and was, with Germany, the principal actor in the several realignments of the early 1980s that shaped the evolution of the EMS, Britain was a non-member of the ERM until late 1990. As had been the case when the Coal and Steel Community and then the European Economic Community were founded, Britain was consulted during the creation of the EMS but decided not to participate.[114] When it finally did join, it did so largely out of parochial self-interest--seeing the ERM as a means of bringing down interest rates and the rate of inflation that were both in double digits prior to the next election.[115] And, of course, when it entered, it did so as a newcomer to a regime within which the founding members had a long and intense history of interaction, occasional discord, and cooperation, within which interactions had led to cooperation that, in turn, had led to the transformation and convergence of policy preferences that, in turn, had led to the creation and internalization of norms about appropriate monetary behavior that, in turn, led to further interaction and cooperation. By its decision to remain outside the ERM, Britain had voluntarily excluded itself from that "evolution of cooperation."[116] Thus, compared to France and Germany, and their extensive interaction and cooperation in international monetary policy over the years, Britain appears marginal and peripheral to the ERM regime, having chosen to be essentially irrelevant during its most important developments.

As France and Germany interacted regularly over ERM issues for more than a dozen years prior to the 1992 crisis, that experience--most notably, in the negotiation of several realignments--created the basis for a normative consensus about appropriate policy within the ERM. In 1981-83, France had confronted a fundamental choice between exit and loyalty, in much the same way that Britain did in 1992. But it had opted, at that critical turning point, to remain in the ERM--despite the arguments of powerful proponents of the exit option (including, by March, 1983, Mitterrand himself)[117]--to accept its rules, and to adjust its domestic policy accordingly. As a result, when France confronted the 1992 ERM crisis, the dilemma of choosing between exit and loyalty had long since been resolved in favor of the latter. Britain, on the other hand, confronted the dilemma with little of the institutional loyalty that France had by then accumulated and, moreover, a long history of non-participation that may have predisposed it to favor the exit option.

The convergence of preferences and creation of norms of appropriate behavior in regard to monetary policy epitomized by the French "conversion" of 1982-83, and its commitment to the ERM regime, was founded, of course, not only on the interactions and cooperation within the EMS but also on the even longer history of cooperation between France and Germany in constructing Europe. As far back as the International Authority of the Ruhr and its successor, the European Coal and Steel Community, and, later, through the "Friendship Summits" begun by

Adenauer and de Gaulle in 1963, the "relaunching" of the Community by Willy Brandt and Georges Pompidou in the late 1960s and their support for EMU and enlargement, the initiative by Giscard and Schmidt to create the European Council and then the EMS, and, most recently, the initiative by Mitterrand and Kohl in April, 1990 to pursue "political union" as well as EMU, the inner core and driving force for institutional and functional innovation in the Community has been the "privileged partnership" between France and Germany.[118] That long history of cooperation no doubt contributed to the interaction and cooperation between officials and non-governmental actors of the two states over the past decade within the ERM[119]--just as Britain's long history throughout the post-War period of self-imposed marginality and exclusion from Europe undoubtedly established a precedent for its non-participation in the formative years of the ERM and set the stage for its acrimonious interactions in September, 1992 with other members of the ERM and, ultimately, the absence of cooperation epitomized by its unilateral defection.[120]

In some sense, Britain in 1992, as it had on several earlier occasions, simply confirmed de Gaulle's view--that it lacked a "European vocation."[121] Because it had rejected membership in the Coal and Steel Community when it was offered, and then had rejected membership in the EEC, and then had left the "snake" soon after having entered, and then had decided not to join the ERM in 1979, and then had bargained hard--even abrasively--over budget rebates in the 1980s, and then had refused to accept the inclusion of the "social chapter" in the Maastricht Treaty and had insisted on an "opt-out" protocal for stage three of EMU, Britain had not experienced either the frequency or intensity of interaction with the member states of the Community that France and Germany had over several decades. And partly, perhaps largely, for that reason, Britain had not internalized the norms of the ERM to the same degree that the other ERM members had and, as a result, diverged markedly from them in its preferences and notions of appropriate behavior in the ERM. That being the case, it is not at all surprising that Britain neither shared the commitment of the other two nations to the ERM nor could draw, as France could, upon a large stock of mark-denominated reserves in order to remain in the ERM.

In short, the very different histories of Britain and France within the European monetary regime, and the very different degrees to which they interacted over a long period with the dominant member, the very different degree of internalization of regime norms and preference transformation, and the very different extent of cooperation between each country and Germany, would have led one to predict--as the domestic politics and structural realist approaches would not--that, as in fact happened, if confronted with a difficult choice between exit and continued loyalty to the ERM, Britain would withdraw, while France, having long since faced that choice and opted to remain in the ERM, would continue as a loyal member and would seek to assure that continued membership by cooperation with Germany. Conversely, those very different histories would have also led one to predict--as the domestic politics approach would not (although the modified structural realist approach might)--that, as in fact happened, when confronted with the prospect, on one hand, of extending support to a British pound that was overvalued and a British government that refused to "play by the rules" in raising interest rates and accepting devaluation, or, on the other, of supporting a French franc that was, if anything, *under*valued and a French government that accepted the rules and norms of the EMS, even at its own political expense, the German Bundesbank would have little hesitation in rejecting the former and opting for the latter, and in so doing demonstrating once again the primacy within the European Community of the Franco-German "privileged partnership."

Conclusion

After having evolved into a quasi-fixed exchange rate regime during the late 1980s and early 1990s, the European Monetary System experienced a profound crisis during the last several months of 1992. After having experienced only one realignment, involving only one currency, in more than five and one-half years, seven devaluations occurred and two currencies were withdrawn from the Exchange

Rate Mechanism of the EMS (and three non-EMS members abandoned their pegs to the Ecu) in a matter of months. Perhaps the most dramatic moment of the crisis came on "Black Wednesday," September 16, 1992, when, after the largest intervention ever conducted by central banks on a single day, Britain withdrew from the ERM. But no less dramatic was the contrasting response of France; on several occasions--first in late September, 1992, after "Black Wednesday," and then again in early December and early January, 1993--the central banks and ministries of finance of France and Germany conducted an unprecedented, coordinated--and successful--defense of the franc.

