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Politics and Exchange Rates: Britain, France, Italy, and the Negotiation of the European Monetary System

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ABSTRACT

When the European Monetary System was negotiated in 1978, governments in France, Britain, and Italy took very different approaches to this new international institution for coordinating exchange rate policies. The French government actively supported the creation of the European Monetary System, the Italian government entered the system but on weaker terms than the French, and the British government refused to enter the system, preferring to allow the pound to float. To explain these different policy choices, I analyze the impact of domestic politics and institutions on exchange rate policy, paying particular attention to how the organization of bank-industry relations and government instability shape policymakers' policy preferences and their abilities to implement these preferences.

There are many approaches for explaining international economic policy coordination. One characteristic most approaches have in common is their focus on inter-state phenomena, such as the distribution of power, (Gilpin, 1987; Krasner, 1976) strategic interaction among egotistical states, (Hamada, 1985) the effects of international institutions, (Keohane, 1984; Krasner, 1983) and ideological consensus among elites in different states. (Gill, 1990) Some have gone so far as to suggest that focusing on domestic politics simply cannot produce viable explanations of inter-state behavior. (Achen and Snidal, 1989, 155)

In this article I take a different approach, arguing that domestic politics and institutions fundamentally shape policymakers' preferences about international economic policy coordination, and their ability to implement coordinated policies. This sort of approach has begun to attract significant attention from scholars of international political economy and comparative politics (Evans, Jacobson, and Putnam, 1993; Putnam, 1988) While international political interactions obviously play an important role in the coordination of policies, for the cases considered here international constraints did not determine policymakers' preferences. Rather, these preferences were shaped by domestic politics and processes, and variation in these processes produced predictable cross-national variation in policy choice.

When the European Monetary System (EMS) for stabilizing exchange rates in the European Community was proposed in 1978, policymakers in Britain, France, and Italy took very different approaches to the issue. To explain policymakers' preferences, I analyze the preferences of domestic sectors and how these are structured by societal institutions. (Henning, 1994) When industrial firms are heavily dependent on bank lending, as in France and Italy, the financial and industrial sectors share common exchange rate policy preferences. But when industrial firms are less reliant on bank lending, as in Britain, each sector articulates different policy preferences. To explain policymakers' ability to coordinate exchange rate policy, I analyze how political institutions that produce unstable governments lead to less cooperation. (Simmons, 1994) When government instability is the norm, as in Italy, policymakers are less willing to implement potentially politically costly policies supportive of a fixed exchange rate.

It is these differences in societal and political institutions that explain why in 1978 France pushed actively for the creation of the EMS, Britain remained outside of the core of the system, and Italy entered the system with a wider fluctuation band. In Britain, the decision about entering the EMS was based on political and electoral considerations. Many members of the ruling Labour party, especially those with strong roots in the tradable sectors, were unwilling to contemplate abandoning monetary policy autonomy and feared that participation in the EMS would require overly restrictive monetary policies. French and Italian policymakers, while concerned about entering a system which could come to be dominated by Germany, nonetheless saw advantages in a system that would stabilize exchange rates but also would be more flexible than the earlier "Snake" of European currencies that floated jointly against the U.S. dollar in the mid-1970s. However, because of greater political instability at home, Italian policymakers had more difficulty implementing these preferences than their French counterparts, and entered the EMS with a wider fluctuation band for the lira.

The article is structured as follows. In the next section, I consider the strengths and weaknesses of international political explanations of the coordination of exchange rate policies in the EMS. I then turn to the domestic level, sketching out the preferences of economic sectors, analyzing how bank-industry relations influence these preferences, and explaining how government instability can make international cooperation more difficult to achieve. The bulk of the article consists of descriptions of the exchange rate policymaking process in the three countries. For each country, these are broken down into two analytical sections: a description of policymakers' preferences about the design of the EMS, and a description of how domestic politics, especially government stability, influenced policymakers' willingness to participate in the EMS. In the conclusion, I compare the three cases and consider alternative explanations.

International Politics and Exchange Rate Policy

In 1978, policymakers recognized that the EMS might come to be characterized by an asymmetrical distribution of the burdens of adjustment between weak and strong currency countries. Under the Snake of European currencies that floated jointly against the dollar in the mid-1970s (formally known as the European Narrower Margins Arrangement), Germany set its monetary policy independently, and other participants chose between (1) sacrificing monetary policy autonomy by fixing the exchange rate for a period, or (2) retaining monetary policy autonomy by allowing the exchange rate to float. (Cobham, 1991; Fratianni and von Hagen, 1992) Because of its large economy, strong currency, and devotion to low inflation, Germany had the greatest influence over monetary policy in the Snake and faced less pressure than other participants to adjust its macroeconomic policies. Because of this, British, French, and Italian policymakers in 1978 advocated a regime that would distribute the burdens of adjustment more equitably. All three countries had withdrawn from the Snake during the 1970s because of the constraints it imposed on macroeconomic policy.

Despite this history of asymmetry in European exchange rate policy coordination, policymakers did have reasons to attempt to stabilize exchange rates. First, floating exchange rates may be subject to destabilizing speculation and overshooting, (Dornbusch, 1976) which can have negative consequences for stable interest rates, the management of foreign exchange reserves, and investor confidence. Second, while unexpected depreciation increases the competitiveness of domestically-produced tradable goods, it also increases the prices of imports, threatening a "vicious circle" of depreciation and inflation (Loriaux, 1991). Policymakers in the three countries considered here experienced both of these problems during the mid-1970s. Finally, participating in an exchange rate regime could enable French, British, and Italian policymakers to extract concessions over the rules of the regime from Germany.

