*Getting the Core.*

***The Union's monetary institution-building in the 90***

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**Abstract**

*The new regionalism, materializing in Europe with the Single European Act and the Maastricht Treaty (1992) and in North-America with the signature of the North-American Free Trade Agreement (1993), is centered on strategic policies and new institutions whose aims are to play a more effective stance in the global competition. In Europe, the shift is marked with the impending process of monetary union and the creation of its related institutions The new approach agreed in the Maastricth Treaty sets out four requirements for eligibility to membership of monetary union. Convergence criteria embodying financial markets' judgment about future inflation, exchange rate and fiscal policy appeared to be the second best choice for governments seeking to institutionalize their commitment to inflation-aversion policies. The whole mechanism is meant 1. to provide the region with a credible monetary institution able to win over the financial markets ; 2. to set up realistic goals to face the inflation-prone pressures of domestic sheltered interests; 3. to commit, through a so called targeting exercise (in Keohane's words) member countries to accomplish the agreed objectives with monetary discipline and macroeconomic adjustment. While facing the threat of failure as previous monetary schemes have done, the EMU's device is also projected as a means of avoiding the logic of political negotiation. After 1992, 1993 and 1995, that device and its timetable is truly coming under fire. Is a monetary union at the dates stated in the Treaty as unattainable as many observers argue? Is the process likely to result in a fragmentation into a two or more speed Europe? Why, then, should the process of the EMU succeed just when the differentials between core*

[1] The author would like to acknowledge a grant by the CNR spent at MIT-Center for International Studies in 1994. During this period she profited from some impressive seminars organized at MIT and Harvard under the leadership of Bob Keohane and Ken Oye. She also profited from a Ph.D. course held at MIT by Ken Oye from which she was able to learn a lot both from Ken and his wonderful students, She also is delighted to remember the unique opportunity to present the paper at its early stage at the Western European Studies at the University of Pittsburgh, and at the University of Massachusetts. The author has further presented a second draft at the World Congress of IPSA held in Berlin (August 1994) as invited paper at the Research Committee on European Unification. She sends her best thanks to Prof. Ghita Jonescu, who has greatly encouraged her to pursue her researches in the fascinating field of European Studies.

*and non-core countries are showing signs of increasing under the speculative attacks of currency and financial markets?*

*Although this paper cannot hope to answer all those questions, as the first step in a broader study of European monetary institution-building, it will limit itself to presenting a succinct description of the process of monetary union as is outlined in the Maastricht Treaty, formulating and evaluating two of many stylized explanations for its unexpected approval in 1991, and finally some significant findings relating to macroeconomic adjustments to theories of international cooperation and political reputation will be analyzed. The paper challenges the predominant realist explanation that monetary union comes out of the interest of some continental members to limit the rising German hegemony (Sandholtz, 1993; De Grauwe, 1993). By considering the convergence criteria as a standard- setting and targeting exercise, it stresses both the commitment of well off- countries to embark on monetary unification, and the choice of reluctant countries to get the core as the combined result of systemic level pressures and discriminatory threats. In support of this thesis, the paper analyzes the formation of the core standards as the result of the "institutional hegemony" of the German Bundesbank. The "institutional hegemony" explanation leads partially, thanks to Keohane and Nye(1993), to an institutionalist analysis which admits that although there is neither a single hegemonic power nor a common government, it is possible to establish sustained cooperation by adopting fairly well defined strategies. These conditions, mainly based on the existence of mutual interests which brings about joint (Pareto-improving) gains, are shaped by the policy of a leading institution. The hegemonic institutionalism of the Bundesbank is easily recognized a) in several aspects of the blueprint for monetary institutions which should apparently follow its successful pattern b) in the strategy chosen to tackle the large differentials which exists between the various EU member countries and the evidence that new members are turning to rigorous monetary discipline aimed at achieving sustainable macroeconomic growth. The paper suggests that, in the absence of an effective hegemonic power, hegemonic institutionalism exercised by a leading institution such the Bundesbank, and enforced by the performance of the core countries, provides the leverage which is necessary to encourage members to work towards macroeconomic standards and to implement policies of domestic monetary restraint. The paper describes getting the core and the hegemonic institutionalism as a single dynamic which aims 1. to fulfill adjustment policies, through a detailed targeting exercise; 2. to integrate and to attune governments policies and the epistemic community of Central bankers so that the appropriate political and institutional environment of the future European Central Bank can be created. The purpose of such hegemonic isnstitutionalism is to provide the future monetary institutions with the degree of autonomy and strength which are considered to be necessary to encsure monetary stability in the whole European region.*

**Contents:**



## Chapter 1. Introduction. The institutionalist approach.

Whether the projected time-table of the Maastricht Treaty will move ahead or not at the intergovernmental conference scheduled for 1996, is subject to much debate and this paper will try to clarify some points. It is becoming widely accepted, as *The Economist* has observed, that "slowly but surely the building blocks of European Economic and Monetary Union are falling into place"[2] and recent evidence is the latests boost to monetary union which the heads of the government of France and Germany gave at their meetings in 1995. The entry of new Northern members, and the tensions following the weakening of the dollar (early months of 1995) are other factors which according several observers should lead governments to take steps which will hasten the introduction of a single currency. This picture is completely different to the stops and goes of the last two years (1992-1994) following the ERM crisis, the Maastricht referenda, and the political elections in several European countries. What is really surprising, however, is that, though the ERM crisis of 1992,1993, and 1995 severely hit the economies of many member countries, the fairly demanding criteria for entry have been complied [3] within an increasing number of countries, even including the new entrants. The latter, in fact, have often adjusted to the economic and financial criteria of the Treaty long before their formal adhesion[4].

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[2] *The Economist*, November 19th-25th 1994,p. 91.

[3] As a recent Report suggests only six of the required majority of eight countries would be able to form the monetary union at the first deadline of 1997. The countries are Germany, France, Luxembourg, The Netherlands, Denmark and Austria. However, available data show a generalized trend towards lower rates of inflation, a reduction of the percentage of public deficit on GDP , not of public debt, in all 12 countries listed in the EU Commission Report, November 1994.

[4] This is the case for Austria, Finland and Sweden. The phenomenon has been conceptualized as "anticipatory adaptation". The notion is a case for a unilateral strategy a policy pattern which sees a "country's unilateral adoption of a set of norms associated with membership in an organization prior to its actually being accorded full status in that organization, or even receiving guarantees of entry". The case is studied in relation to Eastern European countries after the fall of the Communist regime, but is well known in Western and Northern Europe. See: Stephen Haggard, Levy, Moravivcsik, and Nicolaidis, Integrating the Two halves of Europe, in Robert Keohane, Joseph Nye and Stanley Hoffmann (eds.) *After the Cold Wars. International Institutions and State Strategies in Europe, 1989-1991*. Harvard University Press, 1993.

Nonetheless, the EMU is still the most contentious issue on the European agenda among professional economists and political scientists Although the proposal to make the Economic and Monetary Union (EMU) a combination of " two integral parts of a single whole", which would be " implemented in parallel", was made to smooth out the differentials between the member economies, they have not only remained but some economists argue- they are likely to get worse with the completion of the single market and a long drawn-out transition to monetary union. Most of the transantlantic economists who have analyzed the topic using a comparative approach based on North-American experience, have openly criticized some of the central assumptions of the Treaty. They have stressed the damage of setting a linkage between economic and monetary performance and of considering it a fundamental premise to monetary unification (De Grauwe, 1991; Krugman 1991, 1993; Basevi, 1993; Minford, 1993; Tsoukalis, 1994). According to Krugman, the four basic components selected to designate economic union may only help to reinforce a core-periphery model at a European level (Krugman, 1991; 1993).

1. The single market within which persons, goods, services and capital can move freely:
2. Competition policy and other measures aimed at strengthening market mechanisms;
3. Common policies aimed at structural change and regional development; and
4. Coordination of macroeconomic policy including binding rules for budgetary policies.

The last of the four, macroeconomic coordination, includes the basis of a prospective European monetary union and is the main source of doubts and difficulties. Where the Report (1989) views the region as "a currency area in which policies are managed jointly with a view to attain common macroeconomic objectives"[5], Krugman, instead, sees the risk of a core-periphery dichotomy. Though the tenet of the Economic and Monetary Union (EMU) is that the process is an amalgam of both economic and monetary processes, and that only if both are implemented simultaneously, will the members of the Union enjoy all the expected economic benefits, De Grauwe and others fear that only well-off countries will meet the requirements at the scheduled dates, and so will reap all the benefits.

The EMU, however, includes a finly tuned set of rules and procedural steps, which are explicitly engineered to sterilize the negative externalities that professional economists predict when a monetary union is actually created and some countries are told they cannot be part of the optimal currency area (OCA)[6]. The measures aimed at providing a dynamic of objectives and at reinforcing

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[5] The Committee for the study of Economic and Monetary Union (1989)"Report on Economic and Monetary Union in the European Community", par. 22. To a certain extent this is also the case for the EMS as it may be considered a "quasi-monetary union".

[6] See in this paper Chapter 2, 2.3.

virtuous behaviors which should allow member governments a) to meet the agreed requirements and to reduce the resistance of fragmented and protected interests in their respective domestic economies; b) to initiate simultaneously the establishment of monetary institutions which are the precusor to the European Central Bank (ECB). The complex three-stages scenario has been set up to narrow the inter- and intra-member differentials, and to enable member governments to carry out the necessary adjustments. The chosen approach has established a transition period during which 1. member states should attain a high degree of economic convergence; and 2. member central bankers should achieve the necessary coordination and independence of their national governments so as to create the appropriate institutional and operational environment for the ECB.

The attainment of the "convergence criteria" is explicitly designed as a precondition for the entry of each member state into the EMU. At the same time, during the second stage (1994) the Treaty sets up the European Monetary Institute (EMI), whose highly coordinated policies are meant as the necessary institutional arrangements in preparation for the creation of the ultimate goal of EMU: a centralized and indivisible monetary policy managed by the ECB.

The rules of membership, which may well characterize the EMU as an exclusive club, have been widely discussed in Europe, and they mark an important turning point in the practice of institution-building within the European Community. The admission criteria and the evaluation of the required assignments have been drawn up in such a way as to bring to an end 1. the all-together philosophy which had, in previous decades, been a feature of the construction and operation of sovranational institutions, and 2. the practice of negotiating political agreement which has been a prominent feature of the history of European integration with the stops and goes of its member states[7].

The unique and complex procedure which creates the EMU is designed to deal with a number of different problems, ranging from economic to political, and from domestic to international but, raises many querries regarding analytical definitions. Firstly, what is the EMU firstly: Is it a policy? Is it a discipline? Is it the birth of a new institution? As Hobbes noted in the Preface to the *Leviathan*, the first step in scientific inquiry is to define the things, what is being studied. We, however, prefer more modestly to start with a pragmatic attitude by posing questions. The first question might be: *Why have governments agreed and still continue to agree to a project which, according to economists and a number of political analysts, is forcing them into a straightjacket of a rigorous monetary discipline and which will eventually cause them to lose menetary sovereignty?* The economist -monetarist debate

[7] On the stop- and- go of the European integration process see Gerald Schneider and Lars-Erik Cederman, The change of tide in political cooperation: a limited information model of European integration. *International Organization.* N. 48, 4, Autumn 1994, pp. 633-662.

refers to the contrasting positions of the Bundesbank and the German Government (after Schmidt dimission) and the French and Italian governments ( Kennedy, 1993.

A conventional and straightforward response tells us that the European members have agreed to monetary union because of the structural interdependence created with the growth of intra-regional trade and the great amount of transactional costs involved. Such a response, however, ignores the question of why member states have agreed to give up monetary sovereignty. As European and non-European economists have not yet reached any consensus on the need or desirability of a monetary union at a regional level or at a global level,[8] a political analysis of the EMU has been generally welcomed[9]. From a realist and policy-oriented perspective, Wayne Sandholtz (1993) has the merit of having once for all brought an end to the time-consuming economists' debate about which of the possible monetary alternatives would suit the European region best. He has shown that the only possible alternative, the monetary union versus the single currency option, completed with the creation of the European Central Bank, was chosen deliberately to offset the growing imbalance between the German Deutsche Mark on the rest of the European currencies[10] .

The resulting political explanation, however, may overlook some aspects of creating monetary institutions, which are not considered in a purely realist perspective Sandholtz seems to downgrade the importance of the role of Central Bankers and especially of the Bundesbank both in accelerating the conversion to a macroeconomic discipline and in dictating the content of the timetable of the EMU, thus demostrating the apparent weakness of the political actors to oppose them[11], and consequently the weakness of a pure realist approach to the EMU.

Even though pure realist theses are few and far between in the literature, they suggest that governments have moved into Europe pursuing their own national self-interest while looking for a Pareto-optimum. Many consider that the national self-interest is shaped by the interplay of regional

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[8] To many professional economists, the EMU seems to be a truly nonsensical choice, as the lasting differentials between member countries may only magnify the different speeds of economic performance between the European countries and also inside their own national economies, at the sub-national level. Weaker economies, they predict, may become more vulnerable when the capital and financial markets are freed , and as a consequence, in the absence of a single monetary policy (exchange rate policy) and of a central fiscal budget. They may difficulties in offsetting the consequences of asymmetric shocks. Krugman and others predict that the economy of the whole region will enter the formation of a core-periphery pattern, of a European scale. See the recent volume, fruit offered by a Trans-Atlantic scientific community edited by Torres and Giavazzi, *Adjustment and Growth in the European Monetary Union.* Cambridge University Press. 1993

[9] Even if the technical difficulties of the topic have until now hindered research in the field . The few studies, which have been carried out, however, have set the standard for further investigation.

[10] Wayne Sandlots, 1993

[11] The importance of the Bundesbank agreement with the creation of the ECB and the previous failure of the joint Schmidt- D'Estaigne attempt are well analyzed in Ellen Kennedy, *The Bundesbank.* London 1993.

institutions, governments and non-governmental actors, including entrepreneur committees, interest groups and, last but not least, central bankers. Evidence of increasing minilateralism ( Oye, 1993; Majone, 1991) and the importance of transnational actors (Cameron, 1995) has shifted attention from the intergovernamental policies to the decentralized dynamics which is playing a greater role the present phase. In fact, European studies would admit to more than one approach as the Union witnesses the creation of a highly institutionalized environment (Keohane, Nye, 1993; Martin, 1993 ). This meant that the wide-ranging debate of the eighties centered on the question of which theoretical approach would best suit the mix of technicalities and political motives which characterize the regional policies. It is not a question of which is the best approch; but as Weler (1994) has opportunely pointed out it is a question of attention being focussed on the dynamics and which dynamics should be studied if the new post-cold war mood in the EU is to be understood. The thesis of this paper admits that this new dynamic is developing in relation to the creation of monetary institutions. It refers either to the new policies of the member states and to their discrete and autonomous preferences, or to the reciprocal relations between member states. What is original in the dynamic comapred to the previous regional integration dynamic is *a tertium datur*. This new actor is a result of the technical requirements embodied in the high level institutions such as the European Central Bank which is clearly modelled on the German Central Bank. The presence of this new actor which is an amalgam of new actors, the Buba and the community of EU central bankers will not come to any out-of-date conclusions regarding the member countries self-interest. It simply accepts that the new dynamic of institution-building will probably include the legitimate exercise of discrimination and exclusion.

If Putnam's two level game, or a similar paradigm used by economists such as "binding one's hand", is considered, it is seen that such approaches are very useful when applied to questions such as : Why should states resort to "external" constraints to improve domestic fundamentals? In fact, the two level game or other comparable paradigms appear in literature which suggests that foreign economic policy or macroeconomic coordination can be instrumental in determining domestic economic policies [12]. With a similar aim, specific literatures on International Political Economy (IPE) have explained the leverage exercized by sovranational institutions on domestic choice. Commitments to macroeconomic policy, agreed at international fora ( IMF, World Bank, G-7, or Intergovernamental Conferences) are meant to support perfectly both realist and institutionalist explanations. For realist scholars, nation-states may well resort to external constraints as leverage to

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[12] In a general way, Michael C Webb has defined adjustment policies as those policies that "governments can use to reconcile national macroeconomic objectives with international market pressures; they include trade and capital controls, exchange rate policies, balance of payments financing, and monetary and fiscal policies". See Webb, International economic structures, government interests, and international coordination of macroeconomic adjustment policies, in *International Organization*, 45, 3, Summer 1991. p. 309. On the linkage between capital mobility and adjustment policies see further in this article 1.3.

adjust their domestic economies aims and, in this way, protect long-term national interest. While institutionalist scholars argue that a sovranational regime depends on government preferences producing the required changes wanted which will, in turn, produce a Pareto-improvement for the parties involved. The difference between them is that in the opinion of the realists, states will constantly aim to use institutional agreements to gain resources for their own expansionist strategies. In their opinion, institutions are simple "scraps of paper", evanescent agreements which may be overruled at any time to satisfy the state's discretionary interests. Further, as the structure which they assume is inclined to conflict, they may easily predict a regime which is openly modelled on a strategy seeking Pareto-optimum and prone to suffer free-riders. It is clear, however, that a classical one-sided realist analysis is unable to tackle the problem of monetary discipline, which implies, as in the case of convergence criteria in the EMU, a long-term commitment, and it is also unable to consider the problem of creating institutions such as the European Central bank; both elements being crucial to the impending European monetary union.

The institutionalist approach corrected with a little of discrimination power included seems to have a good grasp of the significance of European monetary policy regarding complaince with monetary discipline. Firstly, the institutionalist approach as the one proposed in Keohane and Nye (1993), who have included a well-balanced mix of realist and liberal school' theses plus their own original hypothesis regarding the rules and their enforcement which enable sustainable institutions to be created. Such an approach makes it possible to dedicate sufficient space to the analysis of the *inhibiting factors* which are substantial to any process of institution-building[13]. They, variously defined as a discrimatory threat, or binding's one hand, or even a two level game, make it possible for the member governments which have agreed to the monetary union, to comply with the so called Maastricht disciplne. Discipline, implies the self-constraining behaviour aimed at contaning the compulsive inflationary and spending policy of political governments. Such discipline is built up and enforced by several international institutional and non-institutional *personae*[14] which are actors in an "international political process". As Keohane and Nye put it"The principal focus of institutionalists is on international political processes. Institutionalists note that there is variation across time and space in

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[13] I am freely drawing on the theory of institution-building as it has been shaped in the anthropological philosophy of Arnold Gehlen, *Der Mensch. Seine Natur und Seine Stellung in der Welt.* Akademische Verlagsgesllschaft Athenaion, Wiesbaden 1978. According to Gehlen the generative concept of institution-building should refer to the way human beings keep under control their own impulses. As Gehlen stated inhibited needs can grow into superior interests; the latter, as they are permanent interests go ahead into the future and "remain internal"( long-standing) and are different to daily needs. The inhibited needs are always associated to objective institutions. The creation of institution is made possible by the presence of directive-idea or idea-force. In an another passage Gehlen argues that the institutions are the end state of a process in which the needs of different human beings meet the general and objective needs.

[14] See further the conformity judgment of the Maastricht Treaty.

the ability of states to communicate and cooperate with one another, and that increase in the ability to communicate and cooperate can provide opportunities for redefining interests and pursuing different strategies. Institutionalist analysis makes a distinctive claim of its own: that despite the lack of common government in international politics, sustained cooperation is possible under fairly well defined strategies. These conditions which include the existence of mutual interests that make joint (Pareto-improving) gains from cooperation possible; long-term relationships among a relatively small number of actors; and the practice of reciprocity according to agreed-upon standards of appropriate behavior" ( 1993: 4-5). Secondly, there is the inclusion of discriminatory power as has been used in Kenneth Oye (1993), who raised this key-question. Has the contemporary world economy continued to liberalize despite discrimination or because of discrimination? Following Oye[15], we can hypothesize a process of institution-building in which monetary discipline is being enforced by a set of discriminatory actions the scope of which is to gennerate the compliance of the member participants. The power of discrimination, threatened and eventually applied to member countries, is part of an enforcement mechanism intended to implement a discipline. This discipline is the kernal of the impending process of institution, which cannot tolerate the presence of free-riders without causing their complete failure. In this approach discipline, compliance, enforcement and discriminatory power are all facets of the process of institution-building, whose final result is the European Central Bank. Whether or not reliance on discrimination may turn to be a positive ( a builiding bloc) or negative ( a stumbling bloc), it depends on the extent to which sensitivity to ranking and credibility materialize in the economic and finacial welfare of the single countries. The problem, hovever, may appear frivolous in a world of capital integration and high volatility.

This paper will proceed along three paths presented in three chapters 1. After a brief assessment of the contribution literature has made to the conversion to macroeconomic policies, 2. it will consider the dynamic which is leading member states to comply with the strict requirements of the Maastricht Treaty. The paper defines this dynamic as *getting the core*. It tries to assess some of the problems which are still unsettled on a pure economists' level of analysis. The model is assumed to embody an enforcement mechanism in a process of institution-building which relies explicitly on discriminatory power as a means of enforcing compliance with the entry requirements and as means to deter free riding. 3. The conclusions help to formulate the issue as one of genuine institution-building under conditions of discriminatory actions. The notion of hegemonic institutionalism provides a framework within which it is possible to conceptualize the leadership of the

[15] Kenneth Oye, *Economic Discrimination and Political Exchange. World Political Economy in the 1930s and 1980s*. Princeton University Press 1993. One of the suggestion which makes this book very stimulating and challenging is that " the combination of (oft violated) non-discriminatory norms and discriminatory actions may well be preferable to either pure non discrimination or pure discrimination" p. 137.

BUBA and its epistemic community of central bankers as the functional substitute of a single hegemonic power.

### 1. 1 "Binding one's hand", and the credibility problem.

Since the collapse of the Bretton Woods regime,[16] governments and central bankers have been confronted with the problem of free floating exchange rates. Stability and predictability in international finance, what was implicit in the Bretton Woods system, has been lost on numerous occassions, and in its place, there is increasing volatility and unpredictability which, as has been seen, can have disturbing effects on the world economy. As Boyer has synthesized they were particularly harmful

- to free trade as overvalued currencies awaken powerful protectionist sentiments in "countries with strong currencies".
- because wide exchange rate fluctuations give the wrong or ambiguous signals to resource allocation, especially in terms of long-term investment.
- to goods that are traded internationally, because many people believe that exchange rate volatility demands higher profit margins so as to induce future investments in those sectors.
- because exchange rate volatility complicates domestic macroeconomic adjustments and policy, due to one country's relationship with other economies being uncertain.
- because the disruptive movements also effect domestic price stability[17].

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[16] The "Bretton Woods Regime" refers to the international monetary system established during the Conference held in the New Hampshire in December 1944. It was based upon a policy of fixed exchange rates, the elimination of exchange restrictions, currency convertibility and the development of a system of international payments. Exchange rates were based upon a par value system which required member countries to constrain fluctuations in the exchange rates within a margin of plus or minus one per cent around a par value expressed in terms of US dollars, which in turn were directly convertible into gold at a fixed rate. The regime broke down in 1971, when the US government suspended the convertibility of dollars into gold. The ministers and central bank governors of the Group of Ten ( Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, The Netherlands, Sweden, the UK and the US and along with Switzerland, associate member of the group) met in Washington DC in December 1971 and ratified the "Smithsonian Agreement" which resulted in a 10 per cent devaluation of the dollar and a realignment of exchange rates, including wider margins of fluctuations in lieu of par values. This adjusted par value was largely abandoned when, following another dollar devaluation in 1973, the European Community member countries introduced a joint system of floating their currencies against the dollar. See, David Pearce, *The MIT Dictionary of Modern Economics*, MIT Press 1992,p216.

[17] Mark A. Boyer, *International Monetary Cooperation, in Cooperation and Public Goods.* The John Hopkins University Press, Baltimore and London 1993 pp. 86-87.

The increasing importance of international trade and international payments is shown in the several attempts made by European governments to manage exchange rates by setting- up regional monetary regimes[18].

The Snake in the Seventies, the European Monetary System of fixed exchange rate in 1979, and the Monetary Union approved in Maastricht, December 1992, are all attempts to solve some of the many facets of the increasing of economic interdependence raised at a monetary level[19]. To some extent, they are evolutionary steps toward the establishment of a regional monetary regime following the break down in 1971 of the US hegemonic stability which had been guaranteed for three decades by the dollar's convertibility. This chapter discusses three main points which may account for the European members' commitment to monetary union.. The present section focuses attention on the so called credibility problem, and assumes that cooperation under fixed exchange rates (ERM)[20] has initiated a virtuous trend toward macroeconomic discipline. After reviewing the thesis which centers on the power game played out at the level of monetary policy by the two leading actors of the Community ( section 1.2), section 1.3 centers on the literature which identifies globalization as a factor conducive to European monetary union including the process of regional institution-building.

Two questions are frequently asked about the EMU. 1. *Why should member governments have accepted a monetary discipline which imposes so many painful economic adjustments on weak economies and severe restraints on the well-off members at a time when there is global recession and political upheaval ? 2. How does the Europeanist commitment fit-in with the two or more speed Europe which is raising fears of ranking and may prompt a fragmentation of political union ?*

By addressing the conversion to anti-inflationary rigor,[21] a must for the European states since the early 80ties, this chapter wants to challenge the commonly held view that the EMU has been

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[18] For an analysis of monetary cooperation among Western countries after the collapse of Bretton Woods seen from the point of view of public good in the international economic system : Mark A. Boyer, 1993 Ch. 6. pp. 86- 112.

[19] For a historical account of the European roots to monetary union see Francesco Papadia and Fabrizio Saccomanni, From the Werner Plan to the Maastricht Union: Europe's Stubborn Quest for Monetary Union. in A. Steinherr (ed.) "*30 Years of European Monetary Integration: From the Werner Plan to EMU*", Longman, London 1994.

[20] For a guide to the way the ERM operates see: Robert Minikin, *The ERM Explained*. Kogan Page London 1993.

[21] Goldstein and Keohane have observed that "most egregious proponents of the role of ideas have made is to assume a causal connection between ideas held by policymakers and policy choices. Ideas are always present in policy discussions, since they are a condition for reasoned discourse. But if many ideas are available for use, analysts should not assume that some intrinsic property of an idea explains its choice for policy makers. Choice of specific ideas may simply reflect the interests of actors. It is crucial for anyone working on ideas and policy to recognize that the delineation of the existence of particular beliefs is no substitute for the establishment of their effects on policy. " in Judith Goldstein and Robert O. Keohane, *Ideas and Foreign Policy*. Cornell University Press, 1993.

engineered to reassure well-off countries about the possible unwelcome effects of a monetary unification with not-so-well-off countries with high public deficits and high inflation rates. Though such an approach has not been completely neglected considering the victory of the economic versus monetary approach[22], and at the same time admitting, as realist analysts have done, that the monetary union firstly reflects the leading states' self-interest, this chapter assumes that those policies have been adopted to reinforce the commitment of all European memebrs to macroeconomic discipline, and it was not limited to only the Latin countries.

In the past decade, important sectors of economic literature have interpreted the eagerness of European governments to adopt a fixed exchange rate policy and support the project of monetary union as a tactic move by member governments which are unable to implement suitable domestic policies aimed at budget cutting without price stability. Attention has been centered centered on the positive results which European governments have achieved in the last decade while adhering to the exchange rate mechanism (ERM)[23]. Some literatures argue that the EMS policy rules have contributed to the reduction of inflation and to the increase of capital markets credibility. According to these literatures, fixed exchange rates[24] have contributed to financial credibility. The Exchange Rate Mechanism, which

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[22] The economist -monetarist debate refers to the contrasting positions of the Bundesbank and German Government (after Schmidt resignation) and French and Italian government. See E. Kennedy, 1993.

[23] For an account of the historical roots of the exchange policy in Europe, Francesco Papadia and Fabrizio Saccomanni, Form the Werner Plan to the Maastricht Treaty: Europe's Stubborn Quest for Monetary Union. in A. Steinherr (ed.) *30 Years of European Monetary Integration: From the Werner Plan to EMU.* Longman, London 1994.

[24] According to a technical definition exchange rate is the "price of a currency in terms of another currency". Exchange rates are regularly quoted between all major currencies, but frequently one important currency, e.g. the dollar is used as a standard in which to express and compare all rates. The exchange rate of all fully convertible currencies is determined, like any price, by supply and demand conditions in the market in which it is traded, i.e. the foreign exchange market. More fundamentally, such supply and demand conditions are determined by whether the country's basic balance of payments position is in surplus or deficit. An alternative view of the exchange rate deriving from a monetarist perspective sees the exchange not as price equating the supply and demand for a currency but as the relative price of two currencies, so that any factor which influences the value of a currency will influence its international exchange rate. The most important factor is held to be changes in domestic supplies, and since people begin to form expectations about the likelihood of such changes and of their effects, expectations play a considerable role in determining the exchange rate and help to explain the observed volatility of exchange rates since 1973. When there is no official intervention in the foreign exchange market, the rate is freely floating and will rise or fall to equilibrate the supply to the demand for that currency. Under the Bretton Woods agreement in force between 1940 to 1973 circa. exchange rates were stabilized at agreed par values. Stabilization was effected by the central bank operating as buyer or seller of its currency when it was tending to move outside a permitted range of movement. Since the abandonment of this adjustable peg, exchange rates have generally been subject to a system of managed flexibility, with central banks intervening to smooth out what were considered to be inappropriate fluctuations. Examples of managed flexibility are the European "Snake" and the European Monetary System ( Exchange Rate Mechanism). See David Pearce *The MIT Dictionary of Modern Economic*, Fourth Edition MIT Press, Cambridge Mass. 1992. Fixed exchange rate such as the Exchange rate mechanism is a system by which members of the European monetary System (EMS) are obliged to maintain

came in operation in 1987[25], is a system by which the members of the European Monetary System (EMS) are obliged to maintain their exchange rates within certain bands. All the countries in the EMS except Greece and Portugal are members of the ERM. Each currency in the ERM until August 1993 had a central exchange rate with each of the other currencies in the system, and was permitted to move up to 2.25 per cent above or below the agreed rate. Some currencies were allowed to have a wider margin of plus/minus 6 per cent. The respective central banks have undertaken to maintain the value of their currencies within these limits, by monetary policy and if necessary by direct intervention on foreign exchange markets. If the bands are unsuitable a realignment conference may be called and new mutually agreed exchange rates adopted.

According to Giavazzi and Giovannini (1989), fixed exchange rates can contribute to policy credibility because of variability in the real exchange rate between realignments of the nominal rates is managed. This variability results from inflation differentials with the rest of the world and, it has been argued, it has the effect of making inflation more costly from the policy-makers point of view[26]. "Binding one's hand" (Giavazzi, Pagano 1988) just as Putnam's "two level game"[27] (1986) is meant to account for the policy decisions made by governments whose decisional power to implement of measures to control the public deficit is limited by fragmented dominant alliances or by strong unions. These governments resort *to external constraints* as a substitute for weak decisional capabilities and so manage to intervene directly by cutting expenditure. By setting out monetary policy, the European monetary regime should meet the needs of " wet " governments[28] to justify the introduction and implementation of severe and rigorous policies aimed at cutting public spending, removing obstacles to competition, circumventing domestic protected interest groups.

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their exchange rates within certain bands. All countries in the EMS except Greece and Portugal are members of the ERM. Each currency in the ERM has a central exchange rate with each of the other member countries

25 A recent account of the ERM crisis in B.Eichengreen and Ch. Wyplosz, *The Unstable EMS*. Brooking Economic Activity, Washington, 1993, N. 1.

26 Francesco Giavazzi and Alberto Giovannini, *Limiting exchange rate flexibility: The European Monetary System*, MIT Press 1989 , pp. 104-110.

27 Putnam has made two important contributions to explain international cooperation. His first contribution was made in the two level game hypothesis, where a fruitful explanation of the governments' use of external constraints as a means to policy domestic economy is tested. His second contribution with Nicholas Bayne focused on international summitry. The underlying thesis is that international cooperation is the game table where national governments join to find a solution to unsettled domestic problems. Robert D. Putnam, Two Level Game, *International Organization*, n. 1986. Robert D. Putnam and Nicholas Bayne, Hanging Together. Cooperation and Conflict in the Seven-Power Summits.Harvard University Press, 1987.

28 A former Italian Prime Minister seems to have said at the Maastricht criteria " At least I will have the means to convince my countrymen to do what they should do for their welfare but they do not want to do".

A further result of a "binding one's hand" policy is that governments will see their own credibility and reputation increase. Co-optation and full membership of exclusive clubs may well reward their commitment to " international cooperation policy" with ranking and reputation. Exclusion, instead, is likely to dampen foreign investment, worsen the debt service ( the central banks will be compelled to offer higher interest rates). Such discriminatory action, according to Oye (1993), may well be exploited by governments as a way of curbing the resistance of fragmented and protected interests in the domestic domain. In fact, membership is a visible symbol and enables countries to gain ranking and reputation in the international economic and political community.

Accordingly, the initiative of the monetary union and the adhesion of governments can be easily explained as the desire of European governments to hold on to a certain credibility they had previously won with the ERM between 1986- 1990. Those governments agreed to take risks in the hope of adjusting domestic economies and consolidating the success of the fixed exchange rate policy. The belief that the ERM discipline acted as a leverage to a smooth conversion to macroeconomic adjustment strenghened member governments' willingness to adopt monetary discipline irrespective of domestic political pressures. To raise the probability of countries with "weak" currencies achieving a better performance bot in the public and private sectors the respective governments approved rules and laws which granted independence to their national central banks.[29] The example of a virtuous circle linking independence and low rates of inflation was set off by the German Bundesbank (BUBA) and has been the subject of many studies lately ( Bade and Parkin, 1982 Alesina, 1988, 1989, Grilli, Mascandano and Tabellini 1991). Even though there is limited evidence that central bank independence promotes price stability, and it has no measurable impact on real economic performance (Alesina, Summers, 1993), it is undoubtely true that some European states were won over by the German experience and believed that a fully independent central bank should be free to handle the hot issues of exchange rate policy. As a consequence, they were ready to grant independence to their own central banks and recognize the full independence of a future European Central Bank as well.

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[29] Analysts distinguish between political independence and economic independence. "Political independence is defined essentially as the ability of the central bank to select its policy objectives without influence from the government. This measure is based on factors such as whether or not its governor and the board are appointed by the government, the length of their appointments, whether government representatives sit on the board of the bank, whether government approval for monetary policy decisions is required and whether the "price stability" objective is explicitly and prominently part of the central bank statute. "Economic independence" is defined as the ability to use instruments of monetary policy i.d. the extent to which the central bank is required to finance government deficit. This index of economic independence essentially measures how easy it is for the government to finance its deficits by direct access to credit from the central bank". In Allison and Summers, Central Bank Independence and Macroeconomics Performance: Some Comparative Evidence, in *Journal of Money, Credit and Banking*, Vol. 25, No 2 (May 1993). p. 153.