This paper has sought to explain why the ERM crisis occurred and why, in particular, Britain and France responded in such different ways. The immediate cause of the crisis itself was the failure of the members of the ERM to agree on either a "general" or a "broad" realignment in the late Summer of 1992. In a larger sense, however, the crisis was caused, paradoxically, by the very development that so many celebrated and saw as the necessary prelude to Economic and Monetary Union--the increasing stability of the ERM over the several years prior to 1992 and its evolution into a quasi-fixed rate regime. The crisis derived, also, from the changes that had occurred in recent years in German economic and monetary policy--in particular, the continued increases in interest rates in the wake of the "asymmetric exogenous shock" of unification--as well as changes in the size and composition of currency markets and uncertainties generated by the Danish and French referendums on the Maastricht Treaty.

In explaining why Britain and France responded in such markedly different ways in the crisis, three alternative explanatory approaches were considered. One attributes the difference in response to differences in the domestic politics of the two countries. Another attributes the difference to the structure of the international system and the differing positions of the two countries within it. The third attributes it to the markedly different patterns of participation, interaction, and cooperation, prior to the crisis, of the two countries in the ERM regime, viewed as a polity. Neither domestic politics, conventionally understood, nor structural realism, even when modified, provides an adequate explanation for the contrasting responses of the two countries. To understand why Britain left the ERM, and why it left in the manner it did, and why France remained within it, and why it was able to mount a successful coordinated defense of the franc, one must recognize how their different institutional histories of non-participation and participation in the ERM over more than a dozen years prior to the crisis affected their policy preferences and their propensity to cooperate with other members. The long interaction within the ERM, highlighted by the several realignments of the early 1980s, transformed the policy preferences of France and caused them to converge with those of Germany, and the interaction, coupled with the internalization of norms and transformation and convergence in preferences, facilitated further cooperation. Britain, having opted out of the ERM at its founding, could not "opt in" to that history of interaction, shared norms, convergent preferences, and cooperation simply by joining the ERM at some later date. With their very different histories of participation in the ERM and, indeed, in the larger construction of Europe, it is not at all surprising that, when confronted by a crisis within the ERM, Britain would respond by unilateral defection while France would respond through cooperation with Germany.

Table 1

Devaluations and Floats in the 1992-93 ERM Crisis

September 8, 1992	Finnish markka abandons Ecu peg
September 12, 1992	Italian lira devalued 7 per cent
September 16, 1992	British pound "suspended" from ERM
September 17, 1992	Italian lira withdrawn from ERM
September 17, 1992	Spanish peseta devalued 5 per cent
November 19, 1992	Swedish krona abandons Ecu peg
November 22, 1992	Spanish peseta devalued 6 per cent
November 22, 1992	Portuguese escudo devalued 6 per cent
December 10, 1992	Norwegian krone abandons Ecu peg
January 30, 1993	Irish punt devalued 10 per cent
May 13, 1993	Spanish peseta devalued 8 per cent
May 13, 1993	Portuguese escudo devalued 6.5 per cent

Table 2

Realignments of Currencies in the EMS, March, 1979-August, 1992

Sept., 1979	
German mark	+2.0
Danish krone	-2.9
Nov., 1979	
Danish krone	-4.8
Mar., 1981	
Italian lira	-6.0
Oct., 1981	
German mark	+5.5
Dutch guilder	+5.5
French franc	-3.0
Italian lira	-3.0
Feb., 1982	
Belgian franc	-8.5
Danish krone	-3.0
June, 1982	
German mark	+4.25
Dutch guilder	+4.25
Italian lira	-2.75
French franc	-5.75
Mar., 1983	
German mark	+5.5
Dutch guilder	+3.5
Danish krone	+2.5
Belgian franc	+1.5
French franc	-2.5
Italian lira	-2.5
Irish punt	-3.5
July, 1985	
All except lira	+2.0
Italian lira	-6.0
April, 1986	
German mark	+3.0
Dutch guilder	+3.0
Danish krone	+1.0
Belgian franc	+1.0
French franc	-3.0
Aug., 1986	
Irish punt	-8.0
Jan., 1987	
German mark	+3.0
Dutch guilder	+3.0
Belgian franc	+2.0
June, 1989	
Spanish peseta enters ERM (range +/- 6%)	
Jan., 1990	
Italian lira (range reduced to +/- 2.25 %)	-3.7
Oct., 1990	
British pound enters ERM (range +/- 6%)	
April, 1992	
Portuguese escudo enters ERM (range +/- 6%)	

Table 3

Inflation Rates in ERM Countries, 1985-92
(Per cent change in consumer prices)

	1985	1986	1987	1988	1989	1990	1991	1992
Germany	2.2	-0.1	0.2	1.3	2.8	2.7	3.5	4.0
Netherlands	2.2	0.1	-0.7	0.7	1.1	2.5	3.9	4.0
Belgium	4.9	1.3	1.6	1.2	3.1	3.4	3.2	2.5
Luxembourg	4.1	0.3	-0.1	1.5	3.4	3.7	3.1	3.2
France	5.8	2.5	3.3	2.7	3.5	3.4	3.1	2.2
Denmark	4.7	3.7	4.0	4.6	4.8	2.6	2.4	2.3
Ireland	5.4	3.8	3.1	2.2	4.0	3.4	3.2	3.3
Italy	9.2	5.9	4.7	5.1	6.3	6.4	6.4	5.7
Spain	8.8	8.8	5.3	4.8	6.8	6.7	5.9	6.2
Britain	6.1	3.4	4.1	4.9	7.8	9.5	5.9	4.0
Portugal	19.3	11.7	9.4	9.6	12.6	13.4	11.4	8.9
Difference, ___-Germany:								
Netherlands	0.0	0.2	-0.9	-0.6	-1.7	-0.2	0.4	0.0
Belgium	2.7	1.4	1.4	-0.1	0.3	0.7	-0.3	-1.5
Luxembourg	1.9	0.4	-0.3	0.2	0.6	1.0	-0.4	-0.8
France	3.6	2.6	3.1	1.4	0.7	0.7	-0.4	-1.8
Denmark	2.5	3.8	3.8	3.3	2.0	-0.1	-1.1	-1.7
Ireland	3.2	3.9	2.9	0.9	1.2	0.7	-0.3	-0.7
Italy	7.0	6.0	4.5	3.8	3.5	3.7	2.9	1.7
Spain	6.6	8.9	5.1	3.5	4.0	4.0	2.4	2.2
Britain	3.9	3.5	3.9	3.6	5.0	6.8	2.4	0.0
Portugal	17.1	11.8	9.2	8.3	9.8	10.7	7.9	4.9

Note: Spain joined the ERM in June, 1989. Britain joined in October, 1990. Portugal joined in April, 1992. All three joined with wide (+/- 6 %) bands.