Understanding the international politics of exchange rate policy demonstrates that France, Britain, and Italy had similar interests compared to Germany during the negotiation of the EMS. However, these common systemic interests did *not* lead to similar preferences about coordinating exchange rate policies. In 1978, British, French, and Italian policymakers were all interested in creating a regime more symmetrical than the Snake. However, once German opposition to this idea became clear by September 1978, the French and Italians essentially acquiesced to a system that would remove some of their short-term monetary policy autonomy, while the British refused to do so. International constraints, in this case the potential dominance of German monetary policy, only defined the outer limits of policy makers' options; they do not explain why they made different choices. This requires an examination of how domestic politics and institutions influence policymakers' preferences. (Moravcsik, 1993)

Domestic Politics and Exchange Rate Policy

According to Frieden (1991), economic sectors have identifiable preferences about both the level (appreciated or competitive) and stability of the exchange rate. Producers of tradable goods, such as industry, strongly prefer a competitive exchange rate that reduces their prices compared to those of foreign competitors. Tradable producers also prefer exchange rate stability to facilitate long-term planning for investment and future demand. Producers of non-tradables, such as most services, prefer an appreciated exchange rate to reduce the domestic currency prices of imports. However, they oppose permanently fixed exchange rates, which limit policymakers' ability to adjust macroeconomic policy over the domestic business cycle. Since producers of non-tradables do most of their business domestically, their preference for macroeconomic autonomy is likely to outweigh their preference for an appreciated exchange rate. The financial sector's international orientation determines its preferences. If it is oriented primarily towards domestic finance, its preferences should match these of non-tradable producers. However, if it is heavily oriented towards international finance, it should favor exchange rate appreciation to promote overseas investment, and stability to reduce currency risks.

Aggregate data do not provide much support for this sort of sectoral explanation of policymakers' support for the EMS. There was little difference in the countries' trade dependence on the European Community, indicating that the impact of changes in exchange rates on tradable producers would be roughly the same in the three countries. In 1979, exports plus imports to the EC as a percentage of gross domestic product (GDP) were 19.4% for France, 20.1% for Britain, and 20.8% for Italy. (Calculated from *European Economy* 55 [1993], 145, 149) A rough measure of the financial sector's international orientation is banks' foreign assets as a percentage of the money supply. These data show dramatic differences across the three countries. In 1978, foreign assets as a percentage of the money supply were 19.3% in France, 8.5% in Italy, and 188.7% in Britain.[1] According to the hypothesis that countries with internationally-oriented financial sectors would be more interested in fixing the exchange rate, these data would predict that Britain, not France and Italy, would have been most interested in stabilizing exchange rates.

To supplement this sectoral approach, I focus on how the position of the financial sector in the domestic economy influences its exchange rate policy preferences. The crucial element here is the nature of the financial system, which may be classified as either credit-based or capital market-based. (Zysman, 1983; see also Gerschenkron, 1962; Kurth, 1979) In countries with credit-based financial systems such as France and Italy, the relationship between banks and industry is interdependent. Industrial firms rely on banks for a larger proportion of their financing needs, while banks must ensure that their industrial clients remain profitable and can repay their loans. Consequently, banks come to share industry's preferences for stable and competitive exchange rates. In countries with capital market-based financial systems such as Britain, banks and industry are much more autonomous. Industrial firms rely on banks primarily to finance short-term operating expenses, but draw on bond and equity markets for long-term finance. Banks have few direct stakes in the fortunes of individual industrial firms, and thus banks and industry hold independent preferences about exchange rate policy. (Henning, 1994, 29–31)

These differences in the ways sectoral preferences are aggregated have important implications for policy. When banks and industry share common preferences, policymakers are faced with a broad and cohesive set of preferences for competitive and stable exchange rates. When banks and industry have different preferences, policymakers are confronted with relatively weak and conflicting preferences. Their policy response is likely to be based on short-term partisan and electoral considerations, and they are likely to be hesitant about committing themselves to a fixed exchange rate.

There were significant differences in securities markets and corporate finance practices in Britain, France, and Italy in the 1970s. British

TABLE 1: *Financial Intermediaries' Share of Claims on the Non-Financial Sector, 1975*

Type of Intermediary	*Britain*	*France*	*Italy*
Central Bank	5.2	4.1	19.8
Deposit-Taking Institutions	48.4	48.3	47.7
Long-Term Credit Institutions	21.4	32.9	29.9
Investing Institutions	24.4	9.3	2.6
Other Financial Institutions	0.6	5.4	–

Source: Vittas, 1978, 5.

securities markets were much deeper than those in France and Italy, indicating that British firms more often financed investment by selling debt directly to savers. In 1975, the nominal value of equities at market value in Britain amounted to 41% of GDP, but only 11% of GDP in France and 7% of GDP in Italy. Similar differences existed in the bond market: The nominal value of bonds as a percentage of GDP was 43% in Britain, compared with 16% in France and 65% in Italy (Data is from Vittas, 1978, 30. Note that the Italian figure for bond market capitalization is inflated because it includes bonds issued by long-term credit institutions to finance lending to industry; many of these bonds are in turn bought by commercial banks. See Vittas, 1978, 136).

Table 1 summarizes the allocation of claims of various types of financial intermediaries on the non-financial sectors in the three countries. While the shares of deposit-taking institutions, such as commercial and savings banks, were broadly similar across the three countries, clear differences existed for long-term credit institutions and investing institutions. Long-term credit institutions have about 50% more of the claims on the non-financial sector in France and Italy than they do in Britain, indicating that more financial institutions in France and Italy have substantial interests in the long-term viability of industrial firms. Conversely, investing institutions such as pension funds take a much larger share of claims on the non-financial sector in Britain than in France and Italy, primarily in the form of their securities portfolios.

TABLE 2: *Sources of Corporate Finance, 1971–75*

Source	*Britain*	*France*	*Italy*
Internal Funds	64	45	41
Capital Transfers	4	–	–
New Issues of Securities	5	11	10
Loans	27	44	49

Source: Calculated from Vittas, 1978, 52, 131, 167.

Table 2 describes the sources of corporate finance in the three countries in 1975. Two important differences emerge from this data. First, British firms met a much larger percentage of their financing needs from internal savings than did French and Italian firms. Second, French and Italian firms were much more dependent on loans than their British counterparts.

To summarize the argument to this point, the interdependence of banks and industry in countries with credit-based financial systems leads the financial community to share the preferences of its industrial clients. This makes policymakers in countries such as France and Italy more interested in managing the exchange rate. But their ability and willingness to maintain an exchange rate policy supported by consistent monetary and fiscal policies depends on government stability. When governments are unstable, as in Italy, many relatively small groups – such as labor unions or parties in government coalitions – can block anti-inflationary policies by threatening to withdraw support from the government. This reduces policymakers' willingness to implement the macroeconomic policies required to maintain a fixed exchange rate. Policymakers have little incentive to try to push through macroeconomic policies that would support an exchange rate policy but could also lead to their removal from office. (See especially Simmons, 1994; see also Grilli, Masciandaro, and Tabellini 1991; Walsh, 1994)

Different political institutions produced differences in government stability in France and Italy, the two countries in this study that participated in the EMS. The French president is directly elected to a renewable, seven-year term, and is not dependent on parliamentary support to remain in office. While the president can remain in office and influence policy, particularly foreign policy, without a parliamentary majority, he or she of course prefers parliamentary support. The point is that the president is less vulnerable to parliamentary defections. (Wilsford, 1989) Additionally, the French president's "power of dissolution is his key weapon against a hostile parliamentary majority". (Suleiman, 1980, 101) The Italian prime minister depends on the support of parliament to remain in office. The prime minister's primary political goal is to maintain this support. However, this task is complicated by the nature of the party system. With a highly proportional electoral system during the period covered by this study, the Italian electorate has not given one party a parliamentary majority since the 1950s. The result has been coalition governments consisting of numerous parties, or minority governments that depend on the support of other parties. In either case, the government is vulnerable to the defection of any of the coalition parties or factions. (Hine and

Finocchi, 1991, 79–80) The consequence is that Italian policymakers are less willing to implement the politically and economcially painful policies required to support fixed exchange rates, since they are unlikely to remain in office long enough to enjoy any of these policies' political benefits. (Di Palma, 1979)

French policymakers also have more direct control over many policy instruments. French governments exert significant control over the budgetary process, allowing them to coordinate fiscal and monetary policies to bring down inflation. In Italy, the process is very different: Parliamentary parties battle over the allocation of budgetary resources to favored programs, and consequently give little attention to the overall level of spending and its relation to macroeconomic policy goals. (Della Scala, 1988) Most of the macroeconomic burden of adjustment falls on monetary policy in Italy. (Walsh, 1994)

Domestic Politics and the Negotiation of the EMS

In the remainder of the article, I describe and compare the political environments facing French, British, and Italian policymakers when the EMS was proposed and negotiated in 1978. The article is structured according to the theoretical framework outlined above. It beings with a brief description of the background to the negotiations, including a description of German policymakers' motivations for participating in the EMS. The bulk of the analysis is devoted to the domestic politics of the EMS in France, Britain, and Italy. For each country, I describe the policy preferences of policymakers about the EMS proposal and the dynamics of domestic political negotiations and conflicts.

The Negotiation of the EMS: A Brief Overview

Although a full account of the creation of the EMS is beyond the scope of this study, a brief outline of the negotiations is in order. In October 1977, European Community Commission President Roy Jenkins publicly called for closer coordination of exchange rate and other economic policies within the EC, and initiated discussions among EC foreign ministers. (Jenkins, 1989, 432) His proposals were largely ignored until the meeting of the European Council of heads of state and government in Copenhagen in April 1978, when West German Chancellor Helmut Schmidt proposed the creation of a "zone of monetary stability" in western Europe. Two months earlier, Schmidt had informed Jenkins and French President Valéry Giscard d'Estaing that he intended to advocate a regional exchange rate regime after the March legislative elections in France, and in early April he and Giscard agreed to push for the creation of the EMS. (Ludlow, 1982, 63) In his proposal for a formal exchange rate regime, Schmidt also envisioned (1) the creation of a European Monetary Fund to take over existing swap agreements among EC central banks, (2) the pooling of some official reserves, (3) greater use of EC currencies rather than the U.S. dollar for intervention, and (4) greater use of the European Unit of Account to settle positions among EC central banks, with the aim of making it a new composite reserve asset. (*Le Monde*, 11 April 1978, 5) At the Copenhagen European Council summit in April 1978, Schmidt, French president Giscard, and British prime minister James Callaghan agreed to appoint personal advisers to discuss the issue in secret. (Ludlow, 1982, 91–4)

Schmidt's motivations included dissatisfaction with the Carter administration's handling of U.S.-European relations in general and U.S. international monetary policy in particular. Recent depreciations of the U.S. dollar and of a number of European currencies against the deutschemark threatened the competitiveness of German exports. To limit Germany's exposure to U.S. policy mistakes or changes, Schmidt chose to further European integration, which could help maintain the stability of the deutschemark with Germany's EC trading partners. (Carr, 1985, 139–40; Kennedy, 1991, 60–3; Schmidt, 1989, 265–6; Story, 1988, 397–412)

Schmidt's initiative was also aided by developments in the foreign exchange markets in 1978. The British pound, the French franc, and the Italian lira all experienced significant depreciation in the mid-1970s. By 1977, these large downward movements had removed most of their real over-valuation against stronger currencies, especially the U.S. dollar. In 1978, their real exchange rates were stable throughout most of the year, although they experienced (relatively small) nominal depreciation against the deutschemark and Swiss franc. Speculative pressures against all three currencies developed in October and November 1978, and in response all three governments tightened monetary policy by raising interest rates. But in comparison to 1975 and 1976, the foreign exchange markets were relatively calm, making consideration of the EMS much easier for policymakers. Similarly, by 1978 inflation rates in the three countries had begun to converge; the annual percentage change in consumer prices in 1978 stood at 8.1% in Britain, 9.7% in France, and 12.1% in Italy, and governments in all three countries had recently made lower inflation and macroeconomic stabilization the primary goals of economic policy.

The next major step came at the European Council meeting in early July 1978 in Bremen, where Schmidt and Giscard persuaded the other EC leaders to formally consider establishing the EMS by the end of the year. The essential elements of their proposal were: (1) that the EMS "be at least as strict as the Snake", and be supported by convergence of macroeconomic policies in countries with both strong and weak currencies, (2) changes in parities would be subject to mutual consent, (3) the creation of a new unit of account by pooling some reserves, the ECU, for settlement between EC central banks, and (4) the creation of a European Monetary Fund within two years of the start of the EMS.

Technical discussions over the exact structures and functions of the EMS were held during the summer and fall of 1978. During these negotiations, the French, British, and Italians pressed for a system based on a divergence indicator, rather than a parity grid, that would distribute the burdens of adjustment more equally between countries with strong and weak currencies. This innovation eventually was rejected because of strong German opposition.[2] (Ludlow, 1982, 239) In October 1978, after the annual Labour party conference, British Prime Minister Callaghan decided against taking Britain into the EMS. During negotiations at the European Council meeting of December 1978, Giscard threatened to scuttle the system unless provisions dealing with agricultural trade in the EC were changed, and Italian prime minister Andreotti briefly threatened not to participate in the scheme because of insufficient resource transfers. These difficulties were resolved in early 1979, and the EMS, including the exchange rate mechanism (ERM) of fixed exchange rates, began operation on 13 March 1979, with France and Italy as members of the ERM and Britain opting out.

France

Policymakers' Preferences

Throughout the negotiations, the goals Giscard articulated regarding the EMS were based on a long-held interpretation of France's changing international position. One of his central preoccupations was that French economic and political power should match that of West Germany; this was "a theme to which he [returned] constantly, almost obsessively, in his speeches". (Frears, 1981, 106) France, Giscard stated, must be the equal of Germany within the EC to secure French influence over European politics. As he put it in an interview in October 1978, "Why do I talk so much about Germany . . .? Because it would not be a good idea for Europe to be dominated by one country . . . What I want France to achieve is to make sure that there are in Europe at least two countries of comparable influence, . . .

Germany and France". (quoted in Ludlow, 1982, 200) Becoming the economic equal of Germany required that France increase its exports, especially of high value-added goods, and reduce inflation. (Giscard d'Estaing, 1976, 123–4, 128–9; Ludlow, 1982, 200) Giscard feared that France's international position was threatened by a collapse of the value of the franc and an inflationary spiral which could harm the country's competitiveness. (Goodman, 1992, 126)

Between the collapse of the Bretton Woods system and the negotiation of the EMS, Giscard had twice brought France into the "Snake" of European currencies, but on both occasions was forced to withdraw after a short period. The primary reasons for these failures at monetary policy coordination were persistently high levels of French inflation, which put constant downward pressure on the franc, and the fact that the Snake laid most of the costs of adjustment on weak currency countries such as France.

When Jenkins made his proposals in the fall of 1977, Giscard was interested in promoting French economic convergence with Germany, but was hesitant about participating in a regime which resembled the Snake. (Statler, 1979, 214–5) Instead, he preferred an arrangement which would not only bring about economic convergence with Germany, but also could allow France some influence to soften the impact of disinflationary policies necessary to maintain the franc's position in the EMS. (Giscard D'Estaing, 1988, 141–3) From this perspective, the EMS proposal had a number of advantages over the Snake, including: formal rules requiring that realignments be negotiated, which would reduce the necessity for countries to choose between withdrawal or sharp disinflation; the use of a divergence indicator which could control the rise of the deutschemark; and balance-of-payments financing made available to members. (Giscard d'Estaing, 1988, 141–3; Loriaux, 1991, 251; Statler, 1979, 214–5)

Domestic Politics

By early 1978 Giscard clearly was committed to a new monetary arrangement in western Europe. An important reason for his acceptance of Jenkins' proposal was the desire to reinforce his government's anti-inflationary program under the direction of Prime Minister Raymond Barre. Barre had been appointed by Giscard in August 1976 with an explicit mandate to improve the balance of payments, reduce inflation, and increase profits. The government's *Plan Barre* provided for price and wage freezes, money supply growth targets, increased interest rates and taxes, and incentives for greater investment. (Frears, 1981, 135–6; Goodman, 1992, 119–22)

The government faced an early constraint on its economic policies and approach to the EMS in the form of parliamentary elections scheduled for March 1978. Following setbacks in local elections in the mid-1970s, it was widely expected that the ruling coalition of the *Rassemblement pour la République* (RPR), led by Jacques Chirac, and the *Union pour la Démocratie Française* (UDF), affiliated with Giscard, would lose the 1978 election to the alliance of the Socialist and Communist parties. Although the *Plan Barre* was not meeting its declared economic goals, the government's fear of losing the parliamentary election persuaded Barre not to further increase the restrictiveness of the program. (Goodman, 1992, 123; Ludlow, 1982, 82–4)

As events turned out, the left lost the elections, and the RPR-UDF alliance won a majority of 89 seats in the National Assembly. What was more significant was the distribution of seats within the right-wing alliance. The RPR remained the largest party in the legislature, but still lost 20 seats. Giscard's UDF, in contrast, made significant advances. As a consequence, the government gained a certain amount of legitimacy to continue its disinflationary policies, and greater freedom to begin serious negotiations on the EMS. The victory of the right, and in particular of the UDF, also may have been important in persuading Schmidt to proceed with his monetary ideas, since he now knew that the Barre government would remain in office and continue its disinflationary policies. (Ludlow, 1982, 84–5)

While Giscard's freedom of maneuver at the European level was increased by the results of the 1978 election, as the negotiations over the EMS proceeded he still faced domestic opposition to the scheme and to his government's economic policies. However, this opposition was not strong enough to overcome his commitment to completing the EMS.

Unlike Callaghan in Britain, Giscard did not face serious opposition to his policies from within his own cabinet. Any differences between Giscard and Prime Minister Barre were relatively minor, and the Prime Minister had the full and public support of the President. (Wright, 1984, 17) Although the government was reshuffled in 1977 after the left's victory in local elections, this was not a response "to the electorate's verdict on economic policies" but instead aimed at strengthening *Giscardien* control over economic policy. (Formesyn, 1984, 223) Economic policymaking was highly centralized, with Barre serving until after the 1978 elections as both Prime Minister and Finance Minister, with close input from the President. (Frears, 1981, 137)

Serious negotiations over the EMS began soon after the French legislative elections, culminating in the agreement reached at the

Bremen summit in July, followed by technical negotiations. However, Giscard still faced two domestic challenges before the EMS could come into existence. The first was increasing opposition from his nominal allies in the National Assembly, the RPR. The second came from agricultural interests in France, which feared that the EMS would harm their products' competitiveness in the European market. But with the parliamentary elections safely out of the way, Giscard was able to deal with these challenges rather easily.

