INTERNATIONAL CONSTRAINTS AND DOMESTIC CHOICES: ECONOMIC CONVERGENCE AND EXCHANGE RATE POLICY IN FRANCE AND ITALY

Prepared for the European Community Studies Association
Third Biennial International Conference
May 27-29, 1993
Washington, DC

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ABSTRACT

This paper examines the French and Italian experiences with exchange rate stability and macroeconomic convergence within the European Monetary System since 1979. While France and Italy present roughly similar economic profiles and have been exposed to the same international economic developments, they have experienced differing levels of exchange rate stability and macroeconomic convergence. I consider three theoretical explanations for this difference. The first looks to changes in the international economy to explain differing policy patterns. The second explanation focuses on the dynamics of domestic politics and interests. I conclude that neither of these approaches adequately explains different patterns of French and Italian economic policy within the EC. Instead, I argue that the third approach, which focuses on the nature of policymaking institutions and the instruments accessable to policymakers, best explains the countries' different outcomes.

INTRODUCTION

An important theme in recent discussions of international political economy is that as interdependence grows, states have less room to pursue autonomous economic policies. Increases in international flows of goods, capital, and knowledge have led a number of analysts to put forward the proposition that national economic policies must adapt to a new global marketplace or suffer the consequences of becoming a poor site for investment and production. The comments of Peter Drucker exemplify this view: "[f]rom now on any country. . .that wants to do well economically will have to accept that it is the world economy that leads and that domestic economic policies will succeed only if they strengthen, or at least not impair, the country's economic position."[1]

Such arguments have been particularly notable in the area of international finance. Many observers assume that the amount of internationally mobile capital has risen to such a level that policymakers have no choice but to create a macroeconomic environment of low inflation to attract international portfolio and direct investment. As capital mobility increases, policymakers are less able to adjust to changing conditions in the international economy through devaluation and insulation of the domestic economy. Instead, countries which are successful in adapting to capital mobility focus on increasing or maintaining competitiveness by implementing stable macroeconomic policies, while instituting microeconomic reforms in domestic markets and regulations to facilitate adjustment of factors of production to changes in international supply and demand.

This process has been particularly interesting in western Europe, where a number of highly interdependent countries have undergone significant shifts in economic policy in response to the internationalization of economic production, exchange, and finance. Yet the responses of European countries to this common challenge have not been uniform. France and Italy, which both experienced high inflation and constant pressures on the values of their currencies in the 1970s, have since parted ways. French inflation has come in line with the inflation rate in Germany (and since 1991 inflation in France has been

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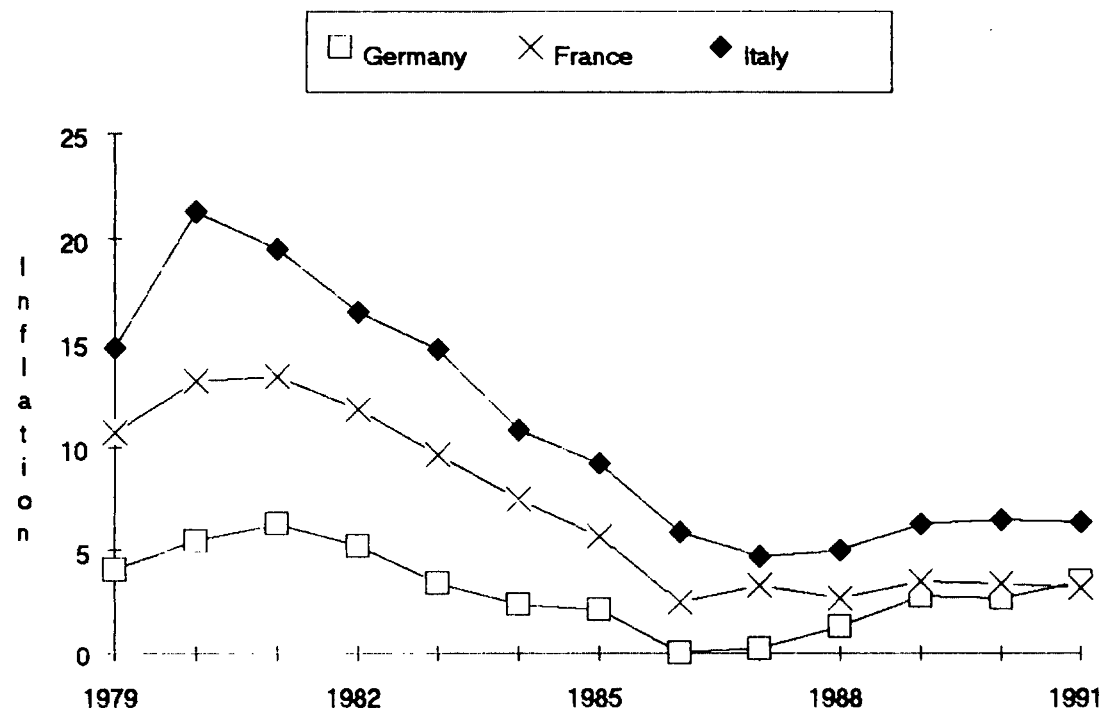
[1] Peter F. Drucker, "The Changed World Economy," in <u>Frontiers of Management</u> (New York: E.P. Dutton, 1986), p. 49.

lower than German inflation), while Italy consistently has had higher inflation than both France and Germany (see Figure 1).

Figure 1
Inflation Rates in Germany, France, and Italy, 1979–91



Source: Calculated from IMF, International Financial Statistics, various issues. Inflation is annual percentage increase in the consumer price index.

Furthermore, since the creation of the European Monetary System (EMS), which pegs the currencies of most members of the European Community (EC), the French franc has experienced fewer and smaller devaluations than the Italian lira (see Table 1). These differing levels of convergence became all the more clear in September 1992, when the franc and lira came under intense speculative attack in the international currency markets. While both the French and Italian governments attempted to maintain their currencies in the EMS and received extensive assistance from other countries, only the French were able to do so, while the lira was withdrawn from the EMS and allowed to float.[2]

Table 1
EMS Realignments

Date	3/22/81	10/5/81	6/14/82	3/21/83	6/22/85	4/7/86	1/90	9/92
France		-3%	-5.75%	-2.5%	-2%	-3%		
Italy	-6%	-3%	-2.75%	-2.5%	-6%		-3.7%*	**

*Fluctuation band for lira narrowed from 6 percent to 2.25 percent.
**Italian lira withdrawn from EMS.
Note: A negative sign indicates that the currency has been devalued against other member currencies.
Source: Axel A. Weber, "Reputation and Credibility in the European Monetary System," Economic Policy 12 (April 1991), pp. 65-7.

What factors explain these differing levels of nominal convergence and exchange rate stability? I consider three explanations, each of which draws on different theoretical traditions in the field of international political economy. The first explanation looks to the effects that international capital mobility have had on each country's exchange rate policy options. Policy convergence, it is argued, is the result of pressures emanating from the international economic system. While this explanation is useful for highlighting the external constraints faced by policymakers, it cannot adequately explain the divergent experiences of France and Italy, countries with broadly similar political and economic profiles.

The second explanation focuses on the interests of domestic actors to explain the different patterns of exchange rate policy experienced by France and Italy. Increasing economic integration in western Europe may lead to greater demands on the part of producers involved in international trade and finance to stabilize the exchange rate. A comparison is made between the levels of trade interdependence for France and Italy, with the conclusion that these profiles are so similar that they cannot adequately explain their policy differences.

[2]For some preliminary analyses of this incident, see Il Mondo, 21 September 1992, pp. 36-7 and pp. 44-46; L'Express, 11 October 1992, pp. 10-12; New York Times, 28 September 1992, p. D1; Financial Times, 18 September 1992, p. 3; and Financial Times, 30 September 1992, p. 2.

The final explanation looks to differing state structures and domestic policymaking institutions. The hypothesis here is that different access to policy instruments and differing state-society relations served as a crucial intervening variable that influenced the ability of policymakers in each state to respond to changes in the international economy. My criteria for testing this proposition follows those laid down by Peter Gourevitch: "The perfect test of the consequences of [state] structure. . .is to find two countries with similar positions or interests in relationship to some policy area but with differing political structures: if the policy is the same, structures do not matter; if the policies differ, structures may well be the explanation."[3] I conclude that this approach best explains why France and Italy have had different experiences with economic convergence during the EMS period, since they have similar economic profiles but differ significantly in the degree of control exerted over economic policy by political leaders.

THEORETICAL PERSPECTIVES

International Capital Mobility and Economic Policy

A country's choice of monetary policy and participation in an exchange-rate regime is heavily conditioned by the international mobility of capital. Briefly, a country has three major monetary and exchange rate policy options:

1) With low capital mobility, the country can pursue an autonomous monetary policy (i.e. one that differs from that of the rest of the world and responds primarily to domestic economic considerations) while maintaining a fixed exchange rate.

2) With high capital mobility, the country can either:

> A) fix its exchange rate while maintaining a monetary policy similar to that of the rest of the world, or
>
> B) pursue an autonomous monetary policy while allowing the exchange rate to float.

For example, consider a country that sets its interest rate lower than prevailing world interest rates in order to stimulate the economy. With low capital mobility, such a policy will lead to increased domestic

[3]Peter Gourevitch, "The Second Image Reversed: International Sources of Domestic Politics," International Organization 32:4 (Autumn 1978), p. 906.

demand and possibly to higher inflation. A fixed exchange rate may be maintained, however, since investors are limited in their ability to move financial assets abroad. But if capital is highly mobile across borders, lowering the domestic interest rate will cause capital to leave the country in search of a higher rate of return abroad, forcing real domestic interest rates back to the world level. Thus as capital mobility increases, policy will be directed toward either monetary policy autonomy and floating exchange rates, or toward exchange rate stability.

However, floating exchange rates do not always allow for complete monetary policy autonomy. Stimulation of the real economy through monetary expansion may be limited if the prices of imports are inflexible. For example, domestic monetary expansion under a floating exchange rate regime usually will raise output, but the impact on production may be limited because, after the resulting depreciation of the exchange rate, the relative costs of imports rise if their prices remain the same in their home currencies. Higher import prices increase inflation and lead to higher costs for production inputs, limiting the expansion of exports and output as the exchange rate depreciates. If this is the case, we can expect that the shift in policy will be toward stabilizing the exchange rate.[4]

The liquidity of foreign exchange markets has increased dramatically over the last two decades. Worldwide daily turnover in foreign exchange, including derivatives, is now roughly $880 billion, rising from $650 billion in 1989 and $325 billion in 1986. While much of this trading involves the U.S. dollar, transactions involving other

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[4]See Richard N. Cooper, "Economic Interdependence and Coordination of Economic Policies," in R.W. Jones and P.B. Kenen, eds., Handbook of International Economics vol. II (Amsterdam: Elsevier, 1985), pp. 1200–1207. See also the econometric simulations for France in Patrick Artus and Philippe Nasse, "Exchange Rates, Prices, Wages, and the Current Account in France," in G. de Menil and U. Westphal, eds., Stabilization Policy in France and the Federal Republic of Germany (Amsterdam: Elsevier, 1985), pp. 147–180. A more general empirical discussion is Organization for Economic Cooperation and Development, Towards Full Employment and Price Stability (Paris: OECD, 1977), especially p. 128 and pp. 283–5. For an analysis of the role of supply shocks and other issues in the 1970s and 1980s, see Michael Bruno and Jeffrey D. Sachs, Economics of Worldwide Stagflation (Cambridge: Harvard University Press, 1985).

currencies (including the franc and lira) have grown rapidly.[5] Such statistics are popularly cited as proof that capital is now perfectly mobile across borders, limiting the ability of governments to pursue macroeconomic policies divergent from those that international investors deem responsible. A more accurate measure of the constraints imposed on economic policy by capital mobility is the covered interest rate theorem, which holds that perfect capital mobility exists when real interest rates in all countries are equalized by capital flows, after subtracting for currency and country risk. Country, or political, risks may lead to real interest rate differentials because of capital controls, transaction and information costs, tax treatment of domestic and foreign investors, and the chance of default. Currency risks are "differences in assets according to the currency in which they are denominated, rather than in terms of the political jurisdiction in which they are issued," including expected depreciation and exchange risk premia.[6]

This approach illustrates the fact that since the 1970s most industrial countries' currencies, including the French franc and Italian lira, have become subject to less country risks while significant currency risks remain. Frankel concludes that both France and Italy have taken significant steps in the 1980s to reduce political barriers to capital flows. As he puts it,

> Only the _country premium_ has been eliminated [by the integration financial markets]; this means that only _covered_ interest differentials are small. Real and nominal exchange-rate variability remains. The result is that a _currency premium_ remains, consisting of an exchange risk premium plus expected real currency depreciation. This means that, even with the equalization of covered interest rates, large differentials in _real_ interest rates remain.[7]

Until 1987, the authorities in both France and Italy used capital controls to insulate their domestic economies from international disturbances such as the oil shocks and destabilizing exchange rate

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[5] _Financial Times_, 2 April 1993, p. 15, and _Financial Times_, 25 September 1992, p. 2.

[6] Jeffrey A. Frankel, "Measuring Capital Mobility: A Review," _American Economic Review_ 82:2 (May 1992), p. 200.

[7] Frankel, "Measuring Capital Mobility," p. 201; emphasis in original.

speculation.[8] Capital controls played an important role in making convergence a gradual process: "the presence of these controls may explain why Italy and especially France were able to reduce fluctuations in their exchange rates against the deutschmark without reducing fluctuations in real interest differentials."[9] This strategy took place when the EMS experienced frequent realignments of it members' currencies (the so-called "soft" EMS), further reducing pressures for economic convergence.

During the early 1980s, capital controls, by limiting arbitrage between the domestic and international (eurocurrency) money markets, caused onshore and offshore franc and lira interest rates to diverge, especially during crises in the EMS. Another effect of capital controls was to limit the size of the offshore eurofranc and eurolira markets. During December 1984, for example, French GNP accounted for 7.9 percent of the total output of eight major industrial countries, but the eurofranc market accounted for only 0.9 percent of the offshore currency market; the corresponding figures for Italy were 5.4 percent and 0.4 percent respectively.[10]

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[8]For details on French and Italian capital controls, see David C. Donald, "Toward a Single European Capital Market," Law and Policy in International Business 20:1 (1988):157-8, Francesco Giavazzi and Alberto Giovannini, "The EMS and the Dollar," Economic Policy 2 (April 1986), pp. 467-9, Emil Claassen and Charles Wyplosz, "Capital Controls: Some Principles and the French Experience," in Jacques Melitz and Charles Wyplosz, eds., The French Economy: Theory and Policy (Boulder: Westview Press, 1985), pp. 245-6, and Jeffrey A. Frankel, "On the Franc," in Jacques Melitz and Charles Wyplosz, eds., The French Economy: Theory and Policy (Boulder: Westview Press, 1985), pp. 188-92.

[9]Kenneth Rogoff, "Can Exchange Rate Predictability Be Achieved Without Monetary Convergence? Evidence From the EMS," European Economic Review 28 (1985), p. 94.

[10]Giavazzi and Giovannini, "The EMS and the Dollar," p. 469. See also Michael J. Artis and Mark P. Taylor, "Exchange Rates, Interest Rates, Capital Controls and the European Monetary System: Assessing the Track Record," in Francesco Giavazzi, Stefano Micossi, and Marcus Miller, eds., The European Monetary System (New York: Cambridge University Press, 1988), pp. 200-1, and Daniel Gros, "Discussion," in Francesco Giavazzi, Stefano Micossi, and Marcus Miller, eds., The European Monetary System (New York: Cambridge University Press, 1988), p. 230. De Grauwe notes that "[b]y segmenting the domestic money market, capital controls increase the incentives for the authorities to follow relatively independent policies and to increase the weight given to domestic policy objectives;" see his "The Liberalization of Capital

In accordance with the Single European Act, both France and Italy since the mid-1980s have removed controls over international flows of capital between member-states and with third countries. The rationale was that, with the development of the internal market of the EC, capital flows and investment decisions would need to be as free to cross borders as goods and services in order to capture gains from increased trade and specialization. Free capital flows also would allow domestic firms greater access to international sources to finance their restructuring in anticipation of the internal market.[11] From about 1987 until 1992, free capital flows did not have a disruptive effect on the operation of the EMS. While greater capital mobility increases the pressure on the authorities to pursue convergent and non-inflationary economic policies, this period was marked by relative calm in the currency markets and increasing convergence of interest and inflation rates.