Source: International Monetary Fund, International Financial Statistics Yearbook, 1991, p. 117; and I.M.F., International Financial Statistics, January 1993, p. 53. The data for 1992 for Germany, France, Britain, Denmark, and Ireland are for twelve months. For Italy, the rate is that in the first quarter. For the remainder, the data are for the first three quarters.

Notes

1. The title borrows, of course, from Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (Cambridge: Harvard, 1970).

2. The Treaty on European Union was agreed to by the twelve heads of government or state of the European Community, meeting as the European Council in the Dutch city of Maastricht in December, 1991. It was formally signed by representatives of the governments in Maastricht in February, 1992. The Treaty stipulates that the second, transitional stage of EMU will begin in January, 1994, by which time all member states will have joined the ERM.

3. There is no formally-designated inner, or "hard," core of the ERM. However, most commentators would identify the German mark, the Dutch guilder, the Belgian franc (and the Luxembourg franc) as "hard" currencies within the ERM. The guilder and the Belgian franc observe margins of +/- 1 per cent vis a vis the mark, rather than the conventional narrow margin of +/- 2.25 per cent. (Belgium and Luxembourg have been joined in a monetary union since 1922 and, since then, have periodically renewed their ten-year agreement to fix the parities of their currencies at 1:1 without bands.) The Danish krone, the Irish punt, and the French franc are generally considered the "hardest" of the other currencies within the ERM, notwithstanding the fact that all three resided at or near their floors in the ERM throughout late 1992-early 1993 (and the fact that one of them, the punt, was ultimately devalued in late January, 1993).

4. According to the Maastricht Treaty, the third stage of EMU, in which a single central bank will come into being that is responsible for a single monetary policy and in which exchange rates are irrevocably locked and national currencies replaced by a single currency, may begin as early as 1997 and, in any event, no later than 1999.

5. When Britain entered the Exchange Rate Mechanism of the European Monetary System in October, 1990, it unilaterally set the exchange rate for the pound at DM 2.95. Entering with a 6 per cent margin vis a vis other currencies in the parity grid, the pound's floor versus the mark was 2.778.

6. On September 8, the Finnish government allowed the markka--which had been pegged since June, 1991 to the European Currency Unit (Ecu), the notional currency of the European Monetary System--to float. On September 12, Italy devalued the lira by 7 per cent. Prior to that devaluation, the last realignment within the ERM had occurred in January 1990, when the lira had moved from a 6 per cent margin to the standard 2.25 per cent margin and had, at the same time, been devalued by 3.7 per cent. The last multi-currency realignment had occurred in January, 1987.

7. By the end of 1992, the rate of unemployment in France was more than 10 per cent and the number of unemployed was close to 3 million, up from the 2.5-2.6 million of 1988-90. In contrast, the rate of inflation for 1992 was only 2.0 per cent, the lowest in 37 years and almost two percentage points below the rate in Germany. In the National Assembly elections of March 21 and 28, 1993, the government did in fact suffer a landslide defeat. The Socialist Party's vote dropped from the 37.5 per cent it had received in the 1988 election to less than one-half that level, and the two conservative parties--the Rassemblement pour la République and the Union pour la Démocratie Française--won about 40 per cent of the vote and, with that 40 per cent, 84 per cent of the seats in the Assembly.

8. The "snake" linked the European currencies in a bilateral parity grid within which they would fluctuate against each other in bands of +/- 2.25 per cent--one-half the width of the band then in effect in the revised Bretton Woods system

(hence the name "snake within the tunnel"). Participation in the "snake" was not restricted to member states of the Community, and it had neither a mechanism for joint intervention at the margins nor one for negotiating realignments. By 1976, all of the large member states of the EC except Germany (that is, Britain, Italy, and France) had dropped out after their currencies had fallen through the floor of the band, (France, in fact, had dropped out twice, once in 1973 and again in 1976.) At the same time, several non-EC currencies--the Norwegian krone, the Swedish krona, and more informally the Austrian schilling and the Swiss franc--remained within it.

9. Provision was made for later entrants to operate within a wider band of +/- 6 per cent. However, Italy, although a founding member, insisted on the right to operate within the wider band and was allowed to do so.

10. For discussions of the creation of the EMS by its principal architects, see Roy Jenkins, European Diary (London: Collins, 1989); Helmut Schmidt, Deutschen und Ihre Nachbarn (Berlin: Siedler, 1990); and Valéry Giscard d'Estaing, Le Pouvoir et la Vie (Paris: Compagnie 12, 1988). See, also, James Callaghan, Time and Change (London: Collins, 1987); and Denis Healey, The Time of My Life (London: Michael Joseph, 1989). For the definitive account of its creation, see Peter Ludlow, The Making of the European Monetary System: A Case Study of the Politics of the European Community (London: Butterworth, 1982). Proposals to repair the "snake," by instituting a mechanism for joint intervention at the margins and joint decision-making in regard to realignments and by limiting its membership to EC currencies, were first made in 1975, in the Report on European Union (Brussels: European Communities, 1975) commissioned by the heads of state and government at their Paris summit in December, 1974, (the so-called Tindemans report, after its author, the Belgian Prime Minister Leo Tindemans) and, later, by Roy Jenkins, the recently-appointed President of the Commission, in his Jean Monnet lecture in October, 1977, published as "European Monetary Union," Lloyds Bank Review, No. 127, January, 1978, pp. 1-14.

11. See David R. Cameron, "The 1992 Initiative: Causes and Consequences," in Alberta M. Sbragia, ed., Euro-politics: Institutions and Policymaking in the "New" European Community (Washington, D.C.: Brookings, 1992), Table 2-7, p. 46. For a discussion of the most important period of norm creation in the evolving European monetary regime, see Cameron, "Exchange Rate Politics in France, 1981-83: The Regime-Defining Choices of the Mitterrand Presidency," Conference on the Mitterrand Presidency, Wesleyan University, April, 1992. On the evolution of the EMS, see, among many, Marcello de Cecco, International Economic Adjustment: Small Countries and the European Monetary System (Oxford: Blackwell, 1983); de Cecco and Alberto Giovannini, eds., A European Central Bank? Perspectives on Monetary Unification After Ten Years of the EMS (Cambridge: Cambridge, 1989); Paul de Grauwe, The Economics of Monetary Integration (Oxford: Oxford, 1992); de Grauwe and Lucas Papdemos, eds., The European Monetary System in the 1990s (London: Longman, 1990); Michele Fratianni and Jürgen van Hagen, The European Monetary System and European Monetary Union (Boulder: Westview, 1992); Francesco Giavazzi, Stefano Micossi, and Marcus Miller, eds., The European Monetary System (Cambridge: Cambridge, 1988); Giavazzi and Giovannini, Limiting Exchange Rate Flexibility: The European Monetary Sysem (Cambridge: M.I.T., 1989); Giovannini and Colin Mayer, eds., European Financial Integration (Cambridge: Cambridge, 1991); Goodman, op. cit., Ch. 6; Paolo Guerrieri and Pier Carlo Padoan, eds., The Political Economy of European Integration (New York: Harvester Wheatsheaf, 1989); Ludlow, op. cit.; Frank McDonald and George Zis, "The European Monetary System: Towards 1992 and Beyond," Journal of Common Market Studies, Vol. 27 (March 1989), pp. 231-48; Heinz-Dieter Smeets, "Does Germany Dominate the EMS?" Journal of Common Market Studies, Vol. 29 (September 1990), pp. 37-52; Axel Weber, "Reputation and Credibility in the European Monetary Sytem," Economic Policy, Vol. 12 (April 1991), pp. 58-89; and John T. Woolley, "Policy Credibility and European Monetary Institutions," in Sbragia, ed., op. cit., pp. 157-190. Especially useful, also, are the several Occasional Papers issued by the International Monetary Fund--for example, Horst Ungerer, Jouko J. Hauvonen, Augusto Lopez-Claros, and Thomas Mayer, The European Monetary System:

Developments and Perspectives, I.M.F. Occasional Paper 73 (Washington, D.C.: I.M.F., 1990).

12. See Cameron, "The 1992 Initiative: Causes and Consequences," op. cit.

13. For a useful discussion, see James Blitz, "How central banks ran into the hedge," Financial Times, September 30, 1992, p.2. See, also, Peter Norman, "London thrives as biggest foreign-exchange centre," Financial Times, September 25, 1992, p. 2.

14. Blitz, op. cit.

15. Quoted in Financial Times, September 16, 1992, p. 6.

16. On this point, see Blitz, op. cit.

17. Many forward traders were simply prudent investors concerned about the "fundamentals" of the currencies and aware of the disparities in risk and return among them. Others, of course, were speculators in the traditional sense, for whom the characteristic response to the commitment of a government to maintain the existing exchange rate of an overvalued currency is to borrow funds to buy the currency, sell it at the existing exchange rate (which the government defends), and then buy forward (hopefully at a lower exchange rate, after a devaluation) in order to repay the borrowings. By such tactics, the Soros Fund Management earned, by the estimate of its managing director, a profit of two to three billion dollars in 1992, "well over half" of which came from speculation on sterling prior to "Black Wednesday." See Financial Times, January 13, 1993, p. 4.

18. In the June, 1988 Council decision, France and Italy agreed to remove all exchange controls by July 1, 1990. Spain and Ireland agreed to remove their controls by January 1, 1993. Portugal and Greece were given until the end of 1994 to eliminate their controls.

19. Nicholas Colchester and David Buchan, Europower: The Essential Guide to Europe's Economic Transformation (New York: Random House, 1990), p. 45.

20. On the Bundesbank, see David Marsh, The Bundesbank: The Bank That Rules Europe (London: Heinemann, 1992). See also Dieter Balkhausen, Gutes Geld und schlechte Politik (Düsseldorf: ECON Verlag, 1992); and John Goodman, Monetary Sovereignty: The Politics of Central Banking in Western Europe (Ithaca: Cornell, 1992).

21. Ibid., pp. 160-61. See, also, Marsh, op. cit.

22. Such concerns in fact lay behind the French and Italian efforts to resurrect EMU and the notion of a single central bank that culminated, several years later, in the Maastricht Treaty. See David R. Cameron, "Maastricht, the ERM Crisis, and the Future of EMU," prepared for the Consortium on the Emerging European Polity, May, 1993.

23. In 1985 through 1987, the rate of economic growth in Germany averaged slightly under 2 per cent. In 1988 and 1989, it increased to 3.5 to 4 per cent.

24. In the run-up to the March, 1990 Volkskammer election, Kohl implied a 1:1 exchange rate beytween the DM and the OM, although the prevailing black market rate at the time was about 1 DM for 5 OM. The Bundesbank objected vigorously and proposed a 1:2 exchange rate. In April, 1990, the government decided on a 1:1 rate for all cash, wages, pensions, and savings up to 4000 OM per person, with

a 2:1 rate for everthing over 4000 OM (except for persons over 60, for whom the 1:1 rate applied up to 6000, and for persons under 14, for whom the 1:1 rate applied only up to 2000 OM). On the reactions of the Bundesbank and its president, Karl-Otto Pöhl, see Marsh, op. cit., and Balkhausen, op. cit.

25. By early 1993, wages in the territories of the former G.D.R. had risen to about 70 per cent of those in the rest of Germany, although productivity in the East was only 30 to 35 per cent of that in the West. Faced with large increases in unit labor costs, employers in steel and metal working revoked the agreement in the Spring of 1993, thereby prompting I.G. Metall call a strike in eastern Germany and, eventually, the entire country.

26. In 1990, G.N.P. in the ex-G.D.R. is estimated to have dropped by 14.4 per cent. In 1991, it dropped by a further 30.3 per cent. (In 1992, it is estimated to have increased by 7 per cent). In 1990, the work force in the ex-G.D.R. comprised some 8.8 million, of whom 0.2 million were unemployed. In 1992, the work force was estimated to comprise 6.1 million, of whom 1.3 million were unemployed. In other words, the active work force decreased from 8.6 million in 1990 to 4.8 million in 1992.

27. Transfers to the citizens and authorities of the East totaled approximately 50 billion marks in 1990, 140 billion marks in 1991, and 160 to 180 billion marks in 1992.

28. On the magnitude of German public expenditures and deficits, see The Economist, April 4, 1992, p. 57; The Economist, Oct. 31, 1992, p. 47; and The Economist, December 5, 1992, p. 57. The deficit figure includes spending by the states and localities as well as the Unity Fund, the Treuhandanstalt, and other public entities. The deficit of the Federal government contributes slightly less than one-half of the total public deficit. The combined deficit of all levels and agencies of government totaled approximately 0.2 per cent of G.N.P. in 1989, 1.7 per cent in 1990, 3.0 per cent in 1991, and 4.0 per cent in 1992, and is projected to increase significantly, both in nominal terms and relative to G.N.P., in 1993.

29. See Mark D. Harmon, "'If We Can't Change the Rules, We Won't Play Your Game': Britain In and Out of the European Monetary System," paper to be delivered at the 1993 Annual Meeting of the American Political Science Association, Washington, D.C. When Britain entered the ERM in October, 1990, it unilaterally established its exchange rate at DM 2.95, a rate that most in the ERM believed was too high, rather than setting it through negotiation in the Monetary Committee.

30. When Britain entered the ERM in October, 1990, the Minimum Lending Rate was 15 per cent, while the German Lombard rate was 8 per cent. By the Summer of 1992, the differential between the two was 0.25 per cent.

31. Reported by Hjalte Rasmussen, "Whose Community? Regions and Peripheries," Workshop at the Minda de Gunzburg Center for European Studies, Harvard University, January, 1993. On top of everything else, we might note the inept campaign conducted by the government on behalf of the Treaty--largely a series of speeches by Uffe Ellemann-Jensen, the Foreign Minister--as well as the inopportune intervention by Jacques Delors, who several days before the vote raised the prospect that in an enlarged EC the small countries might have to forsake some of their institutional perquisites, such as the right to hold the Council presidency and retain an equal vote in the Council.

32. In November, 1992, John Major agreed, as the price for obtaining support from backbench Conservatives on a procedural vote on the Maastricht Treaty, to delay the final vote on the Treaty in the House of Commons until after the second Danish referendum. With that promise, he won the "paving debate" by three votes.

33. The constitutional changes, which were then under consideration in the National Assembly and the Senate, pertained to the creation of a single currency and the extension of the suffrage in local elections to citizens of other member states. Once each house had passed the constitutional revisions by a simple majority, the government could either convene a Congress composed of the two houses that would have to approve the revisions by a 60 per cent majority or call a refendum that would require a simple majority.

34. In the first survey taken after Mitterrand's call for a referendum, 69 per cent of the French said they would vote 'yes' in a referendum on Maastricht.

35. In a vote in the National Assembly in early May on a motion to reject outright the Maastricht Treaty, 101 deputies voted for the motion, including 58 of the 126 members of the R.P.R. and 7 of the 129 members of the U.D.F. (as well as all 26 Communist deputies, the sole deputy representing the Front National, 4 centrist deputies, and 5 left-wing members of the Socialist Party). In a subsequent vote on May 13, the Assembly approved the constitutional revisions by 398 to 77 with 99 abstentions. 88 members of the R.P.R. (including its leader, Jacques Chirac) abstained while 31 voted against and 7 (including Edouard Balladur, the Prime Minister after the elections of March, 1993) voted for the revisions. The Senate approved the constitutional changes on June 18 by a vote of 192 to 117 and the National Assembly passed the Senate's text the next day, by a vote of 388 to 43.

36. In the space of three days, from August 25 to August 28, 1992, three national surveys estimated the support for the Treaty at less than 50 per cent. The BVA survey of August 25 estimated the 'yes' vote at 49 per cent (compared to 63 per cent in its first survey in June after the announcement of a referendum) and the CSA survey of August 28 estimated the 'yes' vote at 47 per cent (compared to 69 per cent on the day after Mitterrand's announcement).

37. The last five polls before the referendum--by IPSOS, ISL, and BVA on September 10, SOFRES on September 12, and IFOP on September 13 (publication of poll results is banned in the week before a referendum)--reported a 'yes' vote among those expressing a definite opinion of 53, 51, 50, 52, and 53 per cent, respectively. In the actual referendum, on September 20, 51.05 per cent said 'yes' to the constitutional amendments. As in Denmark, the French referendum presented an opportunity for a diverse array of citizens to express their grievances against the government. Surveys suggested that opposition to the Treaty was strongest among those with low incomes, low education, and those who were farmers, artisans, shopkeepers, and unemployed. French farmers, most of whom opposed the reforms of the Common Agricultural Policy agreed to in May that would reduce price supports for beef, pork, poultry, and cereals by up to 29 per cent, overwhelmingly voted against the Treaty. Likewise, industrial workers--especially those residing in areas such as the North that were hardest hit by the recession and rising levels of unemployment--opposed it, as did those who believed that the citizenship clause of the Treaty would encourage an influx of immigrants. Political leaders opposed to the Treaty such as the R.P.R.'s Philippe Séguin (chosen by Mitterrand to represent the opposition in a nationally-televised debate with the President) invoked the old Gaullist notion of a Europe des Patries, raising the threat of a loss of national sovereignty to an increasingly intrusive Brussels-based bureaucracy that was "anti-democratic, falsely liberal, and deliberately technocratic." And, of course, many French citizens used their vote on the Treaty to express their low regard for the Socialist government and its policies, and for Mitterrand personally. Surveys estimated that between 80 per cent of the supporters of the Communist Party, 90 per cent of the supporters of the Front National, and 60 per cent of the supporters of the neo-Gaullist R.P.R. opposed the Treaty. See Financial Times, September 23, 1992, p. 16.

38. In discussions within the EMS, a "general" realignment referred to one which involved all currencies, including the mark and other "hard" currencies. A "broad" realignment referred to one which involved several, but not all or most, currencies--as, for example, in the simultaneous devaluation of several of the weakest currencies in the ERM.

39. On the positions of Lamont and Major, see Financial Times, July 11-12, 1992, p.1, and July 13, 1992, p. 1.

40. On the discussions among the central bank officials in the late Summer, see Will Hutton, "UK: The Chancellor, the Banker, and Deaf Ears in Bath: Exit from ERM," The Guardian, November 30, 1992.

41. Quoted in Peter Norman and Lionel Barber, "Monetary Tragedy of Errors," Financial Times, December 11, 1992, p. 2.

42. See Rudiger Dornbusch, "The Arthur Okun Memorial Lectures," Yale University, November 18, 1992.

43. See Hutton, op. cit..

44. See Schlesinger's comments to reporters at the G7 meeting in Washington on September 19, 1992, in Financial Times, September 21, 1992, p. 3.

45. See Hutton, op. cit., and Norman and Barber, op. cit.

46. On the German suggestion of a reduction in interest rates in exchange for a broad realignment, see Financial Times, September 15, 1992, p. 1; September 19-20, 1992, p. 1; and October 2, 1992, pp. 10-11; Hutton, op. cit.; and Norman and Barber, op. cit. The Bundesbank had suggested the linkage of interest rate reductions and realignment to the Ministry of Finance just prior to the Bath meeting.

47. Quoted in Norman and Barber, op. cit.

48. On Schlesinger's comments at Basle, see Hutton, op. cit. Ironically, on the same day, Finland--after experiencing a large outflow of capital--was forced to abandon its peg of the markka to the Ecu, the first of the several decisions that would be taken over the next several months to devalue or float.

49. Financial Times, September 11, 1992, p. 1.

50. The figure was given by Schlesinger in his press conference in Frankfurt with Hans Tietmeyer, the Vice President of the Bundesbank, on September 14, 1992. Schlesinger said the intervention was "extraordinarily high, higher than ever before in a speculation crisis," citing for comparison the 16 billion marks spent in the terminal crisis of the Bretton Woods regime in 1973 and the 15 billion marks spent before the last major ERM realignment in 1987. See Financial Times, September 15, 1992, p. 1.

51. For details about the meeting, see Financial Times, September 15, 1992; Hutton, op. cit.; Norman and Barber, op. cit.; and Peter Norman, "The Day Germany planted a currency time bomb," Financial Times, December 12-13, 1992, p. 2.

52. That the Bundesbank would likely have to continue interventions in support of the lira at massive levels derived from the requirement in the EMS that when a currency reached a floor or ceiling against another currency, the central banks of both countries had to intervene to keep the currency within the applicable

margin, coupled with the fact that the lira was overvalued by as much as 20 per cent.

53. For the most detailed account of this meeting and the actions of Trichet, see Norman and Barber, op. cit. Although written earlier than Norman and Barber, Hutton, op. cit., also discusses this meeting, although in less detail and with some disagreement about facts.

54. See Financial Times, September 15, 1992, p. 1.

55. In a later, public exchange, the British Treasury highlighted these portions of the summary as particularly damaging to sterling. See Financial Times, October 1, 1992, pp. 1 and 2.

56. On the summary of the interview released to the press in Germany, see Financial Times, September 16, 1992, p. 1. For the story of the British reaction on the evening of September 15, see Financial Times, September 19-20, 1992, p. 1; Hutton, op. cit., December 1, 1992; and Norman and Barber, op. cit.

57. At the end of August, Britain had approximately 25 billion pounds ($44.4 billion) in reserves. On "Black Wednesday," the Bank also had available to it a significant portion of the 7.27 billion pound (Ecu 10 billion) credit obtained in early September. At the emergency meeting of the Monetary Committee on September 16-17, the representative from the Bank of England stated that the Bank had spent 11 billion pounds of reserves. The day after "Black Wednesday," the estimates of the total sterling purchases were placed as high as 15 billion pounds, bought with reserves and perhaps a third of the 10 billion Ecu (7.27 billion pounds) foreign currency loan. See Financial Times, September 18, 1992, p. 6.; and Hutton, op.cit.

58. For accounts of "Black Wednesday," see, in particular, Financial Times, September 19-20, 1992; Hutton, op. cit.; and Norman and Barber, op. cit.

59. See Financial Times, September 17, 1992, p. 1.

60. Financial Times, September 19-20, 1992, p. 1.

61. See Financial Times, September 19-20, 1992, p. 1.

62. See "Comments by Bundesbank President Prof. Dr. Helmut Schlesinger on reproaches made by some memebers of the British government," reprinted in full in Financial Times, October 1, 1992, p. 2. Schlesinger revealed, among other things, that during the week of September 14-18 the Bundesbank sold more than 44 billion marks in compulsory sales in support of EMS currencies, the greater part of which was accounted for by interventions to support the pound. He claimed that constituted by far the largest compulsory intervention ever undertaken vis-a-vis a partner currency.

63. See Financial Times, February 5, 1993, p. 1.

64. Quoted in Financial Times, September 19-20, 1992, p. 1.

65. See William Dawkins and David Buchan, "How the French fought to save the franc," Financial Times, November 20, 1992, p. 15.

66. For details, see ibid.

67. Financial Times, September 22, 1992, p. 1.

68. Financial Times, September 23, 1992, p. 1.

69. Ibid.

70. See Financial Times, September 24, 1992, p.2.

71. Ibid.

72. Quoted in Financial Times, November 19, 1992, p. 2.

73. In his "Comments" published on October 1, Schlesinger revealed that the Bundesbank had intervened intramarginally in support of sterling prior to "Black Wednesday"--although that was not known at the time of the interventions.

74. Financial Times, October 15, 1992, p. 3.

75. Financial Times, October 2, 1992, p. 1.

76. See Norman, op. cit. See also William Dawkins, "French weaponry secured win in battle for franc," Financial Times, November 3, 1992, p. 2. Because the details of the Franco-German agreement were secret, one can only speculate about the magnitude of the credit extended by the Bundesbank to the Banque de France. Dawkins estimates that Bundesbank credit may have totaled as much as FFr 130-140 billion of the total Banque intervention of FFr 160 billion, although the data on the change in French official reserves in September suggest the Banque may have made use of no more than half that amount, perhaps FFr 80 billion. That such credit was provided is confirmed by Schlesinger in his "Comments" published in London on October 1, in which he claimed that the Bundesbank had made use of the same facilities--specifically, mark-denominated credit tranches and swaps--in support of the pound that were used in the defense of the franc. It was confirmed also by the Banque in early November, when it announced that it had repaid all funds borrowed from the Bundesbank. See Financial Times, November 9, 1992, p. 2.

77. Financial Times, October 3, 1992, p. 1.

78. Financial Times, September 24, 1992, p. 2.

79. Immediately after the markka's peg to the Ecu had been abandoned by Finland, on September 8, the Riksbank had increased its overnight marginal intervention rate to 75 per cent. It subsequently raised the rate to 500 per cent for several days in the midst of the turmoil surrounding "Black Wednesday."

80. See Financial Times, November 21-22, 1992, p. 1; and November 23, 1992, pp. 1, 3.

81. Portugal devalued with some reluctance. Although Spain was its largest trade partner and its exports would surely suffer from a second devaluation of the peseta, Portugal claimed it did not need to devalue based on economic fundamentals. (However, as Table 1 indicates, its rate of inflation in 1992 was roughly twice that of Spain and the escudo was, based on inflation differentials, overvalued vis a vis both the peseta and the mark.) See Financial Times, November 23, 1992, pp. 1, 3.

82. See Financial Times, December 4, 1992, p. 2; and December 5-6, 1992, p. 1.

83. The krone had been pegged to the Ecu since October, 1990. The Norwegian central bank estimated that it had spent NKr 49.9 billion ($7.7 billion), approximately one-half of its reserves, in defense of the krone during the week of the Swedish float. It also estimated that only 20 per cent of the funds that had left the country after the float of the Swedish krona had returned, despite its increase in the overnight lending rate from 10 per cent to 25 per cent. See Financial Times, November 28, 1992, p. 2; and December 11, 1992, p. 1.

84. On Mitterrand's statement, see his interview in Financial Times, December 9, 1992, p. 12. For Bérégovoy's and Schlesinger's statements, see Financial Times, December 18, 1992, p. 18.

85. See Financial Times, January 6, 1993, pp. 1, 9.

86. On the Irish devaluation, see Financial Times, January 26, 1993; January 27, 1993; January 28, 1993; January 29, 1993; and January 30-31, 1993.

87. See Financial Times, May 14, 1993, pp. 1-2.

88. Quoted in David Marsh and Peter Marsh, "Lessons of Europe's Currency Turmoil," Financial Times, April 30, 1993, p. 3.

89. Financial Times, January 15, 1993, p. 2. These words were spoken, of course, prior to the Irish devaluation of January 30 (and the Spanish and Portuguese devaluations of May 13).

90. Anthony Downs, An Economic Theory of Democracy (New York: Harper and Row, 1957), especially Ch. 8. See, also, William D. Nordhaus, "The Political Business Cycle," Review of Economic Studies, Vol. 42 (April,1975), pp. 169-90.

91. See Etienne S. Kirschen et al., Economic Policy in Our Times, 3 vol. (Amsterdam: North-Holland, 1964). See, also, Douglas A. Hibbs, Jr., "Political Parties and Macroeconomic Policy," American Political Science Review, Vol. 71 (December, 1977), pp. 1467-87.

92. On this point, I am grateful for the comments and suggestions of Ira Katznelson and other members of the Workshop on International Political Economy, Columbia University.

93. See John Zysman, Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change (Ithaca: Cornell, 1983); Peter A. Hall, Governing the Economy: The Politics of State Intervention in Britain and France (New York: Oxford, 1986); Geoffrey K. Ingham, Capitalism Divided? The City and Industry in British Social Development (Basingstoke: Macmillan, 1984); and Frank Longstreth, "The City, Industry, and the State," in Colin Crouch, ed., State and Economy in Contemporary Capitalism (London: Croom Helm, 1979);

94. See Stephen Blank, "Britain: The Politics of Foreign Economic Policy, the Domestic Economy, and the Problem of Economic Stagnation," in Peter J. Katzenstein, ed., Between Power and Plenty (Madison: Wisconsin, 1978); Hall, op. cit.; Ingham, op. cit.; and Susan Strange, Sterling and British Policy (Oxford: Oxford, 1971).

95. See Zysman, op. cit., Ch. 4; and Hall, op. cit., Ch. 6-7.

96. Hall, op. cit., pp. 51, 59-61.

97. Kenneth N. Waltz, Theory of International Politics (Reading: Addison-Wesley, 1979), pp. 40-41.

98. Ibid., pp. 100-101, 105, 117, 97.

99. For convenience, "realism" is used interchangeably with "neorealism" and "structural realism" and "institutionalism" is used interchangeably with "liberal institutionalism," "neoliberalism," "neoliberal institutionalism," etc. For a discussion of the debate between Waltz and his critics and, more generally, between "realists" and "institutionalists," see, among others, Robert O. Keohane, Neorealism and Its Critics (New York: Columbia, 1986), especially ch. 6 by John Gerard Ruggie and ch. 7 by Keohane; Joseph M. Grieco, "Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism," International Organization, Vol. 42 (Summer 1988), pp. 485-507; Grieco, Cooperation Among Nations: Europe, America, and Non-Tariff Barriers to Trade (Ithaca: Cornell, 1990), especially ch. 1-2 and 8; Keohane, "International Institutions: Two Approaches," International Studies Quarterly, Vol. 32 (December 1988), pp. 379-96; Keohane, International Institutions and State Power (Boulder: Westview, 1989); Joseph Nye, "Neorealism and Neoliberalism," World Politics, Vol. 40 (January 1988), pp. 485-507; and Alexander Wendt, "Anarchy is What States Make of It: The Social Construction of Power Politics," International Organization, Vol. 46 (Spring 1992), pp. 391-425.

100. See Grieco, op. cit., especially ch. 2, pp. 27-50.

101. The terms "defensive positionalism" and "relative gains" are Grieco's. See ibid., pp. 36-50, especially pp. 40, 44. For the British and French resistance to devaluation, see the discussion of the Bath meeting in Norman and Barber, op. cit.; and Hutton, op. cit.

102. On the various conceptions of international regime, see Stephen D. Krasner, ed., International Regimes (Ithaca: Cornell, 1983). See, also, among many, Robert Gilpin, War and Change in World Politics (Princeton: Princeton, 1981); Stephan Haggard and Beth A. Simmons, "Theories of International Regimes," International Organization, Vol. 41 (Summer 1987), pp. 491-517; Robert O. Keohane, After Hegemony: Cooperation and Discord in the World Political Economy (Princeton: Princeton, 1985); Charles R. Kindleberger, The World in Depression, 1929-1939 (Berkeley: California, 1973); Kenneth Oye, ed., Cooperation Under Anarchy (Princeton: Princeton, 1986); Duncan Snidal, "The Limits of Hegemonic Stability Theory," International Organization, Vol. 39 (Autumn 1985), pp. 579-614; Arthur A. Stein, "Coordination and Collaboration: Regimes in an Anarchic World," International Organization, Vol. 36 (Spring 1982), pp. 299-324; Stein, Why Nations Cooperate: Circumstance and Choice in International Relations (Ithaca: Cornell, 1990); Oran R. Young, "Regime Dynamics: The Rise and Fall of International Regimes," International Organization, Vol. 36 (Spring 1982), pp. 277-97; and Young, "Political Leadership and Regime Formation: On the Development of Institutions in International Society," International Organization, Vol. 45 (Summer 1991), pp. 281-308.

103. For useful applications of a modified structural realist perspective to recent developments in the European Community, see Andrew Moravcsik, "Negotiating the Single European Act: National Interests and Conventional Statecraft in the European Community," International Organization, Vol. 45 (Winter 1991), pp. 19-56; and Geoffrey Garrett, "International Cooperation and Institutional Choice: The European Community's Internal Market," International Organization, Vol. 46 (Spring 1992), pp. 533-60.

104. On the relative influence of Germany in the EMS, see, among others, Colchester and Buchan, op. cit.; De Grauwe, op. cit.; Fratianni and von Hagen, op. cit., ch. 5; Giavazzi and Giovannini, op. cit.; and Marsh, op. cit. See, also, Andrei S. Markovits and Simon Reich, "'Modell Deutschland' and the New

Europe," Telos, 89 (Fall 1991), pp. 45-63, in which the authors speak of Germany's "emerging position as the European hegemon."

105. Young, "Political Leadership...,op. cit., p. 291.

106. Ibid., p. 291.

107. Quoted in Financial Times, December 7-8, 1991, p. 3.

108. See, for example, Krasner, op. cit.; Haggard and Simmons, op. cit.; Keohane, op. cit.; Stein, op. cit.; and Young, op. cit.

109. For the classic statement on transnational relations, see Robert O. Keohane and Joseph S. Nye, Power and Interdependence, 2nd ed. (Glenview: Scott, Foresman, 1989). See, aso, among many, Walter Bühl, Transnationale Politik (Stuttgart: Klett-Cotta, 1978); Karl Kaiser, "Transnationale Politik," in Ernst-Otto Czempiel, ed., Die anachronistische Souveränität (Köln-Opladen: Westdeutscher Verlag, 1969); Keohane and Nye, eds., Transnational Relations and World Politics (Cambridge: Harvard, 1971); Richard Mansbach et al., The Web of World Politics: Non-State Actors in the Global System (Englewood Cliffs: Prentice Hall, 1976); and James N. Rosenau, The Study of Global Interdependence: Essays on the Transnationalization of World Affairs (London: Pinter, 1980). For a more recent discussion, see James N. Rosenau and Ernst-Otto Czempiel, eds., Governance without Government: Order and Change in World Politics (Cambridge: Cambridge, 1992. On the role of norms in regimes, see, among many, Judith Goldstein and Robert O. Keohane, eds., Ideas and Foreign Policy: Beliefs, Institutions, and Policy Change (Ithaca: Cornell, 1993); Haggard and Simmons, op. cit.; G. John Ikenberry and Charles A. Kupchan, "Socialization and Hegemonic Power," International Organization, Vol. 44 (Summer 1990), pp. 283-315; Keohane, op. cit.; Krasner, op. cit.; Friedrich Kratochwil, Rules, Norms, and Decisions (Cambridge: Cambridge, 1988); and Kathryn A. Sikkink, Ideas and Institutions: Developmentalism in Brazil and Argentina (Ithaca: Cornell, 1991).

110. Keohane and Nye, op. cit., pp. 5, 19.

111. Krasner, "Structural Causes and REgimes Consequences: Regimes as Intervening Variables," in Krasner, op. cit., p. 2.

112. See Keohane and Nye, op. cit.

113. See Goodman, op. cit.; and Marsh, op. cit.

114. See Callaghan, op. cit.; Healey, op. cit.; and Jenkins,op.cit.. For a discussion of the arguments that wracked the British Cabinet about joining in the mid-1980s, see Nigel Lawson, The View from Number 11 (London: Macmillan, 1992).

115. For a discussion of the rationale for British entry and the prolonged and heated debate within Cabinet, see Nigel Lawson, The View From No. 11: Memoirs of a Tory Radical (London: Bantam, 1992); and the discussion in Mark D. Harmon and Dorothee Heisenberg, "Explaining the European Currency Crisis of September 1992," German Politics and Society, No. 28 (Summer 1993).

116. See Robert Axelrod, The Evolution of Cooperation (New York: Basic, 1984).

117. Cameron, "Exchange Rate Politics...," op. cit.

118. See Haig Simonian, The Privileged Partnership: Franco-German Relations in the European Community (Oxford: Oxford, 1985).

119. The argument applies, as well, to other aspects of life within the Community. Garrett, op. cit., notes, for example, that--despite the apparent Thatcheresque nature of the internal market initiative--the Single European Act negotiated in the mid-1980s actually served the interests not of Britain but of Germany and France.

120. An intriguing precedent for British defection and French loyalty exists in the pre-war era as well, involving the gradual demise between 1931 and 1936 of the gold standard regime. Britain "broke with orthodoxy" and suspended the convertibility with gold in September, 1931, whereas France remained a member of the ever-diminishing "gold bloc" and committed to deflationary economic policies until it finally devalued in September, 1936. For a comprehensive account, see Barry Eichengreen, Golden Fetters: The Gold Standard and the Great Depression 1919-1939 (New York: Oxford, 1992), especially pp. 279-85 on the British "defection" and pp. 365-85 on French "loyalty." See, also, Peter Gourevitch, Politics in Hard Times: Comparative Responses to International Economic Crises (Ithaca: Cornell, 1986), pp. 135-40 and 153-58.

121. That was one--although not the only--reason de Gaulle vetoed Britain's bid for membership in the European Communities in 1963 and 1967.