

**Hegemonic Stability Theory and European Monetary Cooperation: Evaluating the
Role of Germany in the EMS and EMU**

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Abstract:

This paper takes a preliminary step toward formulating a theory of German leadership within European monetary politics. Its purpose is to examine the constraints to monetary cooperation in Europe. An analysis of the constraints provides a prerequisite for understanding the particular role of Germany within the bargaining process over the rules of European exchange rate cooperation. The paper locates the crucial constraints to exchange rate cooperation in the distributional concerns of its participants. First, there is the necessity to establish macroeconomic consistency among the participants of an exchange rate regime. There has to be one macroeconomic standard that serves as the focal point for all members of the system. The need for a standard leads to another, and ultimately closely related issue, namely the problem of establishing rules for balance of payments adjustments. I argue that Germany has so far been unwilling to compromise on the question of consistency. Following the N-1 logic, Germany has served as the standard setting country for European monetary politics. On the other hand, Germany has made various concessions on adjustment questions. These concessions have proven to be crucial for the implementation and survival of the EMS. However, in the case of a monetary union the ability to shift bargaining from consistency issues to adjustment issues disappears. Given Germany's uncompromising position on consistency issues, the ability of the other countries to bargain over the rules of a monetary union is severely limited. The history of all three attempts at monetary union (the Action Programme, the Werner Report and the Maastricht Treaty) supports this claim. On the basis of this analysis, subsequent research will evaluate the function of leadership to solve the constraints to cooperation and to allow countries to reap the benefits of exchange rate cooperation.

Hegemonic Stability Theory and European Monetary Cooperation: Evaluating the Role of Germany in the EMS and EMU

This paper takes a preliminary step toward formulating a theory of German leadership within European monetary politics. Its purpose is to examine the constraints to monetary cooperation in Europe. An analysis of the constraints provides the prerequisite for understanding the particular role of Germany within the bargaining process over the rules of European exchange rate cooperation. While the investigation in this paper hints already at some patterns of Germany's monetary politics, the particular leadership role of Germany within the EU needs to be developed in subsequent research.¹

The examination of the constraints to European monetary cooperation evolves in three steps.² The first section analyzes the relevance of the prevailing international relations literature on cooperation for explaining the constraints to exchange rate cooperation in the EC. Here I argue that the Prisoners' Dilemma, which has developed almost into a paradigm case for the analysis of cooperation problems within this literature, provides only limited insights into the problems that impede exchange rate cooperation. Instead, the crucial constraint to exchange rate cooperation can be found in the distribution of costs and benefits. The second section analyzes the implications of the necessity to establish macroeconomic consistency among the participants of an exchange rate regime. The need to solve this issue has important distributive consequences for the participants of an exchange rate regime. In particular it necessitates a solution to another, and ultimately closely related issue, namely the problem of establishing rules for balance of payments adjustments, the subject of the third section.

1 International Cooperation and the Problem of European Monetary Politics

Over the past decade or so a very large segment of the prevailing international relations literature has used the Prisoners' Dilemma and other "mixed-motive situations" frequently as a formal representation for the problems (as well as incentives) that states face for cooperation among themselves.³ In these "mixed-motive-situations" states face incentives to cooperate with each other, because such collaboration promises mutual gains. Simultaneously, however, states also have powerful incentives to defect, because they may wish to attain the gains from double-crossing their partners and from free-riding on the cooperation of others, or, simply, because they

¹ This paper represents an edited version of my dissertation draft chapter on the constraints to European monetary cooperation. Although I tried to eliminate most aspects that might reveal this origin, the paper may still contain some arguments that relate to points made in other chapters of the dissertation. Nevertheless, I hope that the paper can be read as an internally consistent unit.

² The focus in this paper is on the internal logic of bargaining among the Western Europeans to set up systems of stable exchange rates within the EC. This perspective necessarily neglects broader issues of creating order in the international monetary system or possible alternative forms of monetary cooperation. For a comprehensive investigation of these broader issues see Benjamin J. Cohen, Organizing the World's Money. The Political Economy of International Monetary Relations, New York: Basic Books, 1977.

³ See, for example, Robert Axelrod, The Evolution of Cooperation, New York: Basic Books, 1984; Robert O. Keohane, After Hegemony. Cooperation and Discord in the World Political Economy, Princeton: Princeton University Press, 1984; Stephen D. Krasner, ed., International Regimes, Ithaca: Cornell University Press, 1983; and Kenneth A. Oye, ed. Cooperation under Anarchy, Princeton: Princeton University Press, 1986.

are uncertain about the intentions and future actions of other countries⁴ These mixed incentives can often prevent states from attaining mutual gains Much of the prevailing cooperation literature has therefore emphasized conditions and methods that allow states to overcome the constraints "mixed-motive-situations" posed.⁵ Simply said, the crucial constraint to cooperation according to this literature has been the question of enforcement.⁶ In an environment in which states have an incentive to double-cross or to free ride and in which their preferences may be uncertain, their needs to be some form of assurance that they will stick to their bargains.

Occasionally, this general logic of "mixed-motive-situations" has been applied to questions of monetary cooperation. Kenneth Oye, for example, depicts the question of competitive devaluations as one of the main problems that monetary cooperation needed to address during the inter-war period⁷ In this sense, there exists an incentive for states to "free-ride" on the cooperation of others and to set the exchange rate at a competitive level.⁸ Similarly, Robert Keohane perceives as the main constraints to international economic cooperation the problems that emerge from the Prisoners' Dilemma and related "mixed-motive-situations."⁹ Institution-building, in particular, has to overcome the problems that result from uncertainties about the intentions of other players, i.e. the problems of defections and rule enforcement.¹⁰ The analogy of "mixed-motive-situations" also captures some aspects of cooperation on financing arrangements for balance of payments problems.¹¹ One particular cooperation problem in this area is to guard against a potential "free-ride" on the availability of credit below market rates.

These represent valid considerations of problems for international monetary cooperation However, they do not help us really to get at the core of the European monetary problem. While the danger of "beggar-thy-neighbor" policies constitutes an important background variable for understanding the incentives for exchange rate cooperation, the benefits of competitive devaluations are at best short-term and can produce the negative consequences of the J-curve effect and a vicious cycle of inflation and devaluation. Thus, guarding against this type of behavior is much less urgent now than it may have been in the immediate post-World War II era. Similarly, uncertainty does not appear to be the biggest obstacle to European monetary cooperation - in particular, as long as the exchange rate remains a highly visible indicator for the

⁴ On these "mixed-motive-games" see Thomas C Schelling, The Strategy of Conflict, Cambridge Harvard University Press, 1960/1980

⁵ For critical thoughts on the paradigmatic nature of the Prisoners' Dilemma for cooperation problems in international relations see Duncan Snidal, "Coordination versus Prisoners' Dilemma Implications for International Cooperation and Regimes," American Political Science Review 79:4 (December 1985) 923-942; and Stephen D. Krasner, "Global Communications and National Power. Life on the Pareto Frontier," World Politics 43.3 (April 1991). 336-366

⁶ See also Joseph M Grieco, Cooperation among Nations Europe, America, and Non-tariff Barriers to Trade, Ithaca Cornell University Press, 1990

⁷ Devaluation issues are the primary reason for Kenneth Oye to treat monetary cooperation as a traditional collective goods problem See Kenneth A. Oye, "The Sterling-Dollar-Franc Triangle Monetary Diplomacy 1929-1937," in Cooperation under Anarchy, ed Kenneth A. Oye, Princeton Princeton University Press, 1986. 173-199

⁸ See also Robert Gilpin, The Political Economy of International Relations, Princeton Princeton University Press, 1987 147

⁹ Keohane, After Hegemony, 65-109, 141-143, 186-7.

¹⁰ For a discussion of economic policy coordination under this perspective see Miles Kahler, "Organization and Cooperation: International Institutions and Policy Coordination," Journal of Public Policy 8:3/4 (July-December 1988) 375-401

¹¹ Benjamin J Cohen, "Balance-of-Payments Financing Evolution of a Regime," in International Regimes, ed Stephen D Krasner, Ithaca Cornell University Press, 1983 315-336

policies pursued by member states.¹² With respect to the financing mechanisms, the fact that some countries will most likely be the providers - rather than the recipients - of finance assistance makes them interested in designing rules that guard against potential risks. The rules of the Bretton Woods system in this respect reflected largely the interests of the United States.¹³ And within European monetary politics, Germany - the principle creditor country - has consistently tried to keep its own risks low.

The logic of the Prisoners' Dilemma describes even less adequately a number of other issues at stake in monetary cooperation. The threat of free-riding (along the lines of "beggar-thy-neighbor-policies," for example) or persistent uncertainties over the intentions of participants would actually be counterproductive to the achievement of many cooperation goals. For example, countries cannot attain the trade or investment effects associated with exchange rate stability if they do not participate credibly in an exchange rate regime. Neither could governments hope to benefit in the area of balance of payments adjustments through free-ride. In particular, threats to pursue "beggar-thy-neighbor-policies" or persistent uncertainties over their policy intentions would make it difficult for weak currency countries to "borrow credibility" from the Bundesbank. Similarly, attempts to free-ride would not help the EC member states attain the benefits of issue-linkage to other aspects of European integration (i.e., safeguarding the CAP, the customs union or political integration). Moreover, it would be impossible to counterbalance American economic pressures through free-ride.

A monetary union poses more substantial free ride problems. Since it has only one system-wide inflation rate, a common currency distributes the effects of inflationary policies by individual governments through the whole system. This provides every participating member state an incentive to reflate. Moreover, within a monetary union uncertainty over the intentions of other member states can possibly increase because the exchange rate - now "irrevocably" fixed - cannot serve anymore as a signal for "violations" of the agreement by a participating government. The fact that a country's balance of payments no longer automatically "punishes" violations further aggravates this problem. Under these circumstances a monetary union can survive only if the member states reliably relinquish their temptations to "free-ride" through credible coordination of economic policies or if there are effective enforcement mechanisms in place to guard the monetary union against this threat.¹⁴ Thus, the analogies to "mixed-motive-situations" apply more closely to cooperation problems in a monetary union than to a pegged exchange rate system. Nevertheless, the cooperation problems introduced by this free-ride problem in a monetary union pale in comparison to the distributional issues that are at stake in negotiating the terms of an agreement to unite their currencies. In this sense, the constraints to cooperation identified in the remainder of this paper describe the most crucial issues at stake in negotiations to establish either a pegged exchange rate system or a monetary union.

These considerations, as well as the discussion in the following two sections, illustrate that the emphasis on Prisoners' Dilemma and related "mixed-motive-games" in the prevailing international relations literature provides only limited insights into the constraints that states face for successful exchange rate cooperation. The threat of a free ride or uncertainties over the

¹² This situation indicates that free-ride problems can be more pervasive in the case of a monetary union. I will return to this issue shortly.

¹³ Cohen, "Balance-of-Payments Financing."

¹⁴ This is part of the rationale for the convergence criteria and enforcement mechanisms contained in the Maastricht Treaty.

incentives of other participants are not the biggest obstacles to monetary cooperation. Instead, I contend that the distributional problems introduced by the need to establish macroeconomic consistency among the participants of an exchange rate regime represent the core constraint for monetary cooperation. The crucial negotiations in monetary politics take place over how to distribute the costs of adjustment among the participants of an exchange rate regime. This will be the subject of the following two sections.

2 The Consistency-Problem (or Standard-Setting-Problem)

Exchange rate cooperation among nations poses a consistency problem.¹⁵ Broadly speaking, cooperation to stabilize exchange rates can be successful only if member states pursue compatible macroeconomic policies. The analytical problem here is that there is no exact "measure" for macroeconomic consistency among states. The consistency requirement does not necessarily demand that all governments pursue absolutely identical macroeconomic objectives. Rather, pegged exchange rate systems as well as monetary unions can persist in the face of divergences, if the participating states tolerate the costs for adjustment.¹⁶ The EMS, for example, endured significant differences in macroeconomic conditions among its member states during its early years. And German monetary union represents a case of a monetary union that survived despite different macroeconomic conditions in both countries. Thus, the consistency requirement can be quite arbitrary and may reflect "political" rather than "economic" considerations. However, before assessing the problems of "measuring" consistency further, I will first elaborate the issues at stake in the consistency question.

Exchange rates and the problem of macroeconomic consistency

Generally speaking, the question of macroeconomic consistency concerns the whole range of monetary and fiscal policies as well as wage and price policies. However, the core of macroeconomic consistency within the European Community has been the question of inflation and policy issues related to the question of inflation rates. Even the emphasis on convergence in fiscal policies in the Maastricht Treaty (i.e. the deficit and debt criteria) reflects not merely a genuine concern over fiscal convergence but rather an interest in restricting the ability of the individual member states to distribute the costs of reflationary policies throughout the monetary union.

¹⁵ The choice of terminology may seem unusual here. What I have in mind is closely related to what others refer to as "policy coordination." However, the term "policy coordination" conventionally implies some form of explicit bargaining (and possibly compromise among negotiating parties). However, explicit coordination or bargaining are not necessarily the main solutions to the consistency problem. Rather the type of solution established within European monetary cooperation is more easily captured under the label of "standard-setting."

¹⁶ This argument illustrates that the question of macroeconomic consistency and the question of adjustment mechanisms are intricately related. To separate them as two different constraints on monetary cooperation may therefore seem artificial. This is underscored by the fact that the subsequent section of this paper will argue that the question of domestic (or internal) adjustment replicates the consistency problem. However, the crucial point of this distinction between consistency and adjustment issues is that the consistency issue introduces the problem of adjustment. Domestic policy change is only one potential form of adjustment. States can also use external adjustment (for example, a parity change) or temporary measures (for example, financing) to deal with inconsistencies. In this sense, the consistency question does not fully overlap with the adjustment problem.

The most basic economic assumption in this respect is the purchasing power parity condition (PPP).¹⁷ It states that the exchange rate equals the ratio of the respective countries' price levels. Thus, if inflation rates between countries diverge, the exchange rate must change in order to restore equilibrium between the price levels.¹⁸ In other words, if levels of inflation diverge among the members of a monetary system, they will ultimately be unable to keep exchange rates stable.¹⁹ Consequently, an exchange rate regime must have an adjustment mechanism that allows it to establish equilibrium if divergences occur.²⁰

Another economic principle demanding macroeconomic consistency is the interest parity condition. It holds that "the foreign exchange market is in equilibrium when deposits of all currencies offer the same expected rate of return."²¹ Applying this argument to the case of a fixed exchange rate regime, states have to pursue monetary policies that are consistent with each other. In other words, they cannot pursue their national macroeconomic priorities independently of each other, if they wish to keep their exchange rates stable.²²

The degree of capital mobility forms an important background variable for the interest parity logic. As asserted by Robert Mundell, governments cannot hope to achieve simultaneously the three objectives of 1) national policy independence, 2) capital mobility and 3) stable exchange rates.²³ However, one should note that the explanatory links between these three variables have different qualities. A direct causal link exists between policy independence and exchange rate stability - in other words, the logic that follows directly from the traditional interest parity condition. Simply said, states cannot hope to stabilize exchange rates if their macroeconomic policies diverge. Capital mobility, on the other hand, serves as a framing condition. While capital mobility arguably accelerates the dynamics of macroeconomic

¹⁷ The validity of PPP and the accuracy of its predictions have been subject to debate among economists. Nevertheless, PPP provides a useful starting point for a discussion of the political requirements of exchange rate cooperation. For this economic discussion see, for example, Lawrence Officer, "The Purchasing-Power-Parity Theory of Exchange Rates: A Review Article," *International Monetary Fund, Staff Papers* 23:1 (March 1976): 1-61, and Paul R. Krugmann, "Purchasing Power Parity and Exchange Rates: Another Look at the Evidence," *Journal of International Economics* 8 (August 1978): 397-407.

¹⁸ Divergent productivity growth can introduce a complication for PPP. During the Bretton Woods years Japan "compensated" the divergence that was introduced through its higher productivity growth vis-a-vis the United States through higher inflation. As a consequence the yen-dollar exchange rate could remain stable. Germany, on the other hand, never allowed this form of "compensation" for its higher productivity growth - resulting in realignment pressures on the deutsche mark. See Maurice Obstfeld, "The Adjustment Mechanism," in *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*, ed. Michael D. Bordo and Barry Eichengreen, Chicago: The University of Chicago Press, 1993, 201-256 (here 224-228).

¹⁹ This point is to some degree mute for a monetary union, because a common currency would produce one common inflation rate. However, the question of convergence in inflation rates prior to a monetary union has consistently been a contentious issue among the EC member states from the Action Programme and the Werner Report to the Maastricht Treaty negotiations. Secondly, persistent differences in fiscal policies as well as wage and price policies could create tensions within a monetary union.

²⁰ This holds true even for a monetary union. If regions of a common currency suffer from different supply or demand shocks, a monetary union must have adequate adjustment mechanisms available - such as fiscal transfers or factor mobility, see the discussion in Paul de Grauwe, *The Economics of Monetary Integration*, Oxford: Oxford University Press, 2nd rev. ed., 1994.

²¹ Paul R. Krugmann and Maurice Obstfeld, *International Economics: Theory and Practice*, New York: HarperCollins Publishers, 334.

²² The N-1 problem, of course, implies that one member of the system will be in position to pursue its policies independently. This issue will be examined later.

²³ Robert A. Mundell, *International Economics*, New York: Macmillan, 1968: 233-271.

inconsistencies, the degree of capital mobility is not of causal significance in this relationship. Even under low levels of capital mobility it is impossible for governments to maintain a stable exchange rate in the long run if macroeconomic conditions diverge.²⁴ While lower degrees of capital mobility or the imposition of capital controls allow governments to postpone adjustment - or to create breathing room until adjustment measures take effect - they ultimately cannot prevent some form of adjustment in the long run. Higher capital mobility simply speeds up the adjustment process but does not change the causal relationship that exists between macroeconomic divergences and exchange rates.

Both, the purchasing power parity as well as the interest parity condition establish clearly that an exchange rate system requires macroeconomic consistency among its participants. The politically important implication of this consistency logic is that member states need to establish a common macroeconomic standard that applies to all members of the system. Such a standard serves as a measure to assess macroeconomic consistency among the participants of an exchange rate regime. Without a standard, member states would have no reference point for consistency.²⁵

This need for consistency obviously poses a cooperation problem for states. What would be an acceptable standard for the system and how can states establish such a standard? There are two elements to this problem that need to be addressed here. First of all, as already hinted at earlier, macroeconomic divergence or convergence is difficult to assess and may ultimately be a relative, if not arbitrary, category. Thus, the member states of an exchange rate regime will ultimately "choose" a standard that reflects their various political and distributional concerns. And secondly, there exist a variety of possible methods to establish a common standard for the members of an exchange rate regime - both internal as well as external to the monetary system. The method by which a standard is set also has different distributional implications.