How useful is this approach for explaining exchange rate policy choice? An advantage is that it clearly outlines the constraints on national macroeconomic policies when capital is highly mobile across borders. Countries clearly face significant costs in maintaining a fixed exchange rate when domestic inflation is higher than inflation elsewhere. At the same time, allowing the exchange rate to float and pursuing an autonomous monetary policy may be ineffective if import prices are inelastic. Some of these costs may be avoided through the use of capital controls and other constraints on international factor movements. However, a focus on international capital mobility cannot adequately explain why countries as similar as France and Italy have had such different records on economic convergence in the face of common international developments. The next two sections consider some political and institutional explanations of differing policy choice.

Domestic Politics

A second line of research explores domestic political and distributional issues raised by the trade-off between policy autonomy and exchange rate stability under conditions of high capital mobility.

Movements and the EMS," in Piero Ferri, ed., Prospects for the European Monetary System (New York: St. Martin's Press, 1990), p. 161.

[11]Donald, "Toward a Single Euroepan Capital Market," p. 144.

Producers involved in international trade and investment, along with export-oriented and multinational producers of tradable goods (including agriculture, manufacturing, and some services), tend to prefer fixed exchange rates. These firms run greater exchange risks (and thus higher transaction costs) when exchange rates are flexible.[12] At the same time, they are less concerned about maintaining policy autonomy, since the domestic economy may represent only a small portion of their entire market. Other interests tend to favor policy autonomy. Producers of nontradable goods and services are not heavily involved in international trade and investment, so they will have little interest in fixing the exchange rate. However, they do have an interest in maintaining policy autonomy and the responsiveness of economic policy to the domestic business cycle. Producers of import-competing tradable goods will also tend to favor autonomy, because they are not adversely affected by exchange rate risks. These preferences are summarized in Figure 2.[13]

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[12]Uncertainty can be reduced by hedging against changes in the exchange rate through futures and options contracts and other derivatives. While these tools have become increasingly sophisticated and widely adopted since the 1970s, they stilll involve transaction costs for traders and investors. See Paul De Grauwe, International Money: Post-war Trends and Theories (Oxford: Clarendon Press, 1989), p. 227. For evidence that transaction costs have risen since the introduction of floating exchange rates, see Richard M. Levich, "Empirical Studies of Exchange Rates: Price Behavior, Rate Determination and Market Efficiency," in R.W. Jones and P.B. Kenen, eds., Handbook of International Economics vol. II (Amsterdam: Elsevier, 1985), p. 997-1000.

[13]See Jeffrey A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," International Organization 45:4 (Autumn 1991), pp. 444-46, and Paulette Kurzer, "Unemployment in Open Economies: The Impact of Trade, Finance, and European Integration," Comparative Political Studies 24:1 (April 1991), pp. 3-30. This explanation is similar to Ernst Haas' neo-functionalist explanation of European integration; see The Uniting of Europe (Stanford: Stanford University Press, 1958).

Figure 2: Preferred Degree of Monetary Policy Autonomy

High	Low
Import-competing producers of tradable goods for the domestic market	Export-oriented and multinational producers of tradable goods
Producers of nontradable goods and services	International traders and investors

Source: adapted from Jeffry A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," International Organization 45:4 (Autumn 1991), p. 445.

Thus a second possible explanation of different exchange rate policies in France and Italy is that the two countries have experienced differing levels of economic integration with the other member states of the European Community. As trade interdependence increases the political and economic importance of groups preferring low policy autonomy, political leaders would have greater motivation to seek to stabilize the exchange rate with the country's major trading partners. Table 2 and Figure 3 operationalize these concepts in terms of exports to the EC as a percentage of total exports, and in terms of trade in goods with the EC as a percentage of gross domestic product (GDP). For both France and Italy, export dependence on the European Community has grown rapidly since 1960. Exports to the EC as a percentage of total exports have almost doubled for both countries, rising from 29.8 percent in 1960 to 47.6 percent in 1985 for France and from 29.6 percent to 46.1 percent for Italy. Trade with the EC as a percentage of GDP has diverged slightly for the two countries since 1980. This divergence, however, is likely the result of higher Italian inflation in the EMS and decreased competitiveness of Italian goods.[14]

[14]Robert Anderton, Ray Barrell, and Jan Willem in't Veld, "Macroeconomic Convergence in Europe: Achievements and Prospects," in Ray Barrell, ed., Economic Convergence and Monetary Union in Europe (London: Sage, 1992), pp. 6-8.

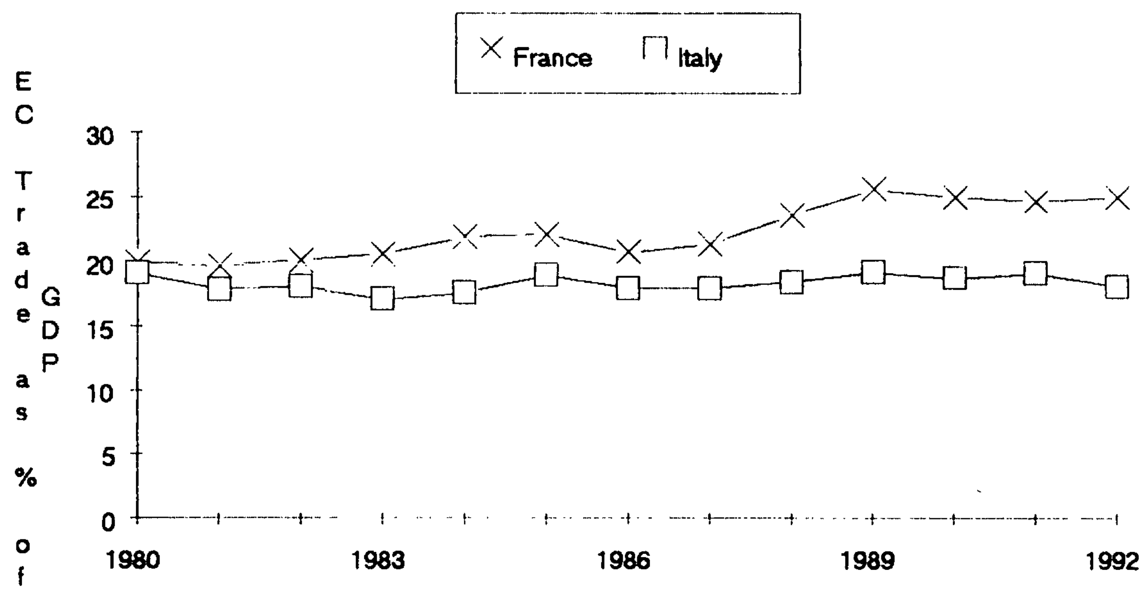
Table 2: French and Italian Exports to the European Community as a Percentage of Total Exports, 1960, 1972, 1985

Country	1960	1972	1985
France	29.8	48.8	47.6
Italy	29.6	45.0	46.1

Source: David R. Cameron, "The 1992 Initiative: Causes and Consequences," in Alberta M. Sbragia, ed., Europolitics: Institutions and Policymaking in the New European Community (Washington: Brookings Institution, 1992), p. 38.

As striking as French and Italian interdependence with the EC may seem, it does not adequately explain why the two countries have experienced differing levels of exchange rate stability since the creation of the EMS in 1979. While export dependence on the EC has grown rapidly in both countries, the differences between the two countries in the levels of dependence are rather small.

Figure 3
French and Italian Trade in Goods with the EC as a Percentage of GDP



Source: European Economy 50 (December 1991), pp. 250, 254.

Interdependence, particularly with other member states of the EC, has risen quite quickly in both countries since 1960. While this is likely to have produced pressures in both countries for greater exchange rate stability, the small differences in the levels of international dependence between France and Italy do not explain different levels of exchange rate stability and economic convergence.

