Werner Report, EMS and EMU: Problems and Prospects of European Monetary Cooperation

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This paper seeks to explain the variance between success and failure of attempts to achieve monetary cooperation and integration in Western Europe. In its first two sections the paper develops six assumptions about international monetary bahavior of states and the conditions for monetary cooperation among them. The first section argues that it is the distribution of power - defined as the ability to reduce or externalize the costs of international interdependence - that drives the monetary behavior of states. This general motive of states produces incentives as well as constraints for cooperation in monetary politics. The second section of this paper argues that it is the leadership of a single state that explains the variance of success and failure in monetary cooperation. The discussion in this section is based on a revised version of hegemonic stability theories, which emphasizes the role of the leader in manipulating the structural constraints incentives that states face in the issue area of monetary politics. It also stresses price stability as well as balance of payments position as power tools in the hands of the leader. Sections 3-5 analyze and compare the outcomes of three attempts at European monetary cooperation since 1970: the Werner Report (which remained unsuccessful), the EMS (which is widely viewed as a success of monetary cooperation) and the design for EMU in the Maastricht Treaty. These case studies trace the explanatory factors that can account for the variance in outcomes to the six assumptions that were developed in the conceptual sections of the paper. Overall, the paper concludes that a realist theory of the international political economy provides the necessary analytical tools to understand the patterns of international monetary policy.

List of abbreviations:

CAP	Common Agricultural Policies
DM	Deutsche Mark
EC	European Communities
ECB	European Central Bank
ECU	European Currency Unit
EMCF	European Monetary Cooperation Fund
ERM	Exchange Rate Mechanism (within the EMS)
EMS	European Monetary System
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
IMF	International Monetary Fund

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Why do the European states sometimes cooperate on monetary issues and why have they at other times been unable to find collaborative solutions to monetary problems? Since the end of World War II there have been various attempts at monetary cooperation in Western Europe. Only one of these attempts has developed into a largely successful collaborative framework: the European Monetary System (EMS).[1] However, other attempts at European monetary cooperation - for example, the integration aspect of the European Payments Union (EPU), the EC Commission's Action Programme for the Second State (1962), the Werner Report (1970) or the 'snake' (1971-1979) - have largely failed. Recent developments, like the various exchange rate crises in the EMS since September 1992 and the difficulties in ratifying the Maastricht Treaty, have also put question-marks behind the newest attempt to create an economic and monetary union (EMU) in Europe by 1997, or at the latest by 1999.

This paper seeks to explain the variance between success and failure in these attempts at monetary cooperation and integration. It argues first, that it is the distribution of monetary power that explains the monetary behavior of states, and second, that it is the leadership of the most powerful monetary actor that accounts for the success or failure of monetary cooperation. The emphasis on power and leadership in this paper has its main origins in a realist approach to international political economy.[2] Nevertheless, I also dispute and modify a number of assumptions of the two main versions of the neo-realist

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[1] The crisis of September 1992 and several following exchange rate crises have called this assessment of an overall success of the EMS into question. However, there is no doubt that the EMS has helped to "create a zone of (relative) monetary stability in Europe" during most of the 1980s. From 1987 to 1992 changes in exchange rates had disappeared from the European monetary landscape, inflation rates had fallen in most Western European countries during the 1980s and interest rate differentials had narrowed. The question as to whether the September 1992 crisis requires a change in this overall assessment will be a topic of discussion in the fourth section of this paper.

[2] For the most fundamental exposition of a realist theory of the international political economy and some of the principles that guide the conceptual thinking of this study see: Robert Gilpin, U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment, New York: Basic Books 1975; and Robert Gilpin, The Political Economy of International Relations, Princeton: Princeton University Press, 1987.

theory of international relations, structural realism[3] and hegemonic stability theory.4

In particular, this paper assumes, first, that power in European monetary politics matters not so much because the survival of states is at stake - the traditional structural realist assumption, - but because states want to insure conditions under which they can pursue their own domestic economic priorities. The second major assumption is that successful monetary cooperation requires leadership not because leaders provide a public good to the other countries in the system or because they can coerce other countries into cooperative frameworks - the traditional assumptions of the two versions of hegemonic stability theories.[5] Rather, leaders are necessary to manipulate the structural incentives for states to cooperate on monetary issues. Moreover, this paper stresses the significance of inflationary performance and, to a lesser degree, the balance of payments position as two of the main sources of monetary power, rather than the traditional emphasis of realist theories on the economic size of a state and the distribution of monetary capabilities (i.e. currency reserves, significance of country's currency for international trade and central bank reserves[6]).

Overall, I argue that European monetary cooperation remains a realm of power politics. Thus, I accept a state-centered or "intergovernmentalist" perspective on European integration.[7] However, I add to this state-centered model

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[3] The prime source for structural realism is: Kenneth Waltz, Theory of International Politics, Reading: Addison Wesley, 1979.

[4] For the literature that is usually identified as "hegemonic stability theory" see: Gilpin, U.S. Power and the Multinational Corporation; Robert Gilpin, War and Change in World Politics, New York: Cambridge University Press, 1981; Gilpin, Political Economy of International Relations; Charles P. Kindleberger, The World in Depression, 1929-1939, Berkeley: University of California Press, 1973; Stephen D. Krasner, "State Power and the Structure of International Trade," World Politics 28 (April 1976): 317-347. For a critical evaluation of the theory see: Robert O. Keohane, After Hegemony: Cooperation and Discord in the World Political Economy, Princeton: Princeton University Press, 1984.

[5] On the distinction between the more coercive and the more benevolent version of hegemonic stability theory see: Duncan Snidal, "The Limits of Hegemonic Stability Theory," International Organization 39 (Autumn 1985): 579-614.

[6] For some of these traditional measures of monetary power see: John Odell, U.S. International Monetary Policy: Markets, Power, and Ideas as Sources of Change, Princeton: Princeton University Press, 30-39 and passim.

[7] For a recent application of a state-centered perspective to European integration see: Andrew Moravscik,

the assumption of leadership. Monetary cooperation is not simply the result of bargaining among states, but rather the outcome of successful leadership by a single state. Monetary politics is inherently asymmetric. This paper shows that the various European attempts at monetary cooperation reflect very adequately the dilemma to establish greater monetary symmetry between the players in Western Europe and the structural necessities that inevitably lead to asymmetric outcomes. This dilemma makes all attempts at monetary cooperation tenuous. Monetary cooperation rises and falls with the shifts in the monetary power structure.

In the first section of this paper I elaborate the assumption that it is the pursuit of power that drives international monetary politics. The second section explains the role of leadership in establishing successful monetary cooperation. Section three analyzes the failure of the Werner Report design for European Monetary Union (EMU) in the 1970s, whereas the fourth section examines the reasons for the relative success of the European Monetary System (EMS). In the fifth section I ask what lessons these case studies offer about the prospects of the EC's most recent attempt to create a full economic and monetary union as envisioned in the Maastricht Treaty.

The choice of these three cases offers a number of important advantages. They provide sufficient variance on the dependent variable: in the case of the EMS, cooperation was largely successful; in the case of the Werner Report, it was not; and in the case of the Maastricht Treaty, the answer is still open. The selection of cases also keeps small the number of relevant independent or intervening variables. In particular, there is little variation in the number and composition of participating countries and the basic institutional parameters (i.e. embeddedness in the EC) remain constant. This situation of significant variance on the dependent variable and the possibility to keep a number of independent variables constant, allows one to zero in on a small number of important explanatory variables that can account for the variance in outcomes of European monetary politics.