Consistency as a relative category

The fact that the consistency problem is ultimately a relative (or perhaps arbitrary) category has two major components. First, following the logic of the purchasing power condition, an exchange rate system could remain stable at a common inflation level of, say, 1% or 50%. Thus, the inflation target of a system reflects the choices of its members states, rather than any absolute criteria.²⁶ Both, the snake and the EMS left the question of consistency - at least in terms of its explicit rules - unregulated. This necessarily led to a situation in which the strongest country (i.e. Germany) would set the standard for the system. In the cases of the Action Programme, the Werner Report and the Maastricht Treaty, rules for macroeconomic consistency became the most important issue of the negotiations. In the first two cases, the EC member states could find no agreement. The Maastricht Treaty, however, prescribes a number of convergence-criteria for membership in EMU.²⁷ It contains a (relative) inflation target,

²⁴ Obstfeld, "The Adjustment Mechanism," 216

²⁵ The issue of standard-setting is closely related to the so-called anchor-problem in pegged exchange rate systems. The anchor-currency obviously serves as the standard of such a system. However, the argument that I develop here also applies to monetary unions, which - except for cases of an external peg - would not have an "anchor" in this sense. Thus, the term "standard" captures a broader reality.

²⁶ The term "choice" in this context does not necessarily mean a bargaining compromise. Rather as I will explain later, the "choices" of some member states may actually be severely limited, and the standard setting issue is ultimately not subject to bargaining.

²⁷ For the following see Council of the European Communities and Commission of the European Communities, Treaty on European Union, Luxembourg: Office for Official Publications of the European

namely that a member's inflation rate cannot diverge by more than 1.5% from the three countries with the lowest inflation rates;²⁸ it provides a rule for interest rates, namely a margin of 2% above those three countries with the lowest inflation rates; it poses explicit constraints on fiscal policies, namely a limit on government deficits of 3% of GNP and on overall debts of 60% of GNP, and it requires member states to have respected the normal fluctuation margins in the ERM without severe tensions for at least the last two years prior to entering EMU. These convergence criteria, however, are also quite arbitrary. Following monetarist thinking, one may wonder why convergence criteria are theoretically necessary at all. On the other hand, there may also be a plausible case for strengthening these criteria or adding others to it. A number of British policy-makers have discussed the idea of adding an unemployment criterion to the Maastricht Treaty²⁹ Some German officials push the idea of greater political union as a quasi-convergence criterion to enable the participants of EMU to "socialize" to the same economic principles³⁰

Table 1 Inflation Differentials in the early snake and early EMS (in percent)

	1971	1972	1973	1979	1980	1981	1982	1983	1984
Germany-France	0.3	0.7	0.3	6.7	7.9	7.1	6.5	6.6	5.0
Germany-Italy	-0.3*	0.2	3.8	10.7	15.9	13.2	11.2	11.3	8.4

Data Source: International Monetary Fund, International Financial Statistics, October 1993

* The negative sign indicates that the Italian inflation rate was lower than Germany's in 1971

The second element of the relative nature of the consistency-requirement is the fact that every exchange rate system can tolerate some degree of divergence. A pegged exchange rate system allows participants to change exchange rate or to finance disequilibria. The EMS of the early 1980s underscores this point. It survived despite considerable divergences between the most important players. Table 1 illustrates the substantial differences in macroeconomic conditions among France, Germany and Italy in the first five years of the EMS. The survival of the EMS is even more remarkable if one compares the situation to the conditions that existed in the early snake-period. At least in the early 1970s inflation levels among these countries deviated much less significantly - although as a lagging indicator, inflation rates tell us little about the actual policies pursued in this period, and should therefore not be overinterpreted.³¹ Despite this caveat, however, table 1 does indicate that the difference in outcomes between the snake and EMS is remarkable. The survival of the EMS constitutes a considerable political

Communities, 1992 "Protocol on the Excessive Deficit Procedure," and "Protocol on the Convergence Criteria Referred to in Article 109j of the Treaty Establishing the European Community "

²⁸ The Maastricht Treaty is not explicit as to whether this rule refers to the average of these inflation rates or the value of the third lowest - an issue that has already instigated debate between Bundesbank officials and the Commission of the EC

²⁹ Various proposals in that direction have come from Prime Minister John Major, the Chancellor of the Exchequer, Kenneth Clarke, and the Governor of the Bank of England, Eddie George; see Financial Times, February 1, 1995, February 4/5, 1995, and February 9, 1995

³⁰ On this idea of "socialization," see the interview of Hans Tietmayer, President of the Bundesbank, with the the public radio station of the state of Hesse on October 31, 1993, reprinted in Deutsche Bundesbank, Auszüge aus Presseartikeln, no. 77, November 2, 1993, p. 1-5.

³¹ As is well known, differences over policy priorities existed since the early 1960s - even if they are not fully reflected in inflation differentials at that time. The oil shock of 1973 intensified these differences significantly

achievement against the odds. The experience of the EMS shows that a pegged exchange rate regime can survive large divergences, if the participants remain politically committed to it and maintain a consensus over the legitimacy of appropriate adjustment mechanisms.

Similarly, a currency union can also survive macroeconomic divergences if the participants have sufficient adjustment mechanisms at their disposal - for example, factor mobility, changes in domestic economic policies, price and wage flexibility or fiscal transfers. Theoretically and practically, large divergences are possible. The 1990 German Monetary Union (GMU) is an example of an exchange rate regime with significant divergences among member states.³² Ultimately, however, GMU could survive only because the partners were politically committed to enduring the costs associated with these divergences and because these costs were believed to be only short- or medium-term, and that East Germany would in the long run follow the path of West Germany. These conditions do not exist to the same extent in the EC. In particular, the EC does not offer the ultimate goal of unification that provided the presupposition for GMU. Consequently, if divergences in a currency union of formally independent states become large enough to endanger the political consensus among its participants, the union will break down.³³

The conceptual problem in evaluating the requirements for consistency here is that optimum currency area theory does not specify precise thresholds for the formation of a monetary union or a fixed exchange rate system.³⁴ This situation limits the theory's predictive and prescriptive value. Thus, the determination of what constitutes consistency or inconsistency of macroeconomic policies and conditions depends ultimately on the "political" assessment of the participants. The convergence criteria of the Maastricht Treaty for EMU reflect the ultimate political character of the consistency requirement. While optimum currency area theory can be read in general terms as an argument in favor of some form of convergence criteria, economists are often hard pressed to justify the economic rationale for the EMU-rules set in the Maastricht Treaty.³⁵ Instead, it seems more compelling to understand these rules as a result of political necessities, namely the need to accommodate Germany's concerns over the costs of EMU.³⁶

All of these considerations result in the same conclusion: If there is no preexisting agreement on the appropriate standard for macroeconomic consistency, standard-setting is an important aspect of negotiations rules for exchange rate stability. Most importantly, every individual country has an incentive to preserve its own domestic standard and use it as the

³² To recall the sequence, GMU went into effect before the exact timetable for political reunification was known. At the time, it was thought that reunification would come only several years later. Favorable international developments - in particular the Soviet-German agreement of July 16, 1990 over united Germany's NATO-membership - allowed German reunification to proceed much faster.

³³ This has been the fate of all historical examples of currency unions between independent states, for example, the Latin Monetary Union or the Scandinavian Monetary Union. See Theresia Theurl, Eine gemeinsame Wahrung für Europa. 12 Lehren aus der Geschichte, Innsbruck: Österreichischer Studien Verlag, 1992, and Benjamin J. Cohen, "Beyond EMU: The Problem of Sustainability," Economics and Politics 5 2 (July 1993): 187-203.

³⁴ For an overview see: Yoshihide Ishiyama, "The Theory of Optimum Currency Areas: A Survey," IMF Staff Papers 22 2 (July 1975): 344-383.

³⁵ See, for example, Barry Eichengreen, "European Monetary Unification," Journal of Economic Literature 31 3 (September 1993): 1321-1357.

