

Explaining the September 1992 ERM Crisis: The Maastricht Bargain and Domestic Politics in Germany, France, and Britain

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In September of 1992, the seemingly inexorable movement of the European exchange rate mechanism from a system of quasi-fixed exchange rates towards monetary union and ultimately a common currency by the end of the decade was abruptly preempted, perhaps indefinitely. Massive speculative pressure on the eve of the French referendum precipitated the worst crisis in the thirteen-year history of the European Monetary System, resulting in the ejection of the sterling and the lira from the ERM, the devaluation of the peseta, the threat of forced devaluation of several other currencies, including the "hard-core" franc, and the abandonment or near-abandonment of unilateral currency pegs to the system by non-ERM countries. Together with political recriminations and blame-laying between Britain and Germany in the aftermath, the crisis represented a tremendous blow to the goals of political and economic integration recently affirmed by EC member governments in the Maastricht Treaty on European Union in December 1991. Nevertheless, conventional wisdom at the time dictated a more sanguine assessment of the prospects for EMU, in the belief that the strains within the ERM were due to the unfortunate confluence of exceptional circumstances -- the shock of German reunification, a debt-driven recession in Britain, and the uncertainties caused by the Danish and French referendums on Maastricht. The situation in 1992 was uniquely unstable, so the argument went, and hence things were bound to improve. German interest rates would come down, the British economy would eventually revive and then the UK government would reconsider the anti-inflationary benefits of ERM membership. The French franc had weathered the September storm, buoyed by an unequivocal Franco-German commitment to its D-Mark parity. Thus, the EC finance ministers emerged emboldened from an emergency meeting on September 28 in Brussels, reaffirming the operating principles of the ERM and rejecting the British chancellor of the exchequer's calls for reform.

However, continuing exchange rate instability in the ensuing months --manifested particularly by continuing speculative attacks on the fundamentally sound franc, devaluation of the Portuguese escudo and the Irish punt, and the spectacular August 1993 decision by EC finance ministers to allow most currencies to fluctuate within a much wider band of 15% on either side of their central rates in the system --shattered this initial optimistic assessment. Turbulence in the ERM following Black Wednesday, coming on the heels of a five year period between 1987 and 1992 in which the system witnessed no realignments and was widely regarded as a de facto fixed rate regime, seems to belie an underlying structural flaw. This paper will argue that the September crisis was a symptom and early warning signal of a flaw that lies, ironically, within the mandates of the Maastricht treaty itself, the heart of which is the three-stage blueprint for monetary union whose future is now highly uncertain.

Although the benefit of hindsight is acknowledged, the study presented here will attempt to circumscribe the events leading up to September 1992 in explaining the causes of the crisis and their implications for the viability of the 3-stage Maastricht process for EMU.

In the first section of the paper, the permissive conditions of the crisis will be discussed, including the implications of financial liberalization and the lifting of capital controls in the EC; depreciation of the dollar and the dollar/D-Mark relationship; evolution of the EMS from a system of fixed but adjustable exchange rates to a "hard ERM" countenancing no realignments, despite policy divergences and inflation differentials among the member states; and the potential problem posed by "asymmetry", with Germany as the nominal anchor of the system.

A brief historical review will show that monetary cooperation in the EC has largely been a vehicle for achieving national interests at the European level, highlighting the importance of intergovernmental bargaining and particularly the Franco-German relationship for progress in this policy sphere. In the following sections, it will be argued that the Maastricht agreement on EMU, whose origins can only be fully understood with reference to international forces and political developments originating outside of Europe, paradoxically introduced an entirely new and destabilizing element into the EMS. Political bargaining among national governments and non-governmental elites advocating fundamentally opposed philosophies of monetary integration -- the "monetarist" versus "economist" debate tracing back to the early 1970s -- produced an untenable compromise with potentially chaotic consequences: the mating of demanding convergence criteria and strict timetables, within an institutionally uncertain environment, upon commencement of Stage II of the EMU process in January 1994. The "framing effects" of the Stage II criteria fundamentally altered the nature of economic discourse during Stage I, highlighting the costs of the loss of monetary autonomy for European governments and inviting markets to test the resolve of members' commitments to their exchange rate pegs.

To assess the credibility of national politicians' commitments to their exchange rate pegs, I turn to the second component of my explanation of the September crisis, domestic politics. The tension between domestic policy needs and the policy measures required to sustain rigid ERM parities in the short-term and to meet tough convergence criteria in the medium-term contributed significantly to exchange rate instability in 1992, as speculators took bets on the parities of currencies not only upon the basis of economic "fundamentals", but also upon the perceived political willingness or ability of national politicians to impose costs on their electorates. Thus, the domestic political debates in Germany, Britain, and France in the months to September arising from the loss of monetary sovereignty and the question of the future of Europe will be examined. In this light, the Danish and French referenda, the British recession, and especially the manner in which the German government chose to finance the "asymmetric exogenous shock" of unification are not merely exceptional circumstances, but are endogenous to an analysis of the underlying causes of the September crisis, since they provided signals of the willingness of domestic coalitions and publics to bear costs associated with the Maastricht bargain. Finally, I will briefly consider the implications of this proposed causal relationship between the Maastricht bargain and the ERM crisis, with domestic politics as an intervening variable determining variance in outcomes (i.e. exit from or loyalty to the ERM in September) for theories of European integration. In the profusion of economic analyses on the costs and benefits of monetary union, it is all too often forgotten that the construction of Europe and the goal of a single currency is a highly political endeavor, which requires the maintenance of long-term political momentum for its realization. At the same time, turbulence in the EMS highlights the fact that much of Europe's failure is political, as national political elites have neglected to build domestic coalitions in support of their supranational policy objectives.

Factors contributing to the ERM Crisis

The environment in which the EMS operates has changed significantly since its founding in March 1979. Several elements created the "permissive conditions" of the September crisis, one of the most important of which is the evolution of the regime itself from a system of fixed but adjustable exchange rates to a de facto fixed rate system, despite considerable economic divergence among the member states.¹ The two principal architects of the EMS, German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing, intended to establish a "zone of monetary stability" within the EC,

as a response to inflationary shocks and the wide currency fluctuations which ensued after the demise of Bretton Woods, and importantly as a way to dramatize politically the long-term goal of European integration. Founded upon the remnants of the "snake", an unsuccessful attempt at European monetary coordination begun in March 1972,² the exchange rate mechanism of the EMS was to be a system of fixed but adjustable exchange rates between member countries. Each participating currency had a central rate relative to the ECU -- a basket of defined amounts of each of the member states' currencies, depending on the state's relative economic weight -- which could be changed by a commonly agreed realignment. From these central rates flowed a series of bilateral rates -- for example the French franc against the German mark, the Dutch guilder against the Italian lira, etc. -- which form the ERM parity grid. Currencies were required to remain within a plus/minus 2.25 percent fluctuation band against other ERM currencies, except for Italy which was initially allowed a 6 percent band.³ Whenever one currency hit its outer margin of fluctuation against another, both countries were obliged to intervene on the foreign-exchange markets to prevent the rate from going further. Automatic and unlimited access to a "very short-term financing facility" (VSTF), consisting of a reciprocal cash facility among ERM-participating central banks, was established to facilitate compulsory intervention.

The first four years up to March 1983 were characterized by frequent realignments (a total of seven, in which five involved two or more currencies) and limited convergence, as countries sought to compensate for inherited price and cost disparities, as well as the additional cost disparities produced by differing national responses to the second oil shock. Realignments in the early phase "were generally agreed without much critical introspection and were not accompanied by comprehensive domestic stabilization measures." ⁴

The comprehensive realignment of March 1983 marked a break with the earlier period, when the Mitterand government in France abandoned budgetary expansion in favor of a rigorous domestic stabilization program aimed at maintaining the franc's value in the ERM. A calmer intermediate phase ensued up to January 1987, with only four realignments, of which three involved two or more currencies. The emphasis was increasingly on nominal convergence and coordination of monetary policies to underpin exchange rate stability.

The third period beginning in early 1987 and lasting for five-and-a-half years until the September crisis witnessed an unprecedented degree of stability, with no realignments⁵ and the enlargement of ERM membership to include the peseta, the sterling, and the escudo. As governments and markets began to view the EMS as a "de facto" fixed exchange rate regime, the dream of monetary union in Europe which had foundered upon the turbulent international economic environment of the 1970s seemed possible again by the late 1980s and early 1990s. It appeared that an incremental extension of the EMS was all that would be required for EMU. The desire for a single currency was bolstered by the impending completion of the single internal market in 1992, characterized by the free flow of goods, services, capital, and labor. It was argued that the EC countries would not capture the full gains of the Common Market unless exchange-rate uncertainties and conversion costs associated with separate national currencies were eliminated. A forceful exposition of this view was presented by the EC Commission in its 1990 brief on EMU, "One Market, One Money."⁶

However, the apparent stability provided by the decreasing frequency of realignments and the potential for irrevocably fixed exchange rates masked a fundamental source of instability -- the divergence in member states' rates of inflation, fiscal policies and competitive positions gave rise to real exchange rate changes despite stable nominal exchange rates. David Cameron's analysis of annual rates of inflation among ERM members since 1985 reveals that "a significant divergence in economic and monetary policy existed after 1987."⁷ Though he observes a negligible cumulative difference between German rates and those in the Benelux countries, Denmark, France, and Ireland after 1988, indicating a convergency in monetary policy among these countries, he notes cumulative differences between German inflation rates and those in Spain and Italy on the order of 10 and 20 percent, respectively, suggesting an overvaluation of the peseta and the lira relative to the D-mark. Sterling as well was widely considered to be overvalued upon entering the EMS in October 1990, at a bilateral rate of DM 2.95.⁸ Therefore, the longer a necessary realignment on the basis of economic fundamentals was postponed, the more likely that the EMS would come under speculative pressure to redress the imbalance between the stated and the true relative values of currencies. Indeed, in 1987 Peter Kenen attributed the success to date of the European exchange rate regime to the fact that "the frequency of realignments has allowed the EMS to make large cumulative changes in exchange rates, needed to offset changes in relative costs and prices, but to make them by small increments ...

speculators have not been offered the old one-way option that they exploited happily under the Bretton Woods system, when realignments were infrequent and thus had to be quite large.⁹ Moreover, the explicit goal of currency union, which had gained considerable support among several key member states by 1990, itself contributed to the rigidity of the system. Bundesbank officials felt that the unification of Germany required a revaluation of the D-mark relative to the other ERM currencies, but this was strongly resisted, particularly by the French, who felt that a realignment would jeopardize the goal of EMU as well as undermine its own franc fort policy.¹⁰

In addition to the evolution of a "hard ERM", the EMS developed a second aspect which was contrary to the intentions of its founders and contributed ultimately to the September crisis. The original plans for the EMS envisaged that the ECU would be at the center of the system, and that a "divergence indicator" -- measuring the deviation of a currency from its ECU central rate -- would identify the currency in need of adjustment. In this way adjustment would be "symmetric", affecting deficit and surplus countries alike. However, this arrangement centering upon a "basket" of currencies raised concerns in West Germany that the rate of inflation in the EMS would converge to the average, thus introducing an "inflationary bias" into the system. The German Bundesbank, although it did not originally favor the creation of the EMS, greatly influenced the negotiations over its structure, and was able to ensure that intervention would be based on the bilateral parity grid rather than on ECU parities.¹¹ This virtually guaranteed that the pressure to adjust would be "asymmetric", i.e. would weigh more heavily upon the weak-currency countries (weak, because of higher inflation or a trade deficit) than the strong-currency countries (strong, because of lower inflation or a trade surplus). If the margin of a band was reached, both central banks would intervene to defend the bilateral exchange rate. However, the strong-currency country could simply issue more of its own currency, whereas the weak country would have to draw down its foreign currency reserves and usually borrow additional funds. Since those reserves were finite, the latter would be forced to adjust by imposing more restrictive economic policies -- raising interest rates to encourage investors to hold the currency and to discourage domestic inflation and import demand.

As the strongest currency in the EMS, the D-mark quickly developed into the nominal anchor of the system, and it is commonly argued that Europe became transformed into a "D-mark zone."¹² The Bundesbank maintained the purchasing power of the deutsche mark by limiting the expansion of domestic monetary aggregates to levels consistent with non-inflationary growth. In turn, the willingness of other members to conduct monetary and financial market policies consistent with maintaining a stable exchange-rate vis-a-vis the deutsche mark reduced the need for realignments in the latter part of the 1980s, as annual rates of inflation converged downward to German levels. This led to the popular interpretation of the EMS as a "disciplinary device", wherein members such as France and Italy "borrowed" anti-inflation credibility from the independent Bundesbank by committing themselves firmly to exchange-rate stability and using that commitment to justify domestic monetary policies aimed at price stability. By "tying their hands" the authorities of higher inflation countries could lower the unemployment costs of disinflation.¹³ The disadvantage of this arrangement, however, is that the Bundesbank in Frankfurt became the de facto central bank of Europe, and by pegging their currencies to the D-mark "EMS participants have to ape a German monetary policy in which they have no formal say."¹⁴ German interest rates effectively set the floor for interest rates in the ERM, as other currencies were required to carry risk premia reflecting the possibility of devaluation against the deutsche mark. Indeed, in none of the twelve realignments up to 1992 were any ERM currencies revalued against the deutsche mark.

The desire to rectify this asymmetry and regain some measure of control over their monetary policies was the motivation behind French and Italian calls for reform of the EMS after 1987. But an asymmetrical system is not only politically distasteful to those countries which want a "a seat at the table" in the making of European monetary policy; it can also be economically painful and destabilizing to the entire system if the anchor country deviates from sound budgetary practices because of its own domestic priorities. Gros and Thygesen note:

[I]f one accepts the view that the EMS is an asymmetric system, the effects of fiscal policy and therefore the spillover effects that arise in the use of this instrument then become different for Germany than for the rest of the EMS. If the Bundesbank sets its own monetary stance independently, a domestic fiscal expansion in Germany will lead to some increase in German, and hence EMS-wide interest rates. This implies that an expansion in Germany might actually depress overall demand in the

other EMS countries so that German fiscal expansion may become a 'beggar-thy-neighbor' policy that hurts the rest of the EMS area.¹⁵

The consequences of the expansionary fiscal policy pursued by the Bonn government following German unification confirmed this observation only too well. As the Bundesbank consistently raised interest rates from 1990 onward to reign in inflationary pressures at home, other ERM countries were confronted with the difficult choice between raising their own interest rates to maintain price stability and their peg with the D-mark, at the cost of slowed growth and higher unemployment; or allowing the traditional spread between their interest rates and German rates to narrow, inducing investors to move out of their currencies in favor of the mark and thereby jeopardizing the quasi fixed-rate regime. German policies with regard to unification and their implications for the viability of the EMS will be discussed in further detail below. For now, let it suffice to reiterate that two aspects of the evolution of the EMS -- its development into a hard-ERM and its asymmetrical functioning -- helped create the permissive conditions for crisis in the system.

Two other antecedents of the September crisis originated to a large extent outside of the EMS. First, the level of international capital mobility has increased greatly in the past few decades, thereby augmenting the capacity for destabilizing speculative flows. One aspect of this growth can be seen in the rapid development of international banking. Between 1972 and 1985, the size of the international banking market increased at a compound annual growth rate of 21.4 percent, compared to compound annual growth rates of only 12.7 percent for world trade and 10.9 percent for world GDP.¹⁶ Just as the eurocurrency markets have increased in absolute size, regulatory and technological changes and financial innovation have facilitated the ability of capital to move across borders. In the late 1970s, the daily turnover in the world's major currency markets was estimated at \$100 billion. By 1992, daily turnover was estimated at 1 trillion. Liberalization of capital flows in Europe was further stimulated by the White Paper put forth by the EC Commission in 1985, which became the centerpiece of the program for the single market. In June 1988 the EC Council of Ministers adopted the Commission's proposals for complete liberalization of all capital transactions by no later than end-1992. The loss of exchange controls removed an important instrument by which EC countries could manage the fluctuation of their currencies, leaving them even more vulnerable to capital movements and speculative attacks. Furthermore, the resources available to central banks for intervention and counter-speculation in the markets declined over the last few years relative to daily turnover. Whereas the G7's aggregate official currency reserves of 150 billion dollars in 1986 were equivalent to roughly one-half of the daily turnover in the global currency market, by mid-1992 those reserves were equivalent to only one quarter of the turnover.¹⁷

Secondly, tensions in the US dollar/D-mark market have historically led to tensions in the EMS. This is yet another indicator of the German currency's special position in the system, as short-run portfolio shifts out of dollar assets tend to go predominantly into deutsche marks, hence raising the value of the D-mark relative to other ERM currencies. Indeed, the German government's concern over the dollar rate of the D-mark in the late 1970s was a key motivation for Helmut Schmidt's EMS initiative.¹⁸ Large American payments deficits through 1977-8 weakened the dollar and led to the overvaluation of the D-mark, with deleterious consequences for German exports. Calls that the US should take measures to fight inflation and halt the dollar decline were met with an attitude of 'benign neglect'; instead the Americans called upon the Germans to reflate their own economy. Although the EMS was intended in part to create a zone of stability vis-a-vis the dollar, inflation was high in some of its member countries at the onset, and it was feared that the EMS would soon break down if a further dollar decline forced a new D-mark revaluation. Elke Thiel notes that "[i]t was thus advantageous to the early performance of the EMS that the Carter administration shifted policy later in 1978 and 1979 to stabilize the dollar and that the D-mark entered a phase of weakness with the advent of a strong Reagan-dollar in the following years."¹⁹

However, the depreciation of the dollar negotiated among the Group of Five industrial states after the Plaza Accord of 1985 was likely to pose a problem for the EMS, as forecast by DeCecco:

Under the umbrella of the strong dollar, the EMS currencies could avoid taking embarrassingly divergent courses and could happily agree on a joint downward float against the dollar. The US market was again available to imports and everybody in Europe could be wise and fat, exporting to the

United States...Convergence of...economic indicators... increased among EMS countries and realignments became relatively infrequent...

It will be very interesting to see whether the new international stance of the dollar [i.e., the depreciation] will again bring turmoil among EMS exchange rates. If it does, the non-essential character of the EMS will have been proved. If monetary and exchange rate stability in the EMS countries persist in spite of dollar devaluation, the EMS can be said to have caused them.²⁰

Thus, given this potential for instability, the dollar rate of the D-mark has always been a serious concern in German economic policy-making. Since the effect of U.S. interest rate levels on German interest rates is rather strong, Thiel notes that German monetary policy has been "most cautious" to keep interest-rate differentials within a range that will not provoke large capital shifts from one country to the other.²¹ However, it appears that after unification Bundesbank officials were distracted by the inflationary threat to the domestic economy, and gave little regard to the widening gap with U.S. rates. In the three and a half years preceding the ERM crisis the U.S. Federal Reserve cut its discount rate eight times. American short-term interest rates were only 3.4 percent in August 1992, their lowest level in 30 years, while German rates were at 9.9 percent, their highest in about 60 years.²² As investors rushed out of dollars into D-marks, first sterling and then the lira fell toward their floors in the ERM in the last weeks of August and the beginning of September. Clearly, the weakness of the dollar exacerbated tensions in the EMS already engendered by the factors mentioned above, namely the potential for massive speculative flows of capital internationally, as well as the rigidity of exchange rate parities and the effects of asymmetry within the EMS itself.

Intergovernmentalism and Monetary Cooperation in the EC

It is important to recognize that progress in European monetary coordination has always been imbued with great political significance, and hence has historically come about through initiatives from the EC heads of government, particularly through Franco-German cooperation. The Werner Plan for Economic and Monetary Union, which envisaged a single EC currency by 1980, grew out of European leaders' desire to break new ground in the EC upon completion of the customs union, and in view of the Community's proposed enlargement to include Britain, Denmark, and Ireland. Meeting at the Hague summit in December 1969, the heads of government felt the need to "reaffirm their belief in the political objectives which give the Community its meaning and purpose," and thus "pave the way for a united Europe capable of assuming its responsibilities in the world of tomorrow." German Chancellor Willy Brandt, who tabled the proposal for monetary union, was a long-standing supporter of federal ideas, but he also had a more specific nationally-conceived motive: to balance his Ostpolitik with a Westpolitik to allay any fears of a resurgent German nationalism, and to strengthen the Federal Republic's relationship with the West, especially with France and the Community. French President Georges Pompidou was equally disposed, for supranational as well as particularistic reasons, to relaunch the development of the Community after it had been frozen by DeGaulle. Though he adhered to the Gaullist tradition of closer ties between France and Germany, he was much less averse than his predecessor to reinforcing these ties in the context of the Community. Moreover, the weakness of the French economy and violent speculation against the franc since the events of May 1968 jeopardized the operation of the Community's agricultural policy, so important to French national interests, and became an additional motive for Pompidou's support of monetary union.²³ Certainly he could count on the support of his finance minister, Giscard d'Estaing, who had recently put forth a proposal for a common currency, to cure the Community of the instability that resulted from the weakness of the franc, as well as the dollar, and the consequent strength of the mark.²⁴

When the question of monetary coordination was taken up again after the turbulent decade of the 1970s, German and French leaders were once more at the helm of the effort. In addition to his dissatisfaction with the monetary policies of the Carter administration and his concern over their effect on German exports, Chancellor Schmidt may also have been influenced by EC Commission President Roy Jenkins' impassioned call for EMU at his Jean Monnet Lecture in 1977, as well as the European Council's reaffirmation of this objective soon afterwards, at the instigation of the Belgian presidency.²⁵ Schmidt readily enlisted the support of his "only friend" Giscard, with whom he had

worked closely since Schmidt became finance minister in 1972 and both men moved from that position to become Chancellor and President respectively in 1974. Both leaders had to overcome domestic resistance to the plan for EMS: in France from the Gaullists, still concerned about sovereignty, and from farmers who sought concessions on agricultural policy which ultimately were not forthcoming; and in Germany from the Christian Democrats, the financial sector and the powerful Bundesbank, all of whom feared possible inflationary implications. John Goodman interprets Germany's endorsement of the EMS as "a victory of industry over the monetary authorities", as Schmidt wanted the EMS to shield the German exchange rate from excessive revaluation with French and Italian monetary laxitude. In terms of trade balances with European and U.S. competitors, Germany was being penalized for pursuing the strong currency option in isolation.²⁶ National motives for the deficit countries of France and Italy included the desire to stabilize their currencies vis-a-vis the deutsche mark while preserving their ability to pursue monetary policies divergent from that of Germany. ²⁷

The British Prime Minister, James Callaghan, was almost alone in expressing serious reservations about the EMS plan. The British feared that it might be deflationary and exacerbate the de-industrialization which was already cause for concern. A second argument was that the EMS could upset the wider international monetary system and annoy the Americans. Callaghan's Atlanticist orientation became clear when he sided with the U.S.' calls for German reflation, rather than working with Schmidt to organize a European response to American concerns. Thirdly, the British had long been skeptical of Continental plans for integration which they believed would never come to pass. UK Treasury official Kenneth Couzens, assigned to work on the technical preparations for EMS, revealed his true feelings at the European Council in Bremen where the plan was officially adopted: "the Treasury remains skeptical to the point of contempt," he reportedly said, "of most of the detailed content of the Franco-German scheme," which illustrated "the danger of allowing enthusiastic amateurs to dream up schemes for monetary reform."²⁸

Though Callaghan understood the political significance of the initiative, any remaining thoughts he might have harbored about putting sterling into the ERM of the EMS were extinguished by a House of Commons resolution signed by 120 Labour MPs, rejecting "any attempt by the EEC, its institutions or its member states to assume control of domestic policies through a monetary system for the Community"²⁹: an attitude which was to underpin Margaret Thatcher's resolution to keep sterling out of the actual exchange rate mechanism throughout the 1980s (though Britain had official membership in EMS from the start) and would continue to plague her successor's attempts to establish a credible policy commitment to the EMS after the pound's eventual entry in October 1990.

The renewed impetus for EMU in the late 1980s derived once again from the desire of member governments to secure nationally-defined objectives through a European framework. However, important changes had occurred within the Community and in the international system, which must be discussed first in order to understand these new developments. As mentioned before, the signing of the Single European Act in 1986 and the decision to complete the internal market by the end of 1992 prompted wide support from Europe's business community for one currency instead of eleven (Belgium and Luxembourg share their franc), to facilitate the planning of long-term investment and to eliminate conversion costs. But one particular decision in the 1992 program helped persuade European politicians of the need for change and drove forward the monetary debate.³⁰ This was the decision in June 1988 to lift all remaining capital controls by July 1990, with derogations for Spain and Ireland until 1992 and Greece and Portugal until 1994-5. In the mid 1980s West Germany, Britain, Belgium, and Luxembourg were the only EC countries which had no barriers to capital movements; among the richer members France and Italy were clearly the laggards in this respect, having reinstated exchange controls in the 1970s. The implications of capital liberalization were tremendous, giving rise to the possibility of speculative flows which could force exchange-rate realignments, or at the very least interfere with the normal course of monetary policy. Some measure of defense against this risk was provided by the Basle/Nyborg agreement of 1987, which augmented the credit facilities available to weak-currency countries and recognized the importance of intra-marginal interventions. However, the Nyborg arrangements did not reconcile the concern expressed in the EC Commission's Padoa-Schioppa report of 1986, which identified an "inconsistent quartet" of policy objectives. In the quest for free trade, full capital mobility, fixed exchange rates, and independent monetary policy, only three of these objectives can be attained simultaneously. Assuming that free trade and capital mobility are required for completion of the internal market, and that the fixed exchange rates of the highly touted EMS would not be sacrificed, then national monetary policies would have to be the casualty. "In the long

run," according to Padoa-Schioppa, "the only solution to the inconsistency is to complete the internal market with a monetary union."³¹

Nevertheless, momentum within the Community for monetary reform appears to be a necessary but not sufficient condition for the relaunching of the EMU initiative in 1988. Indeed, in the late eighties the EMS as it stood was widely regarded to be a great success, having reduced exchange-rate variability among its members and facilitated policy convergence in a way that, because of the much vaunted goal of "Europe", at least partly insulated the governments of the traditionally inflation-prone states from the political costs of their economic stabilization measures. Germany, as anchor of the system, was able to achieve simultaneously its internal objective of price stability and its external objective of stable exchange rate relationships with its partners, which preempted competitive devaluations. It is therefore unlikely that the Federal Republic would have assented to the drastic alteration of an arrangement from which it benefited so well, without some other additional stimulus. Thus, while existing Community institutions and the momentum created by a long history of economic and monetary cooperation placed EMU within the realm of the politically feasible, David Andrews argues convincingly that the causally decisive forces which eventually resulted in the Maastricht agreement originated largely outside of Europe. Without changes in the international position of the dollar and the collapse of the bipolar balance of power between the United States and the Soviet Union, "European monetary integration efforts would likely have continued to focus on the reform of the European Monetary System."³²

For the non-German states of the EMS, particularly France, the balance-of-payments constraint present under conditions of highly integrated capital markets raised the costs of policy divergence from Germany, in the sense that a trade-off existed between an independent monetary policy and exchange-rate stability. Upon joining the EMS, the French quickly discovered that the price of running large deficits was the repeated devaluation of the franc, thus instigating Mitterand's celebrated "U-turn" of 1983. This loss of effective monetary autonomy proved politically acceptable in the early eighties when a strong dollar provided an ample market for European exports, but was exacerbated by the dollar's decline in the wake of the Plaza agreement and the loss of this foreign outlet. As the pursuit of the strong currency option in Europe led to the deterioration of French and Italian trade balances vis-a-vis Germany, political attention was refocused upon the much-resented asymmetrical operation of the system.

In 1988, Edouard Balladur, finance minister in the Chirac government, circulated a paper around his EC counterparts. It was a list of complaints regarding the asymmetry of the EMS which operated to shift the burden of intervention and adjustment onto the weak currency countries, whether or not they were to "blame" for the imbalances, and stated that "no country should be, a priori, exempted from rectifying its policy when the latter departs from commonly-agreed goals, no matter whether this policy is excessively expansive or restrictive." The Balladur paper concluded by suggesting a study of a European central bank to replace the EMS.³³

Italy quickly endorsed the French position in a paper by finance minister Giuliano Amato. Amato was even more explicit in his criticism of the German's role within the EMS. "Not only is the pivot currency of the system fundamentally undervalued, but the growth of domestic demand in Germany is lower than average." He charged that Germany's resulting structural surpluses in relation to the rest of the EC had caused tensions in the system, pushing up the D-mark, particularly when the dollar was weak, and "removing growth potential from other nations." Amato ended by advocating "an agreed loss of autonomy" through a European central bank where all members would have a voice in the making of monetary policy, rather than the unilateral loss of autonomy to Germany implied by the workings of the EMS.³⁴

While the French and Italian proposals were well received by Belgium and the Netherlands, the German response revealed clearly mixed feelings. Foreign minister Hans Dietrich Genscher issued an approving memorandum titled "A European currency area and European central bank" which attracted strong criticism in Germany, particularly from the Bundesbank, for not showing enough caution. Finance Minister Gerhard Stoltenberg waited a month before even acknowledging the proposals. The Finance Minister's memorandum differed from Genscher's in that it made no procedural suggestions to analyze the issue and emphasized the risks of instability in transitory arrangements, suggesting that independence of central banks in all member states, to ensure the priority of price stability, might be a prerequisite for embarking on intermediate steps. Bundesbank president Karl Otto Pohl concurred that EMU could only be a long-term goal and required a central bank committed to price stability and

independent of political instruction. Despite these reservations, Chancellor Helmut Kohl announced that discussion of monetary union would be placed on the agenda of the June Hanover summit, where a committee headed by EC Commission president Jacques Delors and including the 12 member state central bank governors was tasked with providing recommendations for the actions required to move to EMU, and instructed to report back within a year.

The Delors Report, adopted at the European Council meeting at Madrid in June 1989, proposed a three-stage process for moving to monetary union (to be discussed below), on the firm condition that countries would first have to show a sizable degree of economic convergence. The Council agreed to start the first stage on July 1 1990 and to convene an intergovernmental conference to consider amendments to the Treaty of Rome necessary to move beyond the first stage, but declined to set a date for the IGC at this time, at the insistence of the British. The fact that the Delors report soon acquired significant momentum at the highest political levels, particularly in the German government, can only be understood in terms of external events.

The accommodating but relatively cool response of the Germans changed in tone by the latter half of 1989 due to the rapidly shifting events in the international security environment. The revolutions in Eastern Europe, the sudden collapse of Soviet power and Germany's imminent reunification created an urgent political drive within Germany and among its EC partners to strengthen the institutions of the Community and firmly anchor the Federal Republic in the integration process. In a morally appealing and politically shrewd move, Chancellor Kohl insisted that German unity must be part of a wider union of Europe. He wished to reassure his uneasy European neighbors, particularly France, that a reunited nation of 80 million Germans would remain a reliable and cooperative partner, and holding out the promise of a single currency seemed to be the best way of indicating his good intentions.

France, for its part, conditioned its support for German unification on progress in Europe in general and on EMU in particular. On the eve of the dismantling of the Berlin Wall, President Mitterand announced that the fall of Soviet communism required an acceleration of the "construction" of Europe, and in November 1989 he visited the other 11 EC capitals to press the issue of monetary union. Prime Minister Michel Rocard reaffirmed the French commitment to EMU later that month, and in early 1990 foreign minister Roland Dumas linked the accelerated schedule for monetary union to events in Germany.³⁵

The dual processes of German reunification and EMU unfolded rapidly: on November 28, 1989 Helmut Kohl unveiled his 10-point plan for eventual unification; on December 9 the European Council meeting in Strasbourg affirmed their commitment to German unity "in the perspective of European integration" and agreed to convene the IGC on EMU before the end of 1990. In April 1990 the European Council at Dublin adopted the Commission's proposal to integrate the GDR territory into the Community without treaty modification; at the same time President Mitterand and Chancellor Kohl issued a joint communique calling for parallel IGCs on EMU and European Political Union or EPU, which should end in time for their results to be ratified by member states before the end of 1992. And in the months before 1990 drew to a close, German monetary union (July 1) and political union (October 3) had been attained, and the two intergovernmental conferences meeting in Rome had begun work on far-reaching revisions to the original EC Treaty.

"Monetarists" versus "Economists"

Although neofunctional variables have also played an important role, it should be clear from the foregoing discussion that monetary cooperation in Europe has always been firmly ensconced in high politics, with progress in this sphere resting on prior intergovernmental bargains: the initiatives for the Werner Report in 1969, the EMS in 1979, and EMU a decade later bore the distinct imprimatur of national governments seeking to obtain particularistic objectives at the European level, with Germany and France figuring most prominently in the debate. This has had profound implications for the various attempts at monetary coordination and institutionalization, as the dialectic of struggle and compromise between French and German interests has been reflected at each attempt, with ultimately destabilizing consequences. The compromise plan for EMU hammered out between the Delors Report and the Intergovernmental Conference concluding at Maastricht in December 1991 was essentially a struggle between two fundamentally different economic philosophies: the "monetarist" position,

championed primarily by France and Italy, and the "economist" position, defended by the Germans and the Dutch, and which was the view essentially expressed in the report unanimously submitted by the central bankers, Commissioners, and independent experts on the Delors Committee. This rancorous debate traces back to the early 1970s in the provisions for the Werner Report, and will be explicated here briefly.

Although a common currency was the ultimate goal shared by President Pompidou and Chancellor Brandt at the Hague summit, the two leaders had very different priorities for the initial stage. The French president wanted an immediate transition to irrevocably fixed exchange rates, without much emphasis on coordinating economic policies beforehand. Once exchange rates were locked in this way, he argued, economic policies of member states would be forced into convergence. The German Chancellor, on the contrary, insisted on policy convergence as a prerequisite for EMU, arguing that monetary union would have to be the crowning act of a process of harmonization and then unification of economic policies.³⁶ This basic disagreement largely reflected the very different interests of the two countries.³⁷ If the franc remained weak relative to the mark, as was expected, the Bundesbank would have to intervene in exchange markets to support the French currency. For West Germany, such support meant accepting a higher rate of inflation; for France it meant that the Federal Republic would have to share in the costs of adjustment. In the end, the decision reached by the Council to embark on stage one on an experimental basis tilted in favor of the monetarist position. Though the Germans and Dutch wanted to start with economic coordination rather than the narrowing of margins of fluctuation entailed in Werner's initial stage, "French participation remained essential and French refusal an insuperable obstacle."³⁸ Ultimately, the experiment was not successful. The snake's inability to keep the major currencies together reflected differing national interests. West Germany's desire to pursue more restrictive monetary policies than those of France and Italy during the turbulent environment of the early 1970s placed additional strain on EC exchange rates; the desire of France and Italy to retain autonomy led both to the decision to float. According to one observer, "[t]he ambitious goal of economic and monetary union had been placed in question by politics: divergences of economic philosophy and of attitude towards a federal reform of the Community institutions."³⁹

Controversy between the two camps resurfaced during the EMS negotiations. The weak-currency countries of France and Italy favored the use of ECU parities as the indicator of divergence, rather than the bilateral parity-grid supported by the Germans. The weak-currency countries argued that the latter would force the burden of adjustment upon them, since they would have to draw down their reserves and implement economic austerity measures to defend the bilateral rate, whereas the strong-currency country could simply issue more of its currency. The ECU parity mechanism, conversely, would allow France and Italy greater room for maneuver around Germany's strict anti-inflationary goals. The Bundesbank, however, rejected this idea out of hand, and West German negotiators prevailed in their insistence that the bilateral grid carry an obligation to intervene, while the ECU divergence indicator was reduced to a mere "presumption" to act. In practice, the divergence indicator has had almost no influence, and the potentially destabilizing consequences of this asymmetrical arrangement have been discussed above. DeCecco concurs that "the EMS contains two philosophies of economic policy, represented by Germany and the small northern states on one side and by France and Italy on the other. These policies have not collided...because of the lucky coincidence of [external] factors..."⁴⁰

The ongoing tension between these two philosophies -- reflecting fundamentally different national interests -- and the significant bargaining power of their two main proponents would have profound consequences for the viability of the Maastricht compromise and hence for the stability of the EMS. I argue that the September crisis is in part a consequence of this untenable compromise. Although from the first meeting of the Delors Committee, which held eight sessions in Basle from September 1988 to April 1989, members had hoped to avoid a repetition of the "religious wars" of the 1970s between the economist camp led by Germany and their monetarist opponents led by France. It was agreed at the outset that the path to EMU would have to consist of parallel economic and monetary tracks; the committee also quickly agreed "not to repeat the mistake of setting a deadline for EMU as the Werner report of 1970 had done", or as the EMS founders had done in calling for a European Monetary Fund within two years, a plan which was subsequently dropped.⁴¹ Instead, the Report only set a start date for Stage I (July 1 1990), and argued that

the conditions for moving from stage to stage cannot be defined precisely in advance; nor is it possible to foresee today when these conditions will be realized. The setting of exact deadlines is therefore not advisable. (par 43)

Despite concurrence on this issue, philosophic divisions reappeared between the Delors committee's two main protagonists: Bundesbank president Karl Otto Pohl and Jacques de Larosiere, governor of the Banque de France. The French bank governor tabled a "monetarist" proposal for a European Reserve Fund (ERF) in Stage I, a precursor to a European central bank which would manage pooled reserves and intervene on the foreign-exchange markets. Pohl was adamantly opposed to what he perceived as an attempt to circumvent the issue of economic convergence by racing ahead to a Euro-bank. In the end, the ERF was the only issue on which the Delors Report acknowledged division among committee members. It highlighted the importance which the French placed on fast movement to EMU, and foreshadowed the French negotiating position on clear timetables during the intergovernmental conference.

The Germans' position as well was already taking shape during the Delors meetings. Though it was agreed early on that parallel economic and monetary progress would mean that states would have to agree to some constraints on their budgetary deficits (causing some discomfort to Bank of England governor Robin Leigh-Pemberton and others), Pohl took the initiative to argue strongly for binding budgetary rules, in such a heavy-handed manner that it was suspected that the concerns of the Bundesbank council and not just Pohl's were at issue.⁴²

In brief, the final Delors Report proposed the following: Stage I, beginning July 1990, would see the completion of the internal market, the removal of all obstacles to financial integration, greater monetary coordination through the Committee of Central Bank Governors and "quantitative guidelines...for concerted budgetary action by the member countries" (par 51). All Community currencies would enter the ERM of the EMS. "Realignments of exchange rates would still be possible, but an effort would be made by every country to make the functioning of other adjustment mechanisms more effective" (par 52). During Stage II, policy surveillance would be strengthened through ECOFIN Council (an EC body comprising member states' Ministers of Economics and Finance) guidelines for national budget deficits and their financing, but ultimate responsibility for economic and monetary policy would still remain with national authorities. A European System of Central Banks (ESCB) would take over the tasks of the Committee of Central Bank Governors and begin the move from coordination of national monetary policies to the design and implementation of a common monetary policy. Realignments of exchange rates would become the adjustment mechanism of last resort. Stage III of EMU would begin with the irrevocable locking of exchange rates, and preferably the issue of a single currency. The ESCB would assume full control over the conduct of monetary policy, manage the official reserves of all members, and be responsible for exchange market intervention in third currencies. Finally, constraints on national budgets would be enforced by the EC Council, in cooperation with the European Parliament.⁴³

With the exception of the recommendation for a European Central Bank at Stage Two (albeit one with ill-defined and clearly limited powers), the Delors Report represented a victory for the "economist" position, with its emphasis on budgetary restraint to promote convergence (no specific criteria yet), no timetables, and fixing of exchange rates only at the final stage. To a contextual observer this was probably not surprising, as Gros and Thygesen note:

[M]ost monetary officials would have been content to adopt a pragmatic attitude [to EMU]. The Basle-Nyborg agreement had only recently been implemented, and most EC central bankers had a preference for developing its full potential within a system of voluntary coordination...It is arguable that had there not been a clear request in the mandate to the Delors Committee to "propose concrete stages," an important proportion of the members would have expressed a preference for continuing with the existing EMS until sufficient convergence was deemed to have been achieved to move to permanently fixed rates.⁴⁴

The preferences of central bankers were clearly overtaken by the political momentum for EMU propelling their national governments. But the adoption of the first stage of the Delors Report at the Madrid summit, and the subsequent decision taken by 11 EC governments (with Britain dissenting) at Rome in October 1990 to begin Stage II in January 1994,⁴⁵ did not dispel the long-standing division

between monetarists and economists in the European Council, which became clear during the year-long IGC debate.⁴⁶

Whereas governments generally agreed upon the initial steps for Stage I and the final outcome as described in Stage III, controversy centered around the problematical Stage II. It was widely regarded to be the 'weak link' in the Delors Report, due to its dual ambiguity regarding the transfer of monetary authority to a central institution and the conditions required for transition to the final stage. Throughout the course of the IGC, three clear positions among the main protagonists emerged. France and Italy emphasized the catalytic effect of firm timetables upon convergence. They wanted to move quickly to EMU, and believed that rapid institutional change would harness market forces to accelerate nominal convergence in goods markets and financial markets, as well as increase political readiness to take tough measures as deadlines approached. These governments supported the Delors Report's recommendation to set up an ECB in Stage II, to maintain political momentum for EMU.

Predictably, Germany and the Netherlands feared that institutional innovation would get ahead of true economic convergence, and resisted any transfer of monetary authority during the second stage.⁴⁷ They preferred to emphasize the conditions for entering a full monetary union, believing that tough criteria for nominal and real convergence must be met before movement to irrevocably fixed rates and a single currency. But since it cannot be determined a priori when convergence will be achieved, they were emphatically opposed to firm timetables.

During this time Britain was the odd man out. While the Thatcher government strongly favored financial liberalization and the completion of the internal market, it viewed EMU as an assault on economic and political sovereignty, and an attempt to centralize decision-making in a technocratic EC bureaucracy. What particularly irked the British was the Delors Report's insistence that EMU be a "single process": "Although this process is set out in stages which guide the progressive movement to the final objective, the decision to embark upon the first stage should be a decision to embark on the entire process" (par 39). Even after the decision to bring sterling into the ERM in October 1990, the British strategy was one of attempting to decouple the first from the second and third stages. Toward this end the Treasury produced an alternative proposal for an "evolutionary approach" to EMU, which would introduce a Hard European Currency Unit (HECU) into the ERM after the first stage. The HECU would never be devalued against other member currencies, but rather compete against them in the private sector, eventually driving out those with high inflation. The adoption of a single European currency would thus be left to market forces rather than bureaucratic pronouncement. However, the British proposal was never a serious alternative to the Delors strategy. It was challenged on economic grounds as well as political acceptability, since it refused to consider a Community-led strategy.⁴⁸

The third British view can thus be labelled a "pragmatic" view, in that monetary union may be desirable, but it is safer not to be committed to it. Since this position is not easily reconciled with transition to EMU according to a fixed date or upon fulfillment of pre-designated criteria (though Britain would certainly concur with German and Dutch reluctance to set timetables), much time in the IGC was spent figuring how to enable Britain (as well as Denmark) to defer their decisions on monetary union.

During the months of pre-summit meetings, finance ministers agreed that EMU would be based on strict convergence criteria, not only to decide if and when Stage III should start but also to determine which countries could participate. Monetary discipline would be given priority over other macroeconomic targets such as lowering unemployment. To secure German support, the other EC members had also consented to a European central bank independent from political guidelines and committed to price stability, to be established just before Stage III. At the beginning of Stage II a European Monetary Institute (EMI) -- a precursor to the ECB comprised of a politically appointed President (appointed by "common accord" of the heads of state or government), a vice-president, and the 12 EC central bank governors -- would be tasked with coordinating the activities of central banks and formulating "opinions" or "recommendations" on national monetary policies, but responsibility for policy would ultimately remain in national hands. The EMI would also develop an organizational framework for the ECSB, and generally "prepare the instruments and the procedures necessary for carrying out a single monetary policy in the third stage."

Most of these proposals were embodied in a draft of the Treaty prepared by the Netherlands Presidency of the IGC in the weeks just before the Maastricht summit. The Netherlands Draft instructed the Commission and the EMI to report to the Council of Ministers by the end of 1996 on

whether "a high degree of sustainable convergence", as measured by specific quantitative criteria, had been achieved. Four convergence criteria were stipulated:

1) A high degree of price stability, measured in terms of an average inflation rate, over a period of one year prior to the examination, that is no more than 1.5 percent higher than the three best performing member states. Inflation would be measured by a comparable consumer price index (CPI);

2) A sustainable financial position, measured in terms of a government debt no more than 60 percent of gross domestic product (GDP) and a budget deficit less than 3 percent of GDP;

3) Maintenance of the exchange rate within the narrow ERM margins, with no devaluations or "severe tensions", for at least two years before the examination;⁴⁹

4) Interest rates no more than 2 percent higher than the three members with the lowest inflation, over a period of one year prior to the examination.

Based upon the recommendations of the Ministers and the European Parliament, the European Council would decide whether it was appropriate to begin Stage III, and if so, to fix a date. If the convergence criteria had not been satisfactorily met by a sufficient number of member states, the whole process would be repeated periodically thereafter. Moreover, countries meeting the criteria whose parliaments did not "feel free to approve of the irrevocable fixing of its currency" at the beginning of Stage III would be granted an "exemption", similar in effect to the "derogation" granted to countries not meeting the criteria, and carrying the possibility of joining EMU at a later date.

While the Netherlands Draft was endorsed by Germany and other countries not wishing to begin the third stage until convergence was achieved, as well as Britain, the country most likely to exercise the "exemption" option, France and Italy were highly dissatisfied with this formulation. In particular, the refusal of the Bonn government and the Bundesbank to commit to a firm timetable signaled to Paris and Rome that Germany's political commitment to EMU was less than solid. On the eve of the summit, President Mitterand and Italian Prime Minister Giulio Andreotti, a veteran negotiator who had been present at the establishment of the EMS thirteen years earlier, came up with a compromise plan which was accepted at Maastricht. They proposed making EMU obligatory in 1999, if there is no agreement to start it earlier, and with no exemptions (i.e. no opt-out for Germany) for all EC countries fulfilling the rigorous economic targets laid out in the Netherlands proposal. If a majority of members had attained these criteria by 1997, subject to the decision of the European Council following the procedure described above, union could start by that date; otherwise it would begin in 1999, even with only a minority of members.⁵⁰ Britain and Denmark's desire for an opt-out at Stage III could be accommodated in two separate protocols annexed to the Treaty.

Thus the Maastricht bargain was carefully crafted to satisfy the interests of the major member states. In essence it represented a compromise between the monetarist position, which found expression in a firm timetable for EMU, and the economist position, expressed in strict standards for convergence. A concession to the pragmatist view took the form of opt-outs, enabling the two countries concerned to defer their decisions on monetary union. The result was that everyone leaving the table could proclaim a victory -- France and Italy received an unambiguous political signal in favor of EMU, Germany's conditions for an independent ECB had been accepted, and that country and Britain were satisfied that monetary union would not proceed unless the economic conditions were appropriate. In addition, the EC's "poor four" -- Spain, Portugal, Ireland, and Greece -- had wrested an agreement from their wealthier partners to establish a "cohesion fund", a financing mechanism that would cushion the pain of structural changes required to meet the demands of monetary union.

But was this victory for all really a victory for none? The deal struck at Maastricht on EMU was most importantly a deal on Stage II, since EC governments (save Britain and Denmark) largely concurred with the Delors Report recommendations on Stages I and III. But Stage II, because it represents the juxtaposition of incompatible philosophies and interests which have remained consistent since the days of the Werner Report, is inherently problematic. Specifically, the mating of strict convergence criteria with firm timetables in the medium term raised the possibility that several countries would be ineligible for EMU by the time of examination. An analysis of selected economic

indicators for the EC countries in 1990, figures available during the negotiation of the IGC (see Table I), suggests that five EC countries had a long way to go before meeting the inflation-rate criterion with respect to the three best-performing countries -- Portugal, Greece, Britain, Italy and Spain. Four of those countries also fell far short of the interest-rate criterion in comparison to the best performers -- Portugal, Greece, Italy, and Spain. Moreover, several of the stronger-currency countries fared poorly under the fiscal stability criteria. Belgium, Ireland, the Netherlands, and Denmark well exceeded the required debt ratio of 60 percent of GDP, in addition to Italy, Greece, and Portugal. Belgium and the Netherlands, along with Greece, Italy, Portugal, and Spain, also easily exceeded the 3 percent fiscal deficit ratio. A glance at fiscal data for 1991 reveals a continuation in the trend. During Stage II, the possibility that Italy, a founding member of the Community, or Belgium, the seat of the Commission, would not be eligible for EMU at the first launch could spark a political crisis, especially in light of the fact that the newest applicants for EMS membership -- Austria, Switzerland, Norway, and Sweden -- would probably easily qualify. Why would some EC governments agree to criteria which they clearly would have trouble meeting? The most plausible answer is that they were Germany's preconditions for agreeing to EMU, and an EMU without Germany would be nonsensical.

Aside from the fact that the necessity of some of the convergence criteria is disputed by analysts,⁵¹ the criteria in an of themselves would likely not be a destabilizing influence on the EMS if countries had sufficient time to introduce structural adjustment policies, fiscal austerity, and wage restraint in politically acceptable increments, with greater sacrifices becoming possible as national politicians built public support for a rigorous economic stabilization agenda. Indeed, a high degree of prior convergence among the member states could only strengthen any future EMU. Peter Kenen notes:

If the EC governments are truly committed to creating an ECB with the primary aim of maintaining price stability, they should start to reduce inflation before Stage III begins. They should show themselves willing to impose the economic costs and bear the political risks of fighting inflation and thus prove their willingness to grant the ECB the independence it will need to maintain price stability. A decision to move quickly to Stage III, without reducing inflation rates first...would raise serious doubts about the commitments made at Maastricht.⁵²

Despite the widely-recognized hazards of Stage II -- that governments may still try to pursue Padoa-Schioppa's "inconsistent quartet" of policy objectives; or that markets may predict that governments will use their independence before they have to relinquish it, by inflating or devaluing away their debt burdens, thus producing exchange market crises⁵³ -- Kenen nevertheless concedes that "Stage II may be necessary, because convergence may be necessary, and convergence will take time."

But political considerations robbed the EMS of time. The acceptance of the Franco-Italian proposal not only committed the members of the EMS to a fixed start date for EMU in 1999; by implication it set a timetable for convergence reaching all the way back to the beginning of Stage II. In order to be ready for appraisal by the European Council by mid-to-late 1996 for a 1997 decision, countries would have to implement economic austerity measures by mid-1994, in order to meet the criterion of stable exchange rates in the narrow band, with no devaluations, for a two-year period prior to examination. Thus it was agreed at Maastricht that Stage II would unequivocally begin on January 1 1994, removing the ambiguities of the Rome Conclusions on this start date (see endnote 44). Of course, it is theoretically possible for governments to impose painful austerity measures to maintain bilateral rates with the D-mark in the short-term, and reign in budget deficits to meet stiff convergence criteria in the medium term. But this becomes a question of political will, and markets make political judgments as well as economic ones.

I assert that the Maastricht bargain, made possible by forces largely external to Europe, introduced an entirely new and destabilizing element into the EMS, and is thus essential to understanding the underlying causes of the September crisis. Strict timetables and convergence criteria, the result of a Franco-German compromise on Stage II, fundamentally altered the nature of economic discourse on the EMS and the standards by which members' macroeconomic policies were judged. Until 1992, many commentators had expressed surprise that progressive financial liberalization and the lifting of capital controls had not unleashed massive speculative pressures within the EMS. Rather, the system experienced a period of unprecedented stability, with no realignments or expectation of realignments (which would have been indicated by exchange rate pressures), even as members inflation rates and

fiscal policies began to diverge. But within six months after governments signed the Maastricht treaty in February 1992, the EMS suffered the exit of two of its members and the devaluation or threat of forced devaluation of several others. While the evidence is somewhat circumstantial, I argue that the timetables and convergence criteria induced a new round of market scrutinization of member countries' economic "fundamentals" in terms of the stated value of their currencies, unchallenged for the past five years within the "hard-ERM". Unchallenged because the growing political momentum for EMU fed market expectations of no realignment, and the fact that there had been no realignments became a source of European pride and provided governments with the rationale for their goal of monetary union, to the point that the non-German countries would not tolerate a realignment on political grounds even when one was justified economically. But the Maastricht bargain interrupted these mutually-reinforcing expectations. Under this argument, the specific reference numbers in the Maastricht conditions recast the debate over the short- to medium- term sustainability of countries' ERM parities, specifically calling attention to the relative overvaluation of currencies such as the lira, sterling, and peseta. Through framing effects, the convergence criteria for a Stage II of truncated length cast a shadow back to Stage I, highlighting policy commitments which, in the judgment of the markets, were less than fully credible. To explore this issue more fully, I will now turn to the second main component of my explanation of the September crisis, the domestic politics of Europe and of monetary policy.

The Politics of Monetary Policy: Domestic Priorities and European Commitments

The problem of whether and how policymakers can make credible commitments about their future conduct has pervaded discussions about economic and monetary union. In particular, the authors of the Delors Report feared that future policymakers would succumb to the temptation of pursuing short-term economic growth for political reasons despite the costs of inflation in the long term, and thus emphasized the need to adopt "binding procedures" to constrain national policy authorities and reinforce price stability commitments. How has the EMS in the past facilitated the credibility of a national government's anti-inflation commitment? According to conventional wisdom, members "borrowed" anti-inflation credibility from the Bundesbank by accepting German monetary policy. The EMS in this light is an external disciplinary device which, by tying the hands of domestic policymakers, enhances the credibility of domestic policies.⁵⁴ But this theoretically appealing view, while consistent with the operation of the EMS by the mid-1980s, does not distinguish between the effect of the EMS having an anti-inflationary reputation and the problem of acquiring one. John Woolley argues that the EMS by itself entailed a very limited surrender of sovereignty and certainly did not subordinate members to the Bundesbank from the outset, as evidenced by the divergent policies pursued by members in the wake of the second oil shock, the frequency of unilateral realignments in the first phase, and the Bundesbank's expressed fear of importing inflation from its neighbors. Rather, a change in the internal politics of several EMS countries, most notably France after March 1983, solidified a commitment to a policy program consistent with price stability and the external demands of the EMS. Domestic political commitments by national-level politicians initially made the EMS credible, not the other way around. According to the author,

[T]he contribution of institutions to policy credibility must be understood as an unfolding historical process. Critical to this process is the creation of domestic political coalitions in support of substantive policy objectives. Political coalitions create credibility by bearing costs associated with their commitments...EMS institutions did not possess any inherent credibility; they acquired credibility because of the demonstrated willingness of participating governments to bear political costs...In my view, therein lies the most sobering challenge for the proponents of EMU. Fighting and winning domestic political battles were required to make the EMS effective... there will be more domestic political fights to be won before EMU can become a reality with high credibility.⁵⁵

Woolley's key insight, that national-level politicians must build domestic coalitions willing to make sacrifices for external objectives in order to render their commitments credible, can assist us in understanding the problems confronted by policy-makers in the months leading to the September crisis. Governments in Germany, Britain, and France were faced with unique domestic situations which either hampered or facilitated their abilities to meet their European obligations. The immediate costs

associated with policy commitment, in the cases of Britain and France, were reflected in the tension between domestic policy needs and the maintenance of ERM parities. Prolonged economic downturn and growing unemployment in both countries would seem to necessitate a lowering of interest rates, but maintaining their respective D-mark exchange rates required interest rates at painfully high levels. After the Danish referendum, which alerted markets to the fact that domestic public support for the goals of Europe might not be so readily forthcoming, the question asked of governments by the markets was this: Are interest rates at German levels sustainable in your country? And, by implication, Is your exchange-rate commitment credible? For Britain, a recent entrant to the EMS, the answer would be no. This outcome is a predictable one in light of the overwhelming domestic pressures operating on Prime Minister John Major to abandon the D-mark peg and lower interest rates, as well as the brief history of sterling's participation in the ERM. For France, on the other hand, despite widespread disenchantment with the ruling Socialists and the debate over Europe stimulated by the referendum, public and multi-partisan support for the franc fort policy never came into question, comprising a domestic coalition in support of EMS obligations that had survived governments of both the left and the right. Germany, as the anchor country of the EMS, faced a different set of constraints. The Bundesbank's monetary policy effectively determined the monetary policy for Europe, but the inflationary fiscal policies of the Bonn government in the wake of reunification induced the Bundesbank's tough contractionary response, in the form of ever higher German interest rates. The policy performance of the German government with respect to the maintenance of the EMS must be evaluated by the same criteria as its partners: the need to build domestic coalitions that will tolerate the sacrifice of short-run domestic objectives for long-run European goals. Rigid convergence criteria and timetables provided a severe test of the credibility of members' European commitments, but it was not a foregone conclusion that the Maastricht bargain would result in turbulence on the currency markets and the September crisis. A margin of maneuver was left to the member governments, through the demonstration of a willingness to take early and painful measures, in the form of fiscal and wage restraint or timely interest rate hikes, to defend the ERM commitment. A more immediate solution would have been a multilateral realignment of currencies against the D-mark, but this was a political non-starter as Mitterand and Major had staked the reputations of their governments on the promise of no devaluations. Thus, the failure to reach a cooperative solution that may have prevented the September crisis, given the new and destabilizing dynamic introduced by the Maastricht bargain, was in large part a domestic political failure. In the following section I will briefly examine the domestic politics of monetary policy in Germany, France, and Britain, focusing on the months to September, as well as the crisis itself.

Germany

Particularly significant among German institutions is the politically-independent Bundesbank, which is committed by statute to the pursuit of price stability. According to Peter Katzenstein, "the Bundesbank's single-minded pursuit of monetary stability has been the most constant element in West Germany's economic policy, to the chagrin of the Christian Democrats and the Social Democrats alike."⁵⁶ Since the early 1970s, the Bank's ability to pursue an independent monetary policy has had significant implications for German fiscal and incomes policies, enabling it on a number of occasions to rebuff demands from political parties, labor, and capital for greater economic growth and more expansionary monetary policies. Just as successive German governments could not assume that the Bundesbank would accommodate government deficits with greater monetary expansion, so unions and management could not expect the Bank to accommodate inflationary wage demands. However, the Bundesbank is also aware that its long-term independence depends upon continued societal support, so on rare occasion it has given way to political pressure for monetary expansion, if it felt that doing so would not jeopardize price stability.⁵⁷

Externally, independence has enabled the Bank to maintain a strong deutsche mark as the cornerstone of Germany's foreign economic policy. As a participant in European monetary arrangements, it has consistently refused to loosen its monetary policy to ease exchange rate pressure on its partners. When the French franc came under heavy speculative pressure in January 1974, the Bundesbank maintained its restrictive policy despite the pleading of the Bonn government, resulting in France's exit from the snake. In the months following the establishment of the EMS in March 1979, West Germany's partners argued that the Bundesbank should ease monetary policy to take pressure off

the weaker EMS currencies, but the Bank was undeterred, leading to the first EMS realignment in September 1979.

Understanding the modus operandi of the Bundesbank is essential to understanding the implications for the EMS of the Bonn government's financing of German Economic and Monetary Union (GEMU).⁵⁸ While it had been assumed by the Bundesbank that GEMU would be preceded by a gradual process of economic reform and reconstruction in the East culminating with currency union, the rapidity with which GEMU took place was due to the external political momentum generated once the Western powers, the Soviet Union and the GDR accepted the principle of unification; as well as the internal political imperative of stemming the massive flow of migration from East to West Germany. Chancellor Kohl's subsequent actions were dictated by domestic political considerations. During the campaign for the GDR parliamentary elections in March 1990, Kohl's strong indication that the conversion rate of Eastern wages, pensions, and savings would be 1:1 was a shrewd political move designed to win over the East German people, and was implemented despite the objections of the Bundesbank. Analysts agreed that "the rate of exchange chosen amounted to a sharp upwards revaluation of the East German currency and at one stroke made whole industries hopelessly uncompetitive", necessitating an even greater transfer of funds to the East.⁵⁹ The effective loss of the exchange rate as an adjustment mechanism between the two economies led to reductions in production, employment, and income far greater than would otherwise have been the case.

But despite the repeated warnings of the opposition Social Democrats, Kohl consistently downplayed the costs of unification to the West German electorate, arguing that "nobody would be worse off as a consequence" of unification. Necessary tax increases were delayed in the hopes of improving the Christian Democrats' showing in the All-German election of December 1990. An income tax supplement in the form of a Solidaritätsbeitrag (solidarity contribution) was not even introduced until July 1991, and increases in the Value Added Tax were not scheduled until 1993. As a result, unification-related expenditure quickly outstripped new revenue; the belief that reunification would be "self-financing" through Eastern privatization receipts and increased tax yields accompanying growth quickly proved false. Thus, in another triumph of politics over economics, the costs of unification were met by public sector borrowing on an unprecedented scale. Initial government ceilings for public borrowing set at DM 140 billion in 1991 had to be revised sharply upward to almost DM 200 billion, nearly 8 percent of GNP. This represents a significant departure from the customary fiscal conservatism of the Federal Republic, as the public sector budget in the late 1980s averaged about 2 percent of GNP.

The failure of the Kohl government to convey to the united German electorate that sacrifices must be made in the West and expectations must be lowered in the East in order to maintain a sound macroeconomic course had a dual effect -- the inflationary effects in Germany of a fiscal policy driven by political considerations were exacerbated by inflationary incomes policies. East German claims for rapid equalization of living standards were acknowledged as legitimate by politicians in the Federal Republic. Thus, despite vast differences in productivity, the Bonn government acquiesced to agreements reached between employers and labor unions in collective bargaining in the East to achieve wage parity between Eastern and Western union members by the mid-1990s. For example, the metalworkers' and public service workers' unions, now organized on an all-German basis, concluded wage negotiations with employers that yielded a 50 percent increase in 1991 and convergence with the West by 1995. Moreover, wage pressures in the West were facilitated by an initial economic boom which placed unions in a strong bargaining position. The 1991 pay round produced increases averaging 6.6 percent in the industrial sector. And in the spring of 1992, only months before the September crisis, the government became embroiled in a bitter wage dispute with OTV, the public sector workers' union. The public sector strikes that began on April 27 were Germany's first in nearly 20 years, as about 130,000 workers in transport, postal and garbage collection paralyzed services for eleven days in support of a 9 1/2 percent pay claim. Adopting a high-risk, confrontational strategy, Chancellor Kohl's appeal to national solidarity and pay discipline was ultimately unsuccessful, as the government was forced to agree to a wage settlement higher than one it had earlier rejected. As *The Economist* saw it, Kohl was belatedly trying to shock the unions into bearing some of the costs of unification, and he was "paying a high price for underestimating for so long the true costs of unity."⁶⁰

The Bundesbank's predictable reaction to its perception of fiscal indiscipline by the Bonn government and excessive wage demands in the labor market was a tight monetary policy, to send a clear warning that it would not accommodate inflationary pressures with monetary growth. Thus, the

Bank raised interest rates four times in the two years after reunification, so that by the summer of 1992 the discount rate was at 8.75 percent and the Lombard rate at 9.75 percent. The external effect of these increases was to raise the floor for interest rates within the ERM by some six percentage points from 1987 levels, drawing vocal criticism from Germany's EMS partners in the run-up to the September crisis, as these countries were required to maintain their currencies at exceptionally high levels that were inappropriate for their domestic economies and hampered recovery from a Europe-wide recession. But to blame the Bundesbank for intransigence or blatant insensitivity to European goals is to misplace the blame for high interest rates, as should be clear from the discussion above. In 1990, unification year, the Kohl government missed a key opportunity to build domestic coalitions in support of a fiscally sound approach to financing unification, when this support would have been most forthcoming. Subsequently, despite Kohl's rhetorical endorsement of European unity, the concomitant message that responsibility and sacrifice is required for the maintenance of a sustainable economic position to meet European obligations, incumbent upon all EMS governments to convey to their publics, was lost. The difference between Germany and its partners is that if another member cannot summon the political will to control public expenditure and inflation, it must either seek a realignment or be forced out of the system. But if the anchor member pursues imprudent macroeconomic policies, inordinate strains are placed on the system which threaten its very existence.

France

In sharp contrast to the independent status of the Bundesbank, the Banque de France of the post-war era has been fully dependent on the Finance Ministry, and hence the conduct of monetary policy has been effectively subordinated to government objectives.⁶¹ For the French government, the goals of economic growth and modernization after World War II took precedence over monetary stability, and coupled with the government's sensitivity to labor militancy following the events of May 1968, France had a rate of inflation chronically higher than that of West Germany by the 1970s. Following the collapse of the Bretton Woods system, France found that its continued emphasis on growth came into conflict with the restrictive policies pursued in both West Germany and the United States, and that the costs of divergence within financially integrated markets were escalating, in terms of its deteriorating external account and the value of its currency. But postponement still seemed preferable to policy adjustment, and in response to the first oil shock France imposed capital controls to protect its exchange rate and borrowed extensively abroad to sustain its expansionary policy, soon forcing its exit from the snake. The Barre government under Giscard d'Estaing recognized these costs and attempted to reduce inflation through a commitment to exchange rate stability and monetary targets; this economic austerity program was buttressed by Giscard's support for the EMU. However, apprehensions concerning labor unrest, electoral considerations, and criticism from the Gaullists prevented the Barre plan from producing the desired changes, and the victory of Mitterand in 1981 brought the Socialists back to power, along with a renewed commitment to higher economic growth and lower unemployment.⁶² The Socialists' Keynesian approach called for fiscal expansion, income distribution, and increased public sector employment; monetary policy was expected to accommodate the planned increase in government spending.

By September 1981, the Socialists expansionary policies brought the franc under new pressure in the exchange markets. France sought a 12 to 15 percent devaluation vis-a-vis the other EMS currencies, but its partners would only consent to 8.5 percent, and additionally requested the government to present a package of domestic policy measures to promote greater economic convergence. President Mitterand and Prime Minister Mauroy would only agree to a minimal package entailing a slight reduction in the 1982 budget; French monetary policy remained unchanged and continued to reflect the domestic priorities of the Socialists.

But exchange rate pressures in June 1982 and again in March 1983 prompted a watershed reversal in Mitterand's economic strategy, from one of expansion to one of austerity and convergence. The decision was not an easy one. By the early 1980s efforts to continue reflation after the second oil shock proved unsustainable, as the combination of expansion at home and world recession abroad threw France's trade balance into deeper deficit. Mitterand faced two alternatives: he could devalue the franc, take France out of the EMS, and adopt import controls to stabilize the trade deficit -- in so doing he would reverse a long-standing movement towards fuller economic integration in the EC. Or he could maintain France's membership in the EMS and commitment to the EC by lowering the budget deficit

and deflating the economy, giving priority to reducing France's inflation to the level of its major trading partners and maintaining the value of the currency -- the so-called franc fort option.⁶³

Persuaded to choose the latter by Finance Minister Jacques Delors and Budget Minister Laurent Fabius, and thus acknowledging the constraints imposed upon France by progressive integration into the world economy, Mitterand set his country on a course of economic austerity, convergence, and market liberalization that would survive governments of both the left and the right into the next decade. Cuts in public spending to reduce the budget deficit and measures to deregulate the private capital markets taken when Fabius became Prime Minister were continued during the period of cohabitation with the RPR between 1986 and 1988. The Chirac government gave priority to the fight against inflation rather than unemployment, using high interest rates to keep exchange rates at elevated levels. That this cautionary fiscal and monetary stance was not reversed with the return to power of a Socialist government under Rocard attests to the fundamental change which had occurred in French macroeconomic strategy. This change was reinforced by the decline of union strength throughout the 1980s, due mostly to rising unemployment. The trade unions, opposed from the outset to Mitterand's new economic program, found themselves "struggling for members and relatively demoralized in the face of a revival of market rhetoric to which even the Socialists seemed to subscribe."⁶⁴

But by early 1992 a political malaise had settled over France, with the popularity of the President Mitterand and his party at record lows. Regional elections in March yielded the worst showing for the Socialists in their 21 years of existence: 16.4% of the vote for France's 22 regional councils, compared to 23.6% in the 1989 European elections and 37.5% in the June 1988 elections. Unexpectedly, the alliance of the two main conservative parties also lost support, at 33% the lowest score in a decade. Voters migrated to the fringe parties, as the radical anti-foreigner Front National did well with about 14%, the same as the two green parties combined. Why such disenchantment with the political establishment? The franc was strong and inflation was at record lows. Exit polls suggested that slow economic growth and unemployment, hovering near 10%, was the main influence on people's choices, but that the policies of the center-left and center-right had become so blurred there was a sense of frustration and resignation that anything could be done about it.⁶⁵ Mostly voters were dissatisfied with a President in power too long and a Socialist party racked by successive scandals in the months to September: in February, a police investigation of campaign finances and the firing of a presidential aide and three top civil servants following the George Habash affair, the admission of a known Palestinian terrorist leader to France for medical treatment; in April, the replacement of the highly unpopular Prime Minister Edith Cresson after only 10 months in office; in May, the resignation of the minister for urban affairs on charges of forgery and fraud; in July, corruption charges against the president of the National Assembly, a former Socialist party treasurer; and finally, in the weeks up to the referendum, the sensational AIDS trial against former prime minister Laurent Fabius and several ministers and senior health officials, charged with knowingly distributing HIV-contaminated blood to thousands of hemophiliacs in the 1980s.

After the June 2 Danish No vote on Maastricht, a French referendum on the issue became a political necessity for Mitterand. Since a May 5 parliamentary vote on a procedural motion aimed at throwing out the Maastricht treaty garnered a surprisingly high 101 votes, some speculated that the President feared he would not be able to obtain the three-fifths majority of both houses of Parliament needed for ratification, and a referendum was a way of overcoming this. Polls at the time showed a comfortable 2 to 1 majority in favor. Probably a more important factor in Mitterand's decision was the hope of rallying public support for his own flagging leadership and driving a public wedge between the opposition on the right.⁶⁶ The French right's divisions over Europe dated back to 1978, when Jacques Chirac, the neo-gaullist leader, launched an attack on Giscard's pro-European "foreigner's party", the UDF, which he charged would rob France of its sovereignty. These differences had been papered over to preserve the unity of the right alliance, until the Maastricht debate brought them again to light. Giscard, leading the UDF, quickly called for a Yes vote, while Chirac, leader of the Euro-skeptical RPR, wavered for several weeks. Worried for his own presidential ambitions, Chirac belatedly decided on a personal Yes vote, leaving RPR members to make up their own minds.

By late June polls suggested that 35-45% of the French would vote Yes, 25% No and 25% undecided, with the rest abstaining. A heterogeneous anti-Maastricht lobby had formed around the Communist Party, the far right Front National, many neo-Gaullists, some Greens and Socialists, a handful of the UDF, and discontented lobby groups such as farmers and hunters. The ad hoc nature of the coalition suggested that the referendum was as much a vote for or against Mitterand as on

European union, since a No vote would put the President under pressure to resign as DeGaulle did after losing his 1969 referendum.

But the referendum also provided the French people with the opportunity for a long-overdue public debate on the future of Europe, as Mitterand himself acknowledged.⁶⁷ For decades the electorate had quiescently accepted the politicians' vision of a united Europe with France in a leading role, and the semblance of consensus had been maintained by the reluctance of the two main conservative parties to expose their differences. Now fears of the effects of a united Germany on the Community and attention to the fine print of the Maastricht treaty tore the consensus asunder, as the No vote edged out the Yes vote 51% to 49% by late August. Opinion polls revealed many reasons to vote against the Maastricht treaty, including suffrage rights for foreigners, the threat posed by economic liberalism to cherished national cultural values such as agriculture, and a rejection of the Brussels "technocrats", as well as disaffection with President Mitterand.

However, conspicuously free from attack in this debate was the issue of the economic policies of the government, specifically the franc fort and the sacrifices in terms of growth and employment required to maintain membership in the ERM. Clearly an implicit domestic consensus on this issue had long been established, providing the strand of continuity through changes of government between the left and the right in 1986, 1988, and, as we now know, in March 1993, when a resounding rejection of the Socialists and victory for the right alliance did not witness a reversal of this decade-old policy. Indeed, as turbulence on the currency market escalated in the run-up to the French vote, Mitterand refused a devaluation of the franc against the D-mark since he felt it would undercut one of his few successes and be viewed by the electorate as a political defeat; similarly he opposed German requests for a general realignment in late August and again in early September on the grounds that it would contradict the presentation of Maastricht as a leap towards monetary union. And although nearly half of French voters ultimately said No to Maastricht (48.95% No versus 51.05% Yes), for the reasons cited above, they still remained strongly for Europe. A post-referendum poll showed that 60% were still in favor of a single currency.⁶⁸ Thus, it appears that the successful Franco-German defense of the franc immediately following Black Wednesday cannot only be attributed to the Bundesbank's commitment of reputation and reserves, as well as the soundness of French economic fundamentals. The very fact that the markets attacked a sound currency indicates that the speculation was essentially a wager on the political willingness of the government to impose costs on its electorate. That the French government was able to take the painful measures necessary for the franc's defense -- a rise in short-term interest rates from 10.5 to 13 percent on September 23 (during an economic downturn and with elections pending in six months, no less) -- indicates the existence of a domestic consensus on a willingness to bear costs, which in turn lent further credibility to the government's commitment to its exchange rate.

Britain

Britain has a long history of reluctance to permit Community institutions to manage its economic and monetary policy. In the debates leading up to British entry to the EC in 1973, parliament was continually assured that responsibility for economic and financial policies would remain strictly under the control of national authorities. And while the Heath government put sterling into the joint float of European currencies for a few weeks in 1972, it was soon obliged by speculative pressure to take it out, and resisted suggestions that it should be put back in during 1973. Two years later, the subsequently dismal performance of the snake enabled the Callaghan government to note, with relief, that "the program for movement towards full EMU by 1980...was over-ambitious and unattainable." Even more significant was the Callaghan government's decision not to put sterling into the exchange-rate mechanism of the EMS, a move explained above. The change in government in 1979, bringing the Conservatives to power, did not reverse this decision.

It may seem rather surprising at first that the successive Thatcher governments did not bring sterling into the ERM, given the prime minister's rejection of Keynesian demand management policies and strong anti-inflationary preferences. Thatcher was a vocal proponent of the Single European Act, since financial deregulation and the internal market program were completely consistent with her avowed free-market principles; however, the ERM requirements of managed exchange rates through periodic intervention seemed to violate this ideological standard. Moreover, her nationalistic political vision of Europe facilitated the belief that an independent monetary policy best served Britain's

interests; adjustment of the exchange rate was too close to the heart of domestic politics to be shared with Community institutions.

However, by late 1985, the Bank of England and the Treasury had both become persuaded that this view was wrong, and that the ERM would provide net advantages in terms of exchange rate stability.⁶⁹ While the prime minister rejected this advice, Chancellor of the Exchequer Nigel Lawson in February 1987 covertly ordered the Treasury and the Bank of England to link sterling informally to the D-mark. Thatcher publicly clashed with Lawson in March 1988 when she learned of the decision to shadow the EMS, as the Chancellor had been ready to intervene to hold the pound down within its fluctuation margin when it came under upward pressure in March. In a speech to the House of Commons, she declared that anti-inflationary goals were incompatible with "excessive intervention" to support the pound, and sterling was allowed to float upward. Lawson later admitted that his desire to keep sterling's external value stable was one of the reasons why he raised interest rates too late to prevent a surge in inflation in the spring of 1988; this only reinforced Thatcher's inherent dislike for exchange rate pegging.

But the tide soon turned against the prime minister in the run-up to the Madrid summit. Lawson and Foreign Secretary Geoffrey Howe's support for Stage I of the Delors Report, requiring sterling's entry into the ERM, and the indirect pressure of example from Spain, which put the peseta into the ERM in mid-June, operated to isolate Thatcher, and she consented to a commitment to join the ERM sometime during the first stage. When that commitment seemed all but subject to a deadline with the Rome Council's decision to set a tentative start date for Stage II, Thatcher complained she had been "bounced", implying some secret conspiracy between the Foreign and Commonwealth Office and the Italian Foreign Ministry which had set the agenda for the summit. Soon afterwards Lawson and Howe were replaced by John Major as Chancellor and Douglas Hurd as foreign secretary, respectively. But this cabinet reshuffle did not yield the desired results for Thatcher, as one observer notes that

The two men who took over for Howe and Lawson at the Foreign Office and the Treasury were careful not to repeat their predecessors' mistakes by crossing Thatcher, either publicly or privately. But both were decidedly more pro-Community than the prime minister, and both were skilled at structuring their presentation of situations such that Thatcher was drawn into a series of incremental decisions with precisely the ultimate effects intended by Howe and Lawson.⁷⁰

Thus the 1989 Treasury proposal for a "hard-ECU" as an alternative to the Delors plan provided the pretext for British participation in the IGC negotiations on EMU. Again, Thatcher was eventually backed into a corner by the one-year deadline for the termination of the IGC, and Major and Hurd persuaded her to authorize sterling's entry into the ERM in October 1990. The Treasury, without consulting its EMS partners, chose the rather high central rate of 2.95DM, as the government's main concern was fighting inflation (then 10.9%).

From the very beginning the credibility of the British commitment to sterling's D-mark value in the ERM was questioned by markets, as British interest rates were lowered by a full percentage point on the day of the pound's entry. Sterling immediately fell to its floor within the wide fluctuation band, and a political furor arose over what was widely considered to be an overvalued central rate. The new British commitment to the EMS was viewed with skepticism by financial markets for additional reasons: the timing of the announcement on the last day of the Labour party's annual conference, as well as Thatcher's behavior at the Rome Council, where she declared that her fellow heads of government were in "cloud cuckoo land" for deciding to set a timetable for Stage II of EMU.⁷¹

The government headed by John Major quickly reduced the elements of ideology and sovereignty in its stance toward EMU, while pressing its case for the hard ecu as a common but not single currency.⁷² When asked on the day he became prime minister whether the government's opposition to a single currency was permanent, Major replied that one could eventually emerge, but it was "many years down the road." In June 1991 he declared his terms for acceptance for a treaty to permit EMU to go ahead -- a provision that the UK would move to a single currency only if and when a decision was taken by Parliament to do so. In this way Britain could avoid using its veto over the proposed treaty changes, since such an action might induce some of the EMS members to pursue monetary union outside the Community framework. This possibility was the gist of the hints of a "two-speed Europe" which emerged from German and French sources during 1989 and 1990. By mid-1991, one insider argues that Major really was in favor of EMU at this point, if the alternative was a monetary union

among Germany, France, and some other EC countries, and that he was more concerned to avert a split in the Conservative party before the general election in April 1992.⁷³

Major's personal and political commitment to the ERM, if not necessarily the EMU, became clear in the months after Maastricht, but his ability to take the measures necessary to defend sterling's position was constrained by the lack of a strong domestic coalition willing to bear costs, given the sluggish state of the economy. By the end of 1990, Britain had slipped into a recession that was to be longer than any other since the Depression of the early 1930s. In November 1991, when the "green shoots of recovery" refused to appear, the Treasury reconsidered its DM 2.95 central rate, but the prime minister made a political decision not to request a realignment that would appear to weaken the credibility of Britain's commitment to the ERM. Chancellor Norman Lamont concurred that a devaluation would reduce the credibility of government policy and cause interest rates to rise.

The credibility problem lay, however, in the fact that German interest rates were rising steadily, yet Britain refused to maintain the spread between its rates and those in Germany. Indeed, Britain pursued the contrary policy of reducing its rates on nine consecutive occasions after its entry into the ERM. By May 1992, after the latest reduction of the base rate to 10 percent, the British government had essentially eliminated the 7 percent spread between its minimum lending rate and the German Lombard rate that existed at the time of sterling's entry. Yet a credible exchange rate commitment and an essential part of ERM membership entails a political willingness to impose costs, in the form of interest rate hikes, for example, when they are required to defend a currency's position. Many commentators blamed Britain's exit from the ERM on the failure to raise interest rates earlier in the summer, when sterling first came under pressure. A hike from 10 to 12 and then 15 percent on September 15 was considered too little and far too late by the markets, which continued to bet heavily against the ability of Major and Lamont to defend its D-mark exchange rate in the face of overwhelming domestic pressure, building over the last several months, to realign, devalue, or leave the ERM altogether. As early as January of 1992, several newspapers, leaders in the business community, and MPs were urging Lamont to devalue the pound.⁷⁴ What was the source of these pressures?

One important domestic constraint with respect to interest rates facing Major and Lamont was the state of the housing market and its direct link to the recession. The deregulation of British banks and building societies, begun in 1979 with the abolition of exchange controls, fueled an explosion of lending and an acute escalation in housing prices. Many households took out large mortgages on the assumption that inflation would erode the real debt burden. But when interest rates were raised sharply in 1988 to choke off the inflationary surge (recall Lawson's belated decision), over-borrowed house buyers were hard hit. Borrowing shrank, house prices fell, and consumers curtailed their spending, leading to a fall in demand and hence a tenacious economic slump. The Bank of England's Quarterly Bulletin, released in February 1992, noted that surveys pointed to a setback in consumer confidence, a continuing upward trend in the ratio of personal savings to incomes, and "no sign of revival" in the housing market.⁷⁵ The Bank further estimated that over 1 million households in Britain had homes worth less than their mortgages, and warned that debt hangover could constrain consumer spending for some time. Lamont was very aware that an interest rate hike would stifle any recovery in the housing market or the general economy, and thus was under pressure to present a fiscally sound budget in March that would be judged prudent by the markets.

However, the Conservatives' budget was driven by the needs of the April ballot box. The Public Sector Borrowing Requirement was projected at 20 billion pounds in 1992-93 (3% of GDP), up from 11.5 billion in 1991-92. Lamont justified the stimulus on the grounds that 1) ERM membership restricts interest rate policy, so fiscal policy must be employed, 2) the recession was worsening, and 3) that Britain's fiscal finances looked sound in terms of the Maastricht criteria of a budget deficit no more than 3% of GDP and a public debt no more than 60%. Britain's budget deficit of 1.9% of GDP in 1991 was one of the lowest in the EC, even though it had by far the deepest recession; Britain's public debt was only 44%, well below the EC average of 62%. This last pronouncement clearly acknowledges the "framing effects" of the Maastricht conditions, and the manner in which the specific references numbers drew attention to member states' economic fundamentals.

A Tory victory on April 9 initially buoyed sterling, which traded comfortably within its ERM band, until the Danