SYSTEM, POWER, AND EUROPEAN MONETARY INTEGRATION

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INTRODUCTION

Theories of international relations and comparative politics characterize the movement within Western Europe toward monetary integration primarily in regional terms. The global context within which European monetary integration is taking place is viewed in this literature as having little influence or influence which is only episodic, momentary, or ancillary to other, more primary forces. Regional political integration, regional economic interdependence, sectoral interests within European countries, and strategies of national executives and central bankers are instead given primary emphasis.

This article argues, by contrast, that the international system has provided strong incentives for and greatly affected European monetary integration. Changes in and unpredictability of international monetary policies of the United States, in particular, have pushed European governments toward regional monetary integration at several critical historical junctures. Indeed, all of the major successes in monetary integration were closely, and causally, associated with transatlantic monetary conflict and the decline or weakness of the international monetary regime.

The argument presented here emphasizes the international system, the behavior and role of the dominant state, macroeconomic power and influence, and defensive state strategies. The article does not elaborate upon domestic politics and sectoral interest groups as factors underpinning monetary integration in Europe. This is not intended to deny the importance of domestic politics and societal groups. To the contrary, societal preferences, interest group preference aggregation, and bureaucratic relations within governments are very important to international monetary policy determination, as I have argued at length elsewhere.1 As domestic politics bears on monetary and exchange rate policy formulation, it bears on European integration as well.

This article, however, stresses system-level effects, or the global strategic environment of the European states, for two reasons: because domestic and regional political factors have been addressed elsewhere; and because systemic factors have been given short shrift in the existing literature. Interest group and bureaucratic factors at the national level always act within the context of the international system. Whether that context is binding on policy formulation or several steps removed from it is a fundamentally important issue. This article argues that the global context often bears strongly upon European monetary integration and is vitally important to understanding the evolution of that process.

The systemic explanation of regional monetary integration in Europe is valuable for three reasons. First, as noted above and discussed in more detail below, the international environment, and the behavior of the United States in particular, affects regional monetary relationships. It is theoretically useful, therefore, to have a framework for understanding the relationship between the global and regional levels. Second, as also noted above, the impact of the global monetary environment on

European integration has been under-emphasized in the international political economy literature and the comparative politics literature pertaining to European monetary policies. The regional explanations which dominate this literature are helpful but not fully satisfactory. Third, as European monetary integration progresses - and this author believes that it will continue - the creation of a European monetary union will profoundly change the transatlantic monetary relationship. The theory presented here provides a framework for understanding those changes and the global monetary stakes involved.

This article will begin by briefly reviewing the literature and the range of explanations mustered for European monetary integration. Extra-regional influences have been broadly neglected, certainly underemphasized, in the literature. This article will then develop a theoretical framework in which the interaction between the international system and regional integration can be understood. Simply put, monetary instability at the global level - perpetuated for example by a neglectful hegemon - provides strong incentives for groups of closely interdependent countries to integrate in the monetary sphere. Using this theoretical framework, the article will then review the history of European monetary integration. The article will conclude with a summary of the argument presented here and a brief discussion of its relationship to alternative explanations.

In arguing that European monetary integration is a defensive response to American policies that contributed to global monetary instability - meaning, specifically, exchange rate instability - I do not evaluate the appropriateness of American policy. (In some cases, an aggressive or passive U.S. exchange rate policy was appropriate; in other cases it was not.) Such judgments are not necessary to understand the effects of the policies in question on the desirability of regional monetary integration from the European standpoint. American policies which clashed with European preferences, even when Europeans yielded in the short term, created and sustained European interest in regional collaboration in the long term.

LITERATURE

The literature on the political economy of European monetary integration has generally appeared in three waves over the last two decades. These waves were inspired, respectively, by the initial plans for monetary union laid down in the late 1960s, the creation and operation of the EMS, and the Maastricht Treaty provisions for Economic and Monetary Union. Collectively, they present an array of several distinct explanations for exchange rate and macroeconomic policy coordination among the European countries. The international system and U.S. policy are acknowledged in this literature but are rarely central, and in those rare cases they are treated as accidental rather than systematic determinants of European monetary integration.

Loukas Tsoukalis's book on Economic and Monetary Union, the first comprehensive political economic treatment of the subject, does not identify a motive force for monetary integration with clarity. Tsoukalis examined neofunctionalism, supranationalism, and intergovernmentalism but was not satisfied with the explanatory power of any of them. Divergent political and economic interests, simply, prevented agreement on implementation of the ambitious plan for EMU presented in the Werner Report of 1969.2

Examining the launching of the European Monetary System (EMS) in 1979, Jonathan Story argues ideas, power, and domestic politics, three approaches borrowed from John Odell, played important roles. According to Story, power politics and cognitive approaches created facilitating but not sufficient conditions for the launch of the EMS. Domestic politics explains the timing of the initiative more precisely than the other approaches. In discussing power politics, Story takes a global sweep and links the EMS initiative to security policy and Europe's position between the superpowers.3

Peter Ludlow, in his definitive study of the creation of the EMS, couples international and domestic political explanations. Disorder in the Atlantic alliance, pressure from the Carter administration, and the unpredictability of American policy persuaded Schmidt to launch the EMS initiative. Improvements in the domestic political standing of both Schmidt and Giscard, although a secondary influence, affected the character and timing of the proposal.4 Ludlow also argues, however, that personalities, institutions, and ideas were important.

Several years later, economists began examining the successful operation of the EMS.5 Several of them became articulate proponents of the view that the system is the product of German monetary hegemony within Europe. Francesco Giavazzi and Alberto Giovannini argue that the EMS has functioned asymmetrically: Germany has pursued an independent monetary policy suitable to fighting inflation domestically while other countries have defended exchange rate parities within the system by mirroring changes in the Bundesbank's policies. Germany's partners benefited in this asymmetry through the credibility that they thereby borrowed from the Bundesbank, credibility which arguably lowered the cost, in terms of unemployment, of disinflating their economies.[6] Taking a contrary view, Michele Fratianni and Jürgen von Hagen challenge the "German dominance" thesis, arguing that exchange rate stabilization within Europe has been the product of relatively symmetrical policy adjustments among the members.[7]

The negotiation of the Maastricht treaty and agreement therein on Economic and Monetary Union spawned the third and largest wave of theories about the causes of monetary integration.[8] During the lead up to the negotiations over EMU, Tommaso Padoa-Schioppa, the Committee for the Study of Economic and Monetary Union (Delors Committee), and, predictably, the European Commission, among others, argued that the completion of the single market at the end of 1992 would create a spillover effect by eliminating barriers in goods markets. The reduction in those barriers would make national currencies a more salient cause of market segmentation, and eliminate barriers to capital mobility, making the maintenance of fixed exchange rates impossible without closely coordinated monetary policies.[9]

Taking a similar approach, John B. Goodman argues that Europe's monetary integration results ultimately from rising financial integration. Integration of national financial markets increases the costs of divergent monetary policies, producing in turn domestic political acceptance of the reduced autonomy that attends exchange rate stabilization.[10] Kathleen R. McNamara also argues that integration in a separate issue area produced integration in the monetary arena. Specifically, the progress in the late 1960s and early 1970s was spurred by the Common Agricultural Policy (CAP). Because changes in exchange rates created severe problems for the CAP, European governments sought to maintain stable rates. This outcome, according to McNamara, is consistent with neofunctionalist logic, although the process by which it was achieved was more intergovernmentalist than neofunctionalism would have predicted.[11]

A number of other works were inspired by the completion of the Maastricht agreement in late 1991. Barry Eichengreen and Jeffry Frieden argue that there is no clear economic case for monetary union and that thus the main impetus for EMU has instead been political. Eichengreen and Frieden point out that interstate bargaining, issue linkage, and domestic distributional factors are each relevant to explaining the EMU agreement at Maastricht. They conclude however that no single one of these approaches provides a satisfactory explanation of the EMU accord, and even collectively the three approaches fail to provide a full explanation.[12]

Lisa L. Martin emphasizes the institutional context in which EMU was negotiated. The European Community's institutional structure, she argues, facilitated issue linkages which smoothed the way for the Maastricht agreement. Specifically, the richer states secured the agreement of the poorer states through an augmentation of "cohesion funds" for economic development of depressed regions. At the same time, of course, ratification procedures, which require unanimous consent among member states, strongly constrained states in negotiating the treaty amendment.[13]

In his work, David M. Andrews argues that the Maastricht monetary agreement resulted from an almost fortuitous confluence of French and German interests. The erosion of monetary autonomy resulting from international capital liberalization drove changes in French policy, Andrews argues, and the disintegration of the Soviet Union and the unification of Germany drove German policy shifts. The diplomatic imperatives arising from unification have dissipated, however, and the future of EMU rests on the strength of neofunctionalist processes.[14]

Geoffrey Garrett similarly concludes that interstate bargaining and issue linkages are critical. Germany agreed to what Garrett believes is a disadvantageous monetary bargain - one which jeopardizes German preferences for monetary stability - because the demise of the Soviet Union and German unification generated on Germany's part a broader political interest in sustaining European integration.[15] Louis W. Pauly concurs that interstate bargaining is central but adds that Community institutions increasingly shape national interests in monetary integration.[16]

In an interesting comparative article, Benjamin J. Cohen examines the factors which explain success and failure in six different regional monetary unions. He finds that economic conditions and institutional structures are influential in sustaining but not sufficient to support regional monetary unions over time. Rather, interstate politics are the most important factor in determining compliance with commitments. The presence of a regional hegemon or political cohesion, characterized by a dense network of institutions, are needed to persuade states to surrender monetary autonomy.17

Wayne Sandholtz argues that no single theory explains the Maastricht agreement and that different motives explain the support of different states for the project. The conversion to monetary discipline in the European countries in the 1980s, which Sandholtz, like Goodman, attributes to increasing international financial interdependence, was a necessary precondition for monetary union. Neofunctionalist spillovers from the single market program and domestic political support for monetary union represent necessary but insufficient conditions. The high-inflation states wanted to tie their own hands on monetary policy, which explains why states agreed to create a very independent European Central Bank. France was motivated by a desire for greater "voice" in European monetary management. Germany was motivated by a strategy of using monetary union to advance political integration.18 As Andrews and Garrett argue, the German desire to promote European political integration surged with national unification in 1990.

McNamara argues that sectoral interest group theory and hegemonic stability theory, applied on a regional basis, are unsatisfactory as explanations for the Maastricht agreement.19 Owing to analytical ambiguity about the relationship between policies and interests, she argues, changing ideas about the costs and benefits of monetary integration combine with domestic and (European) politics to provide a more complete explanation.20

Throughout this literature systemic influences have been downplayed relative to forces within the region that have pressed for monetary integration. Systemic factors have not been completely ignored, of course; some authors specifically adopt a systemic perspective. Writing generally about European integration, Kenneth Waltz argues that superpower conflict during the Cold War created an environment in which war was thought to be impossible within Western Europe. In that environment, the calculus of Western European countries shifted away from relative gains and losses, making economic integration possible.21 Applying this reasoning to the post-Soviet Union era, John Mearsheimer argues that "Western European states will begin viewing each other with greater fear and suspicion, as they did for centuries before the onset of the Cold War." Concerns about relative status and autonomy will erode European integration.22 Sandholtz and Zysman argue that structural change in the international system, specifically the relative decline of the United States and the increased competitiveness of Japan, triggered strategic rethinking on the part of European governments, which led to the single market program.23 However, these extra-regional explanations are not applied to monetary integration specifically.24

Those explanations which do focus on monetary integration do not apply structural arguments systematically. Tsoukalis for instance acknowledges that the 1971 international monetary crisis played a "decisive role" in EC affairs and mentions the desire on the part of some European officials to create a European rival to the dollar. But, his brief treatments of the external dimension often also treat it as an impediment to monetary integration.25 In a brief essay, Robert Mundell observes a correspondence between weakness of the dollar and European monetary initiatives.26 Among these authors reviewed above, Ludlow gives the greatest emphasis to macroeconomic and exchange rate conflicts with the United States in explaining Schmidt's motives for launching the EMS.27

These treatments, however, throw systemic influences into a pot pourri of explanations, leave the nature of systemic influences theoretically undeveloped, and often resort to systemic factors on an ad hoc basis when a favored theory based on domestic or regional forces proves insufficient. To understand the relationship between the global context and regional integration, we need instead to develop a theory relating the international context to states engaged in regional integration, isolate systemic factors, and apply them systematically to an explanation of integration outcomes.

THEORETICAL FRAMEWORK

The international political economy literature does not contain any well-developed theory or analytical framework by which to understand macroeconomic power and influence. Nor does this literature contain a clear conception of the relationship between global and regional monetary cooperation. Although the literature on open macroeconomics is highly developed, it has not been (fully) harnessed to the problem of understanding power and influence among states in the macroeconomic arena, the defensive strategies of vulnerable states, or the political and strategic benefits of macroeconomic cooperation among subgroups of states in the international system.

This section intends to provide such a framework. It begins with a brief review of open macroeconomics, which provides an understanding of basic macroeconomic interdependence. Using this textbook paradigm, the section then examines the impact of the macroeconomic policies of one country on policy assessment and policy selection within a second country, in other words, macroeconomic influence. The section then explains how, in a three-country model, macroeconomic leverage provides incentives for macroeconomic cooperation among the targets of influence attempts.

The economic effects of macroeconomic instability in one country are transmitted to other countries through different economic mechanisms depending on the features of the international economy. Two particularly important conditions are the degree of capital mobility, which I assume for present purposes to be high, and the exchange rate regime, which might be either fixed or flexible. I also assume for the present discussion that countries maintain relatively open trade policies.

During the 1950s and 1960s, many economists theorized that flexible exchange rates would insulate national economies from the economic policies of other states. However, while flexible exchange rates do instill some autonomy in monetary policymaking, large macroeconomic disturbances are nonetheless transmitted from state to state even with flexible exchange rates. Although flexible rates ameliorate some kinds of disturbances, they in fact exacerbate others. Macroeconomic shocks are not "bottled up" in their national economies, in general. Rather, they splash across borders and ripple through the economies of other states.

Over the postwar period, the flexibility of exchange rates and the mobility of capital at the global level changed greatly. The fixed rates under the Bretton Woods regime gave way to flexible rates after the early 1970s. Capital mobility increased progressively over the decades.28 Thus, as the international economy evolved, states grappled with the international effects of macroeconomic policy shocks under varying sets of basic parameters. We must review the international transmission of economic policy shocks, therefore, with these different underlying circumstances in mind.

Consider a two-country model in which country A embarks on an expansionary monetary policy. Suppose further that capital is internationally mobile between country A and country B. Under these conditions, the easing of monetary policy will produce two initial effects in country A, one through the current account and the other through the capital account. An increase in aggregate demand causes the current account to shift toward deficit. An incipient decline in interest rates spawns an outflow of capital. The shift in the current and capital accounts toward deficit places downward pressure on the value of the currency of country A against that of country B.29

At this point, the standard economics textbook treatment proceeds as follows: Under fixed exchange rates, country A is required to purchase its currency on the foreign exchange markets. This intervention offsets the sales of its currency on the domestic money markets; that is, the original easing of monetary policy is reversed. When capital is perfectly mobile, the easing of monetary policy is fully reversed. Monetary policy has no influence on economic output in country A.

Consider, however, the operation of this mechanism under the kind of asymmetry that characterized the Bretton Woods regime. Assume that country A is large and closed and therefore not vulnerable to exchange-rate instability while country B is small and open and thus vulnerable to exchange-rate change. Although a fixed-exchange-rate regime is in place, country A takes no action to defend its currency and lets that responsibility fall to country B. If country B remains committed to the exchange rate parity, then it will sell its own currency in exchange for that of country A. In doing so, country B will expand domestic credit conditions, thereby mirroring the change in monetary policy of country A. Rather than constraining country A, the burden of the maintaining the rules of the fixed rate regime falls on country B. If B accepts that burden, the change in monetary policy in country A will be replicated in country B. The higher the degree of capital mobility, the more powerfully and immediately these effects are transmitted.

In the textbook model, flexible exchange rates effectively bottle up the effects of a monetary policy shift within the originating country and therefore restore the effectiveness of monetary policy with respect to domestic income. Capital mobility accentuates the increase in effectiveness. An easing of monetary policy, for example, causes an outflow of capital and a depreciation of the currency, stimulating demand for national output. Owing to this effect through the capital account, monetary policy is even more effective with respect to income and employment within country A than in the absence of capital mobility.

For its part, country B encounters a capital inflow, an appreciation of its currency, a decline in the price of tradeable goods, and a decline in foreign demand for its output. The shift resulting shift toward deficit in country B's trade account reduces growth and employment in country B. At the same time, the lower price of tradeable goods reduces the domestic price level (or inflation) in country B as well.

Suppose now that the disturbance originates on the fiscal side, from a large increase in the budget deficit of country A. The increase in aggregate demand raises income and shifts the current account balance of country A toward deficit. The incipient increase in interest rates causes an inflow of capital. If capital is highly mobile, the inflow will more than finance the current account deficit. Under fixed exchange rates, inflows of official reserves force an accommodating shift in monetary policy (assuming again that reserve changes are unsterilized). For country B, the outflow of capital causes a decline in official reserves and a contraction of monetary policy. The contraction of monetary policy in country B is exactly equal in magnitude to the expansionary shift in country A.

Under flexible exchange rates, however, fiscal policy loses its effectiveness for the originating country. The more mobile is capital, the less effective is fiscal policy in stimulating national output; with perfect capital mobility, fiscal policy is completely ineffective.30 The reason is that the inflow of capital causes the currency to appreciate, which in turn reduces foreign demand for the output of country A.

For the non-originating country, country B, the effects of country A's fiscal stimulus are anything but neutral, however. Fiscal expansion in country A is ineffective in raising country A's income because its stimulative effects leak abroad through the capital account and the exchange rate. As the currency of country B depreciates against that of country A, the competitiveness of goods produced in country B rises, shifting its trade balance toward surplus. The shift toward surplus increases employment and growth. The increase in employment and the depreciation of the currency also raise inflation. The more mobile is capital, the more country A's stimulus leaks abroad to country B.

To summarize, under fixed exchange rates and capital mobility, monetary policy is, at least in theory, constrained. In hegemonic monetary regimes, however, secondary states will tend to mirror changes in monetary policy in the dominant state. With flexible exchange rates, secondary states are insulated from monetary shocks. Under fixed exchange rates and high capital mobility, a fiscal stimulus has effects in the second country which are moderate and opposite to those in the source country. Under flexible exchange rates and capital mobility, fiscal policy has powerful effects abroad.

The extent of international transmission of macroeconomic shocks therefore depends on the particular policy in question, but in most cases has substantial impacts on partner countries. The notable exception is the case of a monetary policy shift under flexible exchange rates. This in turn depends on the degree of capital mobility; low capital mobility will increase the effects abroad.

The effects flow in both directions, of course; no country has a monopoly on macroeconomic disturbances. But asymmetries in size and openness will create corresponding asymmetries in the impact of transmitted effects. In particular, policy changes in a large, closed economy will have greater effects on a small, open economy than vice versa. These asymmetries confer power and vulnerability, respectively, on the states involved.

Importantly, the cross-border effects of macroeconomic (and exchange rate) policies create economic and political pressures for policy change in recipient countries. In cases of macroeconomic policy conflict, in particular, transmission effects emanating from the more powerful state change economic conditions within the recipient state. In this was, the more powerful state can alter the opportunity cost of existing policies in weaker states and thereby induce policy change. Opportunity cost is the value of the most beneficial alternative forgone in a choice of policies.

Consider the example of a large country embarking on a fiscal stimulus under flexible exchange rates and in an environment of high capital mobility.31 As previewed above, the effects of this policy shock on recipient countries are substantial. First, depreciation of the foreign (recipient) currency raises the price of tradeable goods and therefore the overall price level abroad. Second, the depreciation will produce a competitive advantage for foreign products, an improvement in the trade balance, and therefore a boost to growth and employment in the small, open economy. Aside from the change in the exchange rate, the increase in demand in the originating country will shift the trade balance toward deficit, further fueling growth and employment abroad.

Suppose that the recipient-country government was committed to a particular set of fiscal and monetary policies. Even if that government took full advantage of the autonomy provided by flexible exchange rates, these transmission effects nonetheless alter the opportunity cost of maintaining the course that had been set for economic policies before the external fiscal shock. National macroeconomic policies remain unchanged initially; but the transmission effects raise domestic employment, growth, and inflation. The change in domestic macroeconomic circumstances forces a reassessment of the macroeconomic policy stance; the policies appropriate for a sluggish economy might no longer be appropriate for a booming economy. Furthermore, the demand for jobs and income is largely satisfied, and fears of inflation and potential financial instability are rising. These shifts would be likely to produce political pressure, from inside and outside the government, to dampen demand and price pressures. The macroeconomic effects transmitted across borders can thereby shift the national policy preference away from stimulating output and toward fighting inflation.32

Note in this example that national preferences for macroeconomic outcomes (growth, employment, and inflation) are stable and not changed by foreign macroeconomic policies. Foreign policies affect the outcomes, not the preferences themselves. But through the effects of their policies on employment and inflation abroad, states can change the preferences of foreign countries with respect to prevailing policies, making them less desirable given the new economic circumstances. Even if a recipient state chooses to offset the effects of foreign policies on the domestic macroeconomy, the source country's policies and the recipient state's response have important consequences. The effect of the shift and corresponding offset is not a simple return to the status quo ante; instead, there will be changes in the policy settings in both countries, macroeconomic performance in the source country, the balance of payments between the two countries, and the exchange rate.

Whether the recipient state actually changes policies in response to the shock from the source country depends on a host of factors: the strength and magnitude of the transmitted effects; the starting position of the economy of the recipient; and of course domestic politics, institutions, policymaking mechanisms. The political impact of these transmission effects, for example, is greater the closer the economy of the recipient is to the boundary of its acceptable range of macroeconomic performance. When inflation in the recipient country is nearing the upper limit tolerated by its central bank, government and electorate, a relatively small stimulus from abroad is likely to have a larger impact on policy than when the country is comfortably below "high" inflation. The international transmission of macroeconomic shocks does not render a policy adjustment in recipient countries inevitable, of course. However, it creates an incentive for policy shift that can be very strong, thereby increasing the likelihood of policy adjustment.

In circumstances of international policy conflict, a source country might deliberately attempt to induce a change of policy in a recipient country. This might occur, for example, when policy initiatives in the originating country might be constrained by shifts in its current account balance, which could be alleviated by policy changes abroad. If it is relatively insulated from currency fluctuations, the country that is the source of the policy shock actively encourage exchange-rate movements in order to strengthen the incentives for macroeconomic policy change on the part of the recipient-country government. This result could be accomplished by the government and central bank through declaratory policies and foreign exchange intervention.33 In a contest between the declaratory policies or intervention practices of a large, closed country and a small, open country, those of the larger country are bound to have a greater impact on the expectations of investors and traders in the foreign exchange market. Elsewhere, I have labelled this phenomenon, as it applies to the United States, the "dollar weapon."34

Therefore in unwavering pursuit of its own, nationally defined macroeconomic objectives, and in its use of exchange rate policy, the government of the large, closed country alters the opportunity cost of policy change to the government of the small, open country. The large country does so not by limiting the set of policy choices of the small country: the small country retains the full range of policy choices originally available. The large country, however, influences the desirability of these choices - their payoff in terms of macroeconomic outcomes - and therefore policy selection. In this way, the large country can induce the small to select policies that it might not otherwise pursue. The ability of the large country to do so confers international macroeconomic power upon it.

Now consider an expanded, three-country world composed of one large, closed country and two small, open countries. The trade and investment flows comprising each of the three bilateral relationships are equal in absolute terms, but they are of course more important relative to the domestic economies of the smaller countries. The two smaller economies are not identical: the international status of their national financial markets differs, international confidence in their national economic policies varies, and their national currencies have different international roles.

Attempts on the part of the large country to influence the policies of smaller countries are likely to have uneven effects abroad. The unevenness of these effects arises from the differing status of the smaller countries in the international economic system. When losing confidence in the monetary policy of the large country, for example, international investors do not rebalance their investment portfolios in all foreign markets equally; they favor the markets in which they have greater confidence. Capital outflows from a leading country will concentrate on secondary markets unevenly, therefore, potentially disrupting the international payments and currency relationships among the smaller states. In this way, fluctuations of the large-country currency can disrupt monetary and trade relations among the smaller countries.