"Negotiating the Single European Act: National Interests and Conventional Statecraft in the European Community," International Organization 45:1 (Winter 1991): 19-56. For an attempt to bridge state-centered and institutionalist perspectives with regard to European monetary cooperation see: Wayne Sandholtz, "Choosing union: monetary politics and Maastricht," International Organization 47:1 (Winter 1993): 1-39.

1. Money and Power in Western European Monetary Politics

Assumption 1: States seek to increase their power in international monetary relations in order to create conditions that minimize the costs of pursuing their domestic economic priorities in an interdependent world economy. Their policy choices are conditioned by the constraints and opportunities they face in the international environment.[8]

International interdependence provides both costs and opportunities for all actors involved. The main benefit of interdependence is the welfare gain that results from a more efficient allocation of resources. The foremost price of interdependence is a relative loss in national decision-making autonomy. Under the conditions of interdependence the ability of a government to pursue its own domestic priorities is constrained by external forces over which it has little or no control. These costs of interdependence, however, are asymmetrical among the various participants. In other words, states possess different degrees of power to adjust to external pressures or to change the international environment under which they operate.[9] A change in the international environment is the preferred option of states, because this would push the costs of adjustment onto other actors in the system and would help to avoid costs in domestic terms. The more powerful a state, the more easily it can externalize the costs of pursuing its domestic priorities.

This assumption illuminates that outcomes in international monetary politics reflect the attempt of states to establish conditions that imply the least possible adjustment costs for their domestic economies to the pressures of international economic interdependence. Consequently, states will cooperate on monetary issues only if they expect that cooperation reduces the costs of pursuing their domestic economic priorities. To elaborate the major benefits of monetary cooperation I introduce this second assumption:

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[8] The most valuable sources that guided my thinking in this section were: Benjamin J. Cohen, Organizing the World's Money: The Political Economy of International Monetary Relations, New York: Basic Books, 1977; and Gilpin, Political Economy of International Relations.

[9] On the various aspects of interdependence see: Robert Keohane and Joseph Nye, Power and Interdependence: World Politics in Transition, Boston: Little, Brown and Company, 1977, 11-19; Kenneth Waltz, "The Myth of National Interdependence," in The International Corporation, ed. Charles P. Kindleberger. Cambridge: MIT Press, 1970: 205-223.

Assumption 2: In an environment of international economic interdependence, states have three major reasons why they may want to cooperate on monetary policy:
1) they wish to stabilize exchange rates - external stability;
2) they wish to coordinate economic policies - internal stability;
3) they wish to achieve certain political side-effects of monetary cooperation - issue linkage.
The relative power of the participants in monetary cooperation explains the balance between these goals in the actual collaborative practice of states.

1) External stability

There are three major reasons for states to cooperate to stabilize exchange rates: trade effects, market failure and collusion.

Trade Effects

The argument for stable exchange rates that produces the most public attention is the assumption that fixed exchange rates would stabilize trading relations and investment patterns among the participating countries. This reasoning is especially popular among politicians to support exchange rate regimes.[10] Economic theory and empirical research, however, offer only relatively tenuous support for this proposition. Flexible exchange rates do not only imply potential risks for exporting firms, they could also lead to huge gains if exchange rates shift in a favorable direction for a firm. Overall, the relationship between the stability of exchange rates and growth in trade rests on a tradeoff where "the positive effect of price uncertainty on average profits should be compared to the greater uncertainty about these profits."[11] Only if firms are risk-averse enough to favor the latter would stable exchange rates facilitate the growth of trade. The empirical evaluation of the relationship between exchange rate flexibility and growth in trade has also produced inconclusive results.[12] The most

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[10] See, for example, President Giscard d'Estaing's official justification for joining the EMS in Michael Loriaux, France after Hegemony: International Change and Financial Reform, Ithaca: Cornell University Press, 1991, 253.

[11] Paul de Grauwe, The Economics of Monetary Integration, Oxford: Oxford University Press, 1992, 66.

[12] International Monetary Fund, Exchange Rate Volatility and World Trade, Occasional Paper No.28, Washington, D.C., 1984. For a comparison of various studies on this issue see: Richard C. Marston, "Exchange Rate Coordination," in International Economic Cooperation, ed. by

convincing case in favor of a connection between trade effects and exchange rates is in the area of short-term and unexpected exchange rate volatility. Here a consensus seems to emerge that surprise movements of exchange rates can harm trading relations.[13] Because unexpected volatility seems to indicate an improper functioning of the financial market mechanism the roots of this argument are already within the area of the market failure argument in favor of stable exchange rates.

Market failure

Besides the just mentioned relationship between unexpected volatility of exchange rates and trade the basic thrust of the theory of market failure basically contends that the economic benefits of stable exchange rates are in the area of balance of payments adjustments rather than in trade.[14] Here the disappointing experience with flexible exchange rates in the inter-war period and after the breakdown of Bretton Woods provides incentives to stabilize exchange rates.[15] Among them are the following problems: volatile currency values overshoot the equilibrium exchange rate and therefore aggravate rather than alleviate balance of payments problems ("overshooting"); prices for real goods have a tendency to adjust upwards but seldomly downwards along the movement of the exchange rate creates inflationary pressures ("ratchet effect"); and depreciation and inflation reinforce each other into a vicious cycle if demand for imported and exported goods remains inelastic ("vicious cycle"). Hence, according to market failure theories, flexible exchange rates have not worked properly and have aggravated rather than alleviated the balance of payments and inflationary problems of weak currency countries.[16]

Martin Feldstein, Chicago: The University of Chicago Press, 1988: 79-136.

[13] Andreas Savvides, "Unanticipated Exchange Rate Variability and the growth of International Trade," Weltwortschaftliches Archiv, Bd. 128:3, 1992: 446-463.

[14] For explaining international cooperation on the basis of theories of market failure see: Keohane, After Hegemony.

[15] For the following discussion see: Loriaux, France after Hegemony, 24-31.

[16] To stay as parsimonious as possible I assume throughout this paper that a weak currency country has a balance of payments deficit as well as inflationary problems. This is obviously a fairly broad generalization. Nevertheless, it provides a good foundation to theorize about the interests of states in international monetary relations.

Collusion

Stronger proponents of market operations, of course, quarrel with the contention that flexible exchange rates have been characterized by market failure. If governments would implement adequate market policies flexible exchange rates would work properly. Thus, market failure is actually a sign of government failure. Collusion theorists, therefore, see the major "benefit" of monetary cooperation in the attempt of states to collude and to escape the disciplining forces of markets: "By agreeing on a convergence of inflation rates and exchange rate stability, each government reduces the 'danger' that its citizens may demand foreign money in place of the domestic money or that they may criticize it for not performing as well as other governments."[17] Another "advantage" of monetary collusion is the availability of means to finance balance of payments deficits at lower than market rates from international institutions such as the the IMF or EMCF, which again indicates the desire of states to reduce the costs of international interdependence.

Hence, the major incentive for states to stabilize exchange rates is the reduction in political costs. Depreciation and devaluation as well as appreciation and revaluation imply costs for various sectors of a domestic economy. Changes in currency parities lead to visble shifts in economic advantages between different sectors of the economy. Consequently, some of the major costs, for example, are temporary unemployment, retraining or relocation. Governments often have an incentive to avoid these short term costs and to keep exchange rates stable. The irony of these incentives, however, is that they can create rigidities in a pegged exchange rate regime that lead to occassional speculative crises, which often call into question the very purpose of the fixed exchange rate regime - most visibly in the crises of the Bretton Woods system in the early 1970s or the September 1992 crisis of the EMS.

Both, market failure theories as well as collusion theories, provide important insights into the incentives of states to cooperate on monetary issues. There remain, of course, important disagreements between these two economic theories. As a political scientist I will not attempt in this paper to settle the economists' dispute as to whether it is market or government failure that accounts for states' incentives to cooperate on monetary issues. I will also refrain from a normative evaluation of cooperation as to

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[17] Roland Vaubel, "A public choice approach to international organization," Public Choice 51 (1986): 39-57 (here: p.45). For another succinct statement of collusion theory see: Roland Vaubel, "International collusion or competition for macroeconomic policy coordination? A restatement," Recherches Economiques de Louvain 51: 3-4 (Decembre 1985): 223-240.

whether monetary cooperation is "good" (market failure theories) or "bad" (collusion theories). I simply take both theories as indications that states have certain incentives to cooperate on external stability.

It is not necessary to settle this dispute because the explanatory power of both theories is rather limited for the question at stake here. Neither market failure nor collusion theories can account for the variance in outcomes of international monetary relations. Market failure as well as collusion theories are structural theories that emphasize incentives for states that do not vary. Moreover, they do not account for the disincentives that states obviously must face, given the fact that they often cannot agree on common rules for monetary behavior. In order to account for different outcomes then we need a conceptual framework that accounts for change in international monetary outcomes. After addressing further incentives to cooperate and some of the collective action problems that states face in the monetary realm I will present such a framework based on the assumption of leadership in the second section of this paper.

2) Internal Stability

The second goal of monetary cooperation - the coordination of economic policies - is a direct consequence of international economic interdependence. Governments can control domestic conditions only if they can influence the decisions taken in other countries. Thus, states want to avoid or constrain negative externalities of other governemnts' pursuit of domestic economic priorities. The most relevant domestic goal at stake here are the issues related to the achievement of price stability. Low inflation countries have an incentive to reduce inflationary pressures from their international environment - preferably by stabilizing price levels in other countries. Higher inflation countries have the incentive that other countries adjust to higher levels of inflation in order to reduce pressures on their exchange rates. If domestic policies do not converge, the goals of internal and external stability become incompatible with each other. This situation makes monetary cooperation extremely fragile and leads to asymmetrical arrangements where leaders provide an anchor and set the domestic economic standard for the other members of the system.

3) Issue linkage

The third major goal of monetary cooperation can be to achieve certain political side-benefits of monetary cooperation. Here states have an incentive for issue-linkage between monetary policy and other policy areas. For example, European monetary cooperation is said to stabilize the Common Agricultural Policy or the Common Market of the EC. Also, states calculate their interests in the monetary

field with political interests in mind. For example, Germany supported initiatives for European monetary cooperation in order to counterbalance its interests in Eastern Europe. Or, to take another example, France favored European monetary cooperation to influence global monetary developments. Often these broader political considerations can be a more important motive for cooperation than the strictly monetary reasons on their own.

The arguments presented in assumption 2 imply that states face significant incentives to cooperate on monetary policy. Nevertheless monetary cooperation has been a relatively rare occurrence in international politics. Why have states often been unable to establish monetary cooperation among them? To tackle this question I introduce a third assumption of monetary politics:

Assumption 3: If states want to establish monetary cooperation they have to overcome familiar obstacles to collaborative action like the free-ride and uncertainty problem.[18] More importantly, however, they have to address two sets of issues that make monetary cooperation especially fragile and problematic:
1) the costs of balance-of-payments adjustments to stabilize exchange rates; and
2) the potential incompatibility of the goals of external and internal stability, which creates incentives to export domestic economic problems and has implications for the solution of the N-1 problem.

Costs of Balance of Payments Adjustments

One of the most formidable obstacles states face in establishing successful monetary cooperation to achieve external stability is the distribution of the costs of balance of payments adjustments. Generally, there are three options for states to deal with a disequilibrium in their balance of payments: they can alter the exchange rate toward its equilibrium value, they can pursue policies (both monetary and fiscal) that reallocate resources within the domestic economy, or they can choose to finance the disequilibrium.[19] Within a pure flexible exchange rate regime, the exchange rate theoretically always adjusts automatically to its equilibrium value.[20] If states,

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[18] For the most relevant literature in this respect see: Robert Axelrod, The Evolution of Cooperation, New York: Basic Books, 1984; Robert Keohane, After Hegemony; and Kenneth Oye, ed., Cooperation under Anarchy, Princeton: Princeton University Press, 1986.

[19] Benjamin J. Cohen, "Balance-of-payments financing: evolution of a regime," in Stephen D. Krasner, ed. International Regimes (Ithaca: Cornell University Press, 1983): 315-336.

[20] This is the original assumption of economic theory. As I pointed out previously, however, market failure

however, attempt to stabilize exchange rates this option of altering the exchange rate toward its equilibrium value exists only during occasional realignments of otherwise fixed exchange rates.

Thus, states that want to establish external stability are left with the options of reallocating domestic resources or financing the disequilibrium. Whereas this logic applies to surplus countries as well as to deficit countries, it puts a much heavier burden on deficit countries. Surplus countries could create as much money supply as they want in order to intervene in the foreign exchange market.[21] Deficit countries, however, have to draw on their (limited) reserves, borrow funds from external credit sources or indeed adjust their domestic economic policies. Thus, fixed exchange rate regimes are inherently asymmetrical: surplus countries are structurally in a much more powerful position than deficit countries. In general, the burden to adjust balance of payments imbalances falls more heavily on deficit countries.

This situation creates a dilemma for deficit countries: Are they better off under flexible exchange rates or under fixed exchange rates? Under flexible exchange rates they would simply let the market take care of balance of payments problems. This, however, creates - as discussed previously - the problem of "overshooting", the "ratchet effect" and the "vicious cycle", which have a tendency to deteriorate further balance of payments problems. Under fixed exchange rates they are in danger of running out of currency reserves and of losing competitiveness vis-a-vis their trading partners. Thus, any exchange rate regime has drawbacks for deficit countries.

Nevertheless, this tradeoff also creates at least some sort of leverage: cooperation to stabilize exchange rates has to alleviate some concerns of deficit countries about adjustment costs. Otherwise they may simply prefer to accept the costs of a flexible exchange rate regime rather

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theories assume that there are a number of effects of flexible exchange in the post-Bretton Woods period that make it doubtful that flexible exchange rate regimes work indeed as smoothly as asserted by economic theory. The "overshooting", the "ratchet effect" and the "vicious cycle" argument all can lead to a further deterioration of balance of payments problems. Collusion theory does not necessarily argue that flexible exchange rates create always an equilibrium but it would point out that these negative effects of flexible exchange rates indicate government rather than market failure.

[21] Creating money to finance a surplus disequilibrium, of course, has its own costs. The inherent danger in buying excess foreign exchange is inflation. Often surplus countries would prefer a revaluation of its currency rather than long and sustained interventions on the foreign exchange market.

than the costs of a fixed exchange rate regime. Italy's and Great Britain's initial hesitations about joining the ERM and their exit from the ERM during the September 1992 crisis reflect this tradeoff very well. Flexible exchange rates can be attractive if the costs of fixed exchange rates are too high.

The likely realm of compromise between deficit and surplus countries will be the financing option. This conclusion follows from the analysis of the three possible options for balance of payments adjustments. Within a pegged exchange rate regime, states can realign currencies only on exceptional occasions. At the same time they wish to preserve the ability to pursue their own domestic economic priorities. Thus, they will accept international pressures to reallocate resources within their domestic economy only if they coincide with their own interests. It is, therefore, not at all surprising if weaker states can negotiate adjustment mechanisms that provide for the protection of some domestic economic policy priorities.[22] Consequently, it is the third mechanism of balance of payments adjustments that is most likely to provide a basis for mutually acceptable bargains among the partners of an exchange rate regime: the financing option.