State Structure and Capacity

A third explanation of different French and Italian experiences with economic convergence and exchange rate policy focuses on the capacity of political leaders to design and implement adjustment strategies in the face of international changes. In the literature on state-society relations, France is depicted as having a "strong" state able to act somewhat autonomously of societal demands, while Italy has a quintessentially "weak" state, one which merely registers and acts on the demands of societal actors.[15] While approaches focusing on state "strength" have been criticized for not clearly defining the state, society, or autonomy, one crucial aspect this literature highlights is cross-national differences in policymakers' capacity to design and implement economic policies.[16] Focusing on state capacity leads to the observation that policymakers' reactions to international changes is conditioned by the policy tools to which they already have access. While other policy instruments may be more effective, if they do not exist, policymakers will be reluctant to expend political capital fighting for their creation.[17]

Policymakers differ in their capacity to design and implement adjustment policies. In France, policymakers have access to a number of important policy tools to facilitate adjustment. The state owns a significant share of large industry, and French policymakers have a long tradition of using state funds and management control to influence the development and restructuring of industry. Policymaking is also centralized within the Finance Ministry, allowing greater governmental

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[15]Peter J. Katzenstein, "Conclusion: Domestic Structures and Strategies of Foreign Economic Policy," in Katzenstein, ed., Between Power and Plenty (Madison: University of Wisconsin Press, 1978), especially pp. 305-7 and pp. 316-323, and Stephen Krasner, Defending the National Interest (Princeton: Princeton University Press, 1978), pp. 55-90.

[16]Peter A. Hall, Governing the Economy (Oxford: Oxford University Press, 1986), pp. 15-17, and G. John Ikenberry, David A. Lake, and Michael Mastanduno, "Introduction: Approaches to Explaining American Foreign Economic Policy," International Organization 42:1 (Winter 1988), p. 11.

[17]Kathleen Thelen and Sven Steinmo, "Historical Institutionalism in Comparative Politics," in Sven Steinmo, Kathleen Thelen, and Frank Longstreth, eds., Structuring Politics: Historical Institutionalism in Comparative Analysis (New York: Cambridge University Press, 1992).

control over the design and implementation of long-range adjustment policies. Finally, French politics is characterized by a decentralized system of interest group organization.[18] While Peter Hall has argued that the French state has developed close links to large industry which hinders its ability to act autonomously of societal pressures, this relationship is clearly interactive: not only has the state come to share many of the goals of large industry, but it is able to act on these goals in a decisive manner.[19]

Italian policymakers, on the other hand, have fewer policy instruments in the area of exchange rate policy, and those instruments which they do possess tend to be of a global nature, rather than the more sector-specific instruments common in France. While the Italian state owns a large proportion of domestic industrial and banking firms, political leaders find it difficult to utilize these public holdings for national policy ends, since each firm tends to be dominated by particular political parties or factions.[20] Similar comments apply to fiscal policy; the politics of budgeting is dominated by factional struggles over the marginal allocation of state resources, with little overall direction or spending targets.[21] The weight of adjustment, then, has tended to fall on monetary policy almost exclusively.[22] Unlike in France, however,

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[18]See John Zysman, Governments, Markets, and Growth (Ithaca: Cornell University Press, 1983), and Zysman, "The French State in the International Economy," in Katzenstein, ed., Between Power and Plenty, pp. 255–294.

[19]Hall, Governing the Economy.

[20]A useful summary of the relationships between political leaders and industry is Judith Chubb and Maurizio Vannicelli, "Italy: A Web of Scandals in a Flawed Democracy," in Andrei S. Markovits and Mark Silverstein, eds., The Politics of Scandal (New York: Holmes & Meier, 1988). See also Guiseppe Di Palma, "The Available State: Problems of Reform," West European Politics 2:3 (July 1979). For a comparison of industrial structure and ownership in France and Italy, see Patrizio Bianchi, "Un Capitalismo Senza Concentrazione," Il Mulino 340 (January/February 1992), pp. 307–318.

[21]Vincent Della Scala, "The Italian Budgetary Process: Political and Institutional Constraints," West European Politics 11:3 (July 1988).

[22]Alan R. Posner, "Italy: Dependence and Political Fragmentation," in Katzenstein, Between Power and Plenty, pp. 225–254; Guido Tabellini, "Monetary and Fiscal Coordination with High Public Debt," in Francesco Giavazzi and Luigi Spaventa, eds., High Public Debt: The Italian Experience (New York: Cambridge University Press, 1988): 90–126. For a critique of the utility of macroeconomic adjustment in Italy, see Ignazio

monetary policymaking is split between the government and the central bank, the Banca d'Italia. The Banca d'Italia, unlike the government-dependent Banque de France, has throughout the 1980s increasingly asserted its autonomy from the government. Political leaders have depended on the Banca d'Italia to design and implement austerity measures to offset continuing fiscal deficits, making the Banca d'Italia a central player in managing the economy, especially during crisis periods.

A second dimension of state capacity concerns the executive's relationship with the legislative branch. Exchange rate policy is an area primarily reserved for executive decisionmaking, because of the public goods nature of the exchange rate and its relationship with overall foreign economic policy goals.[23] However, the executive's willingness to implement austerity measures is influenced by its dependence on legislative support. If the executive branch is relatively insulated from legislative pressures, it is more willing to implement austerity in order to reinforce the country's relative economic competitiveness. The executive will be more willing to pay the short-term political and economic costs necessary to maintain a fixed exchange rate. By structuring the policy debate as one of foreign policy, some of the political opposition to a fixed exchange rate will be muted, since the executive is seen as complying with an international treaty or agreement. Moreover, the executive may use the external constraint of an exchange rate regime to persuade societal actors and the legislature that (often painful) changes must be undertaken to maintain international competitiveness.[24]

Musi, "Per una Riforma della Spesa Pubblica e delle Istituzioni Economiche," Il Mulino 341 (May/June 1992), pp. 415-426.

[23]See Stephen Krasner, "United States Commercial and Monetary Policy: Unravelling the Paradox of External Strength and Internal Weakness," in Peter J. Katzenstein, ed., Between Power and Plenty (Madison: University of Wisconsin Press, 1978), and Joanne Gowa, "Public Goods and Political Institutions: Trade and Monetary Processes in the United States," International Organization 42:1 (Winter 1988), pp. 15-32.

[24]Robert D. Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games," International Organization 42:3 (Summer 1988), Michael Mastanduno, David A. Lake, and G. John Ikenberry, "Toward a Realist Theory of State Action," International Studies Quarterly 33 (1989), and Francesco Giavazzi and Marco Pagano, "The Advantage of Tying One's Hands: EMS Discipline and Central Bank Credibility," European Economic Review 32 (1988).

If the executive is relatively exposed to pressures from the legislature, then domestic goals--re-election, party cohesion, and re-enforcing the power of its political coalition--will dominate policy considerations. Such leaders have less ability to define exchange rate policy as solely a foreign policy problem, since fixing the exchange rate has significant domestic implications, and the legislature has an important voice in such political debates. In this case, state leaders are likely to define the costs and benefits of various exchange rate strategies in terms of internal political goals and the retention of policy autonomy, in order to be able to use the exchange rate to respond to domestic developments. The executive will have less power to use the exchange rate as an external constraint on other policy areas, since he or she must remain alert to short-term developments at home which may threaten the government's position. A government whose hold on office is weak, which faces (planned or unplanned) elections in the near future, or faces significant challenges to its authority (i.e. through votes of confidence) will tend to discount the long-term economic benefits, and focus on the short-term costs, of maintaining a stable exchange rate. An exposed executive also may be tempted to try to use the exchange rate as an external constraint, since this will strengthen his or her bargaining position at home. Nonetheless, this strategy is much less likely to succeed than for an insulated executive, since the exposed executive is more open to domestic constraints and political threats.

While both the French President and the Italian Prime Minister tend to dominate foreign economic policymaking in general and major decisions about the EC in particular,[25] they face different constraints at home. The French President is directly elected for a fixed seven-year term, and is not dependent on legislative support to remain in office.

[25]For more on the intergovernmental aspects of EC negotiations, see Andrew Moravcsik, "Negotiating the Single European Act: National Interests and Conventional Statecraft in the European Community," International Organization 45 (1991), and David R. Cameron, "The 1992 Initiative: Causes and Consequences," in Alberta Sbragia, ed., Europolitics: Institutions and Policymaking in the New European Community (Washington: Brookings Institution, 1992).