³⁶ See also Tommaso Padoa-Schioppa, The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies, Oxford: Clarendon Press, 1994: 198-200.

adequate standard for the system - rather than accepting the standard of another country.³⁷ Indeed, its distributive consequences have implied that the standard-setting issue has remained the most important obstacle for European monetary relations: should a low inflation country bear the costs of establishing consistency by inflating its domestic economy? Or, vice versa, should the high inflation country adjust through a policy of disinflation? Or can the participants meet somewhere in between? Or, finally, can they devise other strategies to deal with divergence among them - for example realignments? These questions describe the central conflict among the EC member states over exchange rate cooperation during the past thirty years. These questions have recurred in every attempt at exchange rate stabilization in Europe from the Action Programme to the Maastricht Treaty

Methods of standard-setting

The same distributive considerations emerge if one discusses potential methods for standard-setting. There are a number of possibilities for cooperating countries to establish a common standard for their exchange rate system. They can either agree on an external standard (e.g. a precious metal or an outside currency) or establish an internal standard (e.g. a currency basket or the macroeconomic standard of one participating member state). There are also various ways to combine standards. For example, the Bretton Woods System was based on a combined gold-dollar standard. The Western Europeans have occasionally debated orienting their monetary policies to the external target of the dollar, for example by assigning a specific weight to the dollar in a European currency basket. All of these possible standards imply adjustment costs for some or all of the participants of an exchange rate regime. Nevertheless, the distribution of costs can diverge considerably between these various forms of standard-setting.

a) External standards

In terms of its formal adjustment rules, the gold standard is symmetric. Since in a system of N currencies there are N prices of gold, no country is in a privileged position. All countries are equally obliged to maintain equilibrium on their balance of payments. Nevertheless, despite this formal symmetry, the actual classical gold standard functioned quite asymmetrically. London developed into the main financial center and Great Britain fulfilled the function of a lender of last resort.³⁸ In particular, the Bank of England effectively set the system-wide interest rate, thereby providing the "focal point for policy coordination."³⁹ In addition to this failure to establish real symmetry, a gold standard entails other disadvantages making it unlikely that states

³⁷ The exception here is the case in which a country intends to use an external standard to borrow credibility. Some of the success of the EMS has been attributed to the fact that the high inflation countries have used the peg to the deutsche mark as a tool for their own disinflation.

³⁸ On these issues see: Benjamin J. Cohen, Organizing the World's Money. The Political Economy of International Monetary Relations, New York: Basic Books, 1977; Barry Eichengreen, "Hegemonic Stability Theories of the International Monetary System," in Can Nations Agree? Issues in International Economic Cooperation, ed. Richard N. Cooper, et al., Washington, D.C.: The Brookings Institution, 1989, 255-298; Robert Gilpin, The Political Economy of International Relations, Princeton: Princeton University Press, 1987, 123-127; Charles P. Kindleberger, The World in Depression 1929-1939, Berkeley: University of California Press, 1973.

³⁹ Eichengreen, "Hegemonic Stability Theories," 270. For a differentiated discussion of the role of the Bank of England under the gold standard see also Barry J. Eichengreen, "Conducting the International Orchestra: Bank of England Leadership Under the Classical Gold Standard," Journal of International Money and Finance 6:11 (March 1987) 5-29.

would return to a gold standard⁴⁰ In particular, a gold standard now is often viewed as too rigid for modern economies, especially when the use of monetary policy is indicated during economic downturns Furthermore, the stability of a gold standard depends heavily on a continuous and reliable supply of gold - which would provide countries such as South Africa and Russia with powerful leverage over the monetary system

The choice of an external currency as the standard for a monetary system is similarly symmetrical as a gold standard in terms of its formal adjustment rules. In a system of N currencies there would be N exchange rates to this outside currency - for example N dollar parities of the participating European currencies. Again, this situation would leave none of the members states in a privileged position, and all participating members states would be equally obliged to maintain balance of payments equilibrium vi-a-vis the dollar. The disadvantage of this is, of course, that an external currency standard would put this outside country - the US in this example - into a privileged position and would consequently require that the member states adjust to the macroeconomic priorities of this non-member.

During the Bretton Woods years, this scenario essentially defined the context of European monetary cooperation Here the parities of the European currencies were fixed to the dollar. Thus, the question of special European monetary cooperation amounted simply to whether the EC member states could move to a system of closer monetary cooperation within the constraints of the global framework. Both the Action Programme and the Werner Report envisioned a monetary union in the context of a global fixed exchange rate system, and during its first year of operation the snake operated "in the tunnel" prescribed by the Smithsonian Agreement

After the breakdown of Bretton Woods, the question of a dollar orientation remained on the bargaining table.⁴¹ The Europeans were divided over this issue along the lines of traditional distributional concerns Italy favored a stronger role of the dollar in European monetary relations - in particular as a means for the repayment of financing assistance, - since it expected the adjustment pressures to be lower than under a pure deutsche mark-led system Great Britain also advocated dollar orientation because of its standing as an oil-exporting nation. Germany consistently rejected a role for the dollar in European monetary cooperation, because it viewed American macroeconomic policies as unreliable and as possibly forcing Germany to reflate German and French interests coincided in the sense that both viewed European monetary cooperation as a tool to counteract American pressures. This common interest certainly ruled out any formal orientation of European monetary cooperation on the dollar.

b) Internal standards

One possible internal solution to the standard-setting problem are explicit coordination, negotiated targets or some other form of compromise among the participants. For example, states could agree simply to use the average among them as the common standard. This idea was essentially behind the proposals for an ECU-based system of fluctuation margins and

⁴⁰ Within the European context it is, however, noteworthy that France remained an advocate for a pure gold standard longer than the other EC member states Two reasons seem especially to account for this: first, France did acquire significant gold reserves during the 1960s by exploiting the dollar-gold convertibility, and secondly, well aware of the fact that France would not be in a position to set the standard for the global or the European monetary system, a gold standard would at least deny such a privileged position to the United States or Germany.

⁴¹ Peter Ludlow, The Making of the European Monetary System, London Butterworth, 1982 99-102

intervention rules advanced by France and supported by other weak currency countries during the EMS-negotiations. This owed to the particular quality of the ECU as a basket currency. As a basket, the ECU would simply reflect the average performance of EC currencies and could therefore potentially reduce pressure on weak currency countries.⁴²

Another feature of the EMS that was supposed to allow for some compromise rather than asymmetric adjustment was the unlimited obligation for very-short-term financing. However, from the inception of the EMS it was evident that this rule would not allow the EMS to become a symmetric system. First, the Bundesbank - most prominently in the so-called Emminger-letter - posed limits on its own obligations for financing support.⁴³ Secondly, other countries did not have the power to enforce the rule of unlimited very-short-term intervention, which is one reason why Germany rejected the multilateralization of credit facilities and currency reserves. Proposals for a European Monetary Fund did not materialize precisely because Germany refused to compromise its own domestic priorities. Thirdly, the EMS did not impose rules against sterilization of currency intervention. This meant that even if the strong currency countries intervened on behalf of the weak currency, such intervention had little repercussions for the domestic money supply and did not lead to symmetric adjustments. Fourthly, financing support needed to be repaid, thereby itself creating limits on the ability to borrow. And fifthly, from historical experience the EMS-members knew that the same unlimited obligation for very-short-term support - except for a shorter borrowing period - had existed within the snake and had not made the snake a symmetrical system.

In a sense, a monetary union also represents a compromise solution to the consistency problem. A common currency is basically a "currency basket" of the previously independent currencies. Since the monetary union establishes one system-wide inflation rate, the average among all participants serves as the system's standard. This feature makes the rules for the pursuit of macroeconomic policies within the union and the rules for membership in a monetary union the crucial areas of distributional concerns among the bargaining partners. Consistent with its balance of payments position in the middle of Europe's monetary structure, France has consistently advocated early monetary unification without strict convergence rules and without a strong central monetary institution, i.e. a European central bank with policy-making power. These kind of rules - usually labeled the "monetarist" strategy - were ideally suited for establishing a macroeconomic compromise close to French economic priorities.⁴⁴ Germany, on the other hand, has always insisted on strict convergence criteria and a strong common policy-making institution - the so-called "economist" strategy. These rules would presumably ensure that the macroeconomic "compromise" created in a monetary union would reflect German priorities - in particular low inflation.

⁴² One of the technical problems with an ECU-based intervention system was that the weak currency countries realized during the EMS negotiations that such a system could potentially also increase pressure on them. They discussed various alternatives - for example, the fixing of the single currency weights in the basket. Ultimately, however, it became clear that Germany would not accept an ECU-based intervention system, and the weak currency countries were forced to accept this idea in the form of the non-binding divergence indicator. See: Ludlow, The Making of the European Monetary System, 158-165.

⁴³ The most useful account of this episode and the surrounding issues can be found in Otmar Emminger's own memoirs. Otmar Emminger, D-Mark, Dollar, Währungskrisen. Erinnerungen eines ehemaligen Bundesbankpräsidenten, Stuttgart: Deutsche Verlags-Anstalt, 1986, 356-371.

⁴⁴ For a definition and the description of the issues at stake see Loukas Tsoukalis, The Politics and Economics of European Monetary Integration, London: George Allen&Unwin, 1977, 90-98.

The crucial point is that so far none of these compromise-alternatives has ever been implemented in European monetary politics. Instead it was another possibility that in reality became the solution to the standard-setting issue in the snake and the EMS. This last option is simply that the domestic standard of one participant serves as the common standard. Disregarding the complexities introduced by the gold-exchange standard, the Bretton Woods system was in essence based on the central position of the dollar, and US macroeconomic policies effectively set the system-wide standard. And within European monetary cooperation it was the deutsche mark that served this function, both in the "snake" and the EMS. The reason that only this last solution to the consistency issue acquired any significance in European monetary relations, has to do with the distributive logic of the other alternatives. To choose the average or a negotiated inflation rate as the standard for the system, forces a low inflation country to reflate its domestic economy. However, if a country is satisfied with its level of macroeconomic performance, it has no incentive to accept any other standard than its own.⁴⁵ These incentives are clearly asymmetrical between the European countries. The low inflation countries have very little incentive to accept a higher level of inflation, and high inflation countries have insufficient leverage to change this incentive.