Incompatibility of Monetary Goals

The main policy conflict that actors have to bridge if they want to achieve monetary cooperation is the incompatibility of goals. Some states may simply prefer to stabilize exchange rates with relatively little emphasis on convergence in economic policies (a position that France represented for some time in the European context). Other states aim at coordination of economic policies and are relatively unconcerned about movements in the exchange rate (the typical German position on European monetary cooperation). The goals of external and internal stability are in sync usually only under ideal circumstances, a situation most visibly achieved during the early 1960s in the Bretton Woods system and during the late 1980s in the EMS. These, of course, were times of relatively low inflation and relatively high economic growth. At other times, however, the aim of price stability and exchange rate stability can conflict and it may be possible to achieve one goal only at the expense of the other.

It seems unlikely that independent states would reliably be able to agree on a durable common standard for internal stability. Governments pursue different domestic priorities and countries have different abilities to adjust wages, prices and employment. Thus, there are essentially

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[22] This is the solution to Ruggie's puzzle of embedded liberalism. See: John Ruggie, "International regimes, transactions, and change: embedded liberalism in the postwar economic order," in Stephen Krasner, ed., International Regimes (Ithaca: Cornell University Press, 1983): 195-231.

two possibilities left to achieve both internal and external stability: either someone - the leader - would set the standard, or the participating states would integrate to a full political union, where a common authority would set the standard.

Both internal as well as external stability require a measure that sets the standard for the achievement of both forms of stability. A stable exchange rate regime needs an anchor to which all other currencies can peg. This is usually referred to as the N-1 problem. In a system of N currencies, only N-1 currencies are free to change their exchange rates. The nth currency, however, is not free to change but provides the anchor to which other currencies can peg.

In theory, various fixed exchange rate regimes have emphasized such international standards as gold or other precious metals (as the classical gold standard and, in conjunction with the dollar, the Bretton Woods System) or have developed artificial basket currencies (as the ECU within the EMS). In practice, however, all these fixed exchange rate regimes had a leading national currency that provided the standard for all other currencies of the system. The British sterling was the key currency under the classical gold standard, the Bretton Woods System explicitly acknowledged the leading role of the US dollar by fixing the dollar-gold parity and the German deutsche mark has developed into the center currency of the EMS. Thus, in the political reality of monetary cooperation it is much more likely that a particular national currency provides the solution to the N-1 problem than a supranational standard like precious metals or currency baskets.

The reason for the fact that it is always a national currency that sets the standard is the accompanying problem of internal stability. Removing one degree of freedom from the system is essential to achieve external stability because it gives N-1 countries the freedom to set their exchange rates "independently" vis-a-vis the center currency. However, it gives the nth country the freedom to pursue its domestic policy priorities unconstrained by balance of payments requirements. Hence, it is the nth country that sets the economic standard for internal stability in the system. All other countries in the system have to adjust to this standard or they have to pay the price in terms of balance of payments adjustments. All past or present exchange rate regimes have focused on the N-1 problem only in the sense of external stability, but they ignored the requirements of internal stability and the implications of the N-1 problem for the coordination of domestic economic policies. Hence, even systems that attempted to establish supranational anchors such as gold or currency baskets could not solve the N-1 dilemma because they did not establish a supranational standard for domestic economic policies. Primarily because of the potential incompatibility of internal and external stability

international monetary cooperation will inevitably remain asymmetrical.

2. Leadership in International Monetary Cooperation

The preceding section argued that international monetary politics is an issue area in which states strive to gain power in order to reduce the costs international economic interdependence. This situation creates incentives for them to cooperate on monetary issues. On the other hand, this condition also leads to a number of severe collective action problems among states. In this section I argue that leadership by a single state is required to overcome these collective action problems to achieve cooperation.

Assumption 4: Leadership of a single state is necessary to overcome the collective action problems in international monetary relations and to establish monetary cooperation. Besides traditional indicators of economic size the most important quality of a leader in international monetary relations is its performance on price stability.

Successful international monetary cooperation to establish external stability requires the subordination of domestic economic priorities to the goal of stable exchange rates. Since the purchasing power parity condition demands the compatibility of internal and external stability, cooperating partners have to agree on a common standard for both of them. The problem here is that this standard is relative. A fixed exchange rate regime - everything else being equal - could run smoothly if all participating countries have inflation rates of 50% or of 1%.[23] The problem, however, is that countries have different economic priorities and different abilities to adjust wages, prices and employment. Hence, it is unlikely that they would voluntarily agree on a common standard for internal stability. In the absence of a common political authority it will be the leader in the system of cooperating states that will set the standard.

Leaders in international monetary policy are, of course, powerful monetary actors in the traditional sense. They have to satisfy the standard criteria for state power in the area of monetary policy:
- their national currency has to be a useful international reserve currency;

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[23] At this point I disregard other aspects that could influence the relative balance of payments position of countries, for example long run structural shifts in the competitive position of national economies (i.e. productivity growth) as well as supply and demand shocks.

- their national currency must be relevant for international trade;
- in addition, a large domestic market provides a country with an important source of leverage;
- and, depending on the constellation of issue linkages, political and military power can reinforce the power position of the leader.[24]

Next to these customary criteria, however, I argue that leadership can emerge only if the leading country pursues the most consistent policy of price stability in the system. Without such an anti-inflationary performance, leadership will decline. In addition to this internal stability argument a balance of payments surplus strengthens the position of the leader. I will explain both assumptions very briefly.

Inflationary performance is a necessary ingredient of monetary leadership and a tool of power because it provides its actor with leverage and - consequently - with the anchor function in the system. Cooperation on internal stability is a coordination game with important distributional consequences. If distributional consequences are involved in a coordination game it is the distribution of power among the players that decides the outcome of the game - and in monetary politics it is in general the low inflation country that is powerful. A low inflation country has no incentive to accept a supranational standard for internal stability that would be higher than its own inflation rate.[25] Any compromise on internal stability - for example, to agree, let's say, on an average inflation rate as the standard - would imply a loss of welfare for this country. For a high inflation country such a compromise could mean a welfare gain of lower inflation, provided it can achieve it at tolerable costs. Consequently, the price stability leader cannot move to a compromise without hurting itself, whereas a compromise could potentially imply a welfare gain for high inflation countries.

This incentive structure gives leverage to the state with the best inflation performance. Hence, its standard of internal stability will become the anchor for the system and the measure for the performance of its partners. This payoff-structure puts the currency of the price stability leader into the position of the nth currency in the system. Other participants either have to follow or have to pay the price in terms of balance of payments adjustments. Hence,

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[24] This point is an important element for explaining the stability of the Bretton Woods System. Moreover, political and strategic aspects are also behind the EC's move to EMU.

[25] I leave out political motivations at this point. It is conceivable that a low inflation country could acquiesce to higher inflation for <u>political</u> reasons. Nevertheless, under these conditions a government would trade in economic gains for certain political gains.

leaders do not necessarily provide a public good. Rather, they manifestly protect their own interests.

While a surplus in its balance of payments position is not as necessary a condition for leadership as is inflationary performance, it provides a leader with additional power resources. Since the leader will not accept a compromise on domestic priorities in order to provide the system with a balance of payments adjustment mechanism, a surplus would give the leader enough leeway to offer a compromise on the financing option of balance of payments adjustment mechanisms.

Assumption 5: Leaders can facilitate monetary cooperation because they can manipulate the structural constraints and opportunities that states face within this issue area. This includes the ability of the leader to enforce the rules of monetary cooperation and the ability to open up a zone for possible compromise among the participants of monetary cooperation.

So far the discussion has shown that it is impossible to find a supranational compromise for internal stability and - linked through the purchasing power parity condition - also for external stability. Leadership based on inflationary performance is a necessary requirement for successful monetary cooperation. Nevertheless, price stability leadership may not be a sufficient condition for monetary cooperation. Weaker countries do not necessarily have to accept the standard provided by the leader. As the discussion on balance of payments adjustment mechanisms has emphasized, weaker states have the option to drop out of fixed exchange rate regimes if the costs are higher than the costs of floating. Thus, weak currency countries have some leverage to achieve a compromise on balance of payments adjustment mechanisms. And the likely area for compromise is indeed the financing option, because under fixed exchange rates realignments are only an occassional option and it is unlikely that states will accept formal rules of external interference in domestic affairs.[26]

Leaders cannot coerce subordinate states into cooperation. Rather they have to offer an acceptable compromise on the balance of payments adjustment mechanisms in order to achieve cooperation. Since the main danger that weak currency countries face in a fixed exchange rate regime is to run out of reserves, a generous offer by the leader on the financing option of balance of payments adjustment mechanisms could potentially make fixed exchange rates less costly for the weaker state than flexible exchange rates.

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[26] This applies only to the formal rules of monetary cooperation. In the reality of monetary politics weak currency countries often have to accept external constraints - be they exercised within or outside of a pegged exchange rate regime.

The ability of the leader to enforce the rules of monetary cooperation will also alleviate the traditional concerns of states about uncertainty and free riding by other countries.

The discussion of assumption 4 and 5 has shown that leaders do not act according to the predictions of both variants of hegemonic stability theory - the coercive and the benevolent version. They do not provide a clear-cut public good. Rather, leadership emerges out of the concern for the leader's own domestic interests. It will not accept a free ride by subordinate states at the cost of achieving its own domestic interests. Leaders will not accept a welfare loss, simply in order to provide a public good. Neither do leaders coerce subordinate states into cooperation, because even the weaker states act according to their own interests. Instead, leaders manipulate the structural incentives that states face in international monetary politics by providing both the standard of orientation for the other members of the system and by alleviating the concerns about the costs of balance of payments adjustments.

Assumption 6: Attempts at monetary cooperation or integration that fall short of a full and complete political union remain fragile, because they are subject to the periodic rise and decline of leadership by a single state.

Since monetary cooperation requires leadership, and since the distribution of power within the system changes over time, monetary cooperation will inevitably remain fragile and only a temporary phenomenon. The notion of hegemonic stability theory is, therefore, a misnomer. Its emphasis is on the dynamics of change in the international power structure and not on stability. According to hegemonic stability theory, a hegemonic distribution of power provides the best conditions to achieve relatively more stable relations among states than any other possible distribution of power. Nevertheless, in an environment of international anarchy the notion of "stability" makes sense only as a relative term compared to less "stable" relations under different distributions of power, and the dynamics of change in the power structure insure this relative "stability" will only be temporary. Hence, this paper emphasizes the dynamics of change in the international political economy as the primary sources of change in the patterns of monetary cooperation among the European states.

The point here is that when leadership declines the monetary system loses its anchor for both the achievement of external as well as internal stability. Thus, cooperation loses its measure of success and under these circumstances the system would be governed exclusively by the pure domestic concerns of each of the participating governments. The crucial question that emerges in these situations is: Can the relevant players in the system organize a smooth transition of leadership from a declining to a rising power

or can the leading power restore its power basis sufficiently to insure a return to successful cooperation?[27] As I have argued in the preceding section it is unlikely that states would be able to provide jointly the necessary leadership. Disagreements about domestic priorities would prevent this solution.[28]

The two preceeding sections have developed a conceptual framework to anayze the politics of monetary cooperation in Western Europe. In the following sections I will anayze three attempts at monetary cooperation within the framework of the EC since 1970.

3. The Werner Report

During the late 1960s and early 1970s the countries of the European Community intensely debated the question of closer monetary cooperation.[29] A study group under the chairmanship of Pierre Werner, then the prime minister of Luxembourg, issued various reports to achieve closer monetary cooperation among the EC countries with the final goal of Economic and Monetary Union (EMU). On March 22, 1971 the European Council adopted a resolution that called for the realization in stages of a complete EMU by 1980. What explains this decision? And why did the EC countries fail to achieve their goal?

The 1971 decision to move to an EMU by 1980 was triggered largely by structural changes in the international

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[27] As I will argue in the section on the EMS, this is precisely the issue in the current situation of the EMS. Germany - as a result of the costs of reunification - is in danger of losing its anchor function in the EMS. Its inflation rate is significantly higher than the ones in a number of other countries (most importantly France). Thus, the issue comes essentially down to the question as to whether Germany can restore its monetary leadership within the EMS, as to whether the EMS could organize a transition in leadership (and the obvious candidate for a successor to Germany would be France) or whether the EMS will simply dissolve.

[28] To the example of the current situation in the EMS: Which one would be the appropriate position for a compromise: the position of the German Bundesbank that higher interest rates are necessary in order to fight inflation in Germany or the position of most of the other participants in the EMS that interest rates ought to be lower in order to facilitate economic growth?

[29] Very good accounts of these discussions and the steps taken by the EC countries are in: D.C. Kruse, Monetary Integration in Western Europe: EMU, EMS and Beyond, London: Butterworths, 1980; and Loukas Tsoukalis, The Politics and Economics of European Monetary Integration, London: George Allen & Unwin, 1977.

political economy that endangered the goal of external stability. The Bretton Woods System was still in operation, however, the system of pegged exchange rates had seen a number of major speculative currency crises during the late 1960s. From the standpoint of EC integration the French devaluation and German revaluation of 1969 were especially irritating, because they implied that monetary relations among the EC members were not stable and it was feared that the parity changes would put other EC policies, in particular the Common Agricultural Policy (CAP), at risk. Moreover, the decisions to devalue the franc and to revalue the DM were taken without prior consultations within the existing EC committees - in violation of an explicit commitment of the EC countries. Furthermore, the 1% fluctuation bands of national currencies around the central parity of the dollar in the Bretton Woods System implied that the the European currencies among themselves had fluctuation bands of 4%. This was seen as too high and as destabilizing for European economic relations.

Next to the advantages of achieving external stability, EMU also promised a number of useful political side-benefits. In particular, France was hoping to achieve a united European position vis-a-vis the United States in negotiating the future of the international monetary system. Especially after the experience during the 1960s when Germany had been caught several times in the middle of U.S.-French conflicts over monetary issues, France had an interest in achieving a monetary alliance with Germany in order to increase its leverage in the global monetary arena. France saw Germany's dependence on the American security guarantee as preventing a unified European position and the beginning of detente opened possibilities for greater German independence in this area. Moreover, Germany's Ostpolitik required a counterbalance within the EC, and the goal of EMU seemed to provide such an opportunity.[30]

In summary, the best explanation for the drive to EMU in the early 1970s lies in the intention of the EC countries to reduce the costs they incurred from participating in a changing international political economy and the political side-effects of monetary cooperation. Despite these advantages of cooperation, however, the Werner Report was never implemented. Many observers blame the breakdown of the Bretton Woods System for this failure.[31] However, the growing crisis of the Bretton Woods System actually was one of the driving forces behind the attempt to coordinate monetary policies more strongly within the EC. What prevented the success of the Werner Report were the

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[30] See: Tsoukalis, Politics and Economics, 85.

[31] See: Theo Peters, "EMU: Prospects and Retrospect," in European Monetary Union: Progress and Prospects, ed. by Michael T. Sumner and George Zis, New York: St. Martin's Press, 1982: 1-17 (here: p.7).

Table 1: Average Annual Rates of Inflation for five countries, 1950-79

	Change in consumer price index		
Country	1950-59	1960-69	1970-79
France	5.6	3.8	8.8
Italy	3.0	3.8	12.2
United Kingdom	4.6	3.6	12.4
United States	2.1	2.4	7.0
West Germany	1.9	2.5	4.9

Source: Charles S. Maier, "Inflation and Stagnation as Politics and History," in The Politics of Inflation and Economic Stagnation: Theoretical Approaches and International Case Studies, ed. by Leon N. Lindberg and Charles S. Maier, Washington, D.C.: Brookings Institution, 1985, 11.

incompatibility of the goals of monetary cooperation and the absense of effective leadership in the EC.

The major policy clash was between the so-called "monetarists" and the "economists".[32] The "monetarists" - a position forcefully presented by France - argued in favor of quick progress on monetary cooperation, which would then serve as a tool to harmonize economic policies. The "economists" - reflecting the position of Germany - argued in favor of prior convergence of economic policies before moving to a monetary union. The "economist" postion was the inevitable outcome of Germany's structural position as a country with a surplus in its balance of payments and with a low inflation rate. Had the monetarist position succeeded, it would have offered deficit and high-inflation countries a free ride: In a complete EMU, Germany would have either had to finance the balance of payments difficulties of the deficit countries or it would have had to accept a higher inflation rate.

To recall assumptions 1-3 presented in the first section of this paper, the EC countries could not cooperate successfully because of the divergence of the goals of internal and external stability. The crucial point is that their expectations regarding internal stability did not converge. Germany had an interest in lower inflation and saw the Bretton Woods System of the late 1960s and early 1970s as harmful to achieving this goal and consequently left the pegged exchange rate system twice, in May of 1971 and in March of 1973.[33] At the time, Germany thought that it was able to reduce its costs of international interdependence - i.e. external inflationary pressures (see table 1) - unilaterally. Overall, Germany would have prefered a joint European float vis-a-vis the dollar and other international currencies. It was not, however, willing to pay too high a price for this goal. Internal stability remained by far the most important monetary goal for Germany.

/ Table 1 about here /

France had the opposite incentive structure. It put the goal of external stability first because it needed a system of pegged exchange rates to allow its domestic

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[32] These terms used in the European discussions are quite at odds with the designations for various schools of thought in the discipline of economics. For the definition of the "monetarist" and "economist" position within the debates on European monetary cooperation see: Tsoukalis, Politics and Economics, 90-98; Kruse, Monetary Integration, 62-70

[33] The DM returned to a pegged exchange rate system in December of 1971 after the completion of the Smithsonian Agreement. The March 1973 floating of the DM was the final blow to the pegged exchange rate system of Bretton Woods.

economy to adjust.[34] Unlike Germany, which prefered flexible exchange rates precisely because they allowed for the achievement of its domestic priorities, France's economy was not very responsive to internal adjustments. In retrospect, the major reforms in the French financial system undertaken since the late 1970s are the prerequisite for the narrowing of the gap between the German and the French position on monetary policy seen during the last few years.

Next to the incompatibility of monetary goals the second major reason for the failure of the Werner Report in the 1970s was the absence of leadership. To recall the criteria of monetary power in assumption 4 of this paper, Germany - the country with the largest market and the most widely used currency in Europe, and the country with the best inflationary record and a powerful balance of payments position - was already in the early 1970s the primary candidate for leadership in European monetary cooperation. However, given the international constraints and opportunities operating in the global political economy in the early 1970s, Germany had a high incentive to reduce its costs of participation in the international political economy - i.e. to reduce the external inflationary pressures of the Bretton Woods System - and it had the power to do so unilaterally, simply by abandoning the Bretton Woods System. Its incentive to induce monetary cooperation in Western Europe was relatively low compared to these domestic considerations.

4. The European Monetary System

Despite a decade of failure to achieve closer monetary cooperation within the EC, the Western Europeans at the end of the 1970s suddenly achieved an arrangement that worked successfully for more than a decade. In 1978 France and Germany negotiated a pegged exchange rate regime, the European Monetary System, which came into operation in 1979.[35] Currency values within the EMS had to be realigned several times, especially frequently during the first four years of the system's operation. Between 1987 and 1992 , however, central parities had remained stable, inflation rates had converged closer to German levels and differences in interest rates had become narrower. Hence, up to September 1992 the EMS was widely seen as a success story.[36] Since then its achievements have become more doubtful and I

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[34] For this argument see: Loriaux, France after Hegemony.

[35] On the emergence of the EMS see: Peter Ludlow, The Making of the European Monetary System, London: Butterworth, 1982.

[36] For an evaluation of the success of the EMS see: Daniel Gros and Niels Thygesen, European Monetary Integration, London: Longman, 1992.

will address this question later in this section. First, however, we have to ask what made the EMS successful.

Similar to the factors that triggered the Werner report, changes in the international political economy conditioned the move to the EMS. During the 1970s the incentive structure that prevailed at the beginning of the 1970s had changed at the end of the 1970s. The dollar crisis in 1978 and the ensuing speculative currency flows made it very costly for Germany to pursue unilateral monetary policies. The crisis of 1978 meant that the DM either had to appreciate to levels that made the German economy uncompetitive or Germany would have to accept higher inflationary pressures as a consequence of sustained intervention of the Bundesbank in the currency markets.

Under these conditions, the incentive for Germany to achieve external monetary stability in Western Europe gained in importance.[37] First of all, external stability within the EC would help to stabilize Germany's competitiveness at least vis-a-vis the other Western European economies. Secondly, Germany could hope that a joint European float against the dollar would slow the appreciation of the DM because it would distribute the impact of the depreciating dollar among the participating countries. And thirdly, the perspective of a slowdown in DM appreciation in addition to joint currency intervention would reduce the inflationary pressures emanating from the volatility of the dollar, hence producing more favorable conditions for the achievement of internal stability - which despite all the changes in German incentives remained unequivocally the primary goal of German monetary policy. Overall, in the late 1970s, Germany saw European monetary cooperation as a chance to reduce the costs of its participation in international economic interdependence. In addition, Germany also saw a number of political side-benefits in establishing European monetary cooperation. In particular, Chancellor Schmidt's dissatisfaction with U.S. foreign and economic policies in the late 1970s provided an incentive to unite Europe in order to create pressure on the U.S..[38]

All this meant was that Germany's incentive structure had effectively moved closer to French priorities. On the other hand, the French government, feeling the strong pressures of the flexible exchange rate regime, had just started its own domestic financial reform efforts to adapt to the pressures of the flexible exchange rate system. Under these conditions it could use German support for its policy of disinflation. The goal of internal stability gained in importance for France and its incentive structure,

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[37] However, this is not to say that external stability surpassed the goal of internal stability in importance. Low inflation has consistently remained Germany's number one objective in economic policy.

[38] See Ludlow, The Making of the European Monetary System, 64-69.

therefore, moved closer toward the German position. Overall, this change in incentives reduced the gap between the goals of internal and external stability.

This is the environment in which the Western Europeans started to negotiate the EMS project. As I demonstrated in the preceding paragraphs, international structural factors account for the monetary policies that the Western European countries pursued. They are, however, insufficient to explain the success of the EMS vis-a-vis the failure of the Werner Report. As assumptions 4-6 of this paper require, leadership has to emerge, and it is my contention in this paper that it is the leadership of Germany that accounts for the relative success of the EMS.

The convergence of monetary goals between France and Germany was certainly one necessary condition for the success of the EMS. Nevertheless, economic convergence was far from complete in the EC at the time. The French and Italian inflation levels were far higher than Germany's and domestic priorities in economic policies were still different. Thus, it was unlikely that states would be able to solve the inconsistency problem. It was especially unlikely that Germany would move to a compromise on internal stability. However, Germany was able to supply leadership both by providing the anchor to which the inconsistency problem had to be directed and by compromising on the other significant collective action problem, the question of balance of payments adjustments.

As predicted by the assumptions of this paper the EMS did not formally encroach on the domestic priorities of the individual member states. In particular it did not agree on a supranational compromise as a standard for internal stability. The European countries agreed on the ECU as a formal reference point for currency parities. However, as a basket currency the ECU only reflects the <u>average</u> performance of currencies. This left it open to the price stability leader to set the standard for the others in the system. As the most stable currency, the DM became the anchor of the system. Other countries either had to follow Germany's lead on internal stability or had to pay the price in terms of other forms of balance of payments adjustments.[39]

As the leader of the system, Germany enforced its interpretation of the rules quite vehemently. For example, there are numerous cases where Germany demanded (and received) French budget cuts in exchange for realignments in the EMS in the early 1980s.[40] Despite allowing formally for

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[39] For some of these participants of the EMS Germany's lead became a useful tool to create a believable commitment to disinflation; see for example: Francesco Giavazzi and Marco Pagano, " The advantage of tying one's hands: EMS discipline and central bank credibility," <u>European Economic Review</u> 32 (1988): 1055-1082.

[40] See: Loriaux, <u>France after Hegemony</u>, 261.

the permissiveness of domestic priorities, the EMS in reality puts constraints on the freedom of domestic choices of weak currency countries. However, since the weak currency country would face many constraints inside as well as outside the EMS, the crucial question for them was simply which one of the two alternatives was less costly for them.

One particular compromise that made it less costly for weak currency countries to participate in the EMS was the agreement reached on balance of payments adjustment mechanisms. Germany's position as a surplus country gave this country additional leeway to offer generous support for the financing option of balance of payments difficulties.[41] Moreover, Italy received a larger fluctuation band of 6% than the more affluent countries, the EC instituted more support programs for the poorer countries, and the realignments within the EMS were made easier than in the unsuccessful precursor of the EMS, the "snake".

The negotiation results as well as the actual arrangements of the EMS reflect the predictions of assumptions 3-5 very well. As expected, the crucial areas of compromise between EMS countries were not domestic priorities but balance of payments arrangements. Germany provided leadership both by setting the standard as well as by manipulating the constraints that weak currency countries faced in their balance of payments position.

Various crises since September 1992 have called the future successful operation of the EMS somewhat into question. First the Italian lira devalued on September 13 and on September 16 Italy and Great Britain had to withdraw their currencies from the Exchange Rate Mechanism of the EMS. This was the first time in the history of the EMS that members had to leave the arrangement. Following these events there were numerous devaluations involving the Spanish, Portugese and Irish currencies as well as various speculative attacks on the French, Danish and Belgian currencies.

These problems in the EMS result from the erosion of German leadership in the EMS. Following reunification Germany's inflation rate has increased and it has not performed as the price stability leader in the system. Rather, most other members of the EMS have currently a better record on price stability.[42] Moreover, Germany's budget deficit has grown rapidly and it would currently not fulfill the convergence criteria of the Maastricht Treaty. In addition, Germany has also become a deficit country on the current account.[43]

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[41] For the technical details see: Gros/Thygesen, 49-51.

[42] Germany is currently only in eigth place in inflation. Belgium, Denmark and France have inflation rates that are between one and two percentage points better than Germany's. Source: EC Commission.

[43] It is likely that united Germany will remain a relatively poorer country than pre-reunification West

Early on, the German government had requested a revaluation of DM in the EMS to alleviate the inflationary pressures resulting from reunification. France, in particular, rejected such a realignment for political reasons. Again, it became obvious that Germany and France still disagree on the major goals of monetary cooperation. From Germany's perspective, cooperation has to serve internal stability. As the revaluation proposal shows external stability remains only a secondary goal. For France, on the other hand, external stability still occupies a comparatively higher rank in its hierarchy of incentives. Since Germany could not get the necessary protection of its domestic interests through multilateral cooperation (i.e. a revaluation), it took unilateral measures to preserve its interests (i.e. rising its interest rates). Similar to the situation at the end of the Bretton Woods System, Germany at the beginning of the 1990s was still strong enough to externalize the costs of its domestic economic priorities but it was too weak to provide consensual leadership among its European partners.

Overall, the erosion in German leadership implies that the EMS has lost its standard. The crises of the EMS demonstrate the validity of assumption 6 of this paper. Monetary cooperation is inherently fragile because it requires leadership by a single state. The question that opens up under the current conditions of the EMS is whether Germany can control the costs of reunification fast enough and restore its leadership position in the system or whether the EMS could potentially provide for a smooth transition to a new leader (France being the obvious alternate candidate for this position).

5. Lessons for the future of EMU

In December 1991, the heads of governments signed the Treaty on European Union in the Dutch city of Maastricht. The most significant provision in the treaty was the agreement to establish a full monetary and economic union within the EC by 1997 (if a majority of countries would fulfill the convergence criteria) or by 1999 (for all the countries that would fulfill the convergence criteria independent of the fact whether this constituted a majority of the EC member states or not). EMU would involve a common currency and a common European Central Bank (ECB).[44]

Germany for quite some time. This could require a devaluation of the DM in the medium term - a prospect that evokes memories of the dollar devaluations in the late phase of the Bretton Woods System. Devaluations of the anchor currency of a monetary system do not indicate stability.

[44] For a good overview for the issues at stake in EMU see: Gros/Thygesen, European Monetary Integration, 311-327; and Sandholtz, "Choosing union,".

Table 2: Average Annual Inflation Rate of EMS Member Countries, 1979-91

	GDP Deflators	
	1979-86	1987-91
Belgium	5.1	3.0
Denmark	7.3	3.7
France	9.1	2.9
Germany	3.5	2.7
Greece	19.5	16.2
Ireland	11.5	3.5
Italy	14.2	6.5
Netherlands	3.4	1.7
Portugal	21.2	12.7
Spain	12.4	6.7
United Kingdom	9.0	6.3

Note: All member countries of the EC are EMS countries, however, they do not necessarily participate in the ERM.

Source: Center for Economic Policy Research (CEPR): Monitoring European Integration: The Making of Monetary Union, A CEPR Annual Report, London 1991, 46.

Various problems in 1992 have made the implementation of the substance of the Maastricht Treaty doubtful. Most importantly among them are the rejection of the Treaty in the Danish referendum in June 1992, the very narrow "yes" in the French referendum of September 1992 and the various crises in the EMS. Nevertheless, it is useful to inquire as to the reasons why the Western Europeans attempted a new approach to European monetary cooperation, despite the fact that its existing framework for monetary cooperation worked properly when the treaty was negotiated.

/ Table 2 about here /

The one most important process that has made this treaty possible is the convergence of France to German economic priorities. Since 1983 French governments have consistently put emphasis on low inflation.[45] France's inflation rate has been lower than Germany's now for more than a year. There is relative little difference between France and Germany anymore on the achievement of internal stability. Moreover, France has basically acquiesced to Germany's "economist" position on European monetary integration. Despite the fact that France secretly still seems to favor "monetarist" ideas, it has accepted German demands for tough convergence criteria as well as the political independence of the ECB. Whereas the Werner Report represented a compromise on the lowest common denominator, the provisions of the Maastricht Treaty follow German interests almost completely.

Again, the major driving force behind the goal of EMU in the Maastricht Treaty was structural change in the international political economy. In particular, France's good inflationary record provided it with sufficient leverage to force the issue of EMU onto the political agenda. The major goal of France is to make European monetary cooperation more symmetrical and to regain some degree of influence on the terms of monetary policy.[46] In this sense, the drive toward EMU reflects the desire of states to gain power in order to keep the costs of international interpendence as low as possible.

Nevertheless, French (and also Italian) hopes to design a more symmetrical system of currency cooperation are probably an illusion. So far Germany has forced its design

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[45] For the convergence of inflation rates in the EMS see table 2.

[46] It is probably appropriate to locate the beginnings of a serious discussion to relaunch EMU in the political initiatives of the French Finance Minister, Edouard Balladur, in late 1987-88. His goal was precisely to reduce the asymmetry in the EMS, which had surfaced in the January 1987 realignment and which had been completely corrected in the Basle-Nyborg agreement to reform, the EMS.

for EMU onto the other member countries of the EC.[47] Moreover, it it is unlikely that Germany will cease its leadership role in a full EMU - provided it can overcome the consequences of reunification soon. As long as the EC does not develop into a full political union with a common central government that would set the standard for internal stability, monetary cooperation requires someone to set the standard and to enforce the rules, especially the fiscal guidelines. The reason for this is that EMU increases the incentives for countries to free ride. Since within EMU there would be only one system-wide inflation rate, every member government would have the incentive to produce "a little bit of inflation" in order to achieve short-term economic growth. Within EMU it could externalize much of the costs because the union would distribute the inflationary consequences throughout the system. Thus, in the absense of leadership the system would likely have an inflationary bias. This is the reason observers have been puzzled by German motives to participate in EMU. According to my analysis it is not necessary to search for various political reasons as to why Germany accepted the goal of EMU - although they may further facilitate German incentives.[48] The potential benefits of EMU are not in the political sphere alone. Germany can gain economically as well, however, only if inflation stays low. The fact that Germany has so far dominated the rules of the Maastricht-game and the prospect that Germany will continue to serve as the leader of the system - if it gets over the costs of reunification quickly enough - in itself explains very well that Germany has an interest in EMU. Potentially, EMU could reduce the costs for the achievement of its domestic goals, because if it continues in its dominant role Germany would be in a position to increase its control over the domestic economic priorities of its partners. Hence, the design of EMU reflects exactly the assumptions made in this analysis: it represents a consensus at the position of the leader of the system. The leader did not have any incentive to move from its position.[49]

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[47] In particular these are the decisions on capital mobility, convergence criteria, the independence of the central bank, the defeat of various ECU-proposals the low degree of responsibility for the European Monetary Institute (EMI) during the transition phase.

[48] See, for example, Sandholtz, "Choosing union,": 31-34 and passim.

[49] Given this German incentive structure, however, it is likely that the political decisions that need to be taken in 1996 about eligibility of the twelve (or more) EC countries for EMU will be quite contentious. Germany has relatively little economic incentive to allow weak currency countries into the union (Italy and Spain being the politically important problems). The resolution to have a special vote on the fulfillment of the convergence criteria

The main reason for the fact that EMU will most likely remain an asymmetrical system is the problem that the Maastricht Treaty does not provide a common political environment in which the ECB could root itself.[50] Since the treaty does not subject European countries to a supranational political institution, intergovernmental cooperation in economic policies will still follow the same logic outlined in sections one and two. The current design of EMU only solves the collective action problems of balance of payments adjustments and of the incompatibility of monetary goals in the formal sense; i.e. the system would have permanently fixed exchange rates in the form of a common currency and a single system-wide inflation rate. Nevertheless, is is still possible that governments would still pursue incompatible economic goals, countries would still have different abilities to adjust wages, prices and employment and countries could still develop balance of payments problems in the sense of lost competitiveness. The conflicts over the structural funds to finance convergence programs in the EC as welle as the disagreements between Germany and its neighbors over the level of interest rates attests precisely this point.

Moreover, the imbalance between centralized monetary policy but decentralized fiscal policies will also create tensions and will make coordination more difficult. The political independence of the ECB does not necessarily provide a guarantee for low inflation in the system. As the President of the Bundesbank, Helmut Schlesinger, has warned: "Monetary policy cannot reverse a grave misdirection of fiscal and wage policies. Anti-inflation policy cannot be reduced to the problem of providing a proper set of technical instruments."[51] Policy conflict will, therefore, likely remain a persistent feature of European monetary politics - even under the roof of a common central bank.

So far, the EC has no system in place that could deal with these conflicts in a supranational procedure. Under these conditions the incompatibility of domestic economic goals and the different abilities to adjust will still

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in 1996, which the Bundestag accepted in conjunction with the ratification of the Maastricht Treaty, further enhances the bargaining position of Germany. It seems unlikely that Germany will accept any compromise in 1996 or thereafter that would impinge on its domestic goal of low inflation. This is further underscored by the fact that the Bundesbank would remain intact as a member of the European System of Central Banks (ESCB), whereas most of the member countries will have to change the institutional setting of their monetary policy making.

[50] Daniel Wincott, "The European Central Bank: Constitutional Dimensions and Political Limits," International Relations 11:2 (August 1992): 111-126.

[51] Quoted in Judy Dempsey, "German bank chief airs treaty worries," Financial Times, April 17/18, 1993.

create tensions that are either solved by the leadership of a state or by the breakdown of monetary cooperation. The dilemma of EMU remains the same as in the EMS: despite the fact that both are designed as symmetric systems with equal rights and obligations for every single member state, the inherent asymmetry in monetary politics will either produce leadership to stabilize relations or it will fall apart. As in the case of the EMS the bargain that could make EMU possible is the provision of financing mechanism for the weaker countries (i.e. structural funds) in exchange for the leader's freedom to set and enforce the common standard of internal stability. The future of EMU, therefore, depends crucially on the (re)emergence of responsible leadership and the difficulties that the project of EMU faces in the current political environment are due more to the decline of leadership within the European monetary domain than to any other factor.[52]

6. Conclusion

This paper has demonstrated that a realist theory of international political economy can explain the patterns of European monetary cooperation. Monetary politics is a realm of action in which states strive to gain power in order to reduce the costs of international interdependence. Monetary cooperation even within the fairly dense network of relations among Western European politics and the relatively even distribution of power among the major players is highly asymmetrical. The particular obstacles for monetary cooperation, especially the incompatibility between the goal of external and internal stability and the balance of payments adjustment problems, require a common standard and a leader to manipulate the structural constraints and incentives that states face within this issue area. Under these conditions the inflationary record of the leader is an important aspect of its power.

The evidence of the three case studies presented in the second part of this paper pointed to the fact that structural changes in the power structure of the international political economy largely drive the behavior of states in the area of monetary politics. They also underscored that the emergence of leadership is the essential requirement for the success of international monetary cooperation. This leadership did not emerge in the case of the Werner Report, because Germany, the most likely candidate for the role of leadership, after the breakdown of the Bretton Woods System saw unilateral action as the least

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[52] Samuel Brittan, speaking of the idea of a fast-track EMU, has observed: "Indeed one reason why the Bundesbank is against an early fast track to monetary union among a few core countries is the belief that Germany is not strong enough for such a step." Samuel Brittan, "Germany fails the Maastricht test," Financial Times, February 4, 1993.

costly way to reduce its vulnerability to internationally generated inflation. On the other hand, German leadership - in terms of changing the structural constraints and opportunities in the field by providing an anchor and the facilities for the financing of balance of payments difficulties - is largely responsible for the success of the EMS. Moreover, the erosion of German leadership (larger deficit, higher inflation and balance of payments deficit) helps to explain the current crisis in the EMS. In its final conclusion, my analysis suggests that EMU will be successful only if Germany restores its leadership position or if someone else can achieve leadership in a smooth transition process.