In sum, the asymmetry between large and small states and exploitation of that asymmetry by the large are attended by economic effects that are often deemed undesirable by the small- and medium-sized states. These effects disrupt domestic political agreements on monetary and fiscal policy, as well as international monetary policy. The exploitation of macroeconomic power further threatens the close relationships among highly integrated yet still differentiated countries. For each of these reasons, small states have strong incentives to counter the use of power by large states.

Assuming that they remain committed to a liberal international trade and investment regime - that is, eschew trade protectionism and capital controls as sources of insulation from external economic disturbances - in the short run, there is little that small states can do about the economic consequences of disturbances emanating from a large country, other than accepting and adjusting to them. However, in the long run, small states can respond with an affirmative strategy by joining together to form a monetary bloc. By tightening monetary and exchange rate cooperation among themselves, small countries can accomplish several things. First, they can reduce the chances that any one of them will be singled out by the large country for pressure for policy change (i.e., spread risk). Second, when pressures for change do arise, they can dissipate the effects of macroeconomic conflict and exchange rate fluctuations over a larger monetary area (i.e., spread costs). Third, they can counteract disturbances to their bilateral relationship arising from policy conflict and currency movements vis à vis the large country. Finally, once their integration becomes advanced, they might exercise countervailing power vis à vis the large country, thereby placing global macroeconomic relations on a more symmetrical basis.

Collectively, small countries would benefit from forming such a monetary bloc against a large country. Whether individual small countries find it advantageous to do so depends on whether the benefits just enumerated outweigh the costs in terms of monetary autonomy at the regional level. When their monetary preferences differ strongly, the costs of surrendering autonomy are likely to exceed the benefits of protection vis à vis large, unruly states. When their monetary preferences converge, the value of monetary autonomy diminishes and the relative gains from common monetary defense rise.

Much depends on whether the large country is a source of stability of instability in the international system. If a large country pursues a consistent, benign set of domestic macroeconomic and international monetary policies, smaller countries would tend to cleave to it. Smaller countries would seek to deepen their integration with such a large country through exchange rate stabilization just as they would among themselves. However, if a large country is a source of macroeconomic instability and disturbances, smaller countries have strong incentives to develop defensive strategies. This is true whether the large country aggressively pressures the small to change macroeconomic policies - to ease constraints on the macroeconomic policies of the large country - or simply disregards the impact of its policies on the economies of the small. In either case, forming a monetary alliance likely to be a profitable defensive strategy for two smaller countries.

HISTORY

Global monetary relations have strongly influenced European governments in their pursuit of regional monetary integration. Economic policy shocks originating from outside the region and their effects in Europe on economic conditions and intra-European economic relations, as analyzed in the previous section, provided strong incentives for European countries to stabilize currencies and coordinate macroeconomic policies. This section will demonstrate that monetary integration is a European response to global monetary instability. When, over the decades, the members of the Community were divided over or uncertain about exchange rate stabilization, global monetary and exchange rate instability helped to nudge the reticent among them along the path toward monetary integration.

Monetary conflict with the United States has provided a particularly strong impetus for monetary integration. American international monetary policy has alternated between neglect and activism over the postwar period.35 Periodic American neglect of the dollar and the balance of payments thrust the burden of exchange rate stabilization and payments financing upon other governments, largely those of European countries. Worse yet for Europe, when American policy was in its aggressively active phases, which preceded cooperatively active phases, U.S. officials often exploited its dominant, or at least stronger, position through the "dollar weapon." American officials "talked" the dollar down or up as part of a conscious strategy to extract a change in macroeconomic policy from European governments and central banks. Governments of the member states of the European Community were, at crucial moments, encouraged by neglectful or aggressive U.S. exchange rate policies to seek shelter from those policies and their effects in regional monetary arrangements.

Under Bretton Woods

In the early postwar period, direct American support for the European Payments Union (EPU) encouraged European governments to make the transition to current account convertibility. The pegged rate regime established at Bretton Woods, however, provided the necessary exchange rate stability among the European countries, obviating the need for monetary integration at the European level. As the Bretton Woods regime began to ossify and decay, however, European initiatives for currency stabilization and monetary integration were spawned.

Creation of the European Community

Led and sustained principally by the U.S., and institutionally embodied in the International Monetary Fund, the postwar international monetary regime governed the relationships among the European currencies as a subset of all regime adherents. As long as the Bretton Woods regime provided a stable framework within which to resolve intra-European monetary problem, European states had little incentive to establish a separate mechanism for regional cooperation outside of this global framework. The European countries and the rest of the world, moreover, were preoccupied with a shortage of international liquidity, captured by the moniker the "dollar gap." "Therefore," as Loukas Tsoukalis has written, "in 1957, when the Treaty [of Rome] was signed, it seemed unthinkable to attempt to establish an independent monetary system within the context of the EEC."36

At the inception of the European Community (EC), accordingly, the six original members did not address monetary cooperation among them in depth. Article 104 of the Treaty of Rome, which dealt with the balance of payments, committed each member state to "pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while taking care to ensure a high level of employment and stable level of prices." Article 105 stated that member states would therefore "coordinate their economic policies" and created the Monetary Committee, with advisory status, to review the monetary and financial situation of members and report to the Council of Ministers and to the Commission. Article 107 stated clearly that "[e]ach Member State shall treat its policy with regard to rates of exchange as a matter of common concern." Article 108 pledged states to come to the mutual assistance of members experiencing balance-of-payments problems.37 However, these provisions fell well short of a full commitment to coordinate monetary and exchange rate policies, and in practice there was little movement in that direction. Although the Monetary Committee was established, its role remained purely consultative.

American Deficits

Notably, the Community took its first tentative and halting step toward monetary integration when the capacity of the United States to support system-wide monetary stability was first questioned. In 1958, the United States entered a period of substantial and continuous balance of payments deficits.38 This not only eased fears of a dollar shortage in Europe but raised the specter of a dollar glut. Concern surfaced for the first time about the credibility of the American commitment to redeem foreign-held dollars with gold. Robert Triffin warned of a fundamental flaw in the international monetary system: provision of sufficient international liquidity through U.S. balance of payments deficits could undermine confidence in the dollar.39

At the same time, Europe grappled with its first foreign exchange crisis since the transition to convertibility. As American deficits and German surpluses became entrenched during 1958-61, Germany experienced capital inflows and upward pressure on the German D-mark. This pressure was unwelcome and was resisted by the German government and the Bundesbank, with the strong support of the German industrial and banking sectors.40 In March 1961, however, the German government under Chancellor Konrad Adenauer revalued the D-mark by 5 percent against the U.S. dollar and thus effectively against the currencies of Germany's European partners as well.41

Under the leadership of Walter Hallstein, former state secretary in the German foreign ministry, the European Commission issued a report in October 1962 that attempted to place monetary integration on the Community's agenda.42 The Commission was acutely aware of the international monetary environment and Hallstein was critical of the unilateralism with which Germany decided to revalue the D-mark.43 The Commission argued that the international monetary system was fragile and would benefit from the Community functioning as a single unit and from the creation of a European reserve currency. In addition, the report noted, the "cohesion" of the Common Market "would inevitably be deeply affected by serious monetary difficulties even if these primarily concerned countries outside the Community."44 With the elimination of intra-European trade barriers, changes in exchange rates could be so disruptive "that the Common Market itself could be imperilled."45 Thus, in this and a subsequent report in June 1963, the Commission proposed the creation of a committee of central bank governors, prior consultation among European governments on changes in exchange rates, and institutionalized cooperation on monetary, exchange rate, and financial policies.46

The Committee of Central Bank Governors was created in 1964. However, this was the only concrete result of this first flurry of monetary proposals from the Commission. The member states for the most part continued to regard the Bretton Woods regime as the primary realm of monetary cooperation, and focused their energy at the regional level not on monetary cooperation but instead on the Common Market, Common Agricultural Policy, and Common Commercial Policy. Nonetheless, the Commission had established a road map for monetary integration, one to which national governments would refer when their faith in the global regime later waned.