After mid-1978, RPR leader Chirac began criticizing Giscard's economic and European policies, in the hopes of increasing the RPR's popularity after its relatively poor showing in the 1978 election. The RPR was responsible for rejection in the National Assembly of some important government legislation. However, the RPR was reluctant to bring down the government for fear of provoking another round of parliamentary elections. Divisions between the RPR and UDF were to increase over the next two years as the two parties' 1981 presidential candidates, Giscard and Chirac, sought to distinguish themselves from the other in the eyes of the electorate.[3] As time progressed Giscard, in particular, was careful not to offend important domestic interests. (Goodman, 1981, 125) However, while the EMS was being negotiated, Giscard was still relatively unconstrained at the domestic level because of the RPR's unwillingness to suffer the criticism that would accompany withdrawing support from the government. (Ludlow, 1982, 201–2)

Giscard's second major problem dealt with the impact of the EMS itself on French farmers. The agricultural lobbies feared that for technical reasons the EMS would unfairly raise the price of French agricultural goods within the European Community to uncompetitive levels. The RPR scheduled a debate on this issue in the National Assembly in mid-December 1978, hoping to exploit the discontent of the agricultural community. In the preceding two weeks, the RPR also announced that it would not participate in a joint list with the UDF for the upcoming first direct elections to the European parliament, and voted with the Communist party to prohibit the use of EC funds for publicizing the elections.[4] In response, the government took a hard stand in the negotiations over this issue within the European Council, threatening to abandon the EMS project and eventually delaying its implementation by over two months. While Barre denied in a meeting with Jenkins in December 1978 that the government suddenly had lost interest in coordinating exchange rate policies through the EMS and was using the agricultural issue as an excuse to scuttle the scheme,[5] he and Giscard pressed hard in private and public for the interests of French farmers. (Formesyn, 1984, 226)

While these actions were no doubt motivated in part by a desire to quiet the outbursts of the RPR and farmers, Giscard was also interested in attracting some of these groups to his camp by making public demonstrations of support for their interests. (Ludlow, 1982, 201–2)

Britain

Policymakers' Preferences

The British government's attitude toward the EMS was heavily conditioned by recent experiences with exchange rate policy, the impending general election, and divisions within the ruling Labour party over economic policy in general and EC policy in particular.

James Callaghan was Chancellor of the Exchequer during the devaluation of 1967, and had become Prime Minister shortly before the sterling crisis of 1976. During this latter crisis, the government's attempts to induce a small drop in the value of the pound got out of control and the government was forced to turn to the International Monetary Fund for assistance. These experiences had "made him [Callaghan] sensitive to the difficulties facing the pound and much more aware of the problems which exchange rate fluctuations and large flows of capital from one reserve asset to another could cause."[6] Similarly, the Treasury had been jarred by the 1976 crisis, and "was disenchanted with floating exchange rates and naturally saw the immense advantages of currency stability as correspondingly more attractive".[7]

Despite these advantages, the government did express serious reservations about the EMS early during the negotiations. The Treasury, including Chancellor Healey, was concerned that participation in a regime similar to the Snake would artificially prop up sterling at unrealistic levels and require high interest rates. This could lead to an increase in unemployment and a trade-union split with the government, factors which eventually brought down the Labour government.[8] (Healey, 1989, 439) These concerns led the British to push during the summer of 1978 for significant resource transfers from other member-states, a more symmetrical distribution of adjustment between countries with weak and strong currencies, and an emphasis on economic growth over exchange rate stability.[9] In addition, Callaghan earlier had proposed policy coordination within the Group of Seven (G-7) countries, with the aim of persuading Germany to adjust through reflation. The G-7 forum had an advantage over the EC from this perspective, since it would allow the UK to ally with the United

States and increase pressures on Germany to reflate. (*The Times*, 17 April 1978, 19; Ludlow, 1982, 109–10)

Domestic Politics

It was widely expected in British political circles that Callaghan would schedule a general election, due by the latest in 1979, for the fall of 1978. The reasons for this speculation were that the economy seemed to be picking up, and the election would roughly coincide with the annual Labour Party conference, allowing the leadership to mobilize rank-and-file support. However, Callaghan informed the Cabinet on 7 September 1978 that a general election would not be held until 1979. He hoped that the economy would continue to improve during the new year, and felt that it was worth waiting to appeal to the electorate since the government did not have a Labour majority in Parliament, and not only had to hold marginal Labour seats but also to win seats from the Conservatives and Liberals. Polls published at the time showed the Conservatives with a small lead, and Callaghan did not wish to risk an election in this environment. (Holmes, 1985, 129–34)

Callaghan's decision to delay the general election effectively made him a captive of intra-Labour party struggles over the EMS. Callaghan had a number of signals that any attempt to join the EMS would provoke rebellion among Labour back-benchers, threatening the position of a government in a precarious position in the House of Commons.

By early 1978, Callaghan's domestic political situation was strengthened momentarily by two developments. The first was the moderate improvement in the performance of the British economy beginning in late 1977, as the balance of payments improved and inflation began to drop. While problems still existed, such as low growth, Callaghan actively touted his economic policy successes. (Ludlow, 1982, 80–1) In the Spring of 1978, Chancellor Healey's budget, with a focus on economic reflation to secure political support from Labour's left wing, was approved by Parliament. (Holmes, 1985, 118) Second, Callaghan's position within Parliament was strengthened by an alliance between the ruling Labour party and the Liberals, which guaranteed the government a working majority. Callaghan negotiated the "Lib-Lab pact" in March 1977 prior to a vote of confidence, which the government duly won by a margin of twenty-four votes; if the Liberals had not supported the government, it would have fallen.[10]