In short, binding one's hand is a paradigm which can explain why European member states are willing to agree to the policy of standards and convergence criteria; the so called monetary discipline. The discussion, however, is limited to the hypothesis that the option in favor of external leverage is consistent with an inflation-aversion policy aimed at securing reputation and credibility on financial markets. Such a paradigm may restrict the rationale of the policy to one in which the main goal is to saveguard national interest without considering the *long-term process of convergence of national monetary policies.* It may not be able to provide full and consistent explanation of the choices leading to the construction of institutions, which may imply the abandonment of monetary sovereignty as is the case for the EMU. A goal which, instead, is clearly at the origin of the EMU; given that the aim is to create a single currency and a European Central Bank. As monetary union will clearly result in an irreversible loss of sovereignty by the committed states and sovereignty will be trasnferred to transnational prospective institutions, a regime explanation is inadequate even if the plan might not succeed. On the other hand, monetary union and the ECB " is made neither by a beneficent social planner weighing the costs and benefits to the participating nations"[30], nor by a hegemonic power which would take on its shoulders the role of the USA after the cold war (see Chapter 3.). The burden of creating and maintaining new institutions is to be shared among all the participants, on an equal footing.

## 1.2 Power game and the policy choice approach.

As Alberta Sbragia has opportunely pointed out, in the last few years much analysis of the new Europe has been carried out using the language and whithin the analytical framework of International Relations[31]. Much of the research has been focussed on whether the realist[32] or neo-

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[30] Eichengreen and Frieden, The Political Economy of European Monetary Unification: An analytical introduction, *Economics and Politics*, Vol. 5 No. 2 1993.

[31] See Alberta Sbragia, The European Community: a Balancing Act, in *Publius*, Summer 1993 Vol. 23 N. 3p. 24.

[32] A strong argument inspiring the realist approach assumes that relaunching Europe should be ascribed to the action of "intergovernmental bargaining", relying on the neo-realist categories of power and national interest. According to the approach designed by Moravics, interstate bargaining aiming at the largest European nation is based on three basic features: intergovernamentalism, lowest-common-denominator bargaining, and strict limits on future transfers of sovereignty The perfect example of such an approach is the Single European Act (SEA). It is viewed as the result of interstate negotiation between France and Germany, which Britain accepted because she feared exclusion from a two-track Europe[32]. In Moravics' explanation, an essential precondition of the whole deal rests on the convergence toward economic liberalism which materialized in these countries following the election of the British Conservative party in 1979 and the reversal of French Socialist party policy in 1983. He considers *intergovernamentalism* to be the form on which the EC has been based since its inception. "Each government views the EC through the lens of its own policy preferences: EC politics is the continuation of domestic policies by other means. Even when societal interests are transnational, the principal form of their political expression remains national". The frailty of Moravics' explanation lies in the assumption that *national interest is to be considered as meant a constant factor* regardless even of the consequences it might cause.

institutionalist approach is the most appropriate framework to use in order to understand how the Community works. The language and the conceptual repertoire of the field has been applied to single operations in the Community so as to demonstrate the validity of each school. The monetary issue as a high prophile step toward political unification is particularly likely to become an overworked subject of international relations analysis.

The intergovernamental approach is one line of thought and Sandholtz has developed an analysis which rests on important assumptions such as the role of the national self-interest in explaining the move towards monetary union in Europe. Though European governments, he argues, have formally surrendered monetary sovereignty by agreeing to the Maastricht Treaty, they still aim to retain control over the monetary issues in that they intend to manipulate the rules of the game to the benefit of their own national self-interest. Recasting the arguments of the realist school, which encourages approaches which give weight to conflict and race among nations, the fabric of the new institutions looks very much like a patchwork of policy choices adopted by each member state in order to achieve a Pareto-optimum. The intergovernamentalist explanation, which rests on realist assumptions may offer some justification for the determination of the leading memebrs to create a series of multilateral institutions, but it may equally make it difficult to recognize the consequences which are inherent in the creation of the EMU as it goes along its so called "coronation" way. [33] There are also the measures which the Bundesbank has set up to offset the unwanted consequences . Three main interrelated arguments have been considered by Sandholtz. 1. The conversion to macroeconomic discipline[34] is interpreted in part to be the result of the race between key-member countries to establish the rules of the game. 2. The choice of the EMU previleges national interest more than in any other alternative option. 3. The creation of the European Central Bank is seen as a threat made by non-virtuous weak-currency countries to challenge the Bundesbank thus making the German representative one among many.

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[33] In this approach David R. Cameron, The 1992 Initiative: Causes and Consequences, in Alberta Sbragia (ed.) *Euro-Politics. Institutions and Policymaking in the "new" European Community.* The Brookings Institution, Washington DC1991.p 65. "(..) by introducing the domestic politics of the member states into the policymaking of a supranational organization such as the Community, institutionalized intergovernamentalism erodes the conventional distinction between foreign policy and domestic policy".

[34] Until now I have used the term monetary discipline in an intuitive way. It is useful, however, to remember that there is a special meaning for monetary discipline. In an article, Carlo A. Ciampi, former Governor of the Bank of Italy, commented on the difference between monetary discipline and monetary discretionality. In his words, both are part of the monetary governance. Monetary discipline relates to the price stability, and as a consequence it has beneficial effects of the sustainability of the growth of investment and revenue. The commitment to price stability is the golden rule of the German Bundesbank and latter the EMU of all the member countries central banks. Carlo Azeglio Ciampi, Scienza e Arte del Banchiere Centrale ( Science and Art of the Central Banker), *Il Mulino*, Spring Issue 1992.

By assuming national interest, governments and domestic institutions to be the actors in the European monetary project, Sandholtz wants to show that the political economy of the European member countries in mid-Eighties, which aimed at reducing inflation and the public deficit, should be considered as the necessary framework in which political choice can be made and at the same time it should be considered as part of an assertive policy aimed at challenging the unilateralism of the German Central Bank (BUBA) and the related German economic hegemony. As Sandholtz rightly claims monetary union with its objective of creating a European Central Bank is such a distinct choice that it should be analyzed more closely as a facet of the power game between France and Germany, the two countries leading two opposing wings. To support this thesis, Sandholtz focuses attention on the policy choice of the Economic and Monetary Union (EMU) and argues that such a policy implies that the goal of one wing (the Southern countries) is to impede that the other wing (the Northern countries led by Germany) from assuming the role of setting monetary policy for all the region. "Shifts in the domestic political economies of several EC states- Sandholtz argues- established the necessary foundations upon which discussions of monetary union could advance. This conversion to macroeconomic discipline was necessary in the sense that without them, it would have been impossible for key states even to consider monetary integration" (1993).

Sandholtz's analysis of the conversion to macroeconomic discipline is very useful, indeed, for it offers more details than are available to the whole thesis. According to his thesis, even if the adoption of pragmatic monetarism and the acceleration of the implementation of a single market (SEA 1992) are part of Europe's response to the loss of competitiveness experienced in many industrial sectors, and to the globalization of financial markets, such factors have not played a significant role in the choice of monetary union. Sandholtz analyzes some of the causes which have seemingly pushed European member states to adopt policies of deficit-cutting and inflation reduction. Acknowledging that the conversion to macroeconomic discipline is the result of systemic conditions, he accepts the concurrence of two combined factors. "First, technological changes and regulatory liberalization were creating a world in which capital could flow across borders more easily and quickly than ever before. This produced a significant external constraint on national monetary policies, as high inflation in one country would lead to outward capital flows and downward pressure on the currency. Second, governments abandoned the (loosely) Keynesian notion that they could trade employment and growth against inflation and adopted a pragmatic monetarism in which low inflation was a precondition for competitiveness and growth. In other words, governments were abandoning the idea that inflation could be used as a means to achieve domestic economic goals like growth and employment"( Sandholtz, 1993: 5-6).

Domestic factors play an unchallenged role in the governments agenda. They also make it possible to appreciate to what extent the increasing interdependence and integration made it impossible to follow Keynesian policies (Tsoukalis, 1993). The realist plea[35] that an analysis of European monetary policy should consider governments, domestic institutions, and related policies to be the actors which were responsible for deciding the route to monetary union cannot be ignored. Sandholtz's analysis, however, shows that the shift to macroeconomic policy has been made by only a handful member countries, which should go on to form in a couple of years' the so called hard core area of the Union. Conversion to macroeconomic discipline for the rest of them still remains a distant goal as the case of Italy shows. In fact, the Sandholtz's analysis, is particularly convincing when he considers the case of France. The point is that the conversion to deficit cutting and monetary discipline was more an obliged adjustment to the crude challenges of financial and capital markets than a *motu proprio* choice. There is evidence that systemic factors played an important role in the crisis of French exceptionalism and the Socialist's U-turn[36]. Inconsistently, Sandholtz rejects the systemic explanation arguing such factors only might have been influential in French politics. His reasoning does not ignore the effects of systemic factors on the French economy. In fact, he draws up a classical list of unwanted consequences. "Inflation undercut French exporters, so the trade deficit ballooned. Outflow of capital promptly answered the nationalization of the bank system and the introduction of capital regulations.; investment slowed and international financial markets came to abandon the franc" ( ). He considers such pressures also in relation to the two choices which were about to be considered by the French government. One choice was a typical French-nationalist attitude: to abandon the European Monetary System and to " throw up protectionist barriers, and continue to reflate on its own", while the other option was to "disinflate, bringing French interest and inflation rates in line with those of its major economic partners." ( ). Mitterand choose the latter. The Socialist government committed itself to fiscal austerity and to reducing inflation. After three devaluations between 1983-1984, it was prepared to maintain the value of the franc within the exchange-rate mechanism (ERM) of the EMS. "In short, as Sandholtz comments, the Socialists consummated the conversion from inflation and devaluation to monetary discipline "( p.7). However, they accepted the measures with the intention of preparing themselves so that they could gain command over the rules of the game. Rules which they adhered to only in order to later control. The core of the Sandholtz

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[35] Wayne Sandholtz, "having rejected systemic approaches, this study focuses on the national governments in the EC and the diverse motives and interests that led them to favor monetary union (..) . We must explain not only why EC governments agreed on monetary integration but also why they preferred monetary integration to the alternatives. If the notion of choice is to be meaningful, we cannot imply that the choices made were somehow inevitable. We must place choices in the context in which actors experienced them, that is, as decisions among real options", 1993, p.5.

[36] Ronald Tiersky, *France in the New Europe*. Belmont, CA: Wadsworth Publishing Company, 1994. See in particular p. 145 and Chapter 9- "France and the New Germany" a thoughtful exploration of the dynamics of the Franco-German relationship from unification to monetary union. He convincingly argues that while German monetary policy has restricted French economic autonomy, France has chosen to participate in European integration as a political means to contain the power of a newly unified Germany.

thesis rests on this point. The choice in favor of the ERM was dictated by systemic pressures. Instead, institutions are a different matter. For as in the case of EMU, the choice was determined by the terms of the strategic game. It aimed at offsetting the increasing hegemonic power of Germany. As Mitterand bitterly put it after the third French devaluation in March 1983. "We are not masters of our own policy. By remaining in this system (the EMS), we are in fact condemned to the policy of a dog that kills itself swimming against the current. Only for the profit of Germany"[37]. After reviewing the different options available to ensure low inflation without monetary unification, Sandholtz goes on to consider the extent to which the French government's concern with the monetary and economic hegemony of Germany and her central bank forced her to settle on monetary unitication as the most effective policy in order to achieve her long-term aims. The rush toward the monetary union and the institution of a European central Bank (ECB) is very much a distinctive policy of all member states except Germany, and is clearly meant to be a move to offset the overwhelming hegemony of Germany and its Central Bank[38]

Though this is not the time for concluding remarks, I would like to say that the Sandholtz' study is completely right about the strategic games being played on the European scene. However, there are some points on which I disagree. *Firstly*, Sandholtz' rejection of the systemic analysis as an appropriate explanation of monetary union is acceptable only on condition that such a policy is sustainable over time. The argument of financial capital markets pressures is not meaningful if it is used to explain a policy move. It becomes meaningful if it is used to explain a long-standing commitment to such a policy. *Secondly*, there is not so great a contrast between the systemic approach and the national self-interest explanation. Sandholtz seems to underrate the extent to which the experience of financial markets learned by French government and other European members has come to be considered central to the inner mechanism of "eligibility criteria", i,e. the EMU rationale. As Artis has commented " The inclusion of the interest rate criterion is a way of taking advantage of the forward-looking character of the financial markets. The financial markets ' judgments about future inflation, exchange rate and fiscal policy are embodied in the interest rate premium".[39] As a general judgment the markets-EMU relationship clearly shows that a systemic factor is being asked to play a role that is much more influential than a structural factor, on its own. *Thirdly*, the analysis accounts perfectly for the causal motives which have strenghened the member governments other than Germany to select the monetary union option, but it does not consider the implications for

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[37] Quotation in Cameron, 1991 p.67-68.

[38] see Sandholtz, 1993 note 65-67.

[39] Michael J. Artis The Maastrich road to Monetary Union, in *Journal of Common Markets Studies*, Vol. xxx No. 3, September 1992, p. 303.

all memebr countries including Germany of the process of institution-building. The choice even if it set whitin the framework of institutionalized intergovernamentalism is expected to produce a more consequential effect than a spilling over from domestic to foreign policy in a power game.

An example is Sandholtz' assessment of the EMU. "(T)he EMU appeared to be the best choice, in the context of the late 1980s, of governments seeking to institutionalize their commitment to low inflation". Questions : *What then should happen in the different context of the 90s and further, as an increasing number of economists predict a trend of low-inflation, which should include European economy and the other areas as well*[40] *? Should the commitment to monetary union still be considered as a necessary tool of "binding one's hand" , or should the memebr states tear up the Maastricht Treaty and go it alone ?*

Not surprisingly, a strongly "political" interpretation which limits its analysis to considering national self-interest may result in the opposite, that is to say underestimating the political significance of the selective, and, to a certain extent, discriminatory procedures of the new institutions could be a new pattern which might be adopted in other important issues of the European Union. A lesson to be learnt is that analysis should not give up the declared goals and motives of a political choice in order to "discover the real power game back-stage ". What very often is on the stage is sufficiently "Machiavellian" to satisfy even the strongest realist taste.

## 1.3 Capital mobility hypothesis and the policy of macroeconomic cooperation.

According to Webb (1991), "the purpose of an economic-structural approach to the international politics of macroeconomic adjustment is to help us to understand some key incentives that governments face when choosing among alternative patterns of international coordination of macroeconomic adjustment policies". Governments are interested in international coordination and cooperation when two aspects of the international economic structure hurt their domestic economies: a) the degree of international integration of markets for goods and services; b) the degree of integration on international capital markets.[41] Increasing interdependence in trade and capital flows has a direct consequence on the

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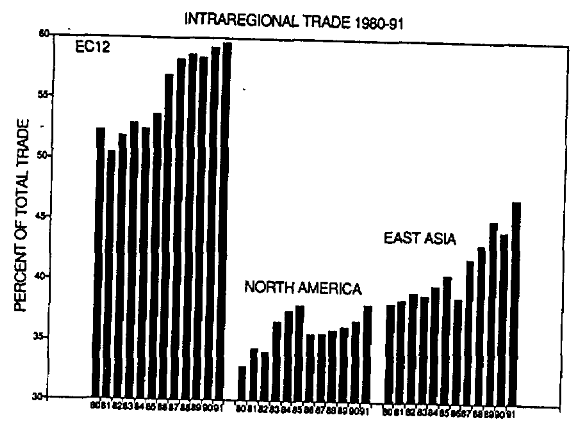
[40] Among others see, Roger Bootle, chief economist at HSBC Greenwell, a securities firm who has just published a study "The End of Inflation Era ", in which he argues that the western world is entering a new period of price stability, similar to that which prevailed for three centuries before the second world war. Boothe challenges the wisdom that the insurgence of inflation is to be ascribed to the output gap. Inflation acknowledged rises when the production of a given country is neat to its production capacity; it remains low when production is lower than production capacity. As a consequence interest rates will rise. For a recent comment on this topic see, *The Economist;* "Economics focus: gapology ", November 19th-25, 1994

[41] With regard to capital markets integration is meant as the market in which bonds and stocks are traded. The operators have in their portfolio, financial assets issued in several countries, and change the composition of their portfolio according to the different yields. Now, in the most industrialized countries there is no restriction on holding financial assets abroad. The consequence is that the capital yield is going to be uniform. However, this is only a very unlikely scenario. Differences in taxation, exchange rates, and capital controls make interest

monetary policy. The high degree of intraregional trade had forced European governments to adopt a stable exchange rate policy long before the official attempts were made in the 70s and 80s. European governments have been particularly interested in stable exchange rates since the 19th century and after the Second World War, as their economies have become even more integrated, thanks to the intensive intraregional trade and the Single European Act (1986), the need for more macroeconomic cooperation and a single currency has been accepted as a logical consequence.

Analysis at a systemic level seems to be the best way to get an understanding of the new mood. By stressing on structural factor as the major force pushing for macroeconomic coordination and also the major pressure calling for action through monetary policy, Andrews has focussed on a powerful factor of International Political Economy within the context of regionalization[42].




From Kenneth A. Oye, 1993.

With the "capital mobility hypothesis" ( 1994), Andrews describes from a Waltzian perspective the way European governments undertook to pursue macroeconomic coordination in exchange rate policy, and as a consequence to start out on the route of monetary union. Andrews' analysis is an important contribution to understanding the globalization-EMU nexus. He assumes globalization and

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rates very different between countries. See, Rudiger Dornbusch- Stanley Fischer, *Macroeconomics* 1990 Mac Graw Hill New York.

[42] Kenneth Oye *Regionalization and Domesticization of Trade*, in Precis , Center for International Studies MIT 1993. According to figures for the 1980s and 1990s, trade within Europe, North America and East Asia increased more rapidly than the total trade of these regions. The regionalization has been matched with the domesticization of trade within and between these regions. " As formal trade barriers have fallen, particularly within Europe and North America, what were once domestic policy matters have become issues of international concern. EC nations are struggling over harmonization of domestic macroeconomic policies as well as domestic regulations governing the environment, product safety, labor and occupational safety, banking, and insurance, while Canada, Mexico, and the United States are seeking to harmonize domestic environmental and trucking regulations and to strengthen domestic mechanisms for fostering adjustment" p. 2.

regionalization to be the major factors which forced the 12 European member states to press for conversion to macroeconomic coordination and currency unification. Globalization, a wide and extensive process which involves many aspects of the IR analyses, is a cause of the capital mobility and the wide and all embrassing process of opening up financial markets all over the world. Students of International Political Economy mention at least three factors: 1. the advances in communication technologies, which have facilitated the flow of capital across borders; 2. innovation by financial firms with the development of Euro money markets; 3. the liberalization of domestic capital markets with the removal of legal and technical barriers to capital mobility by the political authorities of the major Western countries. (Ostry, OECD, Andrews ). The regionalization, which is not the opposite but the the twin of globalization[43] refers to the acceleration of economic activity within a boundary of countries but is accomanied by the exapansion of distinctive political and administrative institutions for that region. There is evidence that the sources of globalization and regionalization have actively interacted with each other producing further reinforcing effects which influence the policy-making of Western governments in the sectors of capital regulations and monetary policy.

The international economy of the 80s was deeply affected by the consequences of capital mobility. The different behaviour of the advanced industrialized and developing economies is not only evidence of the different degree of vulnerability and sensitivity[44] to the globalization of financial markets, but also of their capacity to adjust to them [45]. In the advanced industrialized states, the trend was to accommodate international capital inflows through a competitive deregulation policy. The deregulation and liberalization policies, adopted in the USA and Great Britain, were clear signs of a policy to compete for foreign capital investments, instead of discouraging it. The consequences of the competition for capital investment can be seen in the change of the elements of international economic relations. As competition for capital investment gets more aggressive so multilateral agreements deteriorate[46]. According to Andrews, a "capital mobility hypothesis" can account for the resurgence of monetary regimes aimed at reducing the costs of monetary interdependence, costs incurred by the growing integration of financial markets. The capital mobility hypothesis also predicts a

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[43] Miriam L. Campanella, *Trade Regionalism and Multilateral Institutions. New Strategic Games on the International Scene.* Luxembourg November 24-26 1993. In preparation for publication.

[44] Keohane first attracted attention to the different reactions to globalization in the seminal book *After Hegemony, Cooperation and Discord in the World Political Economy,* Princeton University Press 1984.

[45] Stephen Krasner, *Structural Conflict. The Third World Against Global Liberalism.* University of California Press, Berkeley 1985 ; Miriam L. Campanella, The Geo-political Challenges. Globalization, Governance, and Technology Transfer. in *Global Perspective 2021. Task for Science and Technology*, Vol. 5-67 FOP 323 FAST, Brussels 1993.

[46] Keohane, *After Hegemony*, pp. 90-96

government's relative promptness to adapt, and to surrender monetary sovereignty. In his study, Andrews considers the European Monetary System and the EMU. In order to rationalize the role of the globalization of financial markets[47] in foreign economic policy, Andrews has revised the Waltzian system level explanation (1979), and has adapted it so that it provides an analytical framework which can account for the nexus between capital mobility and exchange rate policy. A typical Waltzian assumption is that international phenomena matter in a states' policy-making as they are "constraining condition which rewards certain behaviors and punishes others" (Andrews, 1994, 202). According to such a view, the globalization of financial markets and across border trade should be regarded as a structural factor which has influenced the choice favoring monetary union ( Gros, Thygesen, 1992).

Though the capital mobility hypothesis, as Sandholtz would argue, is unable to predict the policy choices of each country, it makes it possible to outline one of them. The pressures exerted by international capital are likely to force European governments to reassess the political economic agenda regarding 1. increasing competition for capital investment ; 2. the urgency to globalize domestic industries; 3. convergence towards a common deflationary policy.

Discussion.

In general terms, it is necessary to distinguish between the assessment that professional economists have made regarding the appropriateness and pertinence of the EMU to cope with capital mobility, and its appropriateness and pertinence in accounting for the dynamic of the political actors and institution-building. The former topic lies within the competence of professional economists, while the latter may be dealt with using the tools of political analysis and a strategic interaction approach as it implies that problems of cooperation and institution-building under conditions of interdependence will be involved. In particular, the creation of the EMU embodies a process of regional institution-building and not simply a monetary policy adjustment. If it should become a reality, it will imply more than a reiterate cooperative game between independent states, as the regime theory would suggest.

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[47] For a definition of globalization of financial markets see R. O'Brien, Global Financial Integration. The end of geography, 1992. "International means activities taking place between nations ...multinational describes activities taking place in more than one nation.. Global should refer to operations within an integral whole (..). Global combines the elements of international and multinational with a strong degree of integration between different national parts... A truly global service knows no internal boundaries, can be offered throughout the globe, and pays scant attention to national aspects. The nation becomes irrelevant, even though it will still exists." p.5 quoted in Roy E. Allen, *Financial crises and Recession in the Global Economy*, Studies in International Political Economy Edward Elgar Cambridge, 1994.

The constant belief running through this paper is that the topic is of interest to the institutionalist approach as it may eventually offer a sustainable explication of the European states U-turn in their willingness to surrender monetary sovereignty. At the analytical level, capital integration or globalization of financial and capital markets is defined as a structural change. As such they are a constant feature (Andrews, 1994), and cannot be offered as an explanation of policy-making, but eventually as an *explanandum* for institution-building. There is no apparent inconsistency here for they may be asked to serve as *explicans* for long-term commitments involving the process of institution-building. In order to understand financial capital integration as possible *explicans* of short and long term policies, the distinction made by Padoa-Schioppa between *Prozesspolitik* and *Ordnungspolitik*[48] would seem to be appropriate.

Financial capital integration is fundamental to the creation of the European monetary union as a *Prozesspolitik* if the policies of the member states within the present institutions, instruments and markets are considered. In terms of *Prozesspolitik*, states act in the domestic domain to adjust to and interact with each other in order to manage the short-term impact of the globalization of capital on their preferences and policies. The approach provides an insight into the motivation to action, which I would suggest is the self-interested action of governments, aimed at initiating a process which will allow them to increase their international ranking. Monetary union, however, implies lots of constraints over a government's future action, as primarily it means renouncing a government-dependent monetary policy. *Prozesspolitik* is meant to focus attention on long-term macroeconomic sustainability as well as on the substantial institutional changes in the monetary policymaking. *Ordnunsgpolitik*, a notion taken from Walter Eucken's book *Grundsaetze der Wirtshaftspolitik* (Tubingen 1952), speaks of the "constituent principles" of a market economy (monetary stabilization, free flow of capital, private property, and above all maintaining competition) as the truly fundamental tenets of a sustainable monetary policy. The *Ordnungspolitik* strongly opposes the post-Keynesian theories adopted by several Western countries throughout the post-war period. It differs in its inflation-aversion attitude, for such constitutent principles are meant to be shared completely by the European states and to serve to regulate their preferences in order to achieve long term goals (competitiveness, performance, regional monetary stability). Inspired by the Eucken's *Ordnungspolitik*, EMU is designed to achieve more than short-term adjustments, it calls for convergence at a macroeconomic level, and the creation of the appropriate sovranational institutions, e.g. the European Central Bank, which will replace national institutions.

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[48] The distinction is that *Prozesspolitik* is a policy operating within the existing institutions, instruments and markets, while *Ordnungspolitik* is a policy acting on the existing framework. Padoa-Schioppa, The European Monetary System: a long term view., in Giavazzi, Micossi, Miller, *The European Monetary System*, CEPR, Cambridge University Press 1988. p.369

After giving a brief outline of how the policy approach is unable to account for the strong macroeconomic and institutional aspects of the EMU, the following chapters are an attempt to analyze those aspects of the EMU centered on 1. the EMU as *Ordnungspolitik* embodying the construction of a long-standing framework made by a set of rules and parameters, which are clearly intended to regulate the preferences of member governments over time; 2. institution-building as a result of *Ordnungspolitik* and it is defined in terms of setting up the European Central Bank. The ECB, the institution which is expected to govern monetary policy for the whole region, which is taking place due to the erosion of multilateral cooperation and the increasing process of regionalization of monetary governance. In fact, the creation of the European monetary institution-building should be analyzed simultaneously as an inward-outward-looking process, and not only an inward-looking one. By analyzing the institutional dimension at its outer limit, the paper tries to account for some paradoxes that a pure economist's interpretation has failed to answer.

**2. The EMU and the Getting the Core Dynamic.**

2.1 The theory of optimum currency area and its counter-arguments.

The problem which has confronted the European monetary regional institutions since the very beginning is the great difference in size, performance (rate of growth) and the social and political institutions of the member countries. Only a few of these differences have been smoothed out during the last twenty years of regional policy packages and institutional harmonization. Other changes which are structural in nature are expected to remain long after major economic integration is achieved. The range of differences which in some areas is of 1 to 5 and the different sensitivity of each country to external shocks have produced a lot of skepticism among economists and technical bodies about the desirability and the feasibility of a single currency and monetary policy for Europe[49].

In the Sixties and Seventies, following the theory of optimum currency area (OCA)[50], several economists argued that the EC, given the great differentials which exist, was unlikely to feature an area of monetary stability, where countries link their currencies through fixed exchange rates. By stressing the ideal conditions of the OCA, economists stressed the consequences that monetary unification may cause to weak currency countries. In a general way, the OCA theory predicts that a single currency may

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[49] Regarding the attitude of the Bundesbank officials against Schmidt-Giscard entente on monetary policy see, Loukas Tsoukalis, Money and the Process of Integration, in Wallace, Wallace, and Webb, *Policy-Making in the European Community*, John Wiley and Sons 1983. Ellen Kennedy, *The Bundesbank*,Pinter Publisher London 1993

[50] The seminal contribution on "optimal currency area" is by R. Mundell, A Theory of Optimum Currency Areas , in "*American Economic Review*", n. 51, 1961..

be established under strict conditions. The first condition which generates the possibility of an OCA is the so-called factor mobility (Mundell, 1961). Capital and labour should be free to move freely and quickly within the area in order to deal with high unemployment. According to Mundell, the greater the propensity for labour to move from depressed areas to prosperous regions in order, the less is the need for different policy responses in the two regions in order to prevent the emergence of pockets of high unemployment. Capital mobility may offset imperfectly mobile capital, only under restrictive assumptions.[51] In fact, the direction of factor flows in the Community "is ambiguous, since capital may flows more to dynamic regions while labour may be relatively immobile and reluctant to move from the depressed region" (Harrop, 1992: 176). Further, national differences are very real impediments to the free mobility of labour in terms of linguistic difficulties, lack of skills, shortage of finance and so on. Capital mobility has performed better as there is an increasing trend towards the integration of capital markets in the area.[52] A second OCA condition has been worked out in relation to the degree of openness in the economy; openness refers to the propensity to import and export.

A third condition for an OCA to be set up is the need for a high degree of diversification (Kenen, 1969). Highly diversified economies will be able to manage without having to rely on exchange rate changes, since if demand in one export sector falls, the effect will be small - assuming a high degree of mobility of labour and capital into other sectors. Though the EC member countries are to a certain extent diversified, the greatest major integration is between the Benelux countries which have less diversified economies than the larger member states of the Community (Harrop, 1992 : 177).

A fourth important condition for an OCA is the rate of inflation. Within the European Union, inflation rates diverge since countries have different preferences and a different trade-off between unemployment and inflation. In any kind of monetary union some of the countries have to sacrifice their preferences, either conforming to one preference - usually that of the dominant country- or agreeing among themselves on a common objective. Divergence may cause the weaker countries to free-ride. Countries with low productivity will be tempted to resort to free-riding as they may obtain a higher pay-off in terms of the Philips-curve by opting for inflation. Countries with high productivity and low wage-push have the propensity to low inflation and to subscribe to a rigorous monetary commitment.

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[51] James Ingram, " The case for European Integration", *Princeton Essays in International Finance*, No 98 April, 1973 sustained that capital flows can substitute for labor migration. Eichegreen countered that argument demonstrating that "physical capital mobility eliminates the need for labor mobility only under restrictive assumptions" in T. Bayoumi and Barry Eichengreen, Shocking aspects of European monetary integration, p. 196 in Francisco Torres et alia (ed.) *Adjustment and Growth in the European Monetary Union*. Cambridge University Press 1993.

[52] Jeffrey Harrop, *The Political Economy of Integration in the European Community*. Second Edition Edgar Elgar Newcastle upon Tyne, 1992.

The above mentioned conditions are only partially met in the Community area. As a consequence OCA-economists argue that the project of a monetary union will penalize weaker countries, which whould be better off maintaining monetary sovereignty and following their own monetary policy, particularly is being able to decide their own exchange rate policy. It seemed to most of them that the decision to go ahead with monetary union might only exacerbate the differences between member states. To some of them, however, it seems that if the Community is not an optimum currency area, the feasibility of a single currency might be achieved by merging fiscal and political union within a very short period of time or better time still overnight ( De Grauwe, 1993).

In the years following closer European economic integration, economists would like to point out in greater detail some of the pitfalls that a monetary union might imply in conditions of persisting differentials. The lack of mobility of the labour force and capital, they argue, may set off two distinct but interrelated reactions. *The first consequence* relates to the impossibility of governments to adhere to the single currency to maneuver exchange rates in order to gain competitivity. In other words, the movements in wages and prices in the different countries, due to changes in productivity are not fast enough to make realignments of the exchange rates unnecessary. One of the consequences that the economists of the optimum currency area foresee is that the differentials between countries will worsen at the expense of the weaker countries, which because they do not have have an appropriate exchange rate policy will experience major capital outflows and higher unemployment. A further effect of the loss of monetary sovereignty would be felt in the loss of seignorage[53]. By being part of a monetary union, the relatively less developed countries cannot resort to devaluation to offset a budget deficit. They are compelled to increase taxes and as a consequence to reduce the country's welfare (Dornbush, 1987). For those countries the cost of the monetary union consists in the fact that they would have to resort to expensive ways of increasing revenues. A common currency, argue the economists of the optimum currency area, will only increase the sensitivity and vulnerability of each country to external shocks. According to them, as the economy of the Community is not sufficiently homogeneous and the different countries and regions are rarely subject to the same shocks, it is reasonable to expect that the weaker countries will find abandoning monetary sovereignty more costly.

*The second consequence* is particularly evident at the level of economic geography. A description of the re-distribution of industrial settlements according to a core-periphery model shows the extent to which the map of Europe might radically change setting off the phenomena of core-periphery (Krugman 1991, 1993). According to this analysis, the extent to which the process of merging the

53 Seignorage historically is meant as a toll on metals brought to a mint for coining, to cover the cost of minting and provide a revenue to the ruler who claimed it as his prerogative. See, David W. Pearce, *The MIT Dictionary of Modern Economics*, MIT Press Cambridge Mass. 1992,p.388.

European market gets underway will determine the disappearance of national policies which in turn will determine a new distribution of cores and peripheries. In other words, in a world of increasing returns, this is likely to lead to regional concentration of industrial activities. As geography will come to regain the economic spatiality, which it lost with the presence of obtrusive national barriers, a transnational core-periphery model will supplant the old integrated, and inefficient, national economies. A model drawn up using the conditions of Europe 1992 and the so-called four freedoms - free movements for labor, firms, services, and capital outlined in the Single European Act- suggests that re-organizing the factors of production independently of national protection and import-substitution politics, could provoke difficult macroeconomic adjustment problems of a magnitude far beyond those caused by exchange rate maneuvering[54]. The process of creating a single market may benefit from the continental scale and so enforce a truly European economy at the expense of the national and obsolete small economies. According to Krugman, however, two processes are likely to be set off in the Community area.

1. the areas with an attractive and richly endowed environment will favor the re-location of industries;
2. regions with a 'head start' in production will attract industry away from those areas with less attractive initial conditions, and promote the specialization of primary and related activities in certain areas. 'Foot loose' industries such as electronic firms, software companies, or accounting data processing services, etc. will move toward better endowed environments, and specialized activities (university networks, science parks, cable towns ) according to a geo-economic dynamic. The new emerging European continental economy is one in which several cores are surrounded by hinterlands[55].

A similar conclusion about the difficulties of absorbing asymmetric shocks has been reached by Bayoumi and Eichengreen (1993).

In the last few years, European economists have begun to openly reject some of the arguments based on the "impossibility theorem" of the optimum currency area. They have found evidence that several

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[54] For a positive and corroborating comment to Paul Krugman thesis see Paul De Grauwe, Discussion in Francisco Torres et alia, *Adjustment and Growth in the European Monetary Union*, CEPR, Cambridge University Press 1992 pp. 266-269.

[55] The formation of cores and hinterlands is a self-organizing process that occurred, for example in the late 19 century in the United States. Who gets the core is a policy that describes the present competition as something completely different from Hirschman's *Dependence model*. Krugman's model embodies two features that with a certain grossness may be defined as spontaneous or artificial.. Spontaneous or self-organizing processes are developed by specific economic factors such as re-location and specialization. Artificial or policy led process are those , boosted by the initiative and entrepreneurial capabilities of visionary bureaucrats either as private or as political actors The role of political actors, mainly at sub-national level, is dramatic in the creation of favorable and a richly endowed environment. Krugman's examples are from the success stories of new industries in the USA. The policy-making of local visionary bureaucrats and sub-national administrations plays a more effective role than national or federal governments. Examples are the Silicon Valley and route 128 at MIT Cambridge, and the imitation of the two models in the North Carolina's Research Triangle, created through state support of a research park, in direct emulation of the first two. 'Who get the core", is a policy which may include special packages of initial tax concessions, or modern and cheaper infrastructures.

aspects of the theory are faulty. The first counter-argument questions the *convergence* effect; that is to say the benefits that accepting exchange rate discipline have produced on the weak currency countries.

Evidence is particularly revealing in the seignorage argument developed by Dornbusch. The seignorage revenues were very important for the Southern countries in that they helped to offset the public deficit up to the mid 80s, but after that date they have been greatly reduced (De Grauwe, 1992). After this date, the Southern countries conversion to lower rates of inflation, has contributed to reducing their revenues from seignorage, and as a result to reducing the difference between the best performing country, ie Germany, and the weaker ones.

Revenue from seignorage as a percentage of the GDP (gross domestic product) compared to Germany

| | 1976-1985 | 1986-90 |
|---|---|---|
| Greece | 3,4 | 1,5 |
| Italy | 2,6 | 0,7 |
| Portugal | 3,4 | 1,9 |
| Spain | 2,9 | 0,8 |
| West Germany | 0,2 | 0,6 |

Sources Dornbush 1987, Gros 1990 The table is in De Grauwe, 1991.

A second critical counter-argument argues that a single currency is not feasible given the absence of a truly federative state. By extending the critical arguments of the optimum currency area theory to a country such as the USA or Italy which both present differences in economic fundamentals, Tsoukalis[56] has observed how it is difficult to affirm that those countries should adopt monetary union. In the latter, differences between states and regions are as wide as those encountered in the Community. Nevertheless, as Krugman has observed, in order to make a common currency possible and sustainable, Europe will have to adopt a centralized fiscal budget[57] as soon as possible. A conclusion which implies that monetary union should be conducive to political union as well. The Community, instead, at a political level is a quasi-federal political configuration while it lacks a centralized fiscal budget.

[56] Loukas Tsoukalis, *The New European Economy*, Oxford University Press 1993

[57] This point lies outside the limits of this paper. Nevertheless, the topic is of crucial importance. For several economists supporting the thesis that growing monetary convergence may turn out to be incompatible with persistent fiscal divergence, see R. Dornbusch, The European Monetary System, the Dollar and the Yen. in F. Giavazzi et alia, The European Monetary System. Cambridge University Press, 1988. Paul Krugman, Lessons of Massachusetts. pp. 242-261 in Francisco Torres et alia, *Adjustment and Growth in the European Monetary Union*. Cambridge University Press 1993

The problem of the differences between member countries, however, is not irrelevant as some critics admit. *Why have these differences been taken so seriously in the project of EMU, if they are not so obvious as the critics of optimum currency area sustain ?* Any reply which is given should take into account 1. the international environment 2. the victory of the economic versus the monetarist approach to the problem of monetary union; 3. the high stakes that member countries have attributed to the choice for monetary union and not simply for a single currency policy.[58]

It has been suggested that the harmonization policy and the surveillance service assigned to Community institutions are not able to achieve the ambitious convergence goals needed for Monetary Union. The Delors Committee, formed by Central Bankers, suggested that a new mechanism should be embodied into the framework of the monetary institutions. An evident modification to the dominant paradigm is being introduced in that the new economic and monetary institutions are being conceived of as independent both of any direct interference of member governments and of the existing Community institutions as well[59]. In order to satisfy the standard of the Bundesbank and its excellent performance in maintaining price stability and macroeconomic performance, the choice of independent and reliable regional institutions capable of exercising control over certain fundamentals of the whole region's economy was the result of adopting the German Central Bank as the model.[60] The new institutions, while being compatible with the existing intergovernmental and Community-institutional networking[61], are intended to grow away from them as they build up their own reputation and credibility in dealing with problems such as the rate of inflation, interest rates on long term government bonds, central government budget deficits, the reduction of the ratio of public debt to GNP and control over exchange rate fluctuations. The story of the EMU does not finish here[62]. It should be remebered that a potential compromise emerged only in autumn 1991. It was stated that all the 12 states which were memebrs of the EC would take part in planning and decision

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[58] For a clear analysis of this point, ***The EMU Debate: a Common or a Single Currency. The Economist Intelligence Unit,*** 1990

[59] David Cameron, Transnational Relations and the Development of European Economic and Monetary Union, prepared as a chapter for Thomas Risse-Kappen, (ed.) *Bringing Transnational Relations Back In: Non-State Actors, Domestic Structures, and International Institutions*. Cambridge, Cambridge University Press forthcoming.

[61] In this way see Francis Snyder, EMU-Metaphor for European Union? Institutions, Rules and Types of Regulations. in Renaud Dehousse (ed) *Europe After Maastricht*. Law Books in Europe, Munchen 1994."Whether judged favorably or not, EMU represents an attempt to put in place a major institutional innovation, and also an effort to envisage and shape the Europe of the future. It is a type of legal innovation which draws frequently on existing forms. It uses then in novel ways, however, and also combines them with new elements. It is also a conjunction of diverse strands. This is partly because of the inherent complexity of economic and monetary policy, and partly because EMU itself resulted from bargaining and compromise", p. 63.

[62] For a concise account of the EMU time-table see Moravics, 1993 pp.-16-18.

making regarding the EMU, but some would be granted temporary 'derogation' until they met the economic criteria. At the Summit of December 1991 in Maastricht, eleven states committed themselves to move rapidly and irreversibly towards a single currency and a common central bank. EMU should be fully in place by 1999 at the latest, and possibly as early as 1997. During 1996, the European Council ( heads of state or government) may decide by unanimous vote to move to stage 3 (a single currency and an operational central bank) provided a simple majority of the EC states meet the economic criteria for full participation. If the governments do not agree on the final move to EMU by the end of 1997, stage 3 will begin on 1 January 1999 irrespective of the number of states which meet the economic criteria. The monetary union will be managed by a European central bank, which will be independent of the national governments and the EC authorities and its primary goal will be to ensure price stability. National central banks will become independent of their governments before the transition to stage 3, and at that time they will have in effect become branches of the European System of Central Banks (ESCB). Stage 3 has two deadlines 1997 for those countries meeting the "criteria" listed below and they are known as core-countries or the later date 1999.

- a rate of inflation in the consumer price index no more than one a one-half percentage points higher than the average of the three states with the best performance in price stability.
- interest rates on long-term government bonds no more than two percentage points higher than the average of the three countries with the lowest rates;
- a central government budget deficit no greater than 3 percent of gross domestic product (GDP);

  public debt no more than 60 per cent of GDP;
- a national currency that has remained within the narrow (2,25 percent) band of fluctuations of the ERM for the previous two years and has not been devalued against any other member state currency over the same period[63].

## 2.2 Monetary discipline and Getting the core.

As Putnam once brilliantly observed, metaphors are not theories, but "perhaps every science must start with a metaphor and end with algebra". *Getting the core* is the kind of metaphor which may help the analyst to anticipate the whole vision of the subject under riview, and, at the same time, to introduce the exigency for a new theory. Similar to other metaphors in the literature of European studies,

[63] Moravics, 1993 p.18.

which have anticipated in their vision the rationale of a new theory[64], I would like to introduce the metaphor of *getting the core* as I think it offers symultaneously a feature of 1. a real world dynamic and 2. a theoretical preference. The real world is the dynamic of the observed virtuous trend of member countries to approach the agreed parameters in key-areas such as inflation, public deficit, and interest rates. Such adjustments are already taking place partly spontaneously and partly as the thoughtful initiative of non-virtuos member countries which fear they will miss the bus or fall behind. There is also a theoretical preference for the institutionalist approach as it allows the role of the German Central bank to be evalueted as a model of excellence when crafting the policy of the regional transnational institution. The Bundesbank is not only at the origin of the major transformation of central banking in the region, but is also the imaginary flare for the creation of a community of "transnational actors", in the sense suggested by Cameron[65]; or an "epistemic community"[66], which despite conflicting evidence, is materializing among central banks Governors (Chapter 3 of this paper)

As far as the real world dynamic is concerned, several economists[67] have found clear evidence about the timing of the European partners moves toward a generalized lowering of the rates of inflation. Whether this fall in the rates of inflation should be explicate as an EMS inflation-discipline (Giavazzi, Pagano, 1988; Giavazzi, Giovannini, 1988 ) or an EMS-inflation convergence hypothesis is not settled but (Collins 1988), member countries managed to achieve less divergent rates of inflation even before they joined the system[68], it is a fact that European members have dramatically shifted from an averaged inflation rate of 7,2% in 1978, the year before the European monetary System (EMS) was instituted, to a rate ranging from 2,7 % in Germany to 12,0 per cent in Italy, at the end of 1986, average EMS inflation fell to 2,4 %. The range narrowed considerably: -0,2 per cent in Germany and 5,9 % in Italy.

Compare the following tables.

Table 2.

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64 That is the case for spill-over and neo-functionalist theory. See Miriam L. Campanella, Proactive Policymaking and the State as Actor. Government and Opposition, Vol. 26. No 4, pp. 480-500.

65 David R. Cameron, Transnational Relations and the Development of European Economic and Monetary Union, in Thomas Risse-Kappen (ed.) *Bringing Transnational Relations Back in: Non State-Actors, Domestic Structures, and International Institutions*. Cambridge, Cambridge University Press (forthcoming).

66 The notion of epistemic community applied to central banks has been worked out by Ethan Kapstein,

67 **There are differences between those economists who are not considered in this paper. As often happens political scientists take economists' analyses as resources and not as problems. The author apologizes for the lack of esprit de finesse.**

68 **Susan M. Collins, Inflation and the European Monetary System, in Giavazzi, Micossi, Miller The European Monetary System, Cambridge University Press 1988.**

*The Twelve and Maastricht, 1993- 1994*

| | Inflation (1) | Interest rates (2) | Deficit (1) | Debt (3) |
|---|---|---|---|---|
| B | **2,5** | **6,5** | 5,4 | 138 |
| DK | **2,1** | 7,4 | 3,6 | 78 |
| D | 2,1 | 5,5 | 3,0 | 50 |
| GR | 9,8 | 21,2 | 17,7 | 114 |
| SP | 4,6 | 7,8 | 6,6 | **56** |
| F | **1,7** | **5,6** | 4,8 | **45** |
| IRL | **2,7** | **6,3** | **2,3** | 93 |
| I | **3,3** | 8,8 | 9,0 | 116 |
| L | **3,0** | **6,5** | **0,3** | **10** |
| NL | **2,4** | **6,0** | 3,5 | 83 |
| P | 5,1 | 10,6 | 5,3 | 69 |
| UK | **3,2** | **6,4** | 4,6 | **53** |
| A(4) | 2,6 | | | |
| F(4) | 1,6 | | | |
| S(4) | 2,5 | | | |

(1) Forecast 1995; Source: Semestral Reports of the Commission, May 1994 (2) January 1994; (3) the figures in black meet the Maastricht criteria; (4) Source : Eurostat, Luxembourg new comers January 1, 1995.

.Table 3. The State of Economic Convergence 1994-95 measured in average yearly rates

| | Current account as percentage of GDP | | Gross National debt as percentage of GDP | | Inflation in % | |
|---|---|---|---|---|---|---|
| | 94 | 95 | 94 | 95 | 94 | 95 |
| Germany | **2,9** | 2,4 | **51,0** | 59,4 | **2,8** | 2,2 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Netherland | 3,8 | 3,5 | 78,8 | 78,8 | **2,3** | 2,4 |
| Luxembourg | **1,3** | 1,6 | **9,2** | 9,8 | **2,3** | 2,5 |
| Belgium | 5,5 | 4,7 | 140,1 | 138,7 | **2,6** | 2,5 |
| France | 5,6 | 4,9 | **50,4** | 53,4 | **1,7** | 1,9 |
| Ireland | **2,4** | 2,0 | 89,0 | 83,7 | **2,8** | 2,7 |
| Denmark | 4,3 | 3,0 | 78,0 | 78,0 | **1,8** | 2,1 |
| Italy | 9,6 | 8,6 | 123,7 | 126,8 | 4,0 | 3,5 |
| Spain | 7,0 | 6,0 | 63,5 | 65,8 | 4,9 | 4,5 |
| U Kingdom | 6,3 | 4,6 | **50,4** | 52,4 | **2,5** | 2,9 |
| Portugal | 6,2 | 5,8 | 70,4 | 71,7 | 5,5 | 4,6 |
| Greece | 14,1 | 13,2 | 121,3 | 125,4 | 10,8 | 9,5 |

Source: EU Commission , November 1994 In black the data of the countries meeting the convergence criteria

The data offer some interesting details. They tell us that 1. all member countries have sensibly approached core values in the last few years[69] ; 2. despite the ERM crises of 1992 and 1993 there is evidence that member countries have continued to adopt a convergence policy, and that even the countries which were forced to leave the ERM, Italy and Great Britain, have not used their freedom for free-riding[70] ; 3. there is not such a single best country, with the best all round values. There is no country which dominates the ranking; 4. the three new comers moved towards the core values long before their formal membership.

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69 A certain number of studies agrees that the EMS was very successful in promoting convergence of many economic indicators in the participating countries. As Busch observes " This occurred with respect to the stabilization of intra-EMS exchange rates and interest rates differentials (the volatility of which have gone down both in nominal and in real terms), but most clearly with respect to inflation which has been reduced both in level and variability in the EMS countries since 1979", p. 83. For the literature on this point see Busch, p. 83, footnote 7.

70 Innocenzo Cipolletta, Safety with Europe (Lira, salvezza con l'Europa), Sole 24-Ore Saturday 25 march 1995. The proposal made in the article is that Parliament will authorize the Government to adopt extraordinary measures of limitation of the public deficit by means of expenditure cuts or tax increases in the hope of passing unpopular fiscal and financial laws. It should consist in merely authorizing the government in an emergency to consider itself free from political uncertainty and give it the freedom necessary to restore the objective of the Maastricht Treaty. The expected result should be, according to Cipoletta, to adopt recovery measures in public finance not in relation a generic program of government, but in relation to a European commitment. In the end, he comments, " (Italians) may lose a little national sovereignty, monetary sovereignty of course, as the other member countries, and a little budget sovereignty. A loss, however, which may worth accepting us the price to be paid to have the right to participate in the sovereignty of a much wider nation, the European nation." p.7. The article presents a picture which compares the present Italian parameters with the Maastricht criteria.

Just as in any other regime, the problem of enforcement and free-riding is a major concern. Similarly to the policing exercise of other conventional regimes there are the following three aspects 1. The monetary union is being brought about more through, adjustments achieved by resorting to the "enforcement rule". 2. Sovereign member states seem to have committed themselves to move towards the standards in the fear of exclusion and degradation. Free-riding has lost most of its appeal; 3. The "virtuous" behaviour adopted by all countries is magnified by the fear that memebr states expect the convergence criteria discipline to be legally enforced. A further element, however, makes the difference with an ordinary regime. The fact that the central banks are accredited with a legal status makes the European monetary Union more like a constitution than a regime[71] The crucial question of any regime : *How can governments be induced to undertake virtuous and sustainable behavior in public finance by cutting public expenditure on welfare policies and other forms of side-payments?* has been solved by doubling the level of decisionmaking : now there is the government level, and the level of Central Banks. The quest for a sustainable monetary discipline over time also confirms the move from a "regime" approach to binding institutions. (Padoa-Scioppa, 1988: Saccomanni, 1993). The process of the European monetary union evolving from a regime to a set of central monetary institutions, ranging from EMS to EMU, has been channeled through the convergence criteria drawn up by the Central Bankers. Evidence of this is the mechanism of co-optation by which entry is gained only on merit, and not on membership[72]. A change which has upset the previous political procedure of gaining membership. The EMU response to wet governments legislature challenges the concept of communitarian balance which is still the ethos in many institutional areas of the Community and a different ethos of co-optation to conformity judgment has been introduced. The the opt-out clause is undermined, and, instead, the value of membership through the conformity judgment is reinforced. Secondly, there is the problem of hierarchy and ranking which may cause countries to be eager not to be excluded[73]. Question: How might excluded countries which fear harmful effects on their financial markets react? Will they continue to persist in their efforts to move towards the virtuous values or will they give up thus causing fragmentation or defection along the lines of a core-periphery model? Thirdly, it raises

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[71] Francesco Papadia, L'Unione Economica e Monetaria dopo Maastricht, (The Economic and Monetary Union After Maastricht), *Il Mulino*, Spring issue, 1992

[72] Perhaps this is a case in point of achievement versus ascription. Reservations were expressed by Italian government's representatives after the CDU (German Christian democrats) presentation of a study envisaging the exclusion of founder members from the inner core of the monetary union. The reaction, however, is inconsistent with the Maastricht discipline, which Italy has agreed to. Nevertheless, the negative reaction of the Italian government is understandable and coherent with the getting the core dynamic, as a commentator in *Il Sole-24 Ore* argued.

[73] A subject not yet considered in the literature and which may reveal more surprising facts about the collapse of the Italian consociative political regime.

problems about the paradigm of political union are raised. What are the likely consequences if co-optation and inclusion/ exclusion from the monetary union extend to other areas such as political union as well?

In the next section, we will consider the problems which are being caused by minilateralism as a result of the formation of a core-periphery dynamic[74] and as the consequence of the preferred less-than multilateral relations within the Community[75].

2.3 <u>The core-countries dynamic and the growth of minilateralism.</u>

From a historical point of view, some forms of minilateralism[76] are deeply embedded in the creation of the Community. It is well known how important the special relationship of France and Germany and the *entente elementaire* was after the Second World War in initiating the process of Community-building. No step was taken in the construction of Europe which did not relate to this special bilateral relationship, including above all the creation of the European monetary union.[77] This special relationship is still the motor of this decade, and it has been reinforced with the unification of Germany[78].

The importance of forming of groups and blocs either as a result of concomitant redistridutive interests ( Southern member countries versus well-off Northern countries) or as the result of voting

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[74] An interesting contribution on a similar topic has been made by Anthony de Reuck, International Relations: A Theoretical Synthesis, in *International Interactions*, Vol. 14, No. 4, pp. 321-341. The author distinguishes between the center described as the tenant of "dominant roles of economic creditor, political suzerain and cultural patron over the Peripherals' subordinate roles of debtor, dependency and client (Keohane and Nye, 1971, 1977, Knorr, 1973)." By using the literature of unequal development, de Reuck, describes in terms of economic division of labor, the center as characterized by tertiary (service) activities, the Core by secondary output (capital intensive manufacturing), and the Periphery by primary production (labor intensive agriculture and mining). The limit of such a description rests in its intrinsically staticity, which contrasts the paradigm adopted in this paper "getting the core "which maintains that process of institution-building is meant to develop along a dynamic pattern.

[75] Sir Michael Butler, Europe's Currency Tangle. The Way Ahead, *The Economist*, January 30th 1993.

[76] For an up-to-date analysis of multilateralism versus minilateralism see the excellent paper written by Miles Kahler, Multilateralism with small and large numbers. in *International Organization*, N. 46 Summer 1992 pp. 681-707.

[77] For a historical account of the monetary projects in the Community see: Francesco Papadia and Fabrizio Saccomanni, From the Werner Plan to the Maastricht Treaty: Europe's Stubborn Quest for Monetary Union, in A. Steinherr (ed.) *30 Years of European Monetary Integration: From the Werner Plan to EMU*, London, Longman 1994.

[78] It was very important for Germany to ensure that unification did not jeopardize the Franco-German relationship and that France adopted a supportive position. The improvement in relations was underlined in a speech by Kohl in Paris on 17 January, in which among other reassuring statements he emphasized the importance of close cooperation between Bonn and Paris in their effort to deepen Europe. The Franco-German entente was clearly stated in Kohl and Mitterand joint address to EC member states on 14 April, proposing a faster timetable for economic and monetary union.

procedures in the process of policy-making and decision-making of the Community's institutions is well known.

The minilateralism to which I refer in the context of post-Maastricht Europe is a distinct form both of the special bilateralism such as that of France and Germany, and of the changing groupings due to the preferences of members on different issues. It seem likely that post-Maastricht minilateralism will be the political attitude in vogue during the next few years so as to ensure that, despite of difficult challenges which will arise from the wide range of differentials which exist between the European members and the inclusion of new comers, the Union will retain its ability to act either in deepening or widening links within and ouside the Union so anticipating whenever possible greater union [79]. After a period of uncertainty regarding the different preferences for the two processes[80], and though deepening and widening are very often meant as ways of limiting the effectiveness of decision-making and the effectiveness of the institutions of the Community, a "broader, but much looser, deepening and widening of Europe as a whole is underway" (Nugent, 1992: 327). Minilateralism as a policy to develop flexible approaches and to accelerate integration has already been inaugurated in monetary union and outside the Treaty within the framework of the Schengen Agreement. If the pressure of time is the first feature, the second one is the pressure to move towards a conformity of standards and similar regulations on different issues as well as a "mutual recognition" that groupings of members should recognize each other, and as a consequence full integration will brought forward. The process is particularly apparent in the area of tradable commodities but is expanding into several areas [81]. It foresees that a group of countries may anticipate deeper integration by going ahead faster than the others. Although it is dobtful whether "mutual recognition" or similar policies might generate some "unwanted" consequences such as fragmentation, the resulting minilateralism satisfies the need for more decentralized decision-making. The effects, however, may be both benign or malignant at the same time. Among the *benign effects* there are a) an acceleration of selected union between similar " high standard" countries; b) an incentive for low standard countries to undertake adjustment policies

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[79] Deepening is not such a new phenomenon. Even in the 70s, the decade of Euroschlerosis, there were important policies oriented to deepen the relations among European members. Examples are the European Political Cooperation and the creation of the European Monetary System (EMS). On the institutional front it took shape in the European Council and the decision to introduce direct elections for the European Parliament. Nevertheless, deepening was most strongly pursued in the mid-80s under Delors presidency of the Commission and assumed a dramatic feature with the re-unification of Germany.

[80] In the mid-to late 80s prevalent opinion in the debate and discussion was that there was an irreconcilable dichotomy between deepening and widening. Since the 90s, opinion has changed and it is accepted that the two processes are not irreconcilable. See, Neil Nugent, The Deepening and Widening of the European Community: Recent Evolution, Maastricht, and Beyond. *Journal of Common Market Studies*, Vol. XXX No. 3, September 1992.

[81] See above note 34.

so as not to have to face the harmful effects of exclusion. *Malignant effects,* however, may generate c) fragmentation and a sense of exclusion for those who are still unable or unwillingly to adjust to the highest standard; d) a major overload of conflicting issues to be considered at the Union' s central decision-making bodies

A further *benign* effect, however, consists in having a much slimmer and decentralized policy. The abatement of barriers and the implementation of standards shifting decision-making from the central bureaucracy to member countries means that there will be an acceleration in the process of reducing the differences between member countries and a tighter monitoring, through which each member should be given the power to control the regulations and standards thus getting over the failures of the centralized approach to harmonization and allaying the reluctance of member countries to abide by its rules. By promoting such minilateralism, mutual recognition may enable a member to select closer union (partnership) by means of higher standards overspilling into more politicized issues[82]. What seems to be a mere functional devise may turn into a more sensitive political problem. Mutual recognition while covering the need for more effective implementation and control of economic policies and stressing the need to recognize the many differences between member countries in domestic standards and national achievements, may also engender a form of negative selection. In fact, as in several previous formula, mutual recognition is also a means by which higher standard countries can protect themselves from lowering their standards. The case is not limited to the European Community. The same problématique is now arising for the NAFTA-countries and any future regionalism which brings together countries with wide differentials. On the other hand, it is true that some recalcitrant member governments have used "mutual recognition" as a means to protect their own domestic market fearing, though not without reason, that their markets will be invaded by poor quality products. A case in point is Great Britain, Germany, or Denmark, whose regulatory rules on ecological and quality standards are often higher than those in other average European countries. This does not mean that "mutual recognition" may turn out to be a way of pursuing a la Clausewitz "politics by other means". By arranging selective minilateral relation, in this way, it is possible to lessen the abrupt effects of the centrally chosen policy of the Single European Act (SEA). If the objective of the SEA is to create " an area without frontiers, in which the free movement of goods, persons, services, and capital is ensured", "mutual recognition" may be used as a way of slowing down progress which might be considered too fast and too open. Minilateralism, then may turn out to be a counter-move to the leveling policy of centralization. Further, it may allow countries to adapt gradually to the unwanted effects of abrupt openness.

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[82] A further consequence of mutual recognition is that it extends credibility to decentralized decision-makers at a sub-national level as well to non-governmental actors which have grown impressively in several crucial areas ( environment, pollution, safety etc.).

Minilateralism may turn out to be effective in the process of enlarging the European area to the North and to the East, now possible because of the collapse of the Communist bloc and the dissolution of the Soviet Union[83]. However, it is not yet clear where such processes and their prospective dynamics will lead particularly in terms of the future political and economic shape of the Europe, for there is evidence that pressure is building up for minilateralism, which is at the basis of the models which are most commonly aired in the debate on Europe at "variable geometry" or "multi-speed", will be used to formulate a new institutional approach including new voting procedures. As a recent document of the CDU/CSU argues such an approach, already institutionalized for monetary union, should "as far as possible be sanctioned and institutionalized in the Union Treaty. Otherwise, this approach will continue to be limited to intergovernamental cooperation, which might well encourage a trend towards a "Europe a la carte". It must therefore be decided whether, in the case of amendments to the Maastricht Treaty, the principle of unanimity laid down in Article N should be replaced by a quorum yet to be more clearly specified. It is essential that no country should be allowed to use its right of veto to block the efforts of other countries more able and willing to intensify their cooperation and deepen integration".[84]

In fact, as Nugent has observed : "A Europe of several tiers, a Europe of concentric rings with the Community at the core, a Europe of fast and slow streams, and a Europe of functional groupings with membership overlapping in the manner of the Olympic rings- may well all contain features of the future landscape" (p.327). The situation is in a state of flux and it is not possible to make any confident predictions about which particular direction the Community will evolve. Malignant predictions which assume that minilateralism, allowed as a means of privileged integration, or as a means of protecting embedded blocs of special interest and the creation of a sub-regional hegemonic area may be harmful, have not found much support because of a lack of evidence. However, there is evidence that a much closer and at the same time looser configuration. may develop maintaining the Community at the center of the stage.

*How could minilateralism be developed in the EMU? How should we consider the core-area countries in the creation of the monetary union? Should we consider minilateralism the benign side of a discriminatory power or should we fear the spread of fragmentation[85] ?*

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[83] *The Economist*, The Mats of Post-Maastricht Europe, October 16, 1993; From the Arctic to the Mediterranean March 5, 1994; *The European Union Survey*, October 22, 1994.

[84] The quotation is from CDU/CSU-Fraktion des Deutschen Bundestages, Bonn 1. Sept. 1994."Reflections on European Policy", Section 1. *Further Developing the EU's Institutions.* The section concentrates on agenda-setting for the Inter-Governmental Conference in 1996.

[85] I borrowed this intuition from Kenneth Oye, *Economic Discrimination and Political Exchange. World Political Economy in the 1930s and 1980s.* Princeton University Press, 1992.

As a matter of fact, the minilateralism which is now taking shape in the region is likely to produce benign effects [86]. This is the thesis for the EMU put forward in this paper. The realist political analysts have focused attention on the distinctive and conflicting interests of France, Germany and Great Britain in order to stress the power game occurring among the three major countries of the Community. Instead, from the point of view of the institutionalist approach, the minilateralism of the core-countries seems to be accelerating the creation of the first truly "sovranational institutions" of the Community with the consent of the temporarily "excluded" countries. The monetary union, a result of convergence policies and a three-stage-process, enables the resulting institutions to acquire legitimacy long before they become fully-fledged operational actors. The new *persona dramatis* obtains consensus and compliance as it is created, instead, of redeeming them *post festum*.

To put it in more general terms: The new institution is not equipped only to face its internal differences, but it is designed to face global competition. Even if it is accepted that the core-countries dynamic can cause the process of regional integration to be diverted far from its initial institutional commitments[87], it should be asked whether the new trend of the institution-building philosophy should be identified as one manipulated by regional hegemon (s), or whether it should should be described as generated from a different logic.

Once it is admitted that the new institutions are likely to be placed in the broader context of global challenges, what part could the new institution-building philosophy play in the reform of multilateral institutions? *What descriptions can be used to account for the dynamics ? Which schools of International Relations is best equipped to offer a consistent account of the ongoing process? Which units of analysis should be assumed as principal and which secondary?*

A thesis underlying the next chapter is that multilateralism is declining as far as the continental scale of the new regionalism in Europe is concerned, while it will continue in other geographic areas. The management of differentials is likely to shift from the initial multilateral regime toward a much more selective minilateralism, legitimated by the need of the core countries to set the standards for the other members and to undertake the creation of influential institutions for the whole region.

**3. The Hegemonic Institutionalism of the Bundesbank.**

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[86] A clean cut evidence of the paper's thesis in *Financial Times* April, 16 1994 'France urges 'hard core' of EU members' by David Buchan and David Marsh.

[87] Considering the European exchange rate mechanism crisis and the shift to the loose band, there is evidence of what analysts predicted some years ago 'Wider margins of fluctuation like those already offered to Italy or making realignment easier and more frequent (..) may strengthen existing tendencies towards the creation of a two- or multi-tier Community.

Even though the steps toward an institutional approach to monetary union have been included in the political agenda of ERM-countries, actually between the late 80s and the early 90s., political and economic literature has not shown much interest in the institutional role of member central banks, not even in the most powerful of them, the German Bundesbank, one exception being the recent, excellent study by David Cameron (1995). This lack of interest is probably because a domestic institution such as the Bundesbank and its sister banks do not fit any of the pre-dominant approaches. Neither the policy-realist school, which focusses attention on national interest geared by political actors no the institutionalist approach which takes into account political actors. Instead, the German Bundesbank, a constitutional institution, and according to the Bundesbank Law (1957), " legal person *sui generis* (..) not subordinate to the Federal Government" (paras 3 and 12, BBkG) committed by law to pursue price stability[88] has played and is still playing an important role in the events of European monetary affairs.

Since 1992, the year after the approval of the Maastricht Treaty, the BUBA has been considered directly or indirectly responsible for the major events in the European monetary turmoil: for the shaky currency markets following the re-unification of Germany (1992) and it was criticized for its unwilligness to intervene in favor of depreciating currencies, which in September 1992, resulted in two of the ten[89] currencies, the Italian lira and the British pound, being driven out of the system. The EC's monetary committee, the body responsible for coordinating the operation of the system, held three meetings in the final months of the year in a fruitless effort to identify and correct the system's faults. The doubt whether or not governments which have been driven out of the band will continue to maintain monetary discipline may be one of the most probable causes of financial markets generating a self-fulfilling prophecy[90] regarding currency exchange rates but the Bundesbank policy to abandon

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[88] What has often occurred in the European politics, has happened to the member governments policy: what was planned by rational actors as a means to pursue a Machiavellian objective, often turned out to their interest be against. For an account of the conflict between Helmut Schmidt (SPD), Germany's Prime Minister and the Bundesbank on exchange rate policy see, Ellen Kennedy *The Bundesbank. Germany's Central Bank in the International Monetary System.* New York 1991 pp.40-55. Some implications of the Schmidt/Bundesbank clash are remarkable and will help to explain the tremendous institutional prestige of the Bundesbank vis a vis the political power. An example being : "The Bundesbank is in a better position than governments to pursue its policies by reference to German constitutionalism because its claims to expert objectivity can be more easily translated into concern for the common good than similar claims by politicians. Bonn can nudge the Bank on monetary policy but open challenges to its institutional prerogatives or attempts to circumvent its power to control money supply are bound to fail.". A further implication is that even if the political realities which gave birth to the Bank's legal structure as the guardian of monetary stability and sovereignty have changed, there are no signs that " the Bundesbank Law or the Bundesbank standard is about to shift with the times. Elected governments will have to come to terms with the Bank's independent interpretation of its statutory duties for the foreseeable future. As we have seen, that can impose significant constraints on political maneuverability" pp. 54-55.

[89] Of the Twelve Greece is not a member of the ERM, while Luxembourg's franc is set at par to Belgium's franc.

[90] B. Eichengreen and Ch. Wyplosz, The Unstable EMS, in *Brookings Papers on Economic Activity*, Washington 1993. The rationale of speculative on currencies attacks is built on some "perverse

the pound and the lira to monetary speculation was, in fact widely maintained responsible for their withdrawal from the ERM (Eichengreen, Wyplosz, 1993)

The ERM-crises of 1992[91] , 1993, and 1995 have all resulted in strengthening the D-Mark in the currency markets. They have been shown as evidence of Germany's attempts to play a direct hegemonic role in monetary policy, and of using Bundesbank credibility to impose certain choices on the European partners. The following sections (3.1, 3.2) challenge the realist explanation which considers the timetable of the EMU as perfectly in keeping with the German hegemonic strategy. The BUBA has, instead, played the part of an hegemonic institution which combining the shift to a fundamentalist approach in monetary issues with its constitutional independence at home and prestige and confidence in the international financial markets, has set the generative rules of the first generation of sovranational institutions of the Community. The success of the BUBA has been fully acknowledged in Sir Samuel Brittan' words, "the great benefits of monetary union would arise if such a union were run with a commitment to price stability approaching that of the Bundesbank". This credible commitment cannot be achieved, Wooley reports, unless other policy commitments are checked and institutional structures are appropriate. [92]

The BUBA's policy to continue to maintain its institutional commitments in spite of the fiscal policy pursued by Kohl's government in post-re-unification Germany or the policy to continue to retain the Maastricht requirements seem to support its independence and credibility. In this section, by considering to some results in recent literature (Kapstein, 1993; Cameron, 1995), which assigns central bankers a new and fresh role in the process of cooperation and institution-building in International Political Economy, the policy of the BUBA is assumed to be the generative paradigm of transnational actors facing integrated financial markets (Cameron, 1995), as well as the leading actor of an epistemic community sharing expert knoweledge (Kapstein, 1993).