Beginning in 1961, the U.S. government also began to press the German government to "offset" part of the balance-of-payments burden of maintaining American troops in Germany. Thus in addition to the revaluation of the D-mark, Germany reluctantly agreed to make cash payments and loans to the United States, and to maintain investments in U.S. Treasury bonds, beginning in July 1961. This was the first of seven offset agreements running through mid-1973, the fourth and fifth of which were particularly bitterly contested. As part of the fourth agreement reached in 1967, Bundesbank President Karl Blessing sent a letter to the U.S. Federal Reserve stating that Germany would not request gold conversion of its dollar holdings.47 These agreements, which reveal a clear but exceptional link between American security dominance and transatlantic monetary arrangements, were Germany's first encounter with American arm-twisting in the international monetary field.48

"Benign Neglect"

During the second half of the 1960s, conflict between the United States and its European partners over the management of the international monetary system increased. The United States, which until then had had a superior record of price stability, experienced rising inflation, spawned largely by deficit spending to prosecute the Vietnam War. American inflation and trade deficits damaged international confidence in the dollar and contributed to periodic crises in foreign exchange markets. The response of the Johnson and early Nixon administrations, however, was to let the European and Japanese governments bear the brunt of the foreign exchange intervention and macroeconomic policy adjustments necessary to keep the Bretton Woods regime intact - a U.S. policy labelled "benign neglect."49

In December 1969, the heads of government of the six member states of the Community met at The Hague to discuss the future of the EC. The meeting was convened on the initiative of France at the time of the final stage of the Common Market, German Chancellor Willy Brandt's ostpolitik, and after Georges Pompidou's replacement of Charles de Gaulle as president of France.50 At this time, growing fissures within the Bretton Woods regime, and the inability of the Group of Ten (G-10) to patch them up, provided an inducement to promote economic and monetary union. The summit endorsed the drawing up of plans for EMU, based on the harmonization of economic policies, and the consideration of a European reserve fund.51 A committee chaired by Luxembourg Prime Minister Pierre Werner produced the subsequent report, sweeping in scope, that defined EMU as the irrevocable convertibility of national currencies, the fixing of their exchange rates, and complete liberalization of capital controls, and laid out a plan for achieving all this in three stages. The report stressed the harmonization of monetary policy, as well as the importance of coordinating fiscal policy and implementing regional structural policies. Monetary policymaking would take place within a system of central banks similar to the Federal Reserve System. The Committee proposed the year 1980 as the goal for completing EMU.52

The timetable proved to be wildly optimistic. However, the Werner Report set the framework for the discussion of monetary union for the next twenty-five years. The three-stage approach and many of the principles enunciated in the Werner Report would be echoed by the Delors Report nineteen years later.53 More immediately, the Werner Report established a concrete agenda for exchange rate cooperation. As part of the first stage, the report recommended, the Community countries should adopt a common policy vis à vis the U.S. dollar and common positions within international organizations such as the IMF. The report further suggested that, on an experimental basis, European central banks should tighten the range of fluctuation of their currencies against one another more narrowly than their permitted ranges against the dollar would allow.54 As the Bretton Woods regime began to unravel, Europe began to implement portions of the Werner plan.

Demise of Bretton Woods

The conflict between American macroeconomic policy and the requirements of the Bretton Woods regime finally came to a head in the early 1970s. The United States ran its first trade deficit of the postwar period, and indeed its first deficit of the century, in 1971. Meanwhile, U.S. monetary policy had begun to ease in 1970, contributing to capital outflow. Although inflation had not been conquered, the Federal Reserve was willing to ease policy to accommodate President Nixon's wish to stimulate economic growth.

Meanwhile, in the late 1960s and early 1970s, Germany had experienced several bouts of capital inflows and had complained bitterly of "imported inflation."55 In May 1971, a wave of speculation rocked the currency markets. At that time, the German minister of economics and finance, Karl Schiller, proposed that the European currencies float jointly against the dollar, maintaining relatively stable cross rates. Erik Hoffmeyer, until recently the governor of the central bank of Denmark and frequent partner of German officials in European monetary cooperation, writes:

Germany's number one objective [was] to unwind the dependence on the dollar, and this attitude was the foundation of the policy that set out the path to the confrontation [with the U.S.]. . . . The genuine European support for international cooperation in the early 1960s changed in the latter part of the 1960s to animosity or even hostility towards what was conceived as dollar hegemony - in parallel with reservations towards the U.S. engagement in Vietnam. The German idea of creating a zone of monetary stability independent of the dollar - even though unprofessional - was an economic expression of this political attitude.56

The six members of the EC, however, were far from united on the question of a joint float. Although Germany was in favor, the other European countries feared losing competitiveness by allowing their currencies to float upward with the D-mark against the dollar. Although attracted by the prospect of using European solidarity to force the United States to accept a devaluation, France opposed the joint float and proposed instead more extensive reliance on capital controls. Italy joined France in opposing the joint float. Belgium tended to side with France as well, and the Netherlands with Germany. In the end, the German and Dutch governments decided to float their currencies while the other members reintroduced capital controls.57

In August 1971, as part of his New Economic Program, President Nixon jettisoned gold convertibility, scuttling the Bretton Woods regime, and imposed a hefty 10 percent import surcharge. By the end of August, all of the major world currencies were floating except for the French franc. Freed of the constraints of the Bretton Woods regime, the United States, represented by Treasury Secretary John B. Connally, aggressively sought to negotiate a devaluation of the dollar with its European partners.

Resentful of the duress applied by Connally, the European governments managed to settle on a common position in these negotiations. Acting on agreement with German Chancellor Willy Brandt, French President Georges Pompidou met Nixon in the Azores in December 1971 and concluded an accord on a dollar devaluation against gold. This accord extended the life of the fixed-rate regime and was generalized to the Group of Ten at a meeting a couple of weeks later at the Smithsonian Institution in Washington.58

As the Smithsonian Agreement provided for fluctuations of the European currencies against the dollar of +/-2.25 percent, European currencies could fluctuate against one another by 4.5 percent. This threatened the system of common prices for agricultural goods within the EC.59 The European governments therefore agreed among themselves to restrict the fluctuation of their currencies more narrowly than they were permitted to fluctuate against the dollar, creating the so-called "snake in the tunnel." The snake was part of a broader monetary bargain which included the use of capital controls, particularly in Germany, a revival of economic policy coordination, the creation of the European Monetary Fund, and the advent of assistance to regions. These measures were endorsed at the Paris Summit of October 1972, which affirmed the Werner Report's plan for EMU as a top priority of the EC.60

Meanwhile, the United States persisted in a lax monetary policy, thereby inviting continuing speculation against the dollar. By early 1973, American inflation had risen and both domestic and external indicators argued for a tightening of monetary policy. Such a tightening, had it been accomplished while the fixed-rate regime remained in place, would have given that regime a greater chance of survival. Despite the fact that the Federal Reserve would begin to raise interest rates shortly, however, Chairman Arthur Burns specifically dissociated domestic monetary policy from exchange rate stabilization.61 As speculation mounted, the dollar was devalued in February 1973. At that time, Treasury Secretary George P. Shultz announced that the United States would no longer intervene in the foreign exchange markets and would abolish all capital controls, and that domestic monetary policy would ignore "international concerns."62 As a result, within weeks of the devaluation, U.S. and European officials were forced to float the dollar, marking, in March 1973, the advent of the flexible exchange rate regime. This time, however, the European governments continued to float their currencies jointly; the snake continued without its "tunnel."

Under Flexible Rates

In the absence of U.S. monetary cooperation and successful reform of the international monetary system, the European governments had resolved to attempt cooperation on a regional basis, notwithstanding the formidable challenges posed by the differences among their economies. As is now well known, the combined effects of the fall of the Bretton Woods regime, the first oil shock, a deep worldwide recession and high inflation differentials proved to be too much for the European snake to bear.63 Successful intra-European exchange rate cooperation in the early and mid-1970s was limited to stabilization between the D-mark and the currencies of Germany's smaller neighbors. When American economic policies again became a source of monetary instability for Europe, however, Germany and France renewed their exchange rate cooperation.

Locomotive Dispute

In 1977, the Carter administration sought to stimulate the U.S. and world economies. The strategy which Carter administration officials devised was the so-called "locomotive" approach, whereby countries running trade surpluses would embark upon expansionary fiscal programs and thereby bring themselves and deficit countries out of the lingering economic stagnation of the 1975-76 period. Carter's officials pressed fiscal expansion on Germany, whose trade surplus was growing at that time. They made it clear, however, that their own plans for stimulating American growth would proceed irrespective of whether Germany and other surplus countries complied with the administration's request. (This strategy was pursued simultaneously with respect to Japan.) If the surplus countries did not comply, administration officials declared, the dollar would depreciate, a development which they would view as appropriate and would not resist.64

German Chancellor Helmut Schmidt resisted U.S. pressure for German reflation. Accordingly, as U.S. officials had foreseen, the dollar fell from around DM 2.50 in Autumn 1976 to DM 2.00 in early March 1978. The depreciation reduced the prospects for German exports and thus German growth and employment generally. Schmidt had promised at the London summit in May that the German economy would grow by five percent in 1977; in fact, German growth registered only 2.5 percent for that year. The appreciation of the D-mark threatened to prolong weakness in the recovery and increased political pressure within Germany for offsetting stimulative policies. The appreciation of the D-mark also reduced import prices, softening opposition to expansionary policies on inflation grounds, from the Bundesbank in particular.

Thus, because the German economy was more vulnerable to exchange rate changes than the American economy, the depreciation of the dollar provided the Carter administration with strong leverage over the Schmidt government. Although he deftly used them to his political advantage within Germany, Chancellor Schmidt deeply resented the American use of this leverage. For one thing, foreign pressure to reflate the German economy greatly complicated the political management of macroeconomic policy within his social-liberal coalition. Officials at the Bundesbank, which was forced to intervene and ease domestic monetary policy in order to stem the rise of the D-mark against the dollar, shared this resentment.65

Therefore, in 1978, as the dollar fell toward record lows against the D-mark, Schmidt and French President Valéry Giscard d'Estaing launched negotiations to create the European Monetary System (EMS). Schmidt was explicit about seeking a wider European area of monetary stability over which pressures for currency appreciation, previously concentrated on the D-mark, the so-called "counterpole" to the dollar, could be spread.66 Not only was the D-mark appreciating against the dollar, but the German currency was rising in importance as an international reserve currency. The instability of the dollar and the changeability of U.S. international monetary policy rendered the D-mark more attractive for this purpose. Because historical experienced demonstrated that an international role for a currency could compromise domestic monetary control, the German government and the Bundesbank found this prospect quite threatening. Stabilizing exchange rates among the European currencies and creating the European Currency Unit (ECU) within the new system was, for them, a strategy for avoiding large increases in D-mark holdings in official and private portfolios outside Germany.67

After consulting bilaterally, Schmidt and Giscard began behind-the-scenes negotiations on the basic features of the new system, in which the British government also participated. Because the snake had failed - the French franc having dropped out twice - Schmidt and Giscard decided to create an entirely new system. Their plan was endorsed by the European Council at Bremen in July 1978.

As the negotiators were finalizing the plan, transatlantic monetary turmoil persisted. The Schmidt government yielded to foreign pressure at the G-7 summit in Bonn, also in July, by agreeing to a fiscal stimulus of "up to one percent" of GDP. However, owing partly to an increase in American inflation, the Bonn summit agreement did not calm the foreign exchange markets. At the end of October 1978, the dollar reached an all-time low of DM 1.71, at which time the Bundesbank and other European central banks agreed to participate in a dollar rescue package.68

The European Council decided to create the European Monetary System at their meeting in Brussels in early December, and it began operation at the beginning of March 1979. The EMS restricted fluctuations of most member currencies to +/- 2.25 percent and formally required unlimited intervention at the margins. The system also augmented (compared to the snake) the financing facilities that the central banks could draw upon to support intervention. Although Schmidt and Giscard were unable to persuade British Prime Minister James Callaghan to participate in the system, Belgium, Luxembourg, the Netherlands, Denmark, and Italy all joined Germany and France in the new regime.69

In his account of the creation of the EMS, Peter Ludlow concludes that the transatlantic conflict was the German Chancellor's primary motivation in seeking regional monetary cooperation:

It was his preoccupation with the dollar crisis, his resentment and anxiety about the growing pressure on the Federal Republic to reflate and, more generally, his unease about what seemed to him to be the fallibility and vulnerability of the new Carter administration in Washington that served as the principal motors of his monetary initiative.70

Indeed, when asked later about his purpose in creating the EMS, Schmidt responded that it was an instrument to strengthen European economic and political integration and "an incentive for the Americans to understand that they must not let the dollar go down the drain."71 "[T]he reckless conduct of the United States with respect to monetary policy and the dependence of the monetary policy of the European countries on the dollar, on dollar interest rates, and dollar speculation had had painful effects," Schmidt wrote. "We knew that the national European economies individually were not in a position to arm themselves sufficiently against the turbulences of the world. For that reason we wanted union and common success."72

The French, British, and Italian governments, however, did not object to the locomotive strategy of the Carter administration as did the German government. To the contrary, as deficit countries they stood to gain from German reflation and tacitly approved of American pressure. Thus, transatlantic conflict in the late 1970s did not spur European monetary integration. Rather, differences with the U.S. administration were critical in shifting the German calculus of the costs and benefits of regional monetary integration. High inflation among the European partners continued to concern the German government and Bundesbank. The policies of the Carter administration and Federal Reserve, however, cast the intra-European differences in a new light. U.S. monetary policy would not shift decisively toward fighting inflation until October 1979. In the meantime, the international environment was increasingly less hospitable to German low-inflation preferences. Under these circumstances, creating a zone of monetary stability in Europe took on added importance for Germany.

Dollar Appreciation

The EMS encountered substantial turbulence during its first four years. The second oil shock, double-digit inflation in several countries, a severe recession, and changes in governments in both France and Germany strained the parities. Rather than harmonize domestic monetary policies, during this first phase, participating governments agreed on frequent realignments within the system. The EMS entered a second phase in March 1983, however, with a strengthened commitment toward policy convergence. As in earlier cases of increased monetary cooperation, this episode was accompanied, and spurred in part, by transatlantic conflict.

The U.S. Federal Reserve tightened monetary policy severely beginning in October 1979, a move which satisfied German requests for stronger policies against inflation.73 The Reagan administration, however, embarked in 1981 on a fiscal expansion which rekindled transatlantic arguments over macroeconomic policy. Unprecedented budget deficits and tight monetary policy combined to produce record interest rates in the United States. European central banks responded by tightening monetary policy, which, as Schmidt complained, produced the highest interest rates "since the birth of Christ" in Germany. Moreover, despite appreciation of the dollar, Reagan administration officials declared that they would suspend intervention in the foreign exchange market.74

In this case, however, France rather than Germany was the principal target of American pressure for policy change. Under the leadership of President François Mitterrand, the socialist government had administered a strong fiscal stimulus to the French economy in 1981 and 1982. This choice of reducing unemployment over reducing inflation was diametrically opposed to the choices of most other countries, particularly the United States. The divergence placed downward pressure on the French franc.

When European governments complained about American macroeconomic policy and the rising dollar, Treasury Secretary Donald T. Regan promulgated the doctrine of convergence. Regan stated that the American goal at the Versailles summit in June 1982 would be "convergence of our economies with each more stable and with less inflation. If that happens," he added, "that will stabilize exchange rates."75 His Undersecretary for Monetary Affairs, Beryl W. Sprinkel, was more direct:

> If [the Europeans] want to opt for slower inflation and more real growth as we're doing, we certainly would welcome it. But if they don't opt in that direction, it's understandable their exchange rates are going to decline vis-à-vis the dollar.76

Thus, the United States used, benefited from, the dollar weapon again. Although the direction of movement of the exchange rate had reversed, it nonetheless remained a source of U.S. leverage. The depreciation of the franc against the dollar, as well as against the other European currencies, increased French inflation at a time when it was already high, placing pressure on the Socialist government to reverse course.

Mitterrand proposed a "decoupling" of European from American interest rates. German officials rejected the idea, knowing that capital controls would be required and suspicious that Germany would have to finance French deficits under the plan. Mitterrand also proposed an international conference akin to the Bretton Woods conference of 1944 to discuss reform of the global monetary system. This idea was scuttled by, among others, the Reagan administration.77

By early 1983, therefore, the French government was running out of options. The franc had already been devalued twice within the EMS since the socialist government came to power and speculation against the currency was intensifying. Mitterrand and his government faced a choice between continuing the Keynesian expansionary program on which they had embarked in 1981 and leaving the ERM, or remaining within the ERM, after a devaluation, and implementing restrictive policies to control inflation.78 The Reagan administration had created a very inhospitable international monetary environment for a franc outside the ERM. After intense negotiations with Germany, therefore, the socialist French government decided in March to remain within the EMS and institute restrictive macroeconomic policies.

Mitterrand suffered politically from the reversal of his domestic stimulus program. In explaining his policy reversal, he said, "I overestimated the goodwill of the Americans. I don't expect anything any more from Reagan."79 The German government, as one might have expected, welcomed the French shift to more restrictive policies. The shift, moreover, marked the beginning of a French and German convergence toward stability-oriented policies and a quantum strengthening of the EMS.

Reflation Conflict Renewed

Throughout the first Reagan administration the dollar continued to appreciate. Treasury officials took a benign view of this appreciation and President Reagan cheered the dollar upward in his state of the union address in January 1985. The predictable trade consequences of the overvalued dollar, however, produced a groundswell of protectionism in Congress. In an effort to limit the damage to open trade policies, the second Reagan administration abruptly shifted course and sought a realignment of the dollar against the European and Japanese currencies. This goal was enunciated with the other members of the Group of Five (G-5) in the Plaza accord of September 1985.80

However, after the dollar had fallen a mere seven percent against the D-mark from the level at the time of the Plaza accord - to a level still much too high to reduce the U.S. external deficit significantly - European governments ceased to cooperate with the Reagan administration. The German government and Bundesbank, fearing that D-mark appreciation would reduce exports among other things, were the first to break ranks with the Americans. Treasury Secretary James A. Baker III, always cognizant of trade politics on Capitol Hill, pressed European governments for expansionary fiscal and monetary policies. Germany, with the biggest external surplus, was singled out for special attention. Baker attacked the Bundesbank directly and publicly in Autumn 1986 for failing to ease monetary policy more quickly.

In the absence of expansionary policies in Germany (and Japan), Baker declared, a depreciation of the dollar would be desirable to reduce the American trade deficit. Baker adeptly employed the dollar weapon to press the German government (and Japanese government) to expand domestic demand throughout 1986 and into 1987. As in 1977-78, the resulting appreciation of the European currencies reduced growth prospects and inflation, thereby shifting the calculus of European governments on reflation. The transatlantic macroeconomic conflict and the use of the dollar weapon prompted another quantum strengthening of the EMS and the beginning of a third stage in its development.

Rather than dividing in the face of American pressure to reflate, European governments closed ranks on this occasion. During the locomotive controversy of 1977-78, notwithstanding the decision to create the EMS, France and the U.K. had sided with the U.S. in urging Germany to undertake a fiscal stimulus. In 1986, by contrast, when American pressure on Germany and the Bundesbank was similarly intense, the European partners sided with Germany at a meeting at Gleneagles, Scotland, and criticized the U.S. administration.81

Dollar weakness, moreover, forced a European review of the financing mechanisms of the EMS. By placing differential pressures on the European currencies, as during the 1977-78 episode, the depreciation of the dollar forced a general realignment of the ERM in January 1987. That realignment - the last formal devaluation of the French franc as of this writing - was particularly controversial. French Prime Minister Jacques Chirac bitterly criticized the German refusal to conduct intervention before the D-mark/franc exchange rate reached the margins.82 Exchange rate instability also compromised the goal of the Single European Act, which had been successfully negotiated and was in the process of being ratified, to complete the internal market by 1992. Under these circumstances, the

European governments and central banks embarked on a renegotiation of the rules and terms of participation in the ERM.

The German government and Bundesbank had refused to extend D-mark financing to the French and other central banks for foreign exchange intervention before exchange rates had reached the limits of the EMS margins.83 They were of course concerned about the liquidity effects within Germany of extending such credits for "intramarginal" intervention. Macroeconomic conflict with the United States, however, while contributing to instability among European currencies, again placed the risks associated with intramarginal interventions in a new light.

Secretary Baker agreed to attempt to call a halt to the depreciation of the dollar in exchange for fiscal expansion in Germany and Japan in February 1987. But, despite the signing of the Louvre accord, and despite pleas by German Finance Minister Gerhard Stoltenberg and Bundesbank President Karl Otto Pöhl, the United States refused to take responsibility for the financing of its current account deficit.84 More importantly, the Louvre accord, which established secret target ranges for the dollar/D-mark and dollar/yen exchange rates, threatened to constrain the Bundesbank from raising interest rates. A tightening of German monetary policy, which Bundesbank officials planned for Autumn 1987, would renew downward pressure on the dollar, already now close to the record lows set against the D-mark in late 1978. Bundesbank officials were keenly aware that this tightening would intensify transatlantic conflict.

German officials were therefore more inclined to reach an accommodation with the French over the financing arrangements within the EMS. The agreement with the European partners was laid down in the Basle/Nybourg accord of September 1987. This agreement contained notable concessions on the part of Germany and the Bundesbank in particular.85 By acceding to the Basle-Nybourg agreement, German government and Bundesbank officials could promote European monetary solidarity at a moment when global monetary relations were very rough indeed. The Bundesbank raised interest rates in October, a move that was harshly criticized by Secretary Baker. His criticisms, in part, precipitated the 1987 worldwide stock market crash and a depreciation of the dollar to record lows at the end of the year. The European central banks, on the other hand, used the expanded access to Bundesbank credit to successfully ward off turmoil within the ERM that resulted from global monetary instability.86

Economic and Monetary Union

The Basle-Nybourg agreement did not fully satisfy the French government. Although French officials would not ally with the United States in its argument with Germany over reflation, they were similarly critical of German trade and current account surpluses and the German macroeconomic policies that contributed to them. These were problematic, in the French view, not only owing to their deflationary effects within Europe but owing to their effects on the European exchange rates with respect to the dollar, which reached a record low of DM 1.56 in the aftermath of the October 1987 crash. The French finance minister, Edouard Balladur, argued that the appreciation of the European currencies was "contrary to the fundamental interest of Europe and of its constituent economies" and concluded that "rapid pursuit of the monetary construction of Europe is the only possible solution."87 The proposal was enthusiastically seconded by the Italian minister of the treasury, Giuliano Amato.

Rather than rebuffing Balladur's proposals, senior German officials responded with constructive counter-proposals. Foreign Minister Hans-Dietrich Genscher proposed the creation of a European central bank and currency area, subject to strict conditions, and set down a procedure for achieving these goals. Finance Minister Gerhard Stoltenberg also responded positively. Genscher's memorandum to the Ecofin Council on this subject identified one of several motives: reduction in European dependence on the dollar and "the management of exchange rates to third currencies closer to equilibrium."88 The European Council then commissioned a report on Economic and Monetary Union (EMU) to be written by a committee of experts chaired by Jacques Delors. The study, christened the "Delors Report," presented a detailed three-stage plan on EMU, reminiscent of the Werner Plan, to the European summit at Madrid in June 1989.89

The Single European Act, the prospective completion of the single market, and German proposals to liberalize capital controls throughout the community, and in France and Italy in particular, provided important impetus for EMU initiatives in the first half of 1988. The Delors Report was written during a period of temporary tranquillity in transatlantic monetary relations.