Yet the government was still vulnerable to intra-Labour party divisions over Europe and other issues due to its precarious position in the Commons. Callaghan secretly decided against British participation in the EMS after the Labour party's annual conference in early October 1978, which revealed strong opposition to British entry. At the meeting of the Labour Party's National Executive Committee (NEC) on 1 October 1978 to consider motions for the upcoming party conference, a motion "denouncing and rejecting the EMS" passed by a vote of 16 to 9.[11] At the party conference, party members opposed to the EMS failed to force a vote on this motion, but their efforts revealed enough hostility to the EMS to persuade Callaghan that he could not count on the support of his party on this issue. (*The Times*, 7 October 1978, 2) In mid-November 1978, over half of back-bench Labour MPs signed a motion opposing "any attempt by the EEC, its institutions or its member states to assume control of domestic policies through a new monetary system for the Community." The sponsors of the motion claimed that many more Labour MPs, and half of the non-Cabinet members of the government, supported their position. (quoted in Ludlow, 1982, 220–1; for details on conflicts within the cabinet, see *The Times*, 24 October 1979, and Benn, 1990, 376, 384) By late October, the Trade Unions Congress informed Callaghan and Healey that it opposed the EMS as well. (*The Times*, 31 October 1978, 1) The prime minister avoided formal Cabinet discussions of the EMS until early November 1978 because he knew that the Cabinet was divided on the issue. Until then, only a few close advisors knew that Callaghan had already decided against entry. (Ludlow, 1982, 219) When the issue was discussed, a clear majority of the cabinet, including Chancellor Healey, was opposed to British participation on the grounds that it would slow growth and require high interest rates. (*The Times*, 3 November 1978, 25; *The Times*, 4 November 1978, 2)

In his memoirs, Callaghan writes that he was "sympathetic to the general proposal" of the EMS, but was worried about the political consequences of full participation in the EMS. Callaghan continued:

> I favored the general idea as likely to bring more order into the currency markets of Europe and the world, but quite apart from my technical concerns I could not travel fast. Many people in the Labour Party remained suspicious of what they thought was too close an entanglement with Europe, and this, coupled with my own and the Treasury's belief that sterling was standing too high to make our entry advantageous, led me . . . to tell Schmidt and Giscard that we could not enter the European monetary scheme at the outset. On the other hand, I publicly welcomed the scheme in principle, and when it was finally set up the Cabinet agreed to a number of steps to associate Britain with the development of a European Currency Unit (ECU).[12]

Thus while Callaghan feared the domestic political consequences of British membership in the EMS, he was also concerned to prevent

Britain from being locked out of future European and international exchange rate initiatives. (Owen, 1987, 116–18; Ludlow, 1982, 224, 226) After the decision not to join the EMS, the government announced that it would not pursue a policy of competitive depreciation, but instead would stabilize the pound against the currencies of its major trading partners. The government favored maintaining the pound's value to prevent destabilizing speculation and to lower inflation.[13]

Italy

Policymakers' Preferences

Like their counterparts in Britain and France, by 1978 Italian policymakers were disenchanted with floating exchange rates. Floating exchange rates, they felt, did not allow an effective insulation of domestic economic policy from international developments, and rapid and uncontrolled depreciation could increase inflation.[14] Italian participation in the EMS could limit depreciation of the lira and help control domestic inflation. There was also the fear that failure to participate in the EMS would be a political disaster for Italy's international position. As Renato Ruggiero, foreign ministry official and charged with the oversight of the EMS negotiations, put it: "If we did not participate in the EMS, this would show that we are unwilling to accept the challenge . . . of being a fully European country".[15]

While the government's general attitude toward the EMS was positive, it did not wish to see emerge a system which placed too great an external constraint on its economic policy. In particular, it did not want a system which was as stringent as the Snake of the 1970s, from which Italy had been forced to withdraw after a short period. Instead, as early as July 1978 the government pushed for a more symmetric system, in which obligations to intervene in the foreign exchange market and to change economic policy would be more equally divided between countries with strong and weak currencies. This included the abandonment of the Snake's parity grid, the use of an effective divergence indicator, increased mechanisms for extending credit among central banks, and wider fluctuation bands. (Spaventa, 1980, 72–3, 77–9; Ludlow, 1982, 148–151) In addition, the government pressed for an increase in the EC budget to finance greater funding of regional policy, and a reform of the European Community's Common Agricultural Policy (CAP) to provide more assistance to Mediterranean producers. (Spaventa, 1980, 80–1; Ludlow, 1982, 187)

Most of these demands were not met. On 14 November 1978, the committee of EC central bankers granted Italy a wide +/−6% fluctuation band, but refused to widen the system's bands beyond +/−2.25%, and expressed little interest in the more flexible system advocated by the Italians. Treasury minister Pandolfi pressed for an increased EC budget, more regional funds, and some reform of the CAP at a meeting of economic and finance ministers on 21 November 1978, but his counterparts gave him little support. (Spaventa, 1980, 30–1) At the Brussels summit in December, most of Prime Minister Giulio Andreotti's remaining demands were not met by the other heads of state and government.[16] Andreotti, along with Irish prime minister Lynch, announced a week-long "pause for reflection" because of their failure to secure additional resource transfers, but on 12 December 1978 Andreotti announced before the Chamber of Deputies in Rome that Italy would participate in the EMS without securing further concessions.

Domestic Politics

Andreotti headed a loose coalition of centrist and leftist parties, including the *Partito Comunista Italiano* (PCI), which pledged to support the government in parliament although only Andreotti's party, *Democrazia Christiana* (DC), held cabinet positions. Divisions arose within both the PCI and the DC over the usefulness of this alliance. Right-wing elements of the DC wished to end the agreement with the PCI, and saw divisions over the EMS as a good way to achieve this goal. Within the PCI, many were demanding that the party withdrawal support for the government unless it was granted a formal position in the cabinet. (Hellman, 1988, 93; Ruscoe, 1982, 171–2; Wertman, 1981)

Italian Prime Ministers generally have had difficulty controlling their coalitions, and this was particularly true for the Andreotti government during the negotiation of the EMS in 1978. The small *Partito Repubblicano Italiano* (PRI) actively supported EMS entry in order to tie Italy to the European Community. In response to Andreotti's announcement of the "pause for reflection" at the Brussels summit in December, the PRI threatened to withdraw support from the government if Italy did not enter the EMS in January. (*Il Corriere della Sera*, 7 December 1978; 1; *Il Corriere della Sera*, 9 December 1978, 1) Another small party, the *Partito Socialista Democratico Italiano* (PSDI), did not support the EMS as strongly as the PRI, but by early December 1978 argued that the government had secured enough concessions to participate in the system. (Ludlow, 1982, 212)