## 3.1 The realist approach and German hegemonic power

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incentives" such as the fourth convergence criteria of the Maastricht Treaty which , as we know, requires countries which want to qualify for European monetary union to maintain exchange rate stability". The frequent speculative attacks which have forced ERM-currencies to devalue may be moved by the logic of those perverse incentives . The speculative attack firstly prevents countries from satisfying this requirement, it will induce the government to abandon its currency policy regime. "Because the country, once driven out of the EMS, might no longer qualify for EMU membership, it could have no incentive to continue pursuing the policies of austerity necessary to gain entry. Thus a speculative attack- Eichengreen and Wyplosz admits- could prove self-fulfilling" (1993:52)

[91] Andreas Busch, The Crisis in the EMS. *Government and Opposition*, Fall 1993 pp. 80-96.

[92] Quoted in Wooley, Policy Credibility and European Monetary Institutions, in Sbragia *Europolitics*, 1992 p. 161.

The realist approach includes almost all the major and compelling arguments in an analysis of EMU placing it within a framework of increasing German hegemonic power. The approach clearly draws on the notion of the Kindleberger hypothesis in which one stabilizer is the condition that makes cooperation and stability in a global economy possible. This well known idea asserts that the leading country should bear the responsibility of helping the weaker countries so that they can stay in the game (Cohen, 1993 )[93]. The result is that the leading country will provide a so called "public good". The Kindleberger thesis predicts[94] that in absence of a stabilizer the world economy is likely to collapse, and that leadership is an indispensable prerequisite to cooperation. Parallel with the concept of leadership, Keohane has shaped the notion of hegemony[95], which has very few points in common with the notion of leadership[96]. According to Keohane, cooperation may take place even in absence of hegemonic power.

At the other extreme, there is the malevolent hegemonic power hypothesis. In this case it is argued that technicalities are, at a closer analysis, political strategic moves aimed at fixing the rules of the game in favor of one and its nearest neighbour which together are likely to gain the major benefits from the cooperation.[97] This version of the malevolent hegemon is a step toward that of egoistic national interest.

When applied to the European context, the realist explanation while adhering to the OCA theory[98], rejects the need for regional monetary institutions, as the latter do not necessarily fit in with the technical needs of a single currency. On this hypothesis, De Grauwe (1993) has drawn an extremely

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[93] Benjamin J. Cohen, Beyond EMU: The Problem of Sustainability. *Economics and Politics*. Vol. 5 July 1993 No.2. Cohen's assumption admits that monetary cooperation will succeed in the presence of two conditions: a) in the presence of a locally dominant state, willing and able to use its influence to sustain monetary cooperation, b) in the presence of a broad network of institutional linkages sufficient to make the loss of monetary autonomy tolerable to each partner.

[94] The classical example very often given is the stability of world economy from 1850 to 1914 when Great Britain provided leadership with free trade, the gold standard, and the British navy. The lack of leadership after the end of World War I and World War II, was fateful to the world economy which was fragmented by protectionism and financial crisis. American leadership after World War II again provided the world economy with public goods: free trade, the dollar anchor, and last but not least the US navy.

[95] Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy*, Princeton: Princeton University Press, 1984. Reviewing this book, Kindleberger wrote that the word " hegemony" implies too much overtones of force, threat, pressure, to be matched with his concept of leadership. *International Organization*, n. 1986. It is interesting to remember that Kindleberger has borrowed this notion from political science Norman Frohlich and Joe A. Oppenheimer, "I get Along with a Little Help from My Friends", in *World Politics* 23 October 1970, pp. 104-120.

[96] See Kindleberger, *International Organization* , n. 40 1986, pp. 844-846.

[97] De Grauwe, 1993; Geoffrey Garrett, International Cooperation and Institutional Choice: the European Community's Internal Market, *International Organization*, 46,2,1992

[98] For a recent assessment of the OCA theory vis a vis the after-Maastricht period: Lorenzo Bini Smaghi and Silvia Vori, *Rating the EC as an Optimal Currency Area*, Banca d'Italia , Temi di Discussione N. 187, Gennaio 1993.

clear-cut exposé of the Maastricht Treaty in terms of a "malevolent" continental hegemon, whose main merit may lie in it being couched in a language which is attractive to political scientists.

*The first proposition* acknowledges that "the community of twelve is not an optimum currency area "(De Grauwe, 1993: ). The Twelve European countries do not meet the conditions of an optimum currency area that it is to say wage flexibility, labor mobility and fiscal transfers are not sufficiently free to sustain a monetary union. The economic costs of a monetary union are likely to be larger than the benefits for a significant number of countries

*"The second proposition* argues that there is a subset of EC countries which forms an optimum currency area*"( De Grauwe, 1993: 654 ).*There is, however, a sub-set of EC countries- so De Grauwe claims which satisfies the theory of an optimum currency area and which could merge their currencies and form a set of core-countries to start European Monetary Union. These countries are Germany, Benelux, possibly France and Austria. From the point of view of a pure economic analysis, a two-speed approach is desirable. ' (..) It would be optimal today to start a monetary union with a limited number of countries, and to think about enlargement at a later stage when other countries are ready to join'( De Grauwe, 1993: 654).

Nevertheless, this straightforward economic argument is not convincing enough for him, as it must be confronted with a political analysis, which focusses attention on the conflict of interests of the major participants[99]. Germany is clearly in favor of a hard core currency, evidence of its fundamental interest in keeping a monetary union small so as to not damage its hegemonic position in monetary issues, due to the high esteem of the Bundesbank and its uncompromising pursuit of price stability. By maintaning a small core area for a long time, Germany could be able to play a major role in dictating the rules of the game. On the contrary, by agreeing to a community-like board room, as the future European Central Bank should be, the German representative will be only one of Twelve and thus the dominating role of Germany in monetary matters will disappear. Being a member of the European monetary union necessarily means that Germany will have to give up some of its power to determine monetary affairs in Europe, a choice which it will put off for as long as possible.

The policy of adopting a hard core currency is one that can limit the damage. If Germany manages to get a union with a limited number of countries, she can still play a major role. De Grauwe's concluding argument is that the core-countries solution reduces the effects of a large union involving the twelve members where Germany can easily be outvoted.

The remaining analysis focusses attention on the self interest of the other member countries and on their inherently conflicting positions in the process of monetary institution-building. In De Grauwe's

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[99] De Grauwe, The Political Economy of Monetary Union in Europe, in *The World Economy*, V. 16 n.6 Nov. 1993 p 654.

opinion, the fundamental political interest of the other major countries is completely the opposite to Germany's interest. For example, Germany's main challenger France has exaclty the opposite aim. The European monetary union would enable France to regain some of her monetary influence. In a European Central Bank, the French will sit at the same table as the Germans, and will be equal to the Germans. The other European countries such as Italy and Spain will consider the opportunity to sit at the same table as the Germans to politically attractive. Monetary union for these countries can help their governments to correct a chronically weak and inflationary monetary environment. Such a policy would be weakened, if a long transition process were to be adopted.

*The third proposition* argues that a long transition process such as the one described in the Maastricht Treaty, makes little economic sense"(De Grauwe, 1993). According to De Grauwe, the Maastricht Treaty clearly demonstrates two things.

The first point is that from a technical point of view the transition to EMU implies that once the decision to have a union is made (which presumably was done in Maastricth) the union should and can be organized in a very short time, say, six months.

The second point is that the EMU'convergence criteria, involving rates of inflation, interest rates, a non-devaluation requirement during the two years before the union. As well as a country's budget deficit not having to exceed 3 per cent of GNP (Gross National Product) while government debt must be less than 60 per cent of GNP, are all requirements which are not really necessary from an economic point of view. From a technical point of view, an economists' reply would, instead, be negative.[100] In his conclusion, De Grauwe admits that his analysis of the Maastricht Treaty's monetary union and its underlying philosophy cannot be simply interpreted as one inspired solely by "economic" goals, but should be analyzed through the glasses of the political self-interests of the member countries involved.

De Grauwe's *"fourth and concluding proposition is that most of the convergence criteria described in the Maastricth Treaty serve no economic purpose".*

The first example is the inflation indicator. When countries join a monetary union, they abolish their national currencies so as to acquire the new common currency. Since the old currencies disappear, so does the whole history of inflationary expectations associated with these currencies. The only serious

[100] See also *The Economist*, The Community's Two Unions. September 14th-20th 1991, pp.16-17. The argument is that "Europe would gain hugely from money that was not eroded by inflation. For that to happen, it must set up a central bank with an unequivocal brief - to stabilize prices- and with the independence to pursue it. As well ensuring little or no inflation, the single currency would complement ( and indeed foster) the single market that the 1992 project aims for. Trade between EC countries would be freed of all exchange-rate uncertainty. And each EC government, deprived for ever of delusion that it could devalue its own currency in order to make its industry competitive, would have to tackle the true causes of uncompetitiveness: demoralizing high taxation, red tape, restrictive labor practices, poor education and training, etc. The list is long, but at least it is a true one." p. 16.

problem that will have to be solved, De Grauwe argues, is the choice of the rate at which the old currencies will be converted into the common currency. This problem, however, will also have to be faced in the Maastricht framework which assumes a long transition period to EMU. In 1996 (or 1999) national price levels will be sufficiently varied to make it necessary to fix conversion rates. This would mean a devaluation for some and a revaluation for other currencies, in order to ensure that some countries are not locked in unfavorable competitive positions. The long transition period leading up to EMU, according to this argument, does not solve this problem, quite the opposite it makes it worse.

3.2 Central Bank independence and economic performance.

A further point which questions the link between monetary discipline and the real economy is to be seen in the scarce evidence that several important studies have found in models of the independence of central banks and the record of economic performance[101] .Two parameters have been suggested. One parameter is to value the institutional arrangements, while the other relates to the supply of money to the Finance Ministry. By assuming values for those two coordinates, analyses show that the more independent the bank is, the more likely it is able to maintain price stability. By analyzing the degree of independence enjoyed by member central banks, the Bundesbank is found to have the best record. These studies are evidence that the most independent central banks are associated with lower levels of inflation.

However, independence as a parameter of inflation aversion does not lend itself to further correlations with the real economy. There is no measurable impact of central bank independence on real economic performance ( changes in real economic variables such as growth, unemployment, and real interest rates)[102] .

Table One: **Institutional Structures and Economic Performance**

| Index of CBI* | Index of CWB# | Average Inflation | Misery Index@ 1955-88 |
|---|---|---|---|

[101] Alberto Alesina and Lawerence H. Summers, Central Bank Independence and Macroeconomic Performance: Some comparative evidence, *Journal of Money, Credit, and Banking*, Vol. 25, No. 2 May 1993. Alberto Alesina and Vittorio Grilli, On the feasibility of a one-speed or multi-speed European Monetary Union, *Economics and Politics*, Vol. 5, July 1993, No.2.

[102] Alesina and Summers, 1993 p. 154" Switzerland which has an extremely independent central bank, shows much slower and variable growth than the average country in the sample, while Germany and Netherlands which also have relatively independent central banks have relatively good economic performance. On the other hand, countries with relatively dependent central banks such as Spain and New Zealand have relatively variable economic growth whereas France with a relatively dependent central bank has enjoyed steady growth.".

| | | | | |
|---|---|---|---|---|
| U.K | 2 | 0 | 6.7 | 12.0 |
| France | 2 | 1.5 | 6.1 | 10.3 |
| Italy | 1.75 | 2 | 7.3 | 14.3 |
| Norway | 2 | 4 | 6.1 | 8.2 |
| Sweden | 2 | 4 | 6.1 | 8.2 |
| Netherlands | 2.5 | 3 | 4.2 | 9.3 |
| Japan | 2.5 | 5 | 4.9 | 6.7 |
| U.S. | 3.5 | 0 | 4.1 | 10.1 |
| Germany | 4 | 3.5 | 3.0 | 6.6 |
| Switzerland | 4 | 4 | 3.2 | 3.7 |

CBI* Central Bank Independence :higher levels reflects greater central bank independence
CWB# Higher levels reflect more coordinated wage bargaining
Misery Index@ adds average inflation and unemployment
Sources: Alesina and Summers, OECD ILO.

The above propositions clearly seems to epitomize the substance of the realist approach, as it assumes that : 1. the Maastricht gradual approach serves a political objective, i.e. to manage political conflicts; 2. the main risk for Germany in 1999 is that most of member countries will actually meet the criteria set for joining.; 3. and finally, the prediction that if it happens then there will probably be a political crisis. Although these statements account for some differing aspects of the EMU mechanism, they serve to remind us that as European monetary union is taking place among nation-states and not within a unified federal or national state political motives, and not economic motives alone, play an important role. It is obvious to non-ecoonomists that the European monetary Union is not comparable to monetary unification in the US or even to less a centralized monetary regime. The present union looks bizare to economists. Krugman's analysis (1993) is an example. He fails to consider what makes the European case different. He fails to give sufficient weight to the rationale of monetary discipline and the relatively long transition period, which are mainly due to the fact that this union is taking place between actors which have agreed to lose their monetary sovereignty but still remain nation-states.[103]

[103] In the early days of November 1989, the breaching of the Berlin wall and the flood of migrants rapidly increased to some 1500 a day. The FRG had to face a number of urgent decisions about the political unification, while the German monetary authority had to make the unexpected and controversial political decision, of introducing a unified currency. The FRG government opted rapidly for

By considering the monetary union from the point of view of the economic rationality, analysts end up embracing the explanation of technical inconsistencies as due to the politics of a "malevolent" regional hegemon. Kohl's policy of 1 to 1 parity may be evidence of perfect coordination For two of the three typical conditions of an efficient and stable international monetary system have been satisfied,[104] in that the large amount of D-Marks circulating in unified Germany [105] and the integrated European market have solved the condition of liquidity perfeclty . On the other hand, by resorting to a policy of high interest rates, the German Central Bank has provided non-inflationary liquidity while, at the same time, it has stimulated a vast inflow of financial capital. The BUBA's policy seems to be the only certainty at a time of uncontrollable monetary turbulence. In March 1995, following the peso-crisis and the weakening of the dollar, the D-Mark appears to be about to assume the role of a global reserve-currency.[106] Confidence in the D-Mark is largely based on

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unification on the basis of one people and one currency. Under art. 15 of the Vienna Convention on State successions[103], the FRG was to remain the subject in international law and both FRG and EC law was to apply in the extended part of the country . The inclusion of the former communist Germany in the Community marks a turning point which some months later turned out to be a monetary shock. How should the Bundesbank carry out its constitutional commitments and its impending wider regional role? The policy of a restricted, two-speed monetary union is generally identified with the policies of the Bundesbank. A concise account of European Monetary Union should separate economic analysis and political problems, and institution-building. By centering on the notion that national interest and the balance of power between member-states are the first cut in the analysis, the realist approach predicts that institution-building is a deterministic outcome of the prevailing hegemonic state. According to this view, even within the territorial and political unification, the balance of power has shifted again in favor of the Westphalia State, that some authors see as being interpreted perfectly by the new-unified Germany. Fears that the reunified Germany could cause a rise in regional hegemony have been expressed in several political circles and in public debate in Europe and in North-America The collapse of the ERM a few years later seems to have completed the picture of the Bundesbank as the Trojan horse of the Prussian hegemonism. see *The Economist*, The Unpopularity of Two-Speed Europe, September 14th-20th 1991, pp. 91-92.

[104] Robert Gilpin, *The Political Economy of International Relations*. Princeton University Press, Princeton 1987 Gilpin has enumerated three technical problems: liquidity, adjustment, and confidence. To ensure liquidity, the system must provide an adequate ( but not inflationary) supply of currency, to finance trade, facilitate adjustment, and provide financial reserves. To deal with adjustment problems, the system must specify methods to resolve national payments disequilibria (..). The system must also prevent destabilizing shifts in the composition of national reserves (..)' pp. 118-119.

[105] With regard to the reallocation functions of the state, such as in the provision of subsidies to maintain production, social security, benefits or practice; expenditure on social programs and job retention policies accounts for most of the net financial transfers of public funds from west to east Germany- a total of DM 160bn in 1992, and a similar sum is envisaged for 1993. in Barbara Lippert and Rosalinde Stevens-Stroehmann; *German Unification and EEC Integration.* The Royal Institute of International Affairs, New York 1993 p.53.

[106] It is still unsettled among professional economists and practitioners, whether the D-Mark may really substitute the dollar as global currency. Political panics in Europe, due to election and confidence vote have moved money into D-Mark. That money, Thomas Mayer said. " is flowing into short-term instruments, rather than bonds or equities. When the various political panics subside, it could flow out again." . Nevertheless, there are the Mexican crisis and the huge North-American current-account deficit (150 billion dollars) which may favor the

domestic performance a) German inflation rate dropped from 4,8 per cent in 1992 to 2,3 per cent in January 1995, while the GDP is expected to grow by 3 per cent this year (1995); b) the Bundesbank has emerged from the re-unification crisis with its inflation-fighting credibility intact. "One year ago such an outcome was far from certain" admits *The Economist*[107]. Even taking the risk of aggraviating the economic recession and causing two ERM crises, the Bundesbank has continued to defend the D-Mark against inflationary fall-out from unification That commitment has won the confidence of the financial markets and has proved to be the real strength of the economic and monetary stability entrusted to the Bundesbank ( Miller's Lecture at the LUISS, Rome March 1995).

A too strong and uncontrollable DM seems to many analysts to suit the malevolent hegemon perfectly. They sustain that the Treaty reflects German monetary 'national self-interest'. For them the picture is possibly even more up-to-date when the continuing effects of German unification on capital and financial markets policies are considered. Several analysts believe that the financial market turbulence of 1992, 1993 and 1995 has at least one common feature: German economic post-unification measures.

The argument has been presented along three main lines. **The first** deals with the **fiscal deficit**. The large fiscal deficit produced by the flow of public investment into the former GDR has got worse. Such a situation should be welcomed by the other EMS participants. Although some tension has been caused within the EMS because the Bundesbank raised interest rates and as a consequence forced the other EMS countries to raise their interest rates as well, interest rates differentials (vis-à-vis the DM) have also narrowed so that the pass on effect was only partial.[108] This means that the fiscal deficit is more a problem for Germany than for the rest of the core counties of the Community (Gros and Thygesen, 1992: 192). **The second** variable , i,e. **faster real growth** due to the re-unification, is not a source of tension. The German locomotive is now running faster as many hoped it would before German unification when the slow growth was blamed for the difficult and slow recovery in the EMS countries. **The third** variable, which is alleged to challenge the EMS is the large **financial shock** caused by German unification. The Bundesbank is reputed now not to be strong enough to resist pressure for an easier policy stance in the form of lower interest rates and/or debt relief for enterprises in Eastern Germany A steady flow of D-Marks from the Mittel-European countries derived from their

investors interest to diversify out of the dollar. See for this comment *The Economist*, The rise and rise of Germany's Mighty Mark, February 25th 1995 n. 83.

107 *The Economist*, The Rise and Fall of Germany's Mighty Mark, February 25th 1995 p.83

108 See Gros and Thygesenn, *European Monetary Integration. From European Monetary System to European Monetary Union*, Longam London. 1992 According to the authors "(..) since the increase in German imports is very substantial the net effect of the German fiscal expansion caused by unification on the other EMS members might be positive and certainly cannot be very large if it is negative" p. 192.

foreign trade may reinforce the dominant position of the German currency in the system. Nevertheless, Gros and Thygesen comment that as such a scenario is likely to materialize only if the current EMS has not been replaced by a complete EMU and a joint monetary authority, then the European Central Bank, designed to take over the leadership role of the Bundesbank, should not be set up.

In fact, what has often happened in the fast-changing scenario of European politics is that what was intended to have a certain goal or interest might turn out to favor the opposite result. The option of the ECB, coveted mainly by France and Italy, who saw it as a means of increasing their own influence in monetary decision-making and as a way of offsetting the prestige and influence of the Bundesbank, turned out to be an institutional hegemony of the institution, that it was intended to control. Since 1989, France has been able to continue to move towads the hard core area of the best performing countries, thanks to adopting rigorous budget policies, while Italy has moved further away with an increasing public deficit and is facing its worst ever performance in terms of financial market credibility. The institutional process which should protect the interests of the weaker currency countries is turning out to be much better at serving the strongest due to unwanted side-effects. The institutional approach is setting the rules and standards of the new instituion-building and keeps the size (membership) of the monetary union under strict, by inculcating the prospective members of the European Central Bank into the Bundesbank's monetary creed.

3.3 The . BUBA and its epistemic community.

The pitfalls of the realist approach are apparent in three different orders of description:

**At the level of domestic politics.**

- Such an approach assumes that the German government and the Bundesbank are a coherent and non-conflictual unit of command. This claim is contradicted at the constitutional level in as much as the Bundesbank is modeled on the rule of US Federal Reserve, i.e. at both a constitutional level and a policy level, it is independent of the government's instructions (Cameron, 1995). Further, the assumption ignores earlier and recent conflicts between the BUBA and some German governments[109]

[109] Sharp contrasts between the German Federal Government and BUBA occurred at the time of the Schmidt Administration and resulted in the fall of the SPD-FDP coalition, see E. Kennedy, 1991. More recently the conflict was with the Kohl Administration on the politics of the parity. While there is evidence of a persistent conflict between the former German Kanzler Helmut Schmidt (SPD) and the Presidency of the BUBA. According to Schmidt, there is no reason why severe requirements for admission should be maintained. He has attacked against Hans Tietmeyer, President of the BUBA, and Theo Waigel, Finance Minister of the Kohl Administration, for using D-Mark as a means to pursue nationalistic interests. Sole 24-Ore, Saturday April 8, 1995 p. 5.

- It underestimates Buba's independence and autonomy and, consequently fails to understand the political and institutional dynamic in the governance structure of Germany today.
- On the contrary, as the Buba 's role at a European level is likely to expand, divergence with the German government may increase.

**At a technical level.**

- Such an approach is inconsistent with the realist assumption that a malevolent hegemon may prefer the slow-track. An aspiring regional hegemon should be concerned about the short run in order to avoid counter-moves, and not worry about slow-track policy, as is the case for the fundamentalist approach supported by BUBA

**At the level of fellow institutions.**

- It takes away much of the leadership from the central banks fellow institutions. Such leadership mainly rests on the independence that an increasing number of European central banks have won for themselves in pursuing the goal of price stability. That leadership is likely to result in an epistemic community, which is formally envisaged in the ESCB (European System of Central Banks) of the Maastricht Treaty. The principle of price stability which characterizes the BUBA has shifted to the ESCB, and with this institution the principle of price stability has even strengthened[110].

The lack of understanding of the BUBA's relationship with the other member central banks may well verge on the limit of a pure intergovernamentalist approach, in which new actors are excluded. Although there is daily evidence of their role in the present phase of the European monetary process and of the turbulent monetary and financial changes which are taking place, any comment must be[111] highly intutive needs and a full and proper inquiry is necessary.

Conclusions. <u>What's wrong with the recent great clamor about Europe at a variable geometry[112] ?</u>

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[110] Carlo Monticelli and Jose Vinals, European Monetary Policy in Stage Three: What are The Issues? *Center for Economic Policy Research,* Occasional Paper no.12

[111] Marjorie Deane and Robert Pringle, *The Central Banks*. Hamish Hamilton London 1995. The authors observe that the paradox of the high status of the central banks is that their independence is now being challenged by the loss of control on capital movements. According to them, the status of independence of the central banks has come too late, when the political cycle has changed from the monetary pre-electoral loose policy to the recent fiscal excess. The most effective discipline is that applied by the markets to long term interest rates and not the short interest rates decided by the central banks.

[112] The two-speed Europe is a creation mainly of Wim Kok, The Dutch finance Minister. The draft would allow any six members with healthy economies to strike out on their own in a currency union, leaving the rest behind. Only the Germans reacted enthusiastically to this idea of a two-speed Europe. Most finance ministers preferred

*This paper's main assumption that the rationale and dynamic of the Economic and Monetary Union (EMU) embodies a discriminatory element is proved by the mechanism of inclusion/exclusion by which only virtuous countries will join the third stage. That mechanism, however, should not be taken to mean that convergence criteria will prompt fragmentation in the Union, but, on the contrary, these adjustments will urge member countries to accept the macroeconomic adjustments and in order to make such commitments sustainable over time, an organizational network is being set up. While sharing some results of the institutionalist analyses* ( Martin, 1993; Cohen, 1993; Cameron, 1995), which show that the objectives of monetary union are going to be attained[113] with the help of the "densely institutionalized field of the European integration process,"[114] the paper focusses attention in particular on the role of a domestic institution, the BUBA, the German Central Bank, which has supplied its institutional format and has set the rules for the new monetary institution which is to be set up in the region. The institutionalist approach proves to be particularly useful in accounting for the monetary union policy aimed not at creating a monetary regime but at setting up a transnational *institution*. On the whole I suggest what this dynamic should be described as a process of institution-building, which will substitute a monetary regime (EMS and ERM) with a "central supranational institution with exclusive authority for the conduct of monetary policy"[115]. In order to make the commitments of member states equal to the level and the behavoiur of that institution realistic over time, member governments are committed to achieving some specific parameters which is refered to as a getting the core dynamic. This paper has tried not to fall into the traps of the realist approach of interpreting monetary unification as simply being forced on the weak states by the powerful, so embracing the pure zero-sum game. From the point of view of the institutionalist approach, it is acknowledged that the process of institution-building is the result of a policy choice in which the national self-interest and strategic interaction have played a central role. Nevertheless, the impact of the institutions on the behaviour of member states is acknoledged so diluting the pure realist payoff (Sandholtz, 1993). *In fact*, as Keohane and Nye have rightly recognized the institutionalist approach " (is) not uniformly optimistic", it finds that "international institutions are not necessarily benign: their rules may impose

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the notion that the EC as a whole should decide when to move to phase three. See *The Economist*, The unpopularity of two-speed Europe, September 14th p.91-92.

113 The institutionalist approach has been shaped in several works of Robert Keohane and Joseph Nye. I have drawn freely the pages of the "Introduction: The end of the Cold war in Europe", in Robert Keohane Joseph S. Nye, Stanley Hoffmann (eds.) *After the Cold War. International Institutions and State Strategies*, 1898-1991. Harvard University Press, 1993.

114 Keohane and Nye, see above.

115 Fabrizio Saccomanni, Supranational Institution-building in a rapidly changing region: European Monetary Unification. *The International Spectator*, Vol. XXVII, N. April-June; 1993.

adjustment costs on countries that are weak or have policy preferences that diverge from those of powerful states" (Keohane, Nye 1992: 6). This point is consistent with several aspects of the economists' analysis of the asymmetric gains of a monetary union (Tsoukalis, 1991 ). *Further,* it finds that a truly hegemonic role has been played by a domestic institution, the BUBA, which has supplied with its worldwide credibility the pattern and the rules of the new regional institution[116]. The hegemonic institutionalism exerted by the German Central Bank[117] is providing the model of the future European Central Bank (ECB), and the commitment to the "economist theory" of market fundamentals, explains the monetary discipline and the entry requirement. *Fifth,* the institutionalist approach while helping to explain the entry requirements as a preventive enforcement of the adopted monetary regime, also offers an explanation of the dynamic of *getting the core*. This dynamic challenges the univocal opinion that the EMU in allowing the "integrationist" states, those which meet the objective criteria, to go ahead faster, facilitates a two-speed participation. Although the first consequence is that a handful of well off countries may join the third stage, and so exert the threat of exclusion on the non-virtuous countries, the EMU does not discourage the latter from joining the other core partners at a latter stage. Instead, it encourages the laggard-states to accelerate moves towards the core values, providing them with the necessary "political" levearage to speed up conversion to the macroeconomic discipline and to the required parameters. The payoff is clear. The consequences of staying out will turn out to be costly in terms of financial markets judgment and capital investment. *Sixth,* the institutionalist approach enlarges the vision of the key-actors by including the Central Bank governors which is unjustifiably excluded in a policy analysis. Instead, the Central Bank Governors have supplied the Delors Committee and the Intergovernamental Conference on EMU with a "fundamentalist" approach resulting from the consensus reached among the EC central bank governors on certain principles more explicitly enunciated by the Bundesbank. The consensus reached on the fundamentalist approach to monetary union has facilitaded the formation of an epistemic

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[116] Karl Lamers, responsible of foreign affairs of the German CDU, has clarified the situation in an interview to *Il Sole-Ventiquattrore,* December 2, 1994.

[117] A recent book by David Marsch *The Most Powerful Bank: Inside Germany's Bundesbank*, New York Random House, 1994. A review of the book by Alan Walters in *The National Interest*, Spring 1994 identifies the source of the ideas which influenced the reconstruction of the German Central Bank at the end of the Second World War. As Walters observes the monetary creed of the new Federal Bank were those professed by economists such as Walter Eucken, Wilhelm Roepke, Alfred Muller-Aemark and other scholars. Their Ordo-liberalism wanted to avoid the alienation of dispossessed and disaffected groups that had provided such a fertile ground for the poseurs and demagogues of fascism and communism. This modified Ordo-liberalism was called the social market economy. Eucken, above all, emphasized the need for price signals, undistorted by inflation, for the market to work efficiently and thus the requirement of stable general price level. As Walters commented this background of ideas was quite different from the post-Keynesian ethos which " dominated the Western clerisy in Britain and the United States (..) Even to this day, prominent professors at Cambridge have urged that there is nothing wrong with inflation at 10 per cent, provided it does not vary too much. This is all a far cry from Eucken, Roepke, Erhardt, and their ethos", p. 95.

community which is far more robust than the intergovernamental approach on which the main institutional pillar of EMU is going to be built, namely the European System of Central Banks (ESCB) and the prospective European Central Bank.

By adopting an institutionalist approach, this paper emphasizes that the unconstrained conduct of member countries to comply with the commitments of the monetary discipline during and after the ERM crisis shows that the monetary discipline inspired by the Bundesbank is accepted willingly. There is evidence that even with the wide-band ERM and monetary dumping advantages for exports, the member governments have not taken advantage of their new-found 'freedom' to manage exchange rates, and have complied with the ERM rules..

A possible explanation could be found in the policies of the German central bank, and its role in the process of European monetary union. It is suggested that the BUBA is willing to assume responsibility for leading the process of monetary institution-building and in this way to originate a new family of transnational , regional, institutions. The justification for the new institutions rests neither on Community-led nor on intergovernmental decision-making, its rationale, instead, derives from the need to inaugurate a family of institutions which embody competitive versus distributive rules.

The politics and success of the German central bank and its institutional hegemony have all worked towards the formulation of the institutional paradigm of a growing epistemic community, which has been drawn up by knowledge-based experts sharing common cause-effect conceptions and similar sets of normative and principled ideals.

An important aspect of the new institution-building philosophy is the getting the core dynamic which includes both the self-interest of memebr countries to join the new institution and the efforts they make to follow the appropriate adjustment policy to merit memebrship. In the imminent situation of deepening and widening European regionalism, different opinions regarding the pace and effectiveness of domestic adjustments are affecting the ranking and position of each country, irrespective of how long they have been members. This notion is put forward by Krugman, when he describes what future lies before domestic industries facing the process of regional integration. With the deepening process of regional integration, Krugman envisages two entrenched reactions, the relocation and specialization of industries both of which coagulate a new core-periphery map. Irrespective of national industrial policy, and highly responsive to a competitive challenge, the new cores shape a new economic geography in which some national industries lose their previous position, while others gain a new centrality. Getting the core is now meant to describe the behavior of member countries whose aim is to meet certain requirements and standards in order to share the benefits of membership, and to meet the criteria set out in the core area standards. The threat of exclusion and discrimination stimulate member countries to get the core, encouraging government representatives to face difficult and painful adjustments. In other contexts, economic discrimination and inclusion/exclusion mechanism and relative achievements have been shown to work better than ascriptive admittance (Oye,1992 ). Confirming the parallel analysis put forward by Oye on the widening of bilateral and discriminatory relations, this paper analyzes the discrimination and inclusion/exclusion mechanism in the creation of the European Economic and Monetary Union in terms of a dynamic mechanism which engenders a mechanism of spontaneous compliance in a multi-speed Europe. In short, the paper suggests that the discrimination mechanism embodied in what is being called the two or more speed Europe might stimulate competitive dynamics and strengthen the commitments of governments to succeed in meeting the convergence criteria while encouraging economic adjustments. The paper is a contribution to the growing literature, which focuses attention on economic discrimination, an approach which is proving to be a precious analytical device to account for non-standard analysis conducive to 'economic liberalization, (Oye 1992).

Further, the paper suggests that getting the core dynamic is permeating the process of institution-building. As far as the member countries' central banks are independent of their respective governments, it seems likely that the European Central Bank will be the first of a new family of regional institutions, which do not fit either the pure realist ' national interest', or the Community values. The new family of institutions seems likely to be the first European institution, in which the process is at least as important as the institution itself. From this point of view, the notion of "epistemic community"(Kapstein, 1992) seems to be most appropriate. In fact, the rationale of the new institution-building philosophy rests on the assumption that the responsibility of technically autonomous institutions, is independent of the political arena. Just as central banks have gained independence, these institutions have also gained greater authority to endorse their respective governments's commitment to monetary discipline.

The member governments which adhere to the ERM in fact have not taken advantage of the relaxed commitments of the wider band to free-ride. The example of some European banks (Italy, England, and Belgium) is evidence that member countries, at different tiers, are willingly to adjust and comply with the rationale of the monetary discipline, instead, of free-riding. Even though outstanding economists, one of whom the Nobel prize winner, Franco Modigliani, suggested in the aftermath of the ERM crisis of September 1992 that leaving the ERM was a good reason to to free-ride, up to now the Italian governments and Italian central bank officials have firmly continued to comply with their previous undertakings by maintaining and even reinforcing their pre-crisis commitment to monetary discipline.Finally, the paper suggests that the reason why weaker member governments continue to comply with monetary discipline and continue to get the core is the fear that "go it alone" may erode their countries credibility further, while being excluded from political club may cause them lose ranking and suffer political degradation.