These divergent interests obviously limit the possibility of finding a bargaining-solution on issues of standard-setting. If no special circumstances obtain that compel strong currency countries to sacrifice their economic priorities, a compromise on standard-setting issues is impossible. Thus, all else being equal, the strongest actor in the system effectively sets the standard for the other members of the system.⁴⁶ In other words, if the participants of negotiations on a monetary regime cannot create a situation that induces strong currency countries to compromise their macroeconomic priorities, the issue of consistency will not be subject to bargaining. Instead, compromise must be achieved somewhere else, namely on the rules for adjustment - as I will explain later in this paper.

The history of European monetary cooperation fully supports this contention. While Germany as the principal strong currency country in Europe has always had some incentives to cooperate on exchange rate stability with its EC partners, these incentives have never been strong enough to allow Germany to compromise its domestic economic priorities. This argument even applies to the situation in the late 1970s when the incentives for Germany to stabilize exchange rates in Europe were fairly high.⁴⁷ Throughout the bargaining process over the EMS, Germany rejected any rules that would constrain the pursuit of its domestic economic objectives.⁴⁸ From the inception of the EMS-rules it was apparent to its participants that the strongest currency in the system would necessarily set the standard for the other members of the system, if no other rules were implemented to constrain the strong currency country. Thus, despite the fact that the EMS did not explicitly designate an anchor currency, the deutsche mark

⁴⁵ Note that this line of thinking is a political argument. It rests on the ability of a state to protect its own macroeconomic priorities - in this case, Germany's defense of its inflation rate target. De Grauwe, Economics of Monetary Integration, 121-123, provides the economic rationale in support of my argument. He argues that a higher inflationary level for the low inflation country implies a welfare loss, whereas a high inflation country has every incentive to aim for a lower inflation rate.

⁴⁶ This indeed provides the basis for leadership in the sense of providing a focal point.

⁴⁷ Hugo M. Kaufmann, Germany's International Monetary Policy and the European Monetary System, New York: Brooklyn College Press, 1985.

⁴⁸ For the most detailed description of the bargaining process on the EMS see. Ludlow, The Making of the European Monetary System.

emerged as the center currency by virtue of being the principal strong currency in Europe. Throughout the past thirty years of exchange rate politics in Europe, Germany has consistently refused to accept any other solution to the consistency problem than its own domestic macroeconomic standard. Effectively, Germany never allowed the question of consistency to become the subject of bargaining among the EC member states.

A very popular assertion within the literature is that the EMS was originally designed as a symmetric institution.⁴⁹ This claim, however, is unpersuasive. A symmetric system would have needed to rest on some form of compromise or procedures for explicit bargaining over policy coordination. The claim of intended symmetry ignores the fact that the weak currency countries did not succeed in imposing any rules that could have forced Germany and its strong currency allies to compromise their macroeconomic priorities. Furthermore, the symmetry-argument cannot explain why Germany would have been interested in compromise. Weak currency countries did not have sufficient leverage to obtain compromises. With respect to the issue of standard-setting, the EMS did not change any of the substantial rules that governed the snake. In other words, there was no reason to expect in 1979 that the EMS would work any less asymmetrically than the snake had between 1972 and 1979.

One possible complementary way of explaining the ability of the EC member states to deal with the consistency problem more easily in the late 1970s than during the early 1970s would be the argument that the weak currency countries were more committed to a policy of disinflation and macroeconomic convergence.⁵⁰ Such a policy shift would then in turn explain the emergence and success of the EMS, because the weak currency countries would then presumably be willing to accept the costs of following the German standard. This convergence-argument does not contradict the consistency-logic explained in this paper. Rather it can supplement it. Ultimately, the convergence-argument also views European monetary politics as an inherently asymmetric policy area. Convergence, in the sense of the high inflation countries moving closer to German priorities, is distinct from coordination through a process of bargaining.⁵¹ Convergence as opposed to coordination is a one-sided policy commitment. It does not impose an obligation on the strong partner in this relationship.

Nevertheless, five analytical problems associated with the convergence-argument indicate that a focus on distributional concerns yields a better understanding of some of the issues at stake in European monetary politics.

First of all, it is doubtful if convergence became really an important goal before 1982-3. Significant divergence continued to characterize the EMS until then. Thus, while the commitment to policy convergence can help to understand the success of the EMS in the second half of the 1980s, it provides little insight into the bargaining process over the rules that should govern European monetary cooperation.

Secondly, even if one acknowledges that the weak currency countries were seriously committed to a policy of disinflation in 1978 this is not to say that the German macroeconomic

⁴⁹ The assertion of symmetry is particularly forceful in Daniel Gros and Niels Thygesen, European Monetary Integration, London: Longman, 1992.

⁵⁰ Kathleen McNamara, "Consensus and Constraint: The Politics of Monetary Cooperation in Europe," Dissertation, Columbia University 1995.

⁵¹ This issue underscores that the usual disrespect of political scientists for coordination problems may be misplaced. At least where coordination problems involve distributive problems, it is extremely difficult to achieve real coordination. For a similar argument see Stephen D. Krasner, "Global Communications and National Power: Life on the Pareto Frontier," World Politics 43:3 (April 1991): 336-366.

standard necessarily served as the focal point of convergence. Rather, it seems more plausible to assume that most of the weak currency countries sought to establish some form of compromise somewhere between theirs and Germany's preferences. The debate over the ECU-indicator underscores this intention on the part of the high inflation countries ⁵²

This means, thirdly, that the convergence-argument cannot account for the occurrence of distributive bargaining on the part of the EC member states. If convergence was the reason for cooperation, all member states should have readily endorsed the standard set by the deutsche mark. This, however, was hardly the case. The EMS-negotiations featured significant distributional negotiations among the member states and only the successful resolution of these conflicts allowed for the founding of the EMS.

Fourthly, if convergence had really been central, there was hardly any need to negotiate a new regime for monetary cooperation in Europe in the late 1970s. The snake would have been quite sufficient to serve the purpose of convergence. This suggests, that the rules of the EMS satisfied the concerns of some of its members in ways that the snake was unable to do.

And fifthly, the convergence argument cannot explain the reemergence of the EMU-project in the late 1980s. If convergence is the goal, EMU seems hardly necessary. Rather it is more persuasive to interpret the goal of EMU as a reflection of distributional concerns over the asymmetrical adjustment burden imposed by the EMS.

My case studies will later demonstrate that distributional concerns over the issue of macroeconomic consistency have continuously characterized monetary bargaining among the EC member states from the Action Programme of 1962 to the Maastricht Treaty. They will also show that Germany and its strong currency allies have invariably rejected any compromise on consistency issues. These issues never became a legitimate subject for bargaining among the Europeans from a German perspective. This situation has historically shifted bargaining to the question of adjustment issues - to which the next section will turn.

3. Balance of Payments Adjustments

As already implied in the previous section, the need for the participants of exchange rate negotiations to find a common macroeconomic standard poses an adjustment problem. In the absence of a pre-existing agreement on an appropriate focal point for macroeconomic consistency, governments need to find methods to allow adjustments if macroeconomic conditions among the member countries diverge. While this assertion shows that the consistency problem and the adjustment problem are closely related to each other, it is crucial to treat them separately in this paper. They overlap but they are not identical issues. It is only because exchange rate cooperation requires countries to establish macroeconomic consistency that there exists an adjustment problem. There are three possible forms of adjustment: First, internal adjustment - for example a change in fiscal or monetary policies, or other means of influencing domestic wages, incomes and prices; secondly, external adjustment - most prominently exchange rate changes and less prominently other forms of controlling the flow of goods, services and money across borders, such as trade restrictions or capital controls;

⁵² Some of these different interests persisted into the negotiations over the Basle-Nyborg reforms of the EMS and the EMU-rules of the Maastricht Treaty

and thirdly, temporary measures - in particular the financing of balance of payments disequilibria⁵³

Internal adjustment

The possibility of internal (or domestic) adjustment is the obvious corollary of the argument made in the previous section about the consistency requirement. If there exist divergences between countries, one solution to the consistency-dilemma is indeed that some, or all of them, adjust their domestic economic policies to the common standard. Governments, for example, could agree on particular explicit rules that regulate domestic adjustment - for example, common inflation rate targets, specific rules for monetary or fiscal policies, or common procedures for wage and price policies⁵⁴

This idea, however, just replicates the same problem as the standard-setting issue. Low inflation countries may have little interest in compromising their domestic standard and high inflation countries may find it very costly to disinflate. Under these conditions it will be unlikely that the participants of monetary negotiations would be able to establish a compromise on rules for internal adjustment. Again the question emerges as to who should adjust, the low inflation country or the high inflation country? As argued earlier, Germany has consistently refused to allow this issue to become a subject to bargaining. Rather, the German standard was non-negotiable. Thus, if the other member states wanted to opt for internal adjustment, their only "choice" was convergence to German priorities. One of the advantages of the EMS has been that internal adjustment has not necessarily been the only form of adjustment to divergences. It has allowed for external measures (in particular exchange rates) and has provided facilities for temporary measures (i.e. financing).

Indeed, pegged exchange rate regimes in general are often flexible to exist without explicit rules for domestic adjustment. The negotiations over the rules for the Bretton Woods regime featured significant differences between Great Britain and the United States over the appropriate rules for domestic adjustment, exhibited, for example, in the Keynes- and White-plans for the post-war monetary order⁵⁵. Ultimately, the Bretton Woods System recognized the need for domestic macroeconomic flexibility and did not stipulate explicit rules for internal adjustment⁵⁶.

The European Monetary System also did not establish any explicit rules for domestic policy adjustment. This recognizes the fact that no consensual agreement existed on an appropriate standard. Domestic adjustment was - at least in terms of the explicit rules - at the discretion of the member states. On the other hand, there were other, less explicitly regulated forms to compel countries to adjust domestically. In particular, bargaining over the conditions

⁵³ Helpful discussions of adjustment issues can be found in: Cohen, "Balance-of-Payments Financing," and Michael C. Webb, "International Economic Structures, Government Interests, and International Coordination of Macroeconomic Adjustment Policies," *International Organization* 45.3 (Summer 1991) 309-342

⁵⁴ It is readily apparent that the Maastricht Treaty for EMU spells out specifically rules for the domestic policies consistent with EMU-membership. On the other hand, the EMS does not rest on such explicit rules (although there may exist implicit principles). I will later identify the reason for this difference.

⁵⁵ See Richard N. Gardner, *Sterling-Dollar Diplomacy*, Oxford: Clarendon Press, 1956

⁵⁶ This provides the basis for John Ruggie's assertion that the Bretton Woods System was based on the principle of "embedded liberalism." See: John Gerard Ruggie, "International Regimes, Transactions, and Change Embedded Liberalism in the Postwar Economic Order," in *International Regimes*, ed. Stephen D. Krasner, Ithaca: Cornell University Press, 1983. 195-231

of realignments and financing aid allowed strong currency countries to attach specific conditions on the domestic economic policies of the weaker countries.⁵⁷ These package deals usually involved some form of measure (or promise) by the weak currency country to tighten its monetary or fiscal policies. Germany, however, has never accepted domestic adjustment obligations as a result of realignment deals.⁵⁸ The only form of adjustment deemed legitimate by Germany has been external adjustment, namely the revaluation of the deutsche mark.⁵⁹

In addition to these pressures on domestic adjustment in the weak currency countries, there developed another implicit understanding of "unwritten rules" in the EMS. During the 1980s the legitimacy of the German low inflation goal increased among the other EMS-members and the incentives to converge to this standard grew. While this has largely remained an implicit consensus, the Basle-Nyborg reforms of the EMS in 1987 and the EMU-process that led to the Maastricht agreement can - at least in part - be read as an acknowledgment of the idea of and progress toward convergence.⁶⁰ Ironically, the legitimacy of the standard set by Germany declined during the early 1990s as a result of German economic policies in the wake of reunification. The high interest rate policy used to combat inflation in Germany forced high adjustment costs on the other EMS-members and helped trigger the breakdown of exchange rate cooperation in 1992-3.

In contrast to the EMS-agreement, the Maastricht Treaty does contain explicit rules for domestic policy objectives for the potential members of EMU. The above mentioned criteria for inflation rates, interest rates and fiscal policies prescribe explicit rules for the pursuit of domestic policies - although the inflation and interest rate criteria are relative, in the sense that the performance of the three countries with the lowest inflation rates constitutes the reference value. Whereas this difference in the rules for internal adjustment may seem striking at first sight, the rationale behind these peculiar features of the two systems is identical. Both, the absence of particular rules for domestic policies in the EMS and the existence of convergence criteria for EMU reflect distributional concerns of the member states. While pegged exchange rate systems allow states to shift disagreements over internal adjustment to negotiations over

⁵⁷ For an overview of these connections between realignment decisions and domestic policy measures see Horst Ungerer, Jouko J. Hauvonen, Augusto Lopez-Claros, and Thomas Mayer, "The European Monetary System: Developments and Perspectives," International Monetary Fund, Washington, D.C., Occasional Paper, 73, November 1990, 50-54.

⁵⁸ The one possible exception is the deal reached on September 12, 1992 in connection with the devaluation of the Italian lira. During the weekend-negotiations, Helmut Schlesinger, then President of the Bundesbank, promised a reduction in German interest rates in exchange for realignment. Given the circumstances of September 1992, however, this hardly amounted to a significant concession. For domestic purposes the deal was justified by the Bundesbank as allowing a reduction in the expansionary pressures of the monetary turbulences on the German money supply. Furthermore, the international financial markets viewed the actual rate reductions agreed to by the Bundesbank Council as so minimal (0.5% on the discount rate, 0.25% on the Lombard rate) and indicative of the continued uneasiness of the Bundesbank with the current situation in the EMS, that speculation continued and culminated in "Black Wednesday" three days later and the exit of the British pound and Italian lira from the system and the devaluation of the Spanish peseta.

⁵⁹ The overview in Ungerer, et al. "The European Monetary System," 50-54 underscores this adjustment logic within the EMS vividly. Whereas the weak currency countries often accepted some domestic obligations in the context of realignments, the only form of adjustment accepted in realignment negotiations by Germany has been a revaluation of the deutsche mark.

⁶⁰ The Press Communiqué issued by the Committee of Central Bank Governors describing the changes in rules refers to the goal of convergence more explicitly than the original EMS-agreement. For the text of the Basle-Nyborg agreement see Deutsche Bundesbank, Auszüge aus Presseartikeln, no 68, Sept. 23, 1987, 3.

external and temporary measures, these possibilities for adjustment do not exist within a monetary union (as I will elaborate shortly) A monetary union does not provide participants with the opportunity simply to shift the scene of bargaining over to other adjustment questions. The participants of a monetary union must establish rules for the conduct of domestic policies if some of the countries have distributional concerns. Thus, the logic of the economist-monetarist debate applies here. A monetarist strategy to EMU is only feasible, if the strong currency countries have no distributional concerns. So far, this condition has never existed within the EC. Simply said, convergence criteria for EMU have to exist in order to satisfy German concerns over an inflationary bias in the monetary union.

External adjustment

Exchange rate changes are the most important form of external adjustment to restore equilibrium on a country's balance of payments. Before explaining the significance of parity adjustments, however, it is necessary to mention briefly other forms of external adjustment. Here I am referring to trade policies as well as capital controls. Both types of policies allow governments to influence the flow of goods, services and capital across borders. Deficit countries, for example, are tempted to restrict imports to take pressure off their current account. France and Italy at various times during the 1960s and the 1970s introduced trade restrictions during balance of payments crises - mostly in violation of EC rules for the common market. Similarly, capital controls can allow governments to restrict the outflow of capital. Deficit countries have at various times introduced these controls to alleviate balance of payments deficits - even as late as the 1992 currency crisis, despite the abolition of capital controls in the single market project. For surplus countries the logic has worked the other way around. Germany has often been asked by deficit countries to implement policies that increase imports - although it has rarely heeded these requests; and it has on occasion - although reluctantly - introduced controls on capital inflows.

As indicated earlier, the significance of these two means of external adjustment has declined within the EC over the past few decades. Although trade restrictions and capital controls may provide temporary relief, they are ultimately inefficient. And more importantly, the member states have increasingly lost control over these two policy areas within the EC. Unilateral trade restrictions violate the idea of the customs union, and the single market project prohibits now the use of capital controls. Thus, exchange rate changes have become the only means of external adjustment left to the EC member states.

This feature, in part, explains the attractiveness of EMU. A monetary union removes the last instrument of external adjustment from the policy realm of the EC member states. Here, exchange rates are permanently fixed. In other words, participants of EMU forgo the possibility of external adjustment in favor of internal adjustment. The only policy instrument left to participants in a monetary union to address divergences among them are the domestic economic policies of the member states.⁶¹ This would presumably strengthen the viability of the single market.⁶²

⁶¹ My overall argument in this section refers only to policy instruments of governments. Within EMU, of course, much of the adjustment that may be necessary to address divergences is supposed to come through the market mechanism. This pertains in particular to the question of factor mobility. Although there are significant political issues involved in this question - in particular, one may ask if the EC has the political and cultural prerequisites for a high degree of labor mobility - these mechanisms are not active policy instruments of governments.

However, a pegged exchange rate system allows for alterations of parities. Thus, participants of a pegged exchange rate system negotiate with each other over the particular rules and procedures for exchange rate changes. For example, they have to determine if a country can alter its exchange rate unilaterally or if it needs the cooperation of its partners. Similarly, they must determine the central rates of currencies as well as their fluctuation margins.

These issues are mostly subject to bargaining among the participating countries. In this area, unlike the question of domestic adjustment, Germany has often accepted compromises designed to alleviate some of the adjustment costs of the weak currency countries. One of the most significant concessions was to allow Italy to use a 6% fluctuation band on both sides of the lira's central parity in the ERM, instead of the 2.5% fluctuation bands that applied to the other members.⁶³ During the operation of the snake, Germany always objected to Italian requests for larger fluctuation margins, because it feared that larger bands would compromise discipline in the snake. However, since Italy made larger fluctuation bands its most important demand for participation in the EMS and since it was apparent that Italy would require special arrangements to keep up with the strong currency countries in the system, Germany accepted this demand. Without this concession, "it seems highly unlikely that the Italian government could have entered" the EMS.⁶⁴ Furthermore, Italian participation was not only an achievement for its own sake but also alleviated French concerns of possibly entering the EMS as its weakest participant - a possibility that would have raised similar prestige issues as during the operation of the snake. The fact that this concession to Italy did not impede Germany's pursuit of its own domestic economic priorities certainly made this compromise possible.