The President may appeal directly to the electorate through referenda,[26] as Mitterrand did regarding Economic and Monetary Union in September 1992. The French government also has much greater control over the activities of the legislature than the Italian Prime Minister,[27] and the President's "power of dissolution is his key weapon against a hostile parliamentary majority,"[28] while Italian Prime Ministers have rarely used this tool. Whereas the French President can remain in office and influence policy, particularly foreign policy, without a supporting majority in the National Assembly, he or she of course will prefer parliamentary support. The point is that the President is less vulnerable, especially when elections are not in the offing, to parliamentary revolts and pressures.[29]

The Italian Prime Minister depends on the support of Members of Parliament (MPs) to remain in office. The Prime Minister's primary political concern is thus to maintain the allegiance of coalition members, particularly when the coalition's parliamentary majority is small or threatened by internal divisions. The Prime Minister must manage parliamentary relations so as to avoid challenges from back-benchers and cabinet members:

> The emphasis is inevitably placed on administrative co-ordination, short-term conflict resolution, especially in the legislative area, and coalition troubleshooting. The prime minister has little chance to impose a distinctively personal policy imprint on his government, still less to spend large amounts of time on long-term policy analysis.[30]

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[26]Ezra Suleiman, "Presidential Government in France," in Richard Rose and Ezra N. Suleiman, ed., Presidents and Prime Ministers (Washington: American Enterprise Institute, 1980), p. 104.

[27]See John R. Frears, "Parliament in the Fifth Republic," in William G. Andrews and Stanley Hoffman, eds., The Impact of the Fifth Republic on France (Albany: State University of New York Press, 1981), and Francois Dreyfus, "The Control of Governments," in Peter A. Hall, Jack Hayward, and Howard Machin, eds., Developments in French Politics (New York: St. Martin's Press, 1990).

[28]Suleiman, "Presidential Government in France," p. 101.

[29]David Wilsford, "Tactical Advantages Versus Administrative Heterogeneity: The Strengths and Weaknesses of the French State," in James A. Caporaso, ed., The Elusive State: International and Comparative Perspectives (Newbury Park, CA: Sage, 1989).

[30]David Hine and Renato Finocchi, "The Italian Prime Minister," West European Politics 14:2 (April 1991), pp. 79-80.

Thus the Prime Minister must ensure continued support from Cabinet members and party leaders, which limits the room for independent policy initiatives, especially if ministers threaten to resign and embarrass the Prime Minister over policy differences.

Thus while both France and Italy pursued progressively more stringent macroeconomic policies after 1973 aimed at stabilizing exchange rates with other countries in western Europe, Italian policymakers have been hobbled by institutional and political factors. First, they were unable to pursue as restrictive an overall macroeconomic policy (incorporating both fiscal and monetary policies) aimed at stabilizing the exchange rate because of the factional nature of policymaking, particularly in the area of fiscal policy. This meant that the burden of stabilization fell primarily on monetary policy alone, limiting the effectiveness of convergence. Second, and in marked contrast to the French experience, Italian policymakers were unable to pursue a coherent set of sectoral policies aimed at increasing industrial competitiveness, since effective control of industrial policy instruments, including the control of state-owned enterprises, is widely dispersed throughout the political system.

ECONOMIC CONVERGENCE AND EXCHANGE RATE POLICY

Economic policy in France and Italy between the collapse of the Bretton Woods system and the creation of the EMS in 1979 was largely aimed at delaying adjustment. Both countries used a variety of tools, including foreign borrowing, capital controls, and depreciation to insulate the domestic economy from international shocks. As the 1970s wore on, however, the efficiency and inflationary effects of these tools increasingly came to be questioned, and by 1979 both countries were committed, at least in principle, to maintaining a stable exchange rate within the EMS as a primary economic policy goal.[31]

The commitment of France and Italy toward maintaining a stable exchange rate as the cornerstone of economic policy was strengthened

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[31] See Michael Loriaux, France After Hegemony: International Change and Financial Reform (Ithaca: Cornell University Press, 1991), pp. 183-213, and John Goodman, Monetary Sovereignty: The Politics of Central Banking in Western Europe (Ithaca: Cornell University Press, 1992), pp. 142-81.

throughout the 1980s; for both countries, the exchange rate, earlier viewed as a secondary concern, would in large part dictate macroeconomic policy. But the mix of fiscal and monetary policies pursued differed greatly. The French commitment to the EMS was quite strong (especially after 1983) and led to a tight monetary policy of high interest rates along with fiscal consolidation to reduce pressure on the franc, combined with significant microeconomic reforms in labor markets, industry, and finance. Italian policy instruments, on the other hand, pursued contradictory goals: monetary policy was tightened with the aim of stabilizing the exchange rate and lowering inflation, while fiscal policy remained quite loose, limiting the amount of convergence achieved with other European countries. The structure of domestic policymaking institutions in France and Italy provide an important part of the explanation for this difference.

France

France's moves in 1978 toward negotiating the EMS marked a significant departure from the economic policies pursued until the late 1970s. Premonitions of this change in orientation can be seen in the austerity measures adopted by President Giscard d'Estaing and Prime Minister Barre in 1978 after parliamentary elections, which were important in persuading the German government and the Bundesbank to proceed with negotiating the EMS.[32] Giscard's primary goals in negotiating the EMS were based on his interpretation of France's economic and political position relative to Germany. He feared that unless France could lower its inflation rate and become more competitive, the country would no longer stand as co-equal with Germany on economic, political, and security matters. As he put it in an interview: "[I]t would not be a good idea for Europe to be dominated by one country. . .What I want France to achieve is to make sure that there are in Europe at least two countries of comparative influence, . . .Germany and France."[33]

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[32]Goodman, Monetary Soveriegnty, pp. 124-6, and Peter Ludlow, The Making of the EMS (London: Butterworth, 1982).

[33]Quoted in Peter Ludlow, The Making of the European Monetary System (Boston: Butterworth Scientific, 1982), p. 200. Frears reports that this "is a theme to which [Giscard returned] constantly, almost obsessively, in his speeches." See J.R. Frears, France in the Giscard Presidency (London: George Allen & Unwin, 1981), p. 106.

Meeting this goal required that France increase its exports, especially of high value-added goods, and reduce its inflation rate.[34] The EMS had two principal advantages in meeting these goals compared to the attempts at monetary coordination in the 1970s. First, it would be a negotiated regime, an international commitment which the French president could use to influence domestic political actors. Second, as originally envisioned, the EMS would provide greater financing to deficit countries, and allow them to influence the economic policies of surplus countries, thus easing the process of adjustment and convergence.[35]

But Giscard faced significant political opposition at home, directed primarily at his economic policies. While the Socialists and Communists naturally opposed his policies, his greatest challenge was from the RPR under Jacques Chirac, the largest party in the ruling conservative coalition. In the run-up to parliamentary elections in March 1978, the conservative coalition was rent by political disputes, as both the RPR and Giscard's party, the UDF, attempted to take votes from the other. Surprising everyone, the right won the 1978 election, and Giscard's party significantly increased its number of seats in the National Assembly. This electoral mandate freed Giscard to begin negotiating the EMS, which was agreed to with relatively little significant domestic opposition.[36]

The election of Francois Mitterrand as President in May 1981 would mark a significant shift in French exchange rate policy, although in a direction completely unexpected at the time. Mitterrand was elected on a program of significant change in social and economic policies oriented toward the interests of the workers and middle classes. More specifically, the Socialists advocated extensive nationalizations and the use of an expansive fiscal policy to restore growth to the French

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[34]See Ludlow, The Making of the European Monetary System, p. 200, and Valery Giscard D'estaing, French Democracy, trans. Vincent Cronin (Garden City: Doubleday, 1977).

[35]See Michael Loriaux, France After Hegemony, pp. 251-2, and L'annee Politique, Economique, Sociale et Diplomatique en France 1978 (Paris: Editions du Moniteur, 1978), p. 391.

[36]Ludlow, The Making of the EMS, pp. 199-200; Frears, France in the Giscard Presidency, pp. 60-1; R. Formesyn, "Europeanisation and the Pursuit of National Interests," in Vincent Wright, ed., Continuity and Change in France (London: George Allen & Unwin, 1984), pp. 225-26.

economy, while at the same time improving competitiveness and social equity. Mitterrand's power to influence French economic policy was further strengthened in June 1981 when the left won a majority in the National Assembly, allowing the President to form a government with ministers from the Socialist and Communist parties.

Mitterrand's economic policy in 1981 was based on the assumption that the world economy would recover from recession within a year. Accordingly, the Socialists' planned to spend their way out of recession by administering a large fiscal stimulus to the economy. This "redistributive Keynesianism" aimed to use government spending to boost overall demand by increasing the incomes of low-paid workers and putting the unemployed back to work.[37]

The Socialist administration was focused on solving significant domestic economic problems; little regard initially was given to the external sector. As one Socialist economist noted in regard to this period, "we were thinking more about growth, protecting employment, and structural reforms. . .Defending the franc was a secondary consideration."[38] Yet the government soon encountered crucial problems in precisely this area. The prospect of Mitterrand's election in May 1981 had triggered a run on the franc, forcing the Banque de France to draw down its reserves by $5 billion in two weeks in March 1981 to defend the currency's parity in the EMS. The roots of this crisis went back to before the election. The parity between the franc and the deutchmark had not been changed since 1979, although French inflation during these two years was twice the level in Germany, leading the franc to become overvalued by about 10 percent. To resolve this dilemma, Mitterrand was presented with a choice that would haunt French economic policy for the next two years: withdraw from the EMS and pursue an autonomous economic policy, or remain in the system while abandoning the government's ambitious plan for economic revival. At this point, Mitterrand was not prepared to make such a difficult

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[37]Peter A. Hall, "Socialism in One Country: Mitterrand and the Struggle to Define a New Economic Policy for France," in Philip G. Cerny and Martin A. Schain, eds., Socialism, the State and Public Policy in France (London: Pinter, 1985), pp. 84-5.

[38]Goodman, Monetary Sovereignty, p. 127.

choice. Instead, he postponed the problem by strengthening capital controls and raising market interest rates slightly, while continuing to use government credit controls to allocate investment funds in the hope that worldwide economic recovery would soon emerge.[39]

The next part of the government's exchange rate policy was to negotiate a series of devaluations of the franc within the EMS. Between October 1981 and March 1983, the franc was devalued three times. This strategy became all the more necessary as France began to experience serious balance of payments problems brought on by the country's expansive fiscal policy.[40]

The government soon realized, however, that devaluation would not solve the country's balance of payments problems, as world economic recovery did not materialize in 1982. The devaluation of the franc in June 1982 marked the decisive shift in Socialist economic policy from demand-led expansion to austerity. In order to secure a negotiated devaluation within the EMS, the government promised Germany that it would institute a policy of economic retrenchment. The government's 1982 economic plan aimed to limit the fiscal deficit to 3 percent of GDP by cutting public spending and imposing widespread freezes on the growth of wages, prices, and employers' social security payments, while corporate taxes were cut. These austerity measures were an important turning point for two reasons. First, they marked the end of the policy of fiscal reflation which had formed the core of Mitterrand's economic policy, and second, they indicated that the government was now more interested in redistributing income not to the low-paid and unemployed but to the French business community, whose competitiveness had suffered under the costs of increased social contributions. The year 1983 saw the introduction of further austerity measures, including significant tax increases and spending cuts, while unemployment continued to rise.[41]

Why did the government reject the possibility of leaving the EMS and pursuing an autonomous economic policy? The answer is that

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[39]Jeffrey Sachs and Charles Wyplosz, "The Economic Consequences of President Mitterrand," Economic Policy 2 (April 1986), pp. 270–1.

[40]Hall, "Socialism in One Country," p. 86.

[41]Hall, "Socialism in One Country," pp. 86–7.

increased trade interdependence in an environment of high international capital mobility greatly restricted the impact of national economic policies. The government did consider the option of withdrawal from the EMS. Certain members of the Mitterrand government advocated a policy of protection including unilateral devaluation, withdrawal from the EMS, and import taxes combined with loose fiscal and monetary policies that would redistribute income and promote growth in France: "they suggested that France could develop a new economic strategy based on monetary independence and economic expansion behind rising trade barriers."[42] What seemed to decide the issue for Mitterrand were the economic studies, presented by ministers in favor of continued austerity, that protectionist policies would have to be accompanied by even more deflation than the present course of policy required, since higher import prices would lead to an inflation-depreciation spiral and inflationary demand for domestic products.[43]

Since 1983, French economic policy has been oriented toward maintaining the value of the franc within the EMS by lowering inflation differentials with Germany. By the early 1990s this macroeconomic goal had been achieved. The franc has not been devalued since 1987, inflation by 1991 was lower in France than in Germany, and the franc (unlike the lira) successfully weathered a large speculative attack against its parity with the deutschmark in 1992. Moreover, France is one of a handful of European countries that may meet the strict criteria laid down in the Maastricht treaty for participation in Economic and Monetary Union (EMU).

Monetary policy since 1983 has been described in the following terms: "the overriding goal of France's monetary policy continues to be the maintenance of the purchasing power of the currency. . .[the authorities] have been unwavering in their adherence to this policy, despite the short-term costs involved."[44] This has required that the domestic interest rate be set so as to maintain the franc's covered value

[42]Hall, "Socialism in One Country," p. 88.

[43]See Hall, "Socialism in One Country," p. 88, Philippe Bauchard, La Guerre des Deux Roses (Paris: Grasset, 1986), pp. 142-53, and Serge July, Les Annees Mitterrand (Paris: Grasset, 1986), pp. 90-101.

[44]Organization for Economic Cooperation and Development, Economic Surveys: France (1991/1992), p. 31.

vis-a-vis the deutschmark. The "short-term costs" of this policy of competitive deflation were incurred because a restrictive monetary policy and a general environment of austerity have contributed to slow growth and persistently high unemployment. Throughout the 1980s, short-term interest rates were continuously higher in France than in Germany. Although this differential has decreased since the mid-1980s, it means that France's monetary policy has been dictated by changes in the policy and the business cycle in Germany. For example, since the reunification of Germany the Bundesbank has been concerned primarily with controlling inflation in Germany. French inflation, on the other hand, is lower than the rate in Germany, while signs of recession are appearing. However, the French government cannot use changes in interest rates to promote growth unless it is willing to break its monetary link with Germany.

As discussed above, the costs of this policy mix on the domestic economy were somewhat mitigated by capital controls, which reduced the effects of speculative attacks on the franc by segmenting the onshore and offshore money markets. The authorities began lifting these controls in 1986, fully abolishing them by 1989. This coincided with the "new" EMS, which was marked by free capital movements, a greater emphasis on the use of interest rate differentials to maintain the exchange rate, a commitment to greater exchange rate stability in the EMS, and reduced market expectations of realignment due to the increased credibility of monetary policy.[45]

By the late 1980s, France had achieved the goals of nominal convergence with Germany, especially on inflation. However, this success was mitigated for French policymakers by continuing German dominance of the EMS. Under the EMS, the burden of adjustment falls on countries with high inflation and balance of payments difficulties, while the Bundesbank gears its monetary policy to domestic economic goals. This imbalance was an important reason for the French proposal in early 1988 to create an Economic and Monetary Union. Sandholtz describes the

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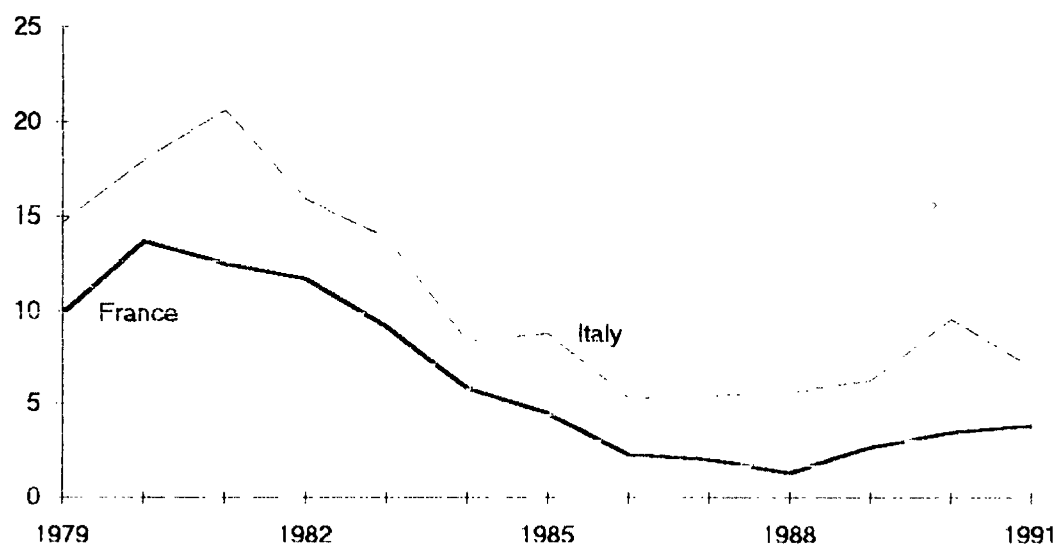
[45]Christian Bordes and Eric Girardin, "The Achievements of the ERM and the Preconditions for Monetary Union: A French Perspective," in Ray Barrell, ed., <u>Economic Convergence and Monetary Union in Europe</u> (London: Sage, 1992): 102-7.

motivation of French policymakers in the following terms: "[f]rom the French point of view, the proposal for monetary union represented a bid to gain a seat at the monetary table, a table that under the EMS was located in Frankfurt."[46]

Figure 4
Annual Increase in Unit Labor Costs for France and Italy, 1979-91



Source: Robert Anderton, Ray Barrell, and Jan Willem in't Veld, "Macroeconomic Convergence in Europe: Achievements and Prospects," in Barrell, ed., Economic Convergence and Monetary Union in Europe (London: Sage, 1992), p. 9.

But if the French were so concerned about regaining control over monetary policy, why did they not simply devalue and leave the EMS? The answer may be found in changes in the international economy and domestic politics. The increase in international capital mobility, combined with heavy reliance on international trade, would limit the expansionary impact of a floating exchange rate. Depreciation, as the French discovered in the 1970s, likely would lead to significantly higher inflation but give only a nominal boost to economic growth. The crucial factor, however, is the domestic political strategies of French policymakers. Having realized in the early 1980s that the effects of changes in macroeconomic aggregates under government control, such as

[46]Wayne Sandholtz, "Choosing Union: Monetary Politics and Maastricht," International Organization 47:1 (Winter 1993), pp. 29-30.

fiscal and monetary policies, are limited when financial capital is highly mobile across borders, policymakers chose a strategy of long-term adjustment to changes in the international economy. This strategy involved, first of all, the macroeconomic austerity described above. But it also included significant changes in the operation of the domestic political economy in the areas of industry, finance, and the labor market. While many of these policy changes attracted significant political opposition, policymakers were able to design and partially implement a strategy of domestic adjustment aimed at increasing international competitiveness.

Fiscal policy has been marked by consolidation of the public sector deficit since 1983. Assistance to nationalized firms was cut back, and reductions in subsidies resulted in increased bankruptcies. Tax and social security obligations of firms were cut, and "controls over the nationalized industries were loosened so that they could lay off workers, become more profitable, invest abroad, and even sell off some subsidiaries to raise funds," while government subsidies were channeled increasingly to research and development.[47] Industrial policy has been decentralized, and greater attention has been paid to regional coordination of industrial development, especially for smaller firms.[48] The government also emphasized reducing inflationary rises in labor costs much more effectively than in Italy (see Figure 4),[49] and has given greater emphasis to labor market policies, rather than control of industry and finance, to promote economic convergence.[50] Government allocation of credit to individual firms through the state-directed banking system gradually was curtailed as new sources of finance were created by the government, including a greater role for the stock markets, the establishment of a financial futures market, and other measures. These measures, taken by Socialist Prime Minister Laurent

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[47]Hall, "The State and the Market," in Peter A. Hall, Jack Hayward, and Howard Machin, eds., Developments in French Politics (New York: St. Martin's, 1990), pp. 178-83.

[48]V. Schmidt, "Industrial Management Under the Socialists in France: Decentralized Dirigisme at the National and Local Levels," Comparative Politics 21:1 (October 1988).

[49]Sach and Wyploz, "The Economic Consequences of President Mitterrand," p. 300.

[50]Hall, "The State and the Market," p. 183.

Fabius, were continued and deepened in 1986-88 under conservative Prime Minister Jacques Chirac, who largely dismantled government credit controls and privatized a number of state-owned firms.[51] The return of Socialist Prime Ministers since 1988 (Rocard, Cresson, and Beregovoy) have seen little change in policy, indicating that the changes instituted in the 1980s under both Socialists and conservatives are seen as the only viable way to increase French competitiveness in the international economy.

Italy

While Italy did not participate in the snake of European currencies during the 1970s, it did join the EMS when it was created in 1979. This move, however, did not imply a decision on the part of the government to move from an autonomous policy stance to one dictated solely by exchange rate stability. Instead, during the negotiations over the EMS, the government repeatedly sought to structure the rules of the EMS so as to allow member states greater flexibility in adhering to the exchange rate regime. The government was largely unsuccessful in this effort, but it did win a concession from its partners that the lira be allowed a fluctuation band of 6 percent around its central parity rate (all other members adhered to a 2.25 percent fluctuation band). While the government wished participate in what was a major European political initiative, it did not want to see emerge a system under which economic policy would have to be geared primarily towards maintaining the exchange rate.[52] Having said this, it is important to point out that by 1979 it had become clear to the Italian authorities, particularly in the Banca d'Italia, that a truly autonomous economic policy was much less viable than in the past. Indeed, by 1980 the OECD remarked that, "in the face of the acceleration of inflation in the course of the year, the defence of the exchange rate now seems to have become the priority objective of the Banca d'Italia, in order to prevent the triggering of an

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[51]For a discussion of the role of international forces in prompting changes in government control of the financial system, see Loriaux, France After Hegemony.

[52]For a detailed discussion of the Italian negotiating position, see Luigi Spaventa, "Italy Joins the EMS: A Political History," Johns Hopkins University Bologna Center Occasional Paper #32 (June 1980), pp. 67-93.

inflation-depreciation spiral."[53] This commitment to greater exchange rate stability by the Banca d'Italia was undermined throughout the 1980s by the government's inability to control inflation and fiscal deficits.

Italy has not experienced as sharp and dramatic break in exchange rate policy as occurred in France in the early 1980s. Instead, any convergence that has occurred has been gradual, and brought about primarily through a tightening of monetary policy. There has been little effective coordination of macroeconomic policy tools toward stabilizing the exchange rate. While the wage indexing system (the scala mobile) has been reformed since 1985 with the intention of reducing its inflationary effects, no real effort has been made to implement an industrial policy aimed at restructuring Italian industry.[54] During the second half of the 1980s, the lira has seen fewer and smaller realignments within the EMS compared to the early 1980s, but these realignments have still been more frequent and larger than realignments of the franc. Until 1990, Italy maintained a wide fluctuation band for the lira within the EMS of 6 percent, further weakening its commitment to a stable exchange rate. Again unlike France, Italy was forced to withdraw from the EMS in September 1992 under speculative pressure, while the franc withstood market speculation over its exchange rate with the deutschmark.

Since the 1970s, monetary policy has borne the brunt of responsibility for convergence. Why have the authorities pursued a tight monetary policy and loose fiscal policy at the same time? One reason has to do with the organization of the policymaking processes in the areas of fiscal and monetary policy. Fiscal policymaking is not a straightforward process in any country, but it is particularly difficult for Italian governments to manage effectively. Instead of setting the level of spending to meet specific policy and macroeconomic goals, it is characterized by intense negotiations between the legislature and Prime

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[53]OECD, Economic Surveys: Italy (March 1980), p. 39; pages 39-41 contain a useful review of monetary policy tools used in the 1970s.

[54]For example, Romano Prodi, former chairman of the state-owned IRI industrial holding company, has characterized the industrial policy debate as confused and characterized by political manouvering. Romano Prodi, "Una Crisi Non Solo Politica: l'Industria Italiana a Rischio," Il Mulino # 337 (September/October 1991), pp. 885-891.

Minister, as well as within the legislature, over specific budget items. This process has been summarized in the following terms:

> The result is that the budget is similar to other types of legislation in Italy. It requires a great deal of co-operation and consensus between the government and Parliament to achieve what is politically acceptable. The attempt to accommodate a wide range of interests has meant that the budgetary process is characterized by uncertainty, making it difficult for a coherent, consistent, economic policy to emerge over time.[55]

In contrast, monetary policy tends to be more centralized in the hands of the Banca d'Italia and the Treasury, with the former increasingly taking the lead since 1981. The rationale for this particular organization of the policymaking process is that, in an environment of highly mobile capital, the Italian state must, in order to preserve economic growth and its legitimacy, pursue some minimal convergence policies. Since fiscal policy is largely unable to be used in any coordinated fashion as a policy instrument to pursue macroeconomic goals such as stabilizing the exchange rate, the burden of adjustment has fallen on the monetary policy authorities. This policy combination significantly limits the degree of convergence with other European economies:

> In the absence of fiscal measures designed to promote structural change, the achievement of monetary policy [in controlling inflation and bringing the balance of payments into equilibrium] has tended to be temporary. . .Monetary policy has tended to be relaxed and the problems of current account deficits and inflationary pressures have re-emerged.[56]

As the pressures for convergence have increased due to the liberalization of international capital movements, monetary policymaking institutions have been able to increase their autonomy from the government and legislature.

Two important institutional changes occurred in the monetary policymaking process, both of which increased the ability of the Banca d'Italia to undertake a tight monetary policy. The first occurred in 1981, when the Banca d'Italia's obligation to purchase unsold public debt at

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[55] Della Scala, "The Italian Budgetary Process," p. 123.

[56] Krishan G. Saini, "Economic Policy Management in Italy," Review of Economic Conditions in Italy #3 (1984), p. 345.

primary auctions was reduced. Under the earlier system, any unforeseen increase in the public sector borrowing requirement forced the Banca d'Italia to exceed its targets for money creation. The rationale for this "divorce" of the central bank from the Treasury, as it was called in the media at the time, was to increase the Banca d'Italia's power to conduct monetary and exchange rate policy by reducing the influence of public deficits on the growth of the money supply. However, greater independence for the central bank also had important implications for political management of the economy: "for the first time, the central bank could resist government pressures to finance the deficit and reject loud protests from labor and government ministers."[57]

The second institutional change occurred in 1983 with the abandonment of administrative credit controls over bank lending and the central bank's targeting of Total Domestic Credit (TDC). Monetary policy henceforth would rely almost exclusively on global and indirect policy tools of interest rates and monetary aggregates. Since 1982, real interest rates have been quite high in order to maintain the exchange rate and stamp out inflation (compared to average negative real interest rates between 1970 and 1982), while the rate of growth of the monetary base has been gradually cut. Tabellini outlines two major reasons for this shift. First, administrative controls began to impose significant efficiency costs on the banking system and the economy, since they could not always keep pace with financial innovation, and in practice were often evaded by private investors. Second, the shift away from targeting TDC toward monetary base targets was a response to continual fiscal deficits. Since TDC includes the public sector borrowing requirement, any unexpected increase in the budget deficit required that more of the annual TDC target be reserved for government deficits, while a corresponding amount would no longer be available for private investment.[58] Rather than attempt to ration credit to particular sectors

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[57] Goodman, Monetary Sovereignty, p. 181. See also Gerald A. Epstein and Juliet B. Schor, "The Divorce of the Banca d'Italia and the Italian Treasury: A Case Study of Central Bank Independence," in Peter Lange and Marino Regini, eds., State, Market, and Social Regulation: New Perspectives on Italy (New York: Cambridge University Press, 1989), pp. 147-164.

[58] Guido Tabellini, "Monetary and Fical Policy Coordination," p. 98.

of the economy in order to increase their competitiveness, the Banca d'Italia favored moving to global policy tools which would further increase its ability to undertake a tight monetary policy independent of political pressures. One reason that the central bank moved in this direction was that neither the Banca d'Italia nor the government could use bank credit ceilings to direct investment to potentially competitive sectors. Mario Sarcinelli, then the Deputy Director of the Banca d'Italia, wrote at the time that unlike the authorities in France and Japan, "in Italy, the fragmentary nature of the banking system makes it more difficult to apply a ceiling based on moral suasion. It is therefore enforced through an automatic penalty mechanism that treats all banks alike."[59]

Officials at the Banca d'Italia also have used their prominent position in economic policymaking to impress upon government ministers, legislators, and interest groups the importance of promoting economic convergence through a stable exchange rate and tight monetary and fiscal policies. Carlo Azeglio Ciampi, Governor of the Banca d'Italia, in early 1992 declared that while adhering to the EMS played an important role in the convergence process, low inflation and higher economic growth would only be restored in the long term if wage rises were brought into line with productivity increases and budget deficits were brought under control.[60] After the lira left the ERM in the fall of 1992, Ciampi and Prime Minister Amato declared that re-entering the mechanism and stabilizing the exchange rate at its new level remained priorities in order to allow Italy to participate in future EC developments, and to restore international confidence in the Italian economy, factors which would push Parliament to implement deficit reduction and labor market reforms.[61] In a statement before the Senate Budget Committee, Ciampi emphasized that even if Italy were to remain outside the EMS for an extended period (a decision which he opposed in principle), it was necessary to gear economic policy toward stabilizing

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[59] Mario Sarcinelli, "The Role of the Central Bank in the Domestic Economy," Review of Economic Conditions in Italy #3 (1981), p. 444.

[60] Carlo Azeglio Ciampi, "Scienza e Arte del Banchiere Centrale," Il Mulino #339 (January-February 1992), pp. 13-17.

[61] See Il Sole 24 Ore, 15 October 1992, p. 1.

the exchange rate and restoring the country's economic policy credibility.[62]

While the Banca d'Italia was able to increase its control over the money supply and promote convergence through a stable exchange rate, stringent monetary policy has not been accompanied by fiscal consolidation. Since the early 1980s, the fiscal deficit has equaled roughly 10 percent of GDP. Continually high government deficits have had important repercussions for Italy's economic convergence with its EC partners. The deficits fuel inflation and put downward pressure on the exchange rate, reducing the willingness of investors to place their money in Italy in the expectation that the lira will be devalued. In order to counter these inflationary pressures, the monetary authorities have pursued a tight monetary policy by maintaining high domestic interest rates to bolster the lira.

Conclusion: State Structures and Policy Change

This paper considers three explanations of the political economy of exchange rate policy in France and Italy. The first looks to the constraints at the international level to explain the choices faced by policymakers over optimal exchange rate goals and policies. The advantage of this level is that it allows a clear explanation of the constraints that high capital mobility imposes on political leaders seeking to maintain economic growth, competitiveness, employment, and ultimately their own political legitimacy. But the international level leaves important questions unanswered, such as why France and Italy have had divergent experiences since the late 1970s.

The second explanation draws loosely on pluralist approaches to comparative politics and neofunctional theories of international cooperation. Here policymakers and political leaders are seen as open to the competing pressures of domestic interest groups in the determination of exchange rate policy. This approach was also deemed inadequate, since France and Italy have similar export and import profiles with the European Community. But two caveats are in order here. First, the pluralist/functionalist approach is not necessarily

[62]Ciampi's remarks are reprinted in full in Il Sole 24 Ore, 25 September 1992, p. 7.

invalidated; increased intra-EC interdependence is likely to have produced greater pressures in France and Italy for stabilizing the exchange rate, and a comparison with a country with a different export and import profile might lend this explanation more support. Second, the indicators used in this paper to measure French and Italian interdependence are admittedly somewhat crude. More specific hypotheses need to be developed and quantitative analyses performed in order to fully explore this explanation.

The third explanation focuses on variation in state structures and policy instruments to explain the differing experiences. Here it is argued that differences in the organization of society and the state has affected the ability of policymakers to implement exchange rate policies. The empirical evidence supports this proposition. French political leaders, in part by virtue of their domination of economic policy formulation, succeeded in implementing macroeconomic austerity while taking steps in the areas of microeconomic policy to improve competitiveness. Italian leaders, in contrast, have been unable to integrate their policy goals even in the macroeconomic area, which has been characterized by a tight monetary policy and loose fiscal policy. The outcome has been a less rigid adherence to the external constraint of the EMS.

France and Italy have both moved toward economic convergence and stabile exchange rates, but with varying amounts of success. But the independent variable, the original impetus to policy change, has been international capital mobility and the need to respond to changes in monetary and exchange rate policies adapted by other states; state structure clearly has served as an intervening variable in the adjustment process. Thus a full explanation cannot look only to either international pressures or domestic organization, but must be prepared to integrate both.

But even this type of integration may be incomplete. Structures are not entirely static. Instead, they change in response to their environment, just like all other social institutions. The cases considered above, for example, discussed significant changes in the organization of the French and Italian policymaking processes. In France, by the late 1980s policymakers had largely abandoned tools such as government credit controls which they had relied on in earlier periods to promote industrial adjustment. And Italy experienced the "divorce" of the Banca d'Italia from the Treasury, considerably changing the dynamics of monetary and exchange rate policymaking. While this paper does not directly discuss this issue, accounting for changes in state structures is an important area for further research.