The PCI, although internally divided and unwilling to reveal its hand too early, (Spaventa, 1980, 83) by late November was critical of immediate entry into the EMS. The PCI argued that participation in the EMS would place Italy under German hegemony, lead to higher unemployment, and that insufficient side-payments had been secured from Italy's partners. Instead, party leaders proposed renegotiation of the terms of the EMS and postponing entry into the system until inflation was lower. (*Il Corriere della Sera*, 9 December 1978, 1) The PCI's public criticisms of the EMS were widely seen as an attempt to tie the hands of Andreotti and demonstrate the party's influence both to its supporters and to other parties. However, the party leadership was reluctant to cause a government crisis over the issue.[17]

The DC leadership formally endorsed EMS entry in early December 1978, although it too was internally divided on the issue. (Ludlow, 1982, 209) Many members of the party, particularly those opposed to working with the PCI, "tended to view the EMS issue as a trial of strength with the Communists, or to transform it into one," and wanted to "dispel the impression" that Andreotti's hesitation in Brussels was inspired by PCI opposition. From this perspective, obliging the government to join the EMS would isolate and humiliate the PCI, perhaps forcing it to withdraw support for the government.[18] Shortly after the Brussels summit, DC foreign minister Arnaldo Forlani stated in an interview that the issue of Italian participation in the EMS could cause a government crisis. (*Il Corriere della Sera*, 8 December 1978, 1)

The *Partito Socialista Italiano* (PSI) expressed some fears that EMS participation would create too stringent an external anchor for economic policy, forcing the government to pursue disinflationary policies harmful to the PSI's supporters. More importantly, the right wing of the party, led by secretary Bettino Craxi, foresaw PCI opposition to the EMS and saw the issue as a useful tool for splitting the PSI from the Communists, allowing the former to ally more closely with the DC at a time when support for the government's alliance with the PCI was weakening in the PSI. (*Il Corriere della Sera*, 9 December 1978, 1; Ludlow, 1982, 212–3) Shortly after the Brussels summit, the PSI approached the PCI with a compromise: Italy would join the EMS, but six months after it began operating to soften the disinflationary impact of the system on the domestic economy. If successful, this compromise would burnish the image of the PSI as a "responsible" party able to reconcile the views of the PCI and DC. (*Il Corriere della Sera*, 10 December 1979, 10) Andreotti, however, decided to enter immediately. His "pause for reflection" at the Brussels summit was an attempt to avoid isolating the PCI by forcing it onto openly opposing the EMS, while also avoiding being seen as capitulating to its demands. (Ludlow, 1982, 215–7) When this failed, he announced his decision to the Chamber of Deputies in early December 1978. (*Il Corriere della Sera*, 12 December 1978, 1) He allowed the PSI to make its proposal in order to embarrass the party and increase his own support within the DC. (Spaventa, 1980, 68; Ludlow, 1982, 273) Prior to the vote on the EMS in the legislature on 13 December, the government attempted to win the support of the PSI and the abstention of the PCI for immediate entry into the EMS, but was unsuccessful. (Spaventa, 1980, 91) The PSI abstained, in part out of anger at Andreotti's behavior, and the PCI voted against the section calling for immediate entry and abstained on the remainder. (*Il Corriere della Sera*, 14 December 1978, 1)

Comparisons and Conclusions

By the late 1970s, policymakers in France, Britain, and Italy were disenchanted with both floating exchange rates and the Snake of European currencies. Floating exchange rates had led to widespread and seemingly uncontrollable speculation, making it difficult to implement macroeconomic policies very different from larger countries such as Germany and the United States. Yet earlier attempts to coordinate policies through the Snake failed because of the asymmetrical distribution of adjustment between weak and strong currency countries.

All three countries had an incentive to participate in the creation of a new, more flexible arrangement for coordinating exchange rate policies in Europe. German chancellor Schmidt also favored such an arrangement, especially because the United States was not interested in engaging in more comprehensive international monetary reform. Despite common international circumstances, the three countries considered here made different choices: The French pushed actively for the creation of the EMS, the British decided not to participate, and the Italians chose to participate but on weaker terms than the French.

I have identified two reasons for these differences: the organization of bank-industry relations, and government stability. Cross-national differences in these institutions shaped (1) policymakers' preferences about the costs and benefits of managing the exchange rate through an international regime, and (2) policymakers' abilities to implement their preferred policies. Important differences existed in policymakers' preferences toward managing the exchange rate, and toward the relationships between exchange rate and other macroeconomic policies. In Britain, Callaghan was quite hesitant about the EMS from early on, and always evaluated it in terms of its effects on his coalition and the upcoming elections. Eventually, he was unwilling to participate because of his fear of upsetting important Labour constituencies that articulated strong opposition to the EMS. He preferred to abjure responsibility for directly managing the pound, allowing the market to determine the exchange rate. Giscard and Andreotti were much more willing to give the exchange rate a prominent role in macroeconomic policymaking. They were also more willing to join the EMS for "political" reasons, i.e. so as to be able to influence its future evolution, perhaps making the system more symmetrical.

But Giscard and Andreotti faced different political constraints at home. While in Britain the decision not to participate in the ERM was driven by electoral and coalition considerations, and the conflicts between exchange rate policy choices were avoided by choosing to float, in France and Italy more consensus existed about managing the exchange rate. In France, domestic politics were relatively unconstraining, in part because Giscard's ally, the RPR, directed most of its criticism toward other issues. Andreotti faced a more complex situation in which parties and factions viewed EMS entry as a potential weapon against their opponents. Andreotti at first was unwilling to risk an exchange rate commitment that would overly constrain macroeconomic policy and force a break with the PCI, bringing down the government. When this failed, he was willing to enter the EMS (with the wide band) because of the knowledge that the PCI was already moving away from the DC, and entering would strengthen his hand with right-wing elements of the DC.