As it turned out, the decision to allow Italy to use larger fluctuation bands is a very significant factor in explaining the survival of the EMS during its early years. The large bands allowed Italy to keep the lira within specified parameters for longer periods of time and to use devaluations only about once a year on average during the first eight years of the EMS. At the same time the larger fluctuation bands discouraged currency speculation because in the case of a realignment they allowed to fix new central rates within the margins set by the old fluctuation bands. Thus, the market rate of the lira would not suddenly "jump" to a new level as a result of a devaluation and therefore prevent currency speculators to cash in on "one-way-bets".⁶⁵

The other area in which Germany has also often granted concessions is the determination of the central parities of currencies in the ERM. The German authorities have often accepted revaluations of the deutsche mark, if the weak currency countries rejected large devaluations. Since this has mostly been a question of prestige and political psychology but has had little economic consequences, these concessions were again easy to make.

Germany's ability to influence the pegging decisions of its partner countries was also quite limited. German policy-makers perceived that the British pound entered the ERM in October 1990 at an overvalued exchange rate. Nevertheless, they had little leverage over the British decision. Ultimately, all the British decision did was to self-impose adjustment pressures and to contribute to the British ERM-exit. Again the decision had very little implications for

and are therefore not addressed here specifically. Ultimately, the functioning of factor mobility would also reflect the various domestic adjustment policies of governments and simply underscore the point made in this chapter.

⁶² Eichengreen, "European Monetary Unification."

⁶³ The Spanish peseta and the British pound, which entered the ERM in 1989 and 1990, also received 6% fluctuation bands at the time of their entry. Italy moved from the larger bands to the 2.5% bands in 1990.

⁶⁴ Ludlow, The Making of the European Monetary System, 239.

⁶⁵ de Grauwe, The Economics of Monetary Integration, 117-120.

Germany's domestic economy. And to take a similar case of parity fixing, Germany had no veto over the objections of the other member states to a revaluation of the deutsche mark following German monetary union in 1990. Despite the explicit request of Germany for a revaluation of the deutsche mark to insulate the EMS better from the costs of German reunification, the other EMS members rejected this proposal. Again Germany was forced to concede a point on questions of exchange rate changes. The consequences of this concession, however, had few implications for the pursuit of German macroeconomic priorities and were felt much more severely in the economies of the other EMS members.

Of course, alignment decisions in the EMS were subject to multilateral decision-making. Germany has always been a significant participant within this decision-making process. Nevertheless, the lack of an overwhelming German ability to influence the pegging decisions of its partner countries seems at first sight to indicate an area of weakness in Germany's otherwise powerful position in European monetary affairs. However, these behavior patterns follow quite consistently the leadership role described by the N-1 logic. As the nth currency in the system, Germany did for the most part neglect its exchange rate and pursued its domestic priorities - although the tendency of the deutsche mark to become undervalued between realignments due to inflation differentials certainly alleviated domestic concerns over the exchange rate and made "neglect" an easy policy to follow. Essentially, Germany left it to the other member states to maintain their balance of payments in line with their exchange rate commitments. Thus, even the lack of overwhelming influence over the pegging decisions of its neighbors is indicative of the strength of the German position within European monetary politics.

The logic of external adjustment described in this subsection indicates that the stability of the EMS as an institution rested to a significant degree on the legitimacy of realignments as a form of adjustment. On the one hand, a revaluation of deutsche mark has consistently been the only form of real adjustment acceptable to Germany. On the other hand, in the absence of German reflation or full disinflation of the weak currency countries, periodic devaluations had to become a legitimate tool of adjustment for the weak currency countries if the EMS as an institution was to survive. As table 2 illustrates the striking difference between the snake and the early EMS in this respect. Although the particular conditions for realignments have always remained subject to political controversies and the question as to which realignments were justified or not continued to instigate squabbles among the EMS-members, there existed a consensus among them that realignments were an appropriate means of adjustment. Both, Italy and France used devaluations vis-a-vis the deutsche mark frequently until 1983 and somewhat less frequently between 1983 and 1987 to adjust for macroeconomic divergences.⁶⁶ Similarly, Spain and Portugal chose frequent devaluations of their currencies after September 1992 as a means of adjustment - a fact that leads one to ask if Italy and Great Britain actually had a similar option, instead of leaving the EMS.⁶⁷

⁶⁶ As noted earlier, these realignments consisted to a large part of deutsche mark revaluations rather than direct devaluations of the other currencies

⁶⁷ The exit-decision of both countries remains a puzzle. In the case of Great Britain, scholars have pointed to the lacking commitment to the rules of the EMS. (See: David R. Cameron, "British Exit, German Voice, French Loyalty: Defection, Domination, and Cooperation in the 1992-3 ERM Crisis," Paper prepared for presentation at the Annual Meeting of the American Political Science Association, Washington, D C, September 2-5, 1993; and Mark Harmon, "If I Can't Change the Rules, Then I Won't Play Your Game" Britain In and Out of the Exchange Rate Mechanism of the European Monetary System," Center For German and European Studies Working paper 2 24, University of California, July 1994.) However, an attempt to generalize this argument confounds rather than solves

Table 2 Number of devaluations of the other large currencies against deutsche mark in the snake and EMS

Number of devaluations against DM	"Snake," 1972-1979**	EMS, 1979-1983	EMS, 1984-1987	EMS, 1988-1991
British pound sterling***	0	-	-	0
French franc	2	4	2	0
Italian lira	0	5	3	1*

Notes * This devaluation on January 8, 1990 is often seen as a more or less technical adjustment for the lira to move to narrow its fluctuation bands from +/- 6% to +/- 2.5%

** all three countries withdrew from the "snake" at various times to avoid devaluations

*** Great Britain participated briefly in the "snake" after its entry into the EC, it did not participate in the EMS until 1990

Source Rainer Hellmann, Gold, the Dollar, and the European Currency Systems: The Seven Year Monetary War, New York Praeger, 1979, and Gros/Thygesen, European Monetary Integration, 68

In light of this discussion, the loss of a commitment to orderly realignments and of a consensus on appropriate adjustment mechanisms after 1987 emerges as an important contributing factor for the severity of the currency crisis that erupted in 1992. Three factors in particular account for the declining legitimacy of realignments in this period. First, the EMS member states achieved significant progress toward convergence to lower levels of inflation, which indicated at least in part a shift from external forms of adjustment to internal adjustment. Secondly, international financial markets entered a phase of relative tranquility after the dollar had declined from its high level during the early 1980s, which meant that dollar developments did not trigger European monetary turmoil. And thirdly, the beginning of negotiations over a move to EMU in 1988 implied that member states rejected realignments for fear that these would be interpreted as signs that they were not yet ready to enter in a full monetary union.

This environment induced the EMS participants to reject early German requests for a revaluation of the deutsche mark after reunification. Similarly, both Great Britain and France resisted devaluations of their currencies during periods of severe turmoil in financial markets after the summer of 1992 - ultimately triggering the British ERM-withdrawal and the widening of fluctuation bands in the ERM. These developments indicated that the assumptions behind the absence of realignments between 1987 and 1992 were in reality quite ambiguous. First, while the weak currency countries had undoubtedly progressed in their convergence-efforts, inflation levels still diverged among the EMS members. Italy, in particular, accumulated a significant inflation differential in these years, and Great Britain entered the ERM during a period of high domestic inflation and at an exchange rate that was generally perceived as overvalued.⁶⁸ Secondly, dollar stability remained only a temporary phenomenon. During the summer of 1992 the dollar hit record lows against the deutsche mark, aggravating and fueling the tensions that

the puzzle. For the case of Italy, the commitment-argument would lead to exactly the opposite prediction. If political commitment is the crucial variable at stake here, Italy - one of the most highly committed members of the EC - should have stayed in the EMS.

⁶⁸ Ironically, the EMS-turmoil erupted when German inflation rates were high. In a sense, speculators attacked the "wrong" currencies. Nevertheless, the Bundesbank policy of fighting domestic inflation forced Italy and Great Britain to pursue policies that neither one of them was able to credibly maintain.

culminated in the September-crisis. And thirdly, the crisis of 1992-3 unmasked the "quasi-monetary union" of 1987-91 as a myth. As long as exchange rates are not permanently and reliably fixed in a full monetary union, financial markets can test the stability of parties. In this sense, the 1992-3 crisis expresses the failure of the EMS members to determine adequately the divergence that German reunification would introduce among them and the appropriate adjustment measure for the EMS - namely an early revaluation of the deutsche mark.⁶⁹

Thus, the institutional stability of the EMS during the first decade of its existence rested to a significant degree on the ability of the member states to use exchange rate changes as a form of adjustment. Exchange rate changes were the only legitimate form of adjustment the strong currency countries accepted for themselves, making this area for many years the ideal place where the adjustment needs of weak and strong currency countries met. It remains, of course, a matter of speculation as to how long the EMS could have survived solely on the basis of this feature. Too frequent exchange rate changes could call the very purpose of an exchange rate regime into question and may not provide a sufficient break on the "vicious cycle" of depreciation and inflation. Nevertheless, the four devaluations of the Spanish peseta and the three devaluations of the Portugese escudo between 1992 and 1995 underscore that weak currency countries can still use the instrument of a realignment for purposes of external adjustment while reaping the benefits of participation in the EMS.

Temporary Measures (Financing)

A third form of addressing divergences among the member states of an exchange rate regime cover temporary measures, in particular the financing of balance of payments disequilibria.⁷⁰ Again, the possibility to address balance of payments disequilibria through financing exists only in a pegged exchange rate system and not in a monetary union. Within a monetary union, financing falls by the wayside, because the members of a currency union cannot experience a balance of payments disequilibrium anymore with other members of the union (at least in the technical sense of a change in a country's reserve position). The question of structural aid is not the equivalent of financing facilities for the context of monetary unions. Financing facilities are an inherent element of the intervention procedures in pegged exchange rate systems. Structural aid, on the other hand, reflects the ability of the weaker countries to obtain a side-payment in the context of monetary negotiations. The purpose of structural aid is not the financing of balance of payments problems, but rather aiding the (domestic) convergence toward the common standard within a monetary union. Thus, financing can become a bargaining issue only in pegged exchange rate regimes.

⁶⁹ It is, of course, a mute point to speculate as to whether an early deutsche mark revaluation would have really prevented turmoil in the EMS. Other factors besides German reunification intervened. As mentioned, inflation differentials had accumulated over five years. In addition, the European economies went into recession at different times and the referenda on the Maastricht Treaty in Denmark and France created uncertainty over the future of European monetary cooperation.

⁷⁰ Another issue that could fit the heading of temporary measures are capital controls. I introduced them as a form of external adjustment in the previous subsection. However, since capital controls do not change the underlying economic "fundamentals," as domestic policy changes or realignments do, they can stabilize balance of payments disequilibria only temporarily. As such they may be regarded also as temporary measures. The economic literature attributes some significance to capital controls for stabilizing exchange rates in the EMS. See, for example: Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, Washington: Brookings Institution, 1994. However, since capital controls remained unilateral measures even as long as they were permitted in the EMS, they did not figure prominently as a bargaining issue among the participants.

In distinction from internal and external adjustment, financing is not truly an adjustment mechanism for balance of payments problems but rather provides a tool to ride out a temporary crisis or to buy time to allow other adjustment mechanisms to take effect. With respect to financing issues the participants of monetary negotiations need to deal with some of the following questions: Under what conditions can governments ask for balance of payments assistance? How much assistance will countries be allowed to borrow? Are the financing mechanisms bilateral or multilateral? What are the repayment conditions?

Like the issue of exchange rate changes, the rules governing financing have been subject to bargaining among the Western Europeans. During the EMS negotiations, Germany has been willing to compromise in order to address the concerns of the weak currency countries. In comparison to the snake, the short- and medium-term financing facilities were doubled. Lending periods for all facilities, including the unlimited very-short-term assistance, were prolonged. And Germany accepted the demand of the weak currency countries to use dollars or ECUs for partial repayment of financing assistance to ease the fear of draining hard currencies from their reserves.⁷¹

Originally the mutual intervention obligation became mandatory when exchange rates reached the margins of their bilateral fluctuation bands. During the Basle-Nyborg negotiations over the reform of the EMS, the strong currency countries accepted proposals for the use of the unlimited very-short-term facilities for intra-marginal interventions (although such use was not automatic but rested on the "concurrence" of the central banks involved).⁷² In the same vein, the Basle-Nyborg accord also extended the duration of very-short-term financing and enhanced the use of ECUs for the settlement of financing aid.

As with the concessions on exchange rate changes discussed in the previous subsection, none of these compromises on financing facilities hurt Germany's own domestic policy priorities. Through sterilization, the Bundesbank was in position to minimize the impact of its interventions in the system. The duration of borrowing periods or the composition of repayments also held little relevance for Germany's domestic economy. If Germany's partners needed these concessions for fear of the required adjustment costs of the EMS they were relatively painless to agree to from the German perspective.

On the other hand, Germany rejected all proposals for financing schemes that could have had an impact on its domestic priorities. In particular, it did not accept the French proposal to use the ECU-grid to determine mandatory interventions. Since this idea opened the possibility that only one currency would reach its fluctuation margin - rather than two currencies as in bilateral grids - the ECU-based intervention system could have indicated an intervention obligation solely for a strong currency country without a corresponding obligation of a weak currency country. To avoid the reflationary potential in such an asymmetric obligation, the strong currency countries insisted on the use of a bilateral grid to determine obligatory interventions.⁷³

⁷¹ For these patterns of German concessions on financing issues see Ludlow, The Making of the European Monetary System, 239-243

⁷² See the Press Communique issued by the Committee of Central Bank Governors on September 18, 1987, reprinted in Deutsche Bundesbank, Auszüge aus Presseartikeln, no 68, Sept 23, 1987. 3

⁷³ For an extensive discussion of the issues involved in the proposal for an ECU-indicator see Ludlow, The Making of the European Monetary System, 158-165

In a similar vein, the German monetary authorities never regarded the formal obligation for unlimited very-short term financing as fully binding. Since unlimited intervention could create inflationary pressures, the Bundesbank - as mentioned earlier - has kept its option open to stop interventions if they endanger Germany's domestic inflation goal. Both Finance Minister Hans Matthöfer and Economics Minister Otto Graf Lambsdorf publicly agreed that the German government would attempt to negotiate a realignment in the EMS if intervention obligations threatened domestic goals in Germany.⁷⁴ This scenario did materialize during the September 1992 crisis, when the Bundesbank approached the German government to negotiate a realignment within the ERM

A third area in which Germany resisted pressures for concessions on financing issues is the question of a multilateralization of financing facilities. In order not to lose control over the German money supply the Bundesbank has consistently refused to pool reserves among then EC member states. In particular, the proposal for the creation of a European Monetary Fund (EMF) envisioned in the EMS-agreement was never implemented, because from the Bundesbank perspective convergence of macroeconomic priorities has so far never been sufficient to warrant such a step. Even in the case of the Maastricht-process this will most likely happen only when EMU enters into its third stage. So far the Bundesbank has refused to transfer reserves to the European Monetary Institute - a possibility allowed by the Maastricht Treaty - before it becomes the European Central Bank.

Summary Evaluation of Adjustment Issues

As indicated at the outset of this section, the need to establish macroeconomic consistency among the members of an exchange rate regime poses the need for an adjustment mechanisms. There are principally three distinct adjustment mechanisms open to member states - internal adjustment, external adjustment and financing. Internal adjustment essentially replicates the logic of the consistency issue. As said earlier, it is unlikely that participants of monetary negotiations would be able to find a bargaining solution to this particular constraint on cooperation. Consistency-issues are largely non-negotiable. Pegged exchange rate systems, however, allow participants to shift bargaining to issues of external adjustment (i.e. exchange rate changes) and financing. Unlike issues of domestic adjustment, rules for external adjustment and financing are subject to bargaining.

A monetary union, however, precludes such a tradeoff between negotiable and non-negotiable issues. As indicated earlier, in a monetary union the two issues subject to bargaining - namely rules for external adjustment and financing - simply disappear. Since exchange rates are permanently fixed, partners cannot bargain anymore over the rules for parity changes. And since they are subject to a common central bank, there is no longer a need for the participants of a monetary union to quibble over the financing of balance of payments disequilibria. This impossibility to shift issues implies a severe political problem for negotiations on a monetary union. Except for side-payments and transitional arrangements, the real solution to the adjustment question in a monetary union must consist of rules for internal adjustment.

⁷⁴ See Emminger, *D-Mark, Dollar, Währungskrisen* 361-362, and Kaufmann, *Germany's International Monetary Policy* 68

Table 3 Issues for European Monetary Negotiations

	Standard-Setting Issues and Internal Adjustment	External Adjustment and Financing Issues
EMU (Action Programme)	<ul style="list-style-type: none"> - convergence rules - rules for common monetary institutions 	
EMU (Werner Report)	<ul style="list-style-type: none"> - convergence rules - rules for common monetary institutions 	
Snake	<ul style="list-style-type: none"> - dollar orientation - role of gold 	<ul style="list-style-type: none"> - terms of financing facilities - terms of repayment - fluctuation bands - rules for exchange rate changes
EMS	<ul style="list-style-type: none"> - ECU intervention system - dollar orientation 	<ul style="list-style-type: none"> - terms of financing facilities - terms of repayment - fluctuation bands - rules for exchange rate changes
EMU (Maastricht)	<ul style="list-style-type: none"> - ECB statute - convergence rules 	

Table 3 illustrates this situation vividly. Projects for monetary unions preclude negotiations over external adjustment or financing. At issue are only questions of standard-setting or internal adjustment. As argued earlier, Germany and its strong currency country allies have so far largely been unwilling to compromise on these issues. From the days of the Action Programme on, Germany has insisted on strong convergence criteria for participation in EMU and a common monetary institution modeled closely after its own Bundesbank. This position has lasted into the Maastricht-process.

Conclusion

This paper has located the constraints to monetary cooperation primarily in the necessity to establish consistency among the members states and to provide adjustment mechanisms in case that macroeconomic priorities diverge. These issues lead to severe distributional concerns of the member states. Strong and weak currency countries prefer different standards for consistency and rules for adjustment. Under these conditions it is unlikely that member states

can find a bargaining solution to the consistency question. Only the rules for adjustment can become subject to bargaining

In subsequent research I seek to examine how states can achieve cooperation under these constraints. This is obviously, where leadership becomes a significant mechanism to overcome the constraints to cooperation. Given the limitations on free-ride in the area of exchange rate cooperation, the provision of public is a much less significant function of leadership than is commonly assumed in traditional hegemonic stability theory. Rather, leadership has to fulfill two primary functions: first, the provision of a standard (or focal point) to solve the consistency dilemma; and secondly, the role of a broker to forge an agreement on consensual adjustment within the system.