Global monetary conflict was nonetheless at the forefront of European strategies on monetary integration, as the timing and content of Balladur's announcement reveals. European officials were also aware of the likelihood of macroeconomic conflict with the United States in the future. Through its effect on trade balances, the huge U.S. budget deficit had been the ultimate source of American pressure for reflation in Europe and a source of instability in international financial markets. However, the new American president, George Bush, demonstrated little political commitment to addressing this problem given his read-my-lips pledge not to raise taxes under any circumstances. American belligerence on macroeconomic policy, Helmut Schmidt wrote at this time, has "grown into a monster of the Loch Ness type: It keeps coming up for air."90

In Spring 1991, as Schmidt's metaphor anticipated, President Bush and his Treasury Secretary, Nicholas F. Brady, launched a new offensive to persuade Europe and Japan to reduce interest rates. Brady was vexed at high German interest rates and the determination of other European countries to match them despite the possible damage to their national economies from doing so. The Bush administration, like the Reagan and Carter administrations before it, also countenanced depreciation of the dollar into 1992.91 Meanwhile, in the midst of the new American offensive on macroeconomics, the governments of the European Community convened the intergovernmental conferences (IGCs) to write the amendments to the European treaties. The resulting agreement, the Treaty on European Union, or Maastricht Treaty, committed the member states to create a monetary union by the end of the decade and laid down an elaborate procedure for achieving this goal.92

The disintegration of the Soviet Union and the unification of Germany played a leading role in the intergovernmental politics during the negotiations over the Maastricht agreement. European governments sought to anchor unified Germany in the West and Germany sought to demonstrate its commitment to Western Europe. The European Union and the monetary union became the principal vehicle for doing so. German unification had a double impact on monetary integration: while it created a "window of opportunity" by securing formal commitments, the economic consequences of unification made it more difficult for European governments to harmonize economic policies to the degree necessary to stabilize exchange rates.93 Thus, although changes in the broad political structure of the international system affected monetary integration, they cut both directions over the medium term. Transatlantic relations on monetary issues, moreover, continued to nudge European governments toward one another. American pressure and the depreciation of the dollar underscored monetary independence from the United States as one of the original motivations for the project.

Although the motive was shared by many in Europe, it was best expressed by the European Commission and French officials. As the European governments were deciding whether to convene the intergovernmental conferences which led to the Maastricht Treaty, the Commission touted greater Community influence in global monetary affairs as a substantial benefit:

There are recurrently episodes in international relations when the strongest powers effectively determine the stance of macro-economic policy at the world level, with the weaker powers having to absorb conditions ill-adapted to their preferences. An example was seen in the early nineteen-eighties, when the U.S. exchange rate and interest rate were higher than Europe would have liked. Another example was seen in the nineteen-eighties when the Japanese Yen remained much undervalued in real terms for a long time. . . . [I]n general terms a Community that was united and well organised in its economic and monetary affairs would be better able to secure a world policy mix more favourable to the interests of the global economy.94

In October 1990, the Commission released a report, entitled One Market, One Money, which presented the case for EMU. The report weighed the costs and benefits of monetary union. By some criteria, one country's gain was another's loss. Enhanced bargaining power in global monetary affairs, however, was a positive-sum selling point for monetary union. Accordingly, the report made the most of it:

As long as Community governments and central banks set their policy in a non-coordinated way, Europe appears as a collection of medium-sized policy centres facing two major poles, the US and Japan. Spill-over effects of individual European policy decisions on non-European countries are small, while those of the US on Europe are several times larger. This asymmetry, which arises from relative sizes and degrees of openness, implies that ceteris paribus the United States has presently less to gain than Europe in transatlantic coordination. Since coordination always involves risks, because of imperfect information, and costs, at least those which arise from domestic political considerations, the incentive for the US to engage in such an exercise is weak. To some extent, the United States can exploit this asymmetry by making its policy choices in a non-coordinated fashion without suffering much from a similar behaviour of European nations. The effect of EMU would be to aggregate 12 economies into a single major block whose degree of interdependence with the US, Japan and the rest of the world would be meaningful.95

This analysis was not confined to the elite within the European Community institutions or member governments. Once the European Council agreed to proceed with EMU and political union at the December 1991 summit at Maastricht, the Netherlands, the Treaty was submitted to national referendums in several countries. On the eve of the referendum in France, the newspaper Libération conducted a poll of the electorate's attitudes toward the European integration. The newspaper reported that 62 percent of the French electorate believed that the European Union would provide equal strength in conflicts with the United States and Japan. In the hierarchy of rationales for the treaty, collective strength was tied for first place with the reasoning that European Union would assure peace in Europe. Of those in the French electorate voting in favor of the Treaty, 77 percent agreed with the strengthen-Europe argument.96

Although the Maastricht treaty entered into force in November 1993, the prospects for EMU were clouded by the succession of currency crises in 1992-93 that culminated in the widening of the ERM bands to +/- 15 percent. At one point during these crises, Prime Minister Pierre Bérégevoy, ex-Prime Minister Raymond Barre, and other French officials lashed out at an "Anglo-Saxon conspiracy" as the source of the franc's problem.97 The British government of Prime Minister John Major was more victimized by currency speculation than the French government. Nonetheless, the accusation suggests that some French officials continue to perceive monetary integration as a contest between a Franco-German commitment to stability, on the one hand, and the forces of instability, including the United States, on the other hand. Undaunted by the switch to wide bands, Jacques Delors reaffirmed an enduring motive for monetary integration:

With a single currency founded on an economic base accounting for a quarter of world production, the European Community could weather the turbulence on the world's capital markets. It would be strong enough to force the United States and Japan to play by rules which would ensure much greater monetary stability around the world.98

European governments are now engaged in the arduous process of trying to meet the convergence criteria for EMU membership laid down in the treaty. The European Monetary Institute (EMI) has been created and sited in the German financial center of Frankfurt with the purpose of preparing the transition to the final, third stage of monetary union. National governments are jockeying for position on the critical question of membership in the monetary union and its broader implications for the politics of the European Union. The history of European monetary integration demonstrates that, although it would be inappropriate to recommend belligerent American policies for this purpose, that a U.S. pressure for macroeconomic policy adjustments and promotion of rapid exchange rate shifts would strongly reinforce the European commitment to follow through on the EMU project!

CONCLUSION

International monetary instability, and inconsistency in American policies in particular, strongly reinforced regional considerations pressing Western European countries toward monetary integration. American pressure on European governments for macroeconomic adjustments and use of the "dollar weapon" provided strong incentives for the members of the European Community to develop a regional monetary regime. While not the only incentive for exchange rate stabilization within the Community, transatlantic monetary conflicts were closely associated with each of the major watersheds in the evolution of European monetary integration: the first proposals by the Commission for monetary union and the creation of the Committee of Central Bank Governors; the Werner Report advocating a three-stage approach to monetary integration; the joint float of the European currencies against the dollar after the unravelling of the Bretton Woods regime; the creation of the EMS; the strengthening of the EMS during the early and mid-1980s; and the Maastricht treaty. Moreover, each major episode of transatlantic monetary conflict produced identifiable progress, albeit tentative and halting in many instances, toward regional monetary integration.

In addition to the close correlation between transatlantic monetary conflict and European monetary integration, the international transmission of unwanted economic effects that attend conflict, and that are described in the theoretical section, strongly suggest that the relationship is causal. Transatlantic conflict did not always act in the same fashion on the same European countries to produce greater impetus for integration; its specific mechanism varied over time. At times of high inflation, American pressure helped to push the French Socialist government in the direction of regional integration. At times of slow growth or recession, American pressure helped to persuade Germany of the benefits of regional monetary integration. The main point is that in each episode of transatlantic conflict, American pressure tended to nudge the most hesitant of European participants forward on the path toward greater integration.

In fact, the unreliability of American monetary policy in the 1970s and of American fiscal policy in the 1980s, and the imperviousness of American economic policymaking to European advice on these matters, helped to drive that most reluctant, indeed hostile, of European bureaucracies, the German Bundesbank, into the European fold. Hostile to the EMS at the time of creation, the Bundesbank had became a defender of the system by the mid-1980s. Having a partner such as the United States reduced the opportunity cost of European monetary integration for the Bundesbank and Germany as a whole.

This systemic approach cannot explain all aspects of European monetary integration; it has limitations. It does not disaggregate the state into its constituent parts. Domestic politics, institutions, and processes play important roles in determining macroeconomic policy and international monetary policy in large and small states alike. The mechanisms of international economic transmission and interstate influence described above work through domestic politics and institutions to affect policy selection. International economic and macroeconomic influence at the systemic level is not the only determinant of national macroeconomic policy, of course. International influences will tend to favor some factions over others on questions of macroeconomic policy and can therefore tip the balance of domestic power on policy choice. Through these mechanisms the systemic context is critical to understanding the dynamics of European monetary integration.