

Learning to Cooperate:
the Creation of Policy Consensus in the European Community

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Why do some efforts at international economic cooperation fail while others succeed?¹ This paper provides one perspective on this question by examining two attempts at exchange rate cooperation in the European Community.² My explanation for the differing levels of cooperation evidenced in the two regimes focuses on how changes in the international economy have constrained governments; it also shows how learning and the development of shared beliefs about domestic policy can have important effects on the potential for multilateral cooperation. While providing a solution to an empirical puzzle about the European Community, this account also offers broader implications for the creation and maintenance of multilateral economic institutions in an era of increasing economic interdependence.

The Puzzle of European Exchange Rate Cooperation

In the spring of 1972, the member governments of the European Community (EC) agreed to create a fixed exchange rate regime within Europe as an alternative to the faltering U.S.-

¹ There is a broad range of international relations scholarship that seeks to answer this question. Two general strands can be identified. The first focuses on the structure of power capabilities in the international system, positing that cooperation is most likely when power is concentrated in the hands of one state that is willing and able to provide for cooperation. See Robert Gilpin, U.S. Power and the Multilateral Corporation (New York: Basic Books, 1975) and Stephen Krasner, "State Power and the Structure of Foreign Trade," World Politics 28 (1976) pp. 317-47. The second argues that cooperation can arise in the absence of hegemony if states have strong incentives to work together to fill their functional needs. See Stephen Krasner, ed., International Regimes (Ithaca: Cornell University Press, 1983), Robert Keohane, After Hegemony (Princeton: Princeton University Press, 1984), and Kenneth Oye, Cooperation Under Anarchy (Princeton: Princeton University Press, 1986).

² There is a rich literature on European integration which can also be categorized in terms of its emphasis on national power (as in the intergovernmentalist approach), or on the functional role of institutions (the neofunctionalist approach.) A prominent example of the former is Stanley Hoffmann, "Obstinate or Obsolete: the Fate of the Nation State and the Case of Western Europe," Daedalus 95 (Summer 1966), pp. 862-915; and of the latter, Ernst Haas, The Uniting of Europe (Stanford: Stanford University Press, 1957).

dominated Bretton Woods international exchange rate system. The European states had a strong interest in achieving exchange rate stability, because they believed that wide fluctuations in exchange rates disrupted trade relations within their common European market. However, this initial attempt at a European fixed exchange rate regime, known as the currency "Snake," lasted for only a few months before key member states exited the agreement and began floating their currencies.

The 1979 launching of a second effort at European exchange rate cooperation, the European Monetary System (EMS), was viewed with almost universal skepticism, for it was constructed along virtually identical lines as the Snake and came at a time of pessimism over the potential for further European Community integration.³ While the Europeans had managed to keep their exchange rates fixed within the context of the earlier Bretton Woods system, because the first effort at constructing and maintaining a solely European exchange rate regime had fared so poorly, there was little to indicate that the EMS would succeed.

Surprisingly, the European Monetary System proved to be a radically more effective and durable fixed exchange rate regime than the Snake. Despite being beset during its first years by economic hard times and political crises on par with those that buffeted the earlier agreement, the EMS has had an almost perfect record of participation by EC states, has reduced currency variability, and has strengthened as an institution since its founding in 1979. In fact, its success at stabilizing exchange rates and the sense that the EMS marked a tangible step forward for

³ The definitive historical assessment of the Snake is Loukas Tsoukalis, The Politics and Economics of European Monetary Integration (London: Allen and Unwin Ltd., 1977) for the Snake; the founding of the EMS is detailed in Peter Ludlow, The Making of the European Monetary System (London: Butterworth, 1980).

cooperation in the European Community provided the impetus for the recent European Monetary Union project, culminating with the Maastricht Treaty on European Union. Even with the recent currency speculation in the wake of German reunification and the Maastricht ratification process, the center of the European Monetary System has held, and the level of commitment to the fixed exchange rate system, particularly on the part of France, has been unprecedented.⁴

What explains this puzzling difference in the outcomes of the two efforts at European exchange rate cooperation?⁵ In this paper, I first focus on the constraints brought about by interdependence, arguing that a conformity in beliefs about monetary policy has become necessary to the achievement of fixed exchange rates as the level and mobility of international

⁴ A fascinating account of the recent currency crisis and the important and unprecedented level of German-Franco cooperation is David Cameron, "British Exit, German Voice, French Loyalty: Defection, Domination, and Cooperation in the 1992-93 ERM Crisis," paper presented to the Workshop on International Political Economy, Columbia University, March, 1993.

⁵ While the economics literature on European exchange rate cooperation and European monetary integration is extensive, there have been few attempts at political analysis of this question. Exceptions include David Andrews, "European Monetary Integration Since 1973: Coordination, Institutionalization, Unification," Ph.D. Diss., M.I.T. (1992); and Richard Pomfret, "What is the Secret of the EMS'S Longevity?"; Journal of Common Market Studies 24 (December 1991), pp. 623-633. There has been significantly more theoretical assessment of the recent European Monetary Union (EMU) project. See for example, John T. Woolley, "Policy Credibility and European Monetary Institutions," in Alberta Sbragia, ed., Europolitics (Washington, D.C.: The Brookings Institution, 1992); Jeffrey Frieden, "Invested Interests: the Politics of National Economic Policies in a World of Global Finance," International Organization 45 (Autumn 1991), pp.425-451; Louis W. Pauly, "The Politics of European Monetary Union: National Strategies, International Implications," International Journal 47 (Winter 1991-2), pp. 93-111; and Wayne Sandholtz, "Choosing Union: Monetary Politics and Maastricht," International Organization 47 (Winter 1993), pp. 1-39. For an overview of the economics literature, see David Cobham, "European Monetary Integration: A Survey of Recent Literature," Journal of Common Market Studies 24 (June 1991); see also the comprehensive and invaluable assessment in Daniel Gros and Niels Thygesen, European Monetary Integration (New York: St. Martin's Press, 1992).

capital flows has increased.⁶ I then identify the emergence of a policy consensus among the EC states on the appropriate goals and instruments of monetary policy during the period between the demise of the Snake and the birth of the EMS as critical to exchange rate cooperation.

This policy consensus, which I term the "consensus of competitive liberalism," centered on the view that monetary policy should be limited to the containment of inflation. It sprang from policymakers' concerns about their national economies, most centrally the failure of Keynesian monetary policy. I explore the roots of this new consensus with reference to three causal factors: policy failure, policy emulation and policy paradigms.⁷

More generally, I argue that the consensus of competitive liberalism that made European exchange rate cooperation possible marks a radical shift from the historic "compromise of embedded liberalism" that John Ruggie uses to characterize the postwar international political

⁶ The issue of how much leeway governments have in fashioning their national policies in an open international system has been addressed by others, most notably David Cameron, "The Expansion of the Public Economy: A Comparative Analysis," The American Political Science Review 72 (December 1978), pp. 1243-1261; Geoffrey Garrett and Peter Lange, "Political Responses to Interdependence: What's 'Left' for the Left?," International Organization 45 (Autumn 1991), pp. 539-64; and Peter Katzenstein, Small States in World Markets (Ithaca: Cornell University Press, 1985). Similar issues are also explored in Richard Cooper, The Economics of Interdependence (New York: McGraw-Hall, 1968).

⁷ As will become evident, my approach takes insights from several bodies of literature that focus on ideational factors in explaining policy change, all of which center on the point that preferences are socially constructed, and cannot be assumed a priori or exogenously for all situations. An argument close to that made here is Peter Hall, "Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain," Comparative Politics (April 1993), pp. 275-96. Unlike Hall, however, my argument includes a role for transnational learning, i.e. a reorientation in a state's policy position that occurs through the process of social interaction among states. In this way, it relates also to works such as Alexander Wendt, "Anarchy is What States Make of It," International Organization 46 (Spring 1992), pp. 391-426, and Emanuel Adler, "Cognitive Evolution: A Dynamic Approach for the Study of International Relations and their Progress," in Adler and Beverly Crawford, eds., Progress in Postwar International Relations (New York: Columbia University Press, 1991), pp. 43-88.

economy.⁸ Ruggie argued that the multilateral cooperation in the Bretton Woods fixed exchange rate system was made possible because its institutional structure allowed for domestic policy autonomy and diversity. In contrast, I show that a fixed exchange rate regime can no longer be maintained if governments use monetary policy to intervene in their economies in response to specific national economic conditions, such as rising unemployment and slow growth. Instead, a high level of policy conformity is necessary, and must be based on a strong policy consensus on limiting the role of monetary policy almost exclusively to inflation reduction.⁹

Finally, my explanation provides some insights into the interaction between the domestic and the international political economy, and illustrates the structural constraints that governments face in deciding among policy options. It also makes a case, however, for the need to focus on interpretation and learning on the part of policymakers, particularly when exploring the roots of policy change. By showing how the redefinition of national preferences can lead to multilateral cooperation, despite previous failure, this paper points to the need for more study of the way preferences are formed, instead of merely assuming them to be fixed exogenously as does much

⁸ John Gerard Ruggie, "International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order," in Stephen Krasner, ed., International Regimes (Ithaca: Cornell University Press, 1983), pp. 196-232.

⁹ A few caveats are in order. Because of the broad nature of the questions I am asking, this paper necessarily presents only an overview of the development of exchange rate cooperation in the EC, and leaves much of its inherent complexity and nuance aside. For example, my use of the term consensus is not meant to indicate that the policy conformity came about in a frictionless manner, or that the consensus was complete. A full account would provide an country by country assessment of the conflicts this policy shift entailed; because of space constraints, that is not done here. Neither have I assessed how shifts in domestic political coalitions played a role in facilitating the development of this consensus. Because I have found no direct evidence of a push for this policy consensus by societal actors, I have concentrated only on the role of international constraints and economic policy beliefs among elite policymakers instead. However, more study remains to be done on all of these issues.

of the literature on international cooperation.¹⁰

Exchange Rate Cooperation: Comparing the Snake and the European Monetary System

Before describing why I define the Snake as an unsuccessful fixed exchange rate regime in comparison to the success of the EMS, I briefly discuss the basic workings of exchange rate systems and show that the two cases share many institutional similarities.¹¹

The Snake and the EMS are both examples of fixed exchange rate systems, set up with the intent of keeping exchange rate fluctuations to a minimum among the member countries because of concerns about the effects that exchange rate swings might have on European trade flows.¹² In a fixed exchange rate regime, national policymakers establish narrow bands within

¹⁰ This is particularly true in certain game theoretic analyses of international cooperation, particularly the indiscriminate use of the prisoners' dilemma. For an astute critique along these lines, see Robert Jervis, "Realism, Game Theory and Cooperation," World Politics 40 (April 1988), pp. 317-349. Attention to preference formation in explaining European monetary integration has also been advocated by Wayne Sandholtz, in "Choosing Union." Sandholtz's argument is directed to the politics of the Maastricht Treaty and EMU, but in its broad outlines is congruent with the more specified argument I offer here on the sources of cooperation in the EMS.

¹¹ A few semantic points are in order. First, the "Snake in the tunnel" moniker came from the image of the European currency band (the snake) operating within a larger Bretton Woods band of fluctuation (the tunnel). Second, I am following the inaccurate but common practice of referring to the European Monetary System when in fact, my investigation is principally of the Exchange Rate Mechanism (ERM), a key component of the EMS.

¹² There is no agreement on how much exchange rate uncertainty and currency transaction costs truly hinder trade flows within Europe. The European Commission presents the case for the high costs of exchange rate variability on trade in Michael Emerson et al, One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union (Oxford: Oxford University Press, 1992), ch. 3. More skeptical accounts include International Monetary Fund, "Exchange Rate Variability and World Trade," Occasional Paper 28 (1984); A. Dixit, "Entry and Exit Decisions under Uncertainty," Journal of Political Economy 97 (1989): 620-30; John Williamson, The Exchange Rate System (Washington, D.C.: Institute for International Economics, 1985); and Paul Krugman, "Deindustrialization, Reindustrialization and the Real Exchange Rate," NBER Working Paper 2586 (1988). It is certain, however, that exchange rate instability disrupts trade in agricultural products across the European Community

which each currency's nominal value can fluctuate.¹³ Should a currency's market value go above or below the band, the member government is obligated to undertake the necessary steps to maintain the value of their currency within the band. These steps can include national central bank intervention in currency markets, that is, the buying and selling of currency to achieve the desired rate. Governments can also take internal measures, involving monetary and fiscal policy changes, to influence the value of their currencies. In both the European regimes, national currency adjustments were institutionally facilitated by mutual lines of credit among the central banks of the participating governments, and by the creation of a fund to allow for short-term financing of imbalances.¹⁴ While greater efforts have been made in the EMS to provide the resources for such interventions and to institutionalize policy coordination among the participating

by complicating the subsidization programs of the EC's Common Agricultural Policy. See Kathleen R. McNamara, "Common Markets, Uncommon Currencies: Systems Effects and the European Community," in Robert Jervis and Jack Snyder, eds., Coping With Complexity in the International System (Boulder: Westview Press, 1992), ch. 12.

¹³ In both cases, the band was set at 4.5 percent (thus plus or minus 2.25 percent around the fixed rate) of the currency's value, although in the EMS new members of the EC were able to have a temporarily widened band, as was Italy. The rates thus are not irrevocably fixed, without any variability, as they would be in a true monetary union. The Bretton Woods fixed rate system initially allowed a fluctuation within 2 percent bands, which was later broadened, eventually becoming a floating rate regime. The European currencies are fixed against each other but float against the broader international system of currencies. Two excellent surveys of many of the issues discussed here are Horst Ungerer, Jouko J. Hauvonon, Augusto Lopez-Claros, and Thomas Mayer, The European Monetary System: Developments and Perspectives (Washington, D.C.: International Monetary Fund, November 1990); and Francesco Giavazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility: The European Monetary System (Cambridge: The MIT Press, 1989).

¹⁴ Giavazzi and Giovannini, Limiting Exchange Rate Flexibility, chapter 2.

governments, the broad outlines of the two fixed exchange rate institutions are very similar.¹⁵

Despite these similarities in institutional structure and organization, the Snake and the EMS differ radically in terms of the degree to which exchange rate cooperation was achieved. Only in the EMS have the European Community states created and maintained an effectively functioning, community-wide fixed exchange rate regime. The outcomes of the two regimes can be compared in three ways: institutional membership; exchange rate variability; and frequency of exchange rate realignments.

Most simply, cooperation can be measured by the extent and longevity of national participation in the fixed exchange rate regime. In the case of the Snake, created in 1972, key member countries, namely Britain, Italy, and France, choose to exit the regime within the first few years of its existence rather than abide by its rules.¹⁶ A limited version of the Snake, consisting of Germany and some of the smaller northern countries, persisted as a "D-mark zone" throughout the 1970s, but for all purposes, the Snake ceased to exist as a full-fledged European

¹⁵ The Snake and the EMS also share another component common to fixed exchange rate systems: while not intentionally designed to do so, they both have evolved into systems anchored, or centered, on the strongest and most stable currency in the system, i.e., the German mark. For an explanation of the historical role of anchor currencies, or numeraires, in fixed exchange rate systems, see Ronald McKinnon, "The Rules of the Game: International Money in Historical Perspective," Journal of Economic Literature 31 (March 1993), pp. 1-44. It should be noted that the mark's position does not signify an overall hegemonic role for Germany like that hegemonic stability theorists posit the United States and Britain played in earlier exchange rate systems. On hegemonic stability theory, see footnote 1. For an overview of the debate on the exact implications of the mark's position, see Michele Fratianni and Juergen von Hagen, "Asymmetries and Realignments in the EMS," in Paul de Grauwe and Lucas Papademos, eds., The European Monetary System in the 1990s (London: Longman, 1990), ch. 5; Richard Pomfret, "What is the Secret of the EMS's Longevity?" Journal of Common Market Studies (December 1991), pp. 623-633; and Giavazzi and Giovannini, Limiting Exchange Rate Flexibility, ch. 4.

¹⁶ For a chronology of the institutional membership of the Snake, see Table 1.1 in Gros and Thygesen, European Monetary Integration, ch. 1.

Community agreement after 1973.

In contrast, the EMS did not experience any loss of membership from its founding in 1979 until thirteen years later in 1992, and has consistently expanded its membership to include new members of the European Community (with the exception of Greece).¹⁷ The only country not participating in the exchange rate mechanism at the founding of the EMS was Britain, which entered the agreement only in 1990. This perfect record of participation was marred in September 1992 when a currency crisis caused Italy and Britain to exit the agreement. The EMS currencies came under very heavy currency market speculation as a result of uncertainty over the fate of the European Monetary Union project contained in the Maastricht Treaty. Higher interest rates in Germany, set by the Bundesbank in an effort to contain the inflationary effects of reunification, also drew funds into the mark and put pressure on the weaker currencies. But despite heavy currency speculation, the exchange rate regime did not collapse, most notably because of extensive cooperative efforts on the part of German and French national officials.¹⁸ In contrast, in the case of the Snake, comparatively low levels of speculative pressures resulted in the exit of several core EC states, most notably France.

A second indicator of cooperation is the overall level of currency fluctuation or variability, as the stated goal of the EC was to create a "zone of monetary stability" through the fixing of exchange rates.¹⁹ Several studies have compared the Snake and the EMS in terms of their

¹⁷ For a chronology that includes the EMS period, See Ungerer et al, The European Monetary System, Appendix III, pp. 91-95.

¹⁸ Cameron, "British Exit, German Voice, French Loyalty."

¹⁹ See "Resolution of the European Council of December 5, 1978 on the Establishment of the European Monetary System and Related Matters," in Commission of the European Communities, European Economy No. 3 (July 1979), pp. 95-97.

overall levels of currency fluctuation, as well as estimating what the likely level of currency variability would have been if the currencies had been floating during the Snake and EMS years.²⁰ According to these analyses, the Snake succeeded in decreasing exchange rate volatility initially if compared to the period immediately preceding its establishment. However, the repeated exit and reentry of several of the Snake member states after the first year significantly increased the level of volatility. The studies all indicate a much stronger overall decrease in variability in the case of the European Monetary System. Thus, measured according to the goal of a zone of monetary stability, cooperation was considerably greater under the European Monetary System than in the Snake.

A third measure of the degree of cooperation in a fixed exchange rate system is the frequency of currency realignments. Realignments occur when a government sets a new fixed value for its currency, around which a new fluctuation band is drawn. Realignments are thus discrete changes in the value of a currency made by government officials. Realignments are distinct from exchange rate variability, discussed above, which is based on the measurement of the day-to-day movements of currencies in response to market conditions. Frequent realignments indicate that the participating governments may not be willing to change their internal economic policies, and are instead relying on external policy changes (i.e., changes in the exchange rate) to adjust to shifts in their international economic position. The overuse of realignments conflicts with the objective of exchange rate cooperation, because it increases the level of currency

²⁰ Data on variability of exchange rates is found in Ungerer et al., The European Monetary System, pp. 20-22, and Tables 10-12 in Appendix 1; Francesco Giavazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility: The European Monetary System (Cambridge: The MIT Press, 1989), ch.3; and M. J. Artis and M.P. Taylor, "Exchange Rates and the EMS: Assessing the Track Record," CEPR Discussion Paper 250 (1989).

instability.

Realignments occurred frequently in the Snake, and they would have been even more frequent if not for the fact that several countries chose to exit the Snake agreement completely instead of seeking further realignments.²¹ In contrast, the EMS period has seen a significant overall decrease in the use of realignments, without an attendant decline in national participation, indicating that the EMS agreement is functioning more smoothly than the Snake.²² Although there were a series of realignments in the early years of the EMS, their incidence began to taper off, particularly after 1983. After a period of five years without a realignment of exchange rates, several currencies were realigned after the currency crisis of September 1992.

The three measures of cooperation described above demonstrate the striking difference in the adherence of European countries to fixed rates in the European Monetary System as opposed to the Snake. It also demonstrates why European officials saw the durability of the EMS as a platform from which to reinvigorate European integration through the establishment of a European Monetary Union. But what explains this increased cooperation in the European Monetary System?

²¹ For a chronology of realignments in the Snake, see Table 1.1 in Gros and Thygesen, European Monetary Integration, ch. 1.

²² Useful assessments include Gros and Thygesen, European Monetary Integration, ch. 3 and 4; also see E.C. Hallett, "Economic Convergence and Divergence in the European Community: A Survey of the Evidence," in M. Hodges and W. Wallace, eds., Economic Divergence in the European Community, pp. 22-23 for 1973-79; and Manuel Guitian, Massimo Russo, and Giuseppe Tullio, Policy Coordination in the European Monetary System (Washington, D.C.: International Monetary Fund, 1988), p. 19, Table 2.

Explaining Exchange Rate Cooperation

Why were the states of the European Community able to achieve fixed exchange rates in the case of the European Monetary System but not in the Snake? To answer this question, my argument centers on the creation of a new policy consensus across the European states, a consensus on the goals and instruments of domestic monetary policy that emphasizes inflation reduction and restrictive monetary policies. Using Bretton Woods as a comparative illustration, I first explain why the lack of this consensus was such an obstacle to cooperation in the Snake and why its presence made possible the dramatically different EMS outcome. In the second part of the explanation, I suggest three causal factors that shaped policymakers preferences and proved critical to the creation of consensus: the experience of policy failure; the process of policy emulation; and policy paradigms.

The Constraining Effects of Capital Mobility: the Mundell-Fleming Model

What does the development of a consensus on the role of restrictive monetary policy have to do with exchange rate cooperation? The answer to this question has changed over time as international capital mobility has increased. Although I contend that such a policy consensus underlies the current success of European exchange rate cooperation, the achievement of fixed exchange rates did not always require a high level of policy consensus around this view of monetary policy. In fact, multilateral exchange rate cooperation in the Bretton Woods postwar system of fixed exchange rates, as John Ruggie has argued, was based not on a domestic policy consensus but on the "compromise of embedded liberalism."²³

²³ Ruggie, "International Regimes, Transactions and Change." "Embedded liberalism" refers to the idea that Bretton Woods was liberal in the sense of encouraging international economic transactions, but its liberalism was tempered by, or embedded within, a larger social context of

In Ruggie's view, states adhered to the Bretton Woods regime because for the most part it did not prevent them from following their chosen domestic macroeconomic policies.²⁴ The Bretton Woods system allowed for extensive government intervention in the domestic economy with the tools of Keynesian macroeconomic management--expansion and contraction of the money supply in the quest for full employment and economic growth--without jeopardizing the common goal of multilateral exchange rate cooperation.²⁵ In other words, the working of the Bretton Woods system was such that states could set their monetary policies unilaterally and still achieve fixed rates.

By the time the Snake was created, in the last months of the Bretton Woods system, divergent domestic policies were proving to be incompatible with participation in a fixed exchange rate regime. The compromise of embedded liberalism, which allowed states much leeway in directing their domestic economies with Keynesian monetary policies, no longer formed a solid basis for multilateral cooperation.

The reasons for this change are rooted in the increasingly open nature of the international system, most importantly, the rising level and mobility of capital flows. A full explanation of

goals beyond economic efficiency. It stands in contrast to the laissez-faire approach, where government intervention is minimized and market rationality is given primacy despite the negative effects it might have on national unemployment and other domestic conditions.

²⁴ Ruggie also emphasizes the equivalent dynamic for the trade regime: states cooperated to achieve free trade but were allowed to deviate from the agreements when their internal domestic conditions required it. The present validity of his embedded liberalism approach in today's trade regimes is not assessed here, however, only the monetary aspects of his argument.

²⁵ This point has been widely acknowledged. See Ronald McKinnon, "The Rules of the Game," pp. 11-15; Benjamin Cohen, Organizing the World's Money (New York: Basic Books, 1977), pp. 90-107; and Robert Solomon, The International Monetary System, 1945-1981 (New York: Harper and Row, 1982).

the sources, characteristics and implications of rising capital mobility is beyond this paper, but two points can be made. The first is that starting in the mid-1960s, capital flows began to increase in part due to the development of new financial instruments, technological advances and a gradual reduction in capital controls.²⁶ The demise of the Bretton Woods system and the inflationary effects of the first oil crisis increased the level and volatility of capital flows as well. The second point is that while governments played a role in encouraging these developments, I am assuming in the discussion that follows that once integrated into the global capital market, states can not effectively opt out of this new world of capital mobility.²⁷ As one account states "in international finance, regulators are at a great disadvantage because money is so slippery,"

²⁶ For an overview of the data on international capital flows, see International Monetary Fund, Determinants and Systemic Consequences of Capital Flows (Washington, D.C.: IMF, March 1991), pp. 3-7. Other relevant literature includes Susan Strange, Casino Capitalism (Oxford: Basil Blackwell, 1986); Charles Kindleberger, International Capital Movements (Cambridge: Cambridge University Press, 1987); and Mark Allen et al., International Capital Markets: Developments and Prospects (Washington, D.C.: IMF, 1989 and 1990). The 1980s have seen an entirely unprecedented level of capital market integration, but even by the mid-1970s, capital mobility had become significant enough to have important effects on the European governments' macroeconomic and exchange rate policies. On the more recent innovations, see John Goodman and Louis Pauly, "The New Politics of Capital Mobility," International Business and Trade Law Papers no. 29, University of Toronto Faculty of Law, 1991.

²⁷ Capital controls can reinstate some degree of policy autonomy, by preventing or slowing down the adjustment that would occur if financial transactions were free from controls. However, capital controls have become less and less effective in all but the very short term, due to the increased volume and responsiveness of capital. See Daniel Gros, "The Effectiveness of Capital Controls: Implications for Monetary Autonomy in the Presence of Incomplete Market Separation," Staff Papers of the International Monetary Fund Vol. 34/4 (December 1987): 621-642. Gros' study mainly addresses the types of quantitative controls employed in the EMS, concluding that international capital flows effectively offset the actions of national monetary authorities, and thus can "provide only temporary autonomy for national monetary policy" (p. 639). The French experiment with capital controls in the early 1980s is an example of how difficult it is to put the genie back in the bottle once freed. On the Mitterrand experiment see Michael Loriaux, France After Hegemony (Ithaca: Cornell University Press, 1991), ch. 8.

and while governments attempted to place new restrictions on the rising financial flows in the wake of the breakdown of Bretton Woods, these regulations only spurred more innovations to circumvent them.²⁸

A conceptual framework from the economics literature, the Mundell-Fleming model, is a useful way to analyze why increasing capital mobility changed the set of options available to states attempting to achieve fixed exchange rates. It gives us a broad brush understanding of the interaction between domestic policy choices and multilateral cooperation as capital markets become increasingly integrated and the volume of capital flows rises.

The Mundell-Fleming model holds that policymakers can choose only two of the three following policy options at any one time: free capital flows; a fixed exchange rate; or monetary policy autonomy.²⁹ Thus, if a state wishes to keep its exchange rate fixed in the context of international capital mobility, national monetary policy must be used to maintain the exchange rate parity and thus cannot be directed towards other internal goals.

This constraint can be illustrated with a simple example. If a country decided to use monetary policy autonomously in the hope of stimulating growth or employment, monetary policy would be relaxed and interest rates would be lowered. The fall in interest rates would have the

²⁸ "Fear of Finance: A Survey of the World Economy," in The Economist (September 19-25, 1992), p. 12. This survey provides an excellent overview of the growth of capital flows.

²⁹ See Robert Mundell, "The Appropriate Use of Monetary and Fiscal Policy Under Fixed Exchange Rates," IMF Staff Papers 9 (March 1962), pp. 70-77, and his "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates," Canadian Journal of Economics and Political Science 30 (August 1964), pp. 421-31. A general discussion can be found in R. Dornbusch and S. Fischer, Macroeconomics (New York: McGraw Hill, 1990), pp. 194-207, or any open economy macroeconomics text. I thank Bart Turtelboom and Chris Canavan for helpful discussions on this point.

effect of encouraging investors to move their funds out of that country in search of higher rates elsewhere. As a result of the capital outflow, a balance of payments deficit is created. The resulting pressure for currency depreciation would force the central bank to intervene by buying up its own currency and selling foreign money in exchange until the currency is stabilized at the fixed rate. However, this currency intervention would have the same effect as a contraction of the money supply, undoing the effects of the initial expansion and raising interest rates back to their original levels. This process could be stymied only if capital mobility is low and investors are not prone to moving their money between national markets, or alternatively, if the state ceases to defend its fixed exchange rate.

The implications of the Mundell-Fleming model can be used to frame the historical record, as I illustrate below.

The Mundell-Fleming Model in Historical Perspective

(The model specifies that only two of the three conditions can be met at one time.)

	Capital Mobility	Autonomous Monetary Policy	Fixed Exchange Rates
Bretton Woods	NO	YES	YES
European Currency Snake (failed)	YES	YES	NO
European Monetary System	YES	NO	YES

The Mundell-Fleming model helps make sense of the new constraint on national monetary policymaking that European governments faced in trying to achieve fixed rates under conditions of capital mobility. Yet it only sets the structural conditions or constraints under which

cooperation can occur. It does not tell us what choice governments will make when faced these three incompatible goals of capital mobility, policy autonomy and fixed rates. While it has become increasingly difficult to erect effective barriers to capital mobility, governments can move to floating from fixed exchange rates, as they did in the case of the Snake. So we are left with one vital question unanswered: why were the European states willing to forgo the autonomous conduct of monetary policy, instead of fixed rates. in the case of the EMS but not in the Snake?

The Creation of Consensus

This section will probe the sources of the shift in the policy preferences of the European governments. I argue that in the years between the birth of the Snake and the creation of the EMS, the majority of European Community states ceased to follow domestically oriented, Keynesian monetary policies as national policymakers fundamentally redefined the role of the state in the conduct of monetary policy. The new policy consensus that emerged rejected the view that governments could best further their national interests by actively using monetary policy in an attempt to achieve full employment and high growth rates. Instead, the new consensus prescribed a very limited role for monetary policy in the national arena, orienting it only to the reduction of inflation by restricting the growth of the money supply.

This European policy consensus differed from the embedded liberalism of the Bretton Wood system in two ways: it entailed a much higher level of conformity among nations in the goals and instruments of monetary policy; and it was based on more orthodox liberal, or conservative principles than its predecessor. Overall, the policy shift was driven by individual governments' concerns about the deteriorating position of their economies in an increasingly open and competitive world economy. For this reason, I term this new consensus the "consensus of

competitive liberalism."

Three factors were critical to the creation of this new consensus: policy failure; policy emulation; and policy paradigms. The first factor, policy failure, refers to the experience of European governments during the first oil crisis, when they found that the expansionist, activist policies they had been following no longer achieved national employment and growth goals. The second, policy emulation, describes the important role that the success of the German government's more restrictive, anti-inflationary policies played in offering a concrete, persuasive example for other EC governments to follow. Finally, I argue that the shift in national strategies that produced this consensus was aided by the availability of a policy paradigm, monetarism, to underpin the movement away from Keynesianism.

Two points are important here. First, none of these factors alone would have produced the consensus that underlies the EMS; instead they all build on one another to explain the particular choice made by governments to eschew independent, activist monetary policies and, thus, to make cooperation possible in the European Monetary System.

The second point is that this explanation draws much of its explanatory dynamic from observations about social learning on the part of policymakers, although I link this process to concrete environmental and contextual constraints.³⁰ Learning and ideas do not occur in a

³⁰ A related argument about policy consensus and cooperation is Barry Eichengreen, "Relaxing the External Constraint: Europe in the 1930s," in Alogoskoufis et al., External Constraints on Macroeconomic Policymaking, p. 75. Eichengreen argues that while a coordinated reflation would have been an appropriate and effective response to the severe world-wide depression of the 1930s, countries were unable to achieve coordination because they subscribed to different models of the economy, and that the divergent views were "derived from the different historical experiences of the nations involved." Louis Pauly briefly discusses the role of consensus in "The Politics of European Monetary Union: National Strategies, International Implications," International Journal (Winter 1991-92), p. 96, as does Wayne Sandholtz in

vacuum, but occur within certain configurations of interests and constraints such as those brought on by increasing openness in the international economy. As Emanuel Adler has pointed out, "the environment does not "instruct" policymakers, it challenges them," making attention to the social and cognitive aspects of policy choice necessary as well.³¹

The Experience of Policy Failure: Stagflation and the First Oil Crisis

The first causal factor important in the creation of the consensus of competitive liberalism is the experience the majority of European governments had in the early 1970s with policy failure. Governments found themselves unable to solve the slow growth, high unemployment, and high inflation of the 1970s with standard Keynesian demand management tools. As Peter Haas has observed, "Failed policies, crises, and unanticipated events that call into question [decisionmakers'] understanding of an issue-area are likely to precipitate searches for new information, as are the increasing complexity and technical nature of problems."³² Broadly speaking, the experience of crisis and failure prompted policymakers to adjust their policies to

"Choosing Union." Other works that investigate the interaction of ideas and institutional and environmental factors, albeit from a variety of viewpoints, are Peter Hall, ed., The Political Power of Economic Ideas (Princeton: Princeton University Press, 1989); Stephen Van Evera, "Cult of the Offensive and the Origins of the First World War," International Security 9 (Summer 1984); and John Odell, U.S. International Monetary Policy (Princeton: Princeton University Press, 1982).

³¹ Adler, "Cognitive Evolution," p. 53. I assume, congruent with the view articulated by Alexander Wendt and others, that ideas cannot be separated from interests because of the inherent nature of reality and identity as social constructions. As such, "ideas" are not meant to "compete" against power or interests as explanatory variables. For the purposes of this essay, however, I do not delve into the epistemological implications of this assumption, but instead hope to offer an empirical illustration of the role that redefinitions of preferences and interests can play in producing cooperation among states. See Wendt, Raymond Duvall, and Himadeep Muppidi, "Institutions and Collective Representations in International theory," Draft Manuscript, August 1992.

³² Peter Haas, "Introduction: Epistemic communities and international policy coordination," International Organization 46 (Winter 1992), p. 29.

the changed international environment, in essence, to learn from their mistakes.

Throughout the postwar era until the mid-1970s, the countries of Western Europe had followed a broad mix of macroeconomic policies based loosely on Keynesian ideas of stabilization through demand-management and countercyclical policies.³³ In the period from 1960 to 1972, according to an OECD report, the emphasis was primarily on using fiscal and monetary policy to smooth out fluctuations in real demand, with more attention to employment and growth than to fighting inflation.³⁴ However, the strategies for achieving these goals varied among the different countries, as did the timing of the implementation of countercyclical policies.³⁵ As the Bretton Woods system began to crumble and the plans for the Snake were drawn up, the increasing openness of the world economy and the expansionary policies of the

³³ Individual policy histories for the major European countries can be found in two volumes: Peter Katzenstein, ed., Between Power and Plenty, and Peter Hall, ed., The Political Power of Economic Ideas (Princeton: Princeton University Press, 1989). See also Peter Hall, Governing the Economy (New York: Oxford University Press, 1986), Michael Loriaux, France After Hegemony (Ithaca: Cornell University Press, 1991). Andrea Boltho's edited volume, The European Economy (Oxford: Oxford University Press, 1982) contains both invaluable analytic surveys of the economic issues discussed here and empirical chapters on each major European country's macroeconomic experience during this time period.

³⁴ OECD, The Role of Monetary Policy in Demand Management (Paris: Organization for Economic Cooperation and Development, 1975), p. 9. The study surveyed monetary policy across the major industrial countries up to 1972, concluding that "the main internal task of monetary policy was seen as one of stabilizing real demand at a level commensurate with current productive capacity. The longer run linkages from monetary variables to price developments and the role of monetary policy in dampening cost inflation were not nearly as much in the forefront of policy debates" as they were to become in the mid-1970s (p. 131).

³⁵ For example, one country could be contracting its money supply, while another, responding to the requirements of its particular domestic conditions, would expand to encourage demand. This added up to an overall divergence in policy strategies across the European countries, but the effect of divergence on fixed exchange rates was cushioned, as discussed above, by the relatively low level of capital mobility and by the "agreement to disagree" that underlay the rules of the Bretton Woods system.

U.S. began to create serious economic problems as "inflationary forces were spilling over from one country to another throughout the entire world economy via the channel of price levels in integrated commodity and product markets as well as via capital flows." Thus, "With the expansion of economic interdependence in the late 1960s, it became clear that inflation was an international macroeconomic problem," one that was severely limiting the ability of governments to use Keynesian demand management policies, particularly activist, expansionary monetary policies, in the pursuit of domestic economic goals.³⁶

A key element of the macroeconomic policy dilemma facing policymakers was the incompatibility of the Phillips Curve, the economic model that guided governments throughout the 1960s and early 1970s, with the changed economic environment. In 1958, A.W. Phillips showed that there was a strong historical relationship between the unemployment rate and the inflation rate.³⁷ Over almost a century, as inflation rose, unemployment fell, and vice versa. Thus, postwar policymakers generally acted on the belief that expansionary monetary policies, while causing some inflation, would also decrease unemployment. This relationship held throughout the 1960s for most industrialized countries, but in the 1970s, governments for the first time confronted conditions that contradicted the Phillips Curve relationship.³⁸ Inflation and

³⁶ Gilpin, The Political Economy of International Relations, (Princeton: Princeton University Press, 1987, p. 140. Data indicating the extent of the crisis is found in Fritz Scharpf, "The Political Calculus of Inflation and Unemployment in Western Europe," Center for European Studies Working Paper Series #6. See also his Crisis and Choice in European Social Democracy (Ithaca: Cornell University Press, 1991), especially pp.41-55 and pp. 161-168.

³⁷ A.W. Phillips, "The Relationship Between Unemployment and the Rate of Change of Money Wages in the United Kingdom, 1861-1957," Economica (November 1958).

³⁸ The reasons behind the breakdown of the Phillips Curve are uncertain and too complex to be treated here. In general, a rise in inflationary expectations may explain the fact that an increase in the money supply no longer brought growth and jobs. The argument is that workers

unemployment seemed to move together: high rates of inflation were matched by high rates of unemployment and slow growth, producing the "stagflation" experience of the 1970s.³⁹

Despite the indications that the Phillips Curve relationship no longer held, when faced with the worsening economic conditions that followed in the wake of the first oil crisis of 1973, the majority of the European countries once again tried to reflate their way out of low growth and high unemployment.⁴⁰ The exigencies of the electoral cycle, and an unwillingness to discard their traditional methods brought about a range of policies from the European states, most of which closely matched the previous national strategies.

These diverging economic strategies were reflected in the troubled first years of the currency Snake.⁴¹ Key states like France and Italy exited the Snake agreement during its first

and employers, when faced with increasing levels of inflation in the late 1960s and early 1970s, began to expect inflation and calculate it into their decisions about wages and prices. The result was that people no longer viewed the increase in money brought on by an expansionary monetary policy as a boost to the economy. Instead, they began to calculate the real value of their wages and prices and demand increases in the nominal values to match the new level of anticipated inflation. This phenomenon was predicted by Milton Friedman, in "The Role of Monetary Policy," American Economic Review (March 1968), and Edmund Phelps, "Money Wage Dynamics and Labor Market Equilibrium," Journal of Political Economy Part 2 (July/August 1968).

³⁹ Jeffrey D. Sachs and Felipe Larrain B., Macroeconomics in the Global Economy (Englewood Cliffs, NJ: Prentice Hall, 1993), pp. 452-473 provide an excellent overview of the Phillips curve and recent developments in theories about relationship between unemployment and inflation.

⁴⁰ Peter Katzenstein, ed. Between Power and Plenty is the definitive work on the variations in national level responses to the first oil crisis. Also see Fred Hirsch and John H. Goldthorpe, eds., The Political Economy of Inflation (Cambridge: Harvard University Press, 1978; Richard Medley, ed., The Politics of Inflation: A Comparative Analysis (New York: Pergamon Press, 1982); and Leon Lindberg and Charles Maier, eds., The Politics of Inflation and Economic Stagnation (Washington, D.C.: The Brookings Institution, 1985).

⁴¹ See Gros and Thygesen, European Monetary Integration, ch. 1, and Loukas Tsoukalis, The Politics and Economics of European Monetary Integration.

few years so as to be able to continue following autonomous, expansionary policies.⁴² The loss of exchange rate stability for regained policy autonomy might have been tenable but for the fact that the European governments were no longer able to achieve their macroeconomic goals even outside the Snake. Those European economies that exited the Snake did not show improvement in their national economic performance, and indeed found that they were doing worse than the countries that remained.

By 1976, the evidence had mounted: the domestically driven mix of Keynesian demand management strategies was no longer working across many of the European states, and had not proved to be worth the sacrifice of exchange rate stability it entailed.⁴³ This experience with policy failure led key economic policymakers and national leaders to try alternative policy strategies. By mid-decade, the majority of the major European governments had begun to jettison their traditional policies.⁴⁴

⁴² For example, the French government, under Prime Minister Chirac had begun an expansionary fiscal program in 1975 and the franc began to depreciate in value. After already exiting once before, in March of 1976, France left the Snake for good. The French were attempting to regain industrial competitiveness after the first oil shock by floating the franc and allowing it to devalue. They were also trying to protect French foreign exchange reserves strained by the deteriorating balance of payments. Tsoukalis, The Politics and Economics of European Monetary Integration, ch. 5.

⁴³ This viewpoint was articulated in an important report issued by the OECD, Towards Full Employment and Price Stability (Paris: OECD, 1977). This document, also known as the McCracken Report, was authored by a group of prominent economists, most of whom had held high government positions. It is evaluated in Robert Keohane, "Economics, Inflation and the Role of the State: Political Implications of the McCracken Report," World Politics 31 (October 1978), pp. 108-128.

⁴⁴ After the failed Chirac expansion, France radically shifted its policy to a new austerity program the 1976 Barre Plan that included restrictive monetary policy and the use of monetary targets. Similar stabilization programs were also under way in Italy and Britain. See Ludlow, The Making of the European Monetary System, p. 44.

Two aspects of these newly adopted policies are notable. First, the shift was to a restrictive, anti-inflationary policy stance informed by monetarist principles. As the OECD reported, this turn toward the "dampening of inflation" was becoming the trend in government policy, shifting away from the management of fluctuations in demand.⁴⁵ Second, the nature of the new policies--directed towards a general goal of price stability, instead of being tailored to suit the domestic circumstances of each national economy--created a striking degree of consensus among national governments on what constituted appropriate economic policy goals and instruments. An OECD survey of monetary policy among six industrialized countries, including the United Kingdom, France, Germany, and Italy, concluded that although monetary policy had historically varied among those countries, "the convergence of methods of monetary management emerges as the principal conclusion that can be drawn" about the direction of monetary policy in the mid-1970s.⁴⁶

To sum up, the experience of policy failure changed the views of policymakers about what constituted appropriate monetary policy and laid the groundwork for the European Monetary System by calling into question the power of national policies to protect economies against changing global conditions. But it is necessary to examine more than the context of policy failure to explain this interpretation of the experience and choice of new strategy. I focus next on the role that Germany played in providing a strong example of policy success with restrictive

⁴⁵ OECD, The Role of Monetary Policy in Demand Management, p. 9. See also the evidence cited in Joint Economic Committee, "Monetary Policy, Selective Credit Controls, and Industrial Policy in France, Britain, West Germany and Sweden," Staff Study, Joint Economic Committee, U.S. Congress (Washington, D.C.: USGPO, June 26, 1981).

⁴⁶ OECD, The Role of Monetary Policy in Demand Management, p. 25.

monetary policies.

Policy Emulation and the Role of the Germany

While most of Europe was struggling with stagflation after the first oil crisis, Germany stood out as relatively successful in managing its economy. As a result, Germany offered an example of policy success at a time when national governments were searching for new approaches. The general European shift to restrictive monetary practices in the mid-1970s was in part due to the example that Germany provided of an alternative policy that seemed to be accomplishing what other countries' could not: moderate inflation and relatively high levels of growth and employment. The policy emulation that followed can be seen as an example of how transnational learning can occur through social interaction among states.

In contrast to the majority of its European Community neighbors, West German policy throughout the pre-oil crisis Bretton Woods era had been marked by the pursuit of economic stability in conjunction with policies to promote industrial adjustment to international economic conditions. Keynesian policies were used only sparingly in the Bretton Woods years, because the emphasis on countercyclical demand policies was "effectively preempted by another set of policies, oriented toward the supply side and the social market economy" and characterized by tight money policies.⁴⁷

As a result, the German response to the first oil crisis was on the whole restrictive and emphasized price stability. For example, German officials began publishing monetary aggregate

⁴⁷ Christopher Allen, "The Underdevelopment of Keynesianism in the Federal Republic of Germany," in Hall, ed., The Political Power of Economic Ideas, p. 263.

targets in 1974, the first major European country to use this policy instrument.⁴⁸ These policies, a longstanding commitment to economic stability, and a high degree of social cohesion allowed Germany to experience less economic disruption than the other European states in the wake of the oil crisis.⁴⁹ Germany was generally seen by European policymakers as the nation that had best adjusted after the demise of Bretton Woods, and it was viewed by other European countries as an example worth following. For example, the relative success of Germany was a recurrent theme in comments by French President Valéry Giscard D'Estaing, to the point that "the obsession of the present rulers of France with Germany's economic success" and the desire to achieve equal economic status became a point of criticism by those who felt a German restrictive policy stance was simply incompatible with the institutional and political context in France.⁵⁰

Aside from the evidence suggesting that policies of monetary stability had enabled the Germans to better weather the crises of the early 1970s, transnational learning and policy emulation was encouraged by institutionalized interaction among national policymakers. While not intensive or comprehensive enough to have produced policy consensus by itself, the presence of several forums for EC policy coordination and interaction facilitated policy emulation.⁵¹ The Council of Ministers of Economics and Finance (ECOFIN), established in the late 1950s,

⁴⁸ Joint Economic Committee, "Monetary Policy, Selected Credit Controls," p. 109.

⁴⁹ On this point, see Michael Emerson, ed., Europe's Stagflation (Oxford: Clarendon Press, 1984), ch. 1 and ch.2; and Andrea Boltho, ed., The European Economy, ch.16.

⁵⁰ Cited in Ludlow, The Making of the European Monetary System, p. 199. See also comments in the interview with Giscard in Le Monde, 18 October 1978.

⁵¹ For example, the EC committees had only small staffs and limited resources, because national authorities did not want their economic policymaking capabilities usurped. Gros and Thygesen, p. 23.

provides a ministerial platform for economic policy coordination in the EC. The Monetary Committee, established during the same period, acts as a forum for the exchange of information and background preparation for the meetings of the ECOFIN.⁵² Finally, in the mid-1960s, interaction and policy emulation was facilitated by the creation of the Committee of Central Bank Governors, which meets regularly to oversee the operation of the fixed exchange rate regime and coordinate policy. Gradually these groups have developed a closer rapport and an increasing influence on efforts at policy coordination and the choice of national strategies.⁵³

One further interpretation of the role of Germany in bringing about cooperation should also be considered. The theory of hegemonic stability, which holds that a strong, hegemonic state is necessary to bring about cooperation in a multilateral regimes, would predict that it is German structural power combined with conscious leadership that brought about cooperation in the EMS. Although the argument cannot be fully investigated here, I argue that it is inappropriate to view the role of Germany in facilitating this consensus in the terms described by standard hegemonic stability theorists.⁵⁴ Instead, Germany is better seen as providing an

⁵² The Monetary Committee is made up of representatives from the central bank and the finance ministry of each state, plus European Commission representatives.

⁵³ The development of routinized interaction among the European central bankers was singled out as a facilitating factor for transnational learning by one European Commission official, (Interview, Brussels, October 1991.) See also Gros and Thygesen, p. 22-23; and Niels Thygesen, "International Coordination of Monetary Policies--With Special Reference to the European Community," in John E. Wadsworth and Francois Leonard de Juvigny, eds., New Approaches in Monetary Policy (Sijthoff and Noordhoff: The Netherlands, 1979), pp. 205-224.

⁵⁴ This assertion rests on two points. First, in the Snake and the EMS, Germany has not had the preponderate economic, political and military power over its EC neighbors that hegemonic stability theorists such as Krasner and Gilpin have viewed as keys to the structural position of Britain in the nineteenth and the United States in the twentieth centuries. See Stephen Krasner, "State Power and the Structure of International Trade," and Robert Gilpin, U.S. Power and the Multinational Corporation. Second, Germany has not played the leadership role in the Snake or

example of policy success for other states to emulate.

Policy Paradigms: Consensus and Monetarism

The development of a European consensus regarding the need for restrictive monetary policy was aided by one final factor. It was the existence of monetarism, which provided a ready-made, alternative intellectual framework, or policy paradigm, to guide policymakers as they sought an alternative to Keynesian policies. Under the conditions of uncertainty that prevailed in the period following the first oil crisis, monetarism gave policymakers both a new lens with which to interpret their experiences as well as specific prescriptions to guide their behavior.

Policy paradigms, to use Peter Hall's term, are critically important in macroeconomic policymaking because of the opacity of cause and effect relationships in this area of government policy.⁵⁵ A policy paradigm acts as a guide with which policymakers can analyze the complex technical relationships that make up the economy. Previously, governments had held to a Keynesian policy paradigm that viewed the private sector as fundamentally unstable, and emphasized the role of the state in directing the economy, particularly through the use of fiscal and monetary policy designed to influence growth rates, employment, and production. In

the EMS that theorists like Kindleberger point to as key in stabilizing monetary regimes. Germany is a pivotal player in the EC, with a currency that acts as the benchmark around which others must adjust, but its role is far more nuanced than is captured in standard hegemonic stability theory. Charles Kindleberger, The World in Depression, 1929-1939 (Berkeley: University of California Press, 1973). A theory focusing on the role of hegemons in the formulation of norms might provide more insights. See G. John Ikenberry and Charles Kupchan, "Socialization and Hegemonic Power," International Organization 44 (Summer 1990), pp. 283-315.

⁵⁵ Hall, "Policy Paradigms, Social Learning, and the State," Hall's study of the shift from Keynesian to monetarist policies in Britain is an excellent country-specific assessment of many of the issues touched on here.

contrast, monetarism emphasized the inherent stability and adaptability of the private sector and viewed traditional Keynesian efforts to manipulate the economy, particularly full employment strategies, as ineffective.⁵⁶ Monetarist theory rejects the existence of a Phillips curve (depicting a trade-off between employment and inflation as discussed above), arguing that rapid economic expansion will lead directly to inflation without an increase in economic activity and employment.

The monetarist paradigm seemed to fit the experience of most European governments during the 1970s with policy failure and stagflation, and its success in offering an interpretation of these events lent credibility to its policy prescriptions. Setting goals, or monetary targets, for a stable, predictable annual increase in the aggregate money supply, monetarists argued, is the best way to avoid inflation and provide an environment conducive to economic growth.⁵⁷ The widespread adoption of monetary targeting as a policy tool by the majority of European governments in the mid-1970s indicates the influence of the monetarist framework on policymaking.⁵⁸ While the European countries used different measures of monetary growth, there was a widespread and unprecedented consensus on the need for controlled growth of the money supply and the primacy of inflation reduction.

It is important to note, however, that the governments of Europe did not accept wholesale

⁵⁶ This discussion draws on Peter Johnson, "Unpopular Measures: Translating Monetarism into Monetary Policy in the Federal Republic of Germany and the United States, 1970-1985," Ph.D. Diss., Cornell University, 1991, ch. 1; and Thomas Mayer, The Structure of Monetarism (New York: W.W. Norton, 1978).

⁵⁷ The classic statement is Milton Friedman and Anna Schwartz, A Monetary History of the United States 1866-1945 (Princeton: Princeton University Press, 1963).

⁵⁸ For details of the transition to targeting in Europe, see the OECD, "Monetary Targets and Inflation Control," Monetary Studies Series (Paris: OECD, 1979), p. 7.

the precepts of monetarism. For example, monetary targeting was widely adopted after the first oil crises as only one tool among several that governments used to achieve national economic goals. For example, monetary targets were used in tandem with fixed exchange rates, whereas monetarist theory would argue that exchange rates should be allowed to float, as government action should be limited to controlling the growth of the money supply.⁵⁹ This pragmatic monetarist stance indicates that while economic theory played a role in the reorientation of domestic monetary policy, the actual policy choice of the European governments must be explained by reference to factors other than the persuasiveness of economic experts who espoused monetarist principles.⁶⁰

Conclusion

I have sought to explain the radically different fates of two attempts at exchange rate cooperation in the European Community, the failed currency Snake of the early 1970s and the

⁵⁹ See Llewellyn, International Financial Integration, p. 3. This pragmatic approach differs from the "ideological monetarism" of the Thatcher government or that of the United States in the first years of Paul Volker's chairmanship of the Federal Reserve (1979-82). For a discussion of the difference in these approaches see Johnson, "Unpopular Measures," ch. 1. For an overview of the differences in monetary practices see Joint Economic Committee, "Monetary Policy, Selective Credit Controls, and Industrial Policy in France, Britain, West Germany and Sweden," Staff Study, Joint Economic Committee, U.S. Congress (Washington, D.C.: USGPO, June 26, 1981).

⁶⁰ Another reason to doubt a singular focus on the role of monetarist theorists is the fact that monetarism had been around for some time before its certain of its insights were taken up by the European states. Therefore, an epistemic community approach, which focuses on how a group of experts, empowered by scientific knowledge, can influence the outcomes of international agreements is not sufficient to explain the European policy consensus described here. The work of epistemic community scholars such as Peter Haas do provide helpful insights, however. See Haas, "Do Regimes Matter? Epistemic Communities and Mediterranean Pollution Control," International Organization 43 (Summer 1989), p. 377; and Haas, ed., "Knowledge, Power, and International Policy Coordination," Special Issue, International Organization 46 (Winter 1992).

more successful European Monetary System begun in 1979. My approach first situates the requirements for exchange rate cooperation within a broader historical framework, and points to the constraints brought on by increasing capital flows. Drawing on the Mundell-Fleming model, I argue that under conditions of rising capital mobility, governments must give up substantial monetary policy autonomy in order to achieve a fixed exchange rate.

More specifically, I argue that in a increasingly open economic system, an agreement among policymakers on the desirability of limiting monetary policy to inflation reduction, as opposed to the traditional Keynesian use of monetary policy to combat unemployment and slow growth, is necessary for exchange rate cooperation. I show that the development of such a consensus in the period between the founding of the Snake and the EMS was responsible for the latter regime's durability. The second part of my argument traces the roots of this unprecedented movement towards restrictive monetary policy. I show how three factors, policy failure, policy emulation and policy paradigms, influenced the development of the consensus on the value of restrictive monetary policy and formed a strong basis for cooperation in the European Monetary System.⁶¹

This recent policy convergence, which I term the consensus of competitive liberalism, marks a radical shift from the historic "compromise of embedded liberalism" that John Ruggie

⁶¹ I am not asserting that these were the "correct" policies, although I try to explain why policymakers thought they might be. James Tobin has written that the view, "more solidly entrenched in Europe than in North America," that unemployment cannot be cured by expansionary policies without unacceptable risk of inflation is an example of "overlearning the lessons of the 1970s." Tobin argues that now that the effects of the oil crisis have subsided, governments should try expansionary policies again to combat unemployment. Tobin, "Unemployment in the 1980s: Macroeconomic Diagnosis and Prescription," in Andrew J. Pierre, ed., Unemployment and Growth (New York: Council on Foreign Relations, 1984), quotes p. 86, and p. 87.

uses to characterize the cooperation in the Bretton Woods system. In contrast to the Bretton Woods case, the contemporary European experience indicates that for multilateral exchange rate cooperation to succeed, there is room for only very limited domestic intervention in the economy. This development has profound implications for the governing of the European economies.

Finally, although my explanation explores the constraining effects of the international economy, it also is meant to show that the international system does not dictate a particular policy path. By focusing on how European policymakers came to choose the policies of competitive liberalism that kept them within the European Monetary System, I have illustrated the important role interpretation and learning play in explaining preference formation and policy change.