Finally, there is an alternative explanation that cannot be entirely dismissed by these comparisons. This concerns the ideology of the party or parties in power. One might posit that left-wing governments would be less likely to enter the EMS because of the fear that it would limit their ability to fight unemployment by requiring higher interest rates and lower budget deficits. (Simmons, 1994) This sort of hypotheses clearly fits the cases at hand, with France ruled by a coalition of conservative parties, Britain under a Labour government, and Italy ruled by a center-left coalition including both the PCI and PSI. However, this approach cannot account for later developments in the EMS, including the Thatcher government's unwillingness to bring the pound into the ERM until 1990, and the commitments of Socialist governments in France under Mitterand and in Italy under Craxi to the EMS in the mid-1980s.

NOTES

1. Calculated from International Monetary Fund, 1993, 353, 431, 719. Foreign assets are defined as foreign assets of deposit money banks (line 21); money supply is from line 351 and is defined as money (line 34) plus quasi-money (line 35).
2. Acceptance of the "Belgian Compromise" by the negotiators only partially met demands for a system in which the burdens of foreign exchange market intervention and changes in economic policy would be shared more equally by countries with strong and weak currencies. Countries with weaker currencies favored relying on the divergence indicator to guide policy. Under the divergence indicator, the burden of intervention and/or policy changes would fall on countries whose exchange rates were diverging from the EC average, whether the currency was strengthening or weakening. Countries with stronger currencies, especially Germany, favored a parity grid to determine intervention. With a parity grid, the burden of intervention would fall on weaker currency countries. Under the Belgian Compromise, both the divergence indicator and parity grid were to be used. However, the divergence indicator did not require policy changes on the part of stronger currency countries, but spoke only of a "presumption of action". See van Ypersele, 1985, 48–49. Van Ypersele was the Belgian representative to the EC Monetary Committee and the author of the Belgian Compromise.
3. In November 1979 the RPR voted against the government's 1980 budget and other legislation, requiring Barre to resort to constitutional devices to get the government's program enacted. See Frears, 1981, pp. 60–61. In early December 1978, Chirac began criticizing the government's European policy. However, he devoted relatively little attention to the EMS, instead concentrating his opposition on the direct election of the European Parliament and the harmonization of value added taxes. See *Le Figaro*, 7 December 1978, 1.
4. Chirac's distancing of the RPR from Giscard was embodied in his "letter to the nation" of 5 December 1978; see *Le Figaro*, 6 December 1978, 1, and *Le Monde*, 7 December 1978, 1.
5. For Jenkins' account of this meeting, see Jenkins, 1989, 380.
6. Statler, 1979, 208; see also Callaghan's remarks to the House of Commons in *Hansard*, 10 April 1978, col. 986.
7. Johnson and Painter, 1980, 321; see also Chancellor Denis Healey's remarks in *Hansard*, 29 November 1978, col. 464.
8. Shortly before the Bremen summit in July 1978, Callaghan gave an interview in which he expressed opposition to a fixed exchange rate regime without significant resource transfers, and stated that he would not support unequivocally the Franco-German plan put forth at the summit. See *The Guardian*, 7 July 1978, 1.
9. See, for example, *The Times*, 27 June 1978, 21, and *The Times*, 6 July 1978, 16. However, British policymakers rejected an Italian proposal that both the pound and lira enter the system with wide fluctuation margins. While the Bank of England pointed to the political benefits of *any* external constraint on monetary policy, the idea was eventually rejected because the political costs of bringing in the pound outweighed any "scapegoating" benefits of a weak external constraint. See Ludlow, 1982, 151–152.
10. For a discussion of the government's difficulties in securing a parliamentary majority, see Barnett, 1982, 138, and Holmes, 1985, 115.
11. See *The Times*, 2 October 1978, 2, and Benn, 1990, 353–354. In later meetings with the government, the NEC reiterated its opposition; see *The Times*, 25 October 1978, 2, and *The Times*, 28 October 1978, 2.
12. Callaghan, 1987, 492–3; see also Statler, 1979, 224, and Johnson and Painter, 1980, 325. In *A Life at the Center* (page 466), EC Commission President Jenkins reports that 'Callaghan vehemently denied that he was staying out [of the EMS] because of political difficulties at home, and insisted that if he was convinced it was right for Britain, he would come in whatever the political problems. But, he [Callaghan] added, "I am nervous of being locked in at too high a rate of exchange, which will prevent my dealing with unemployment".' In another account of this meeting, Jenkins reports that he felt Callaghan understated the importance of domestic political considerations in explaining his decision (Jenkins, 1989, 333–334).
13. See Chancellor Healey's Mansion House speech, reprinted in *The Times*, 20 October 1978, 22.
14. For example, Paolo Baffi, Governor of the Banca d'Italia, wrote that " . . . in the conditions prevailing in Italy the effectiveness of exchange rate changes as a balancing force is limited

in both degree and duration; after a small initial gain, the rapid adjustment of domestic prices to the new exchange rate tends to cause a shift to a higher rate of inflation". See Banca d'Italia, 1978, 138–139.

15. Quoted in Spaventa, 1980, 69. Prime Minister Andreotti later wrote that both Giscard and Schmidt telephoned him in early December 1978, urging Italian participation for similar reasons, as well as to prevent the government from being seen as giving in to pressure from the Communist party. See Andreotti, 1981, 287–288.
16. The exception was the credit facilities to be available under the EMS, most of which were designated for short-term support of foreign exchange market intervention with settlement within 45 days. See Spaventa, 1980, 84.
17. After the PRI threatened to leave the government over the EMS senior leaders of the PCI, PSI, and DC separately published articles in party newspapers calling on the PRI to consider the consequences of a government crisis. See *Il Corriere della Sera*, 7 December 1978, 1.
18. Spaventa, 1980, 87. See also Ludlow, 1982, 207, and Ruscoe, 1982, 172–174. These concerns were heightened in the fall of 1978, when Andreotti dismissed his right-wing DC Minister of Industry, Carlo Donat-Cattin, and helped settle a wave of strikes. See *Il Corriere della Sera*, 3 November 1978, 1. By December, Andreotti clearly did not want to be seen as a "slave" to the PCI; see Andreotti, 1981, 287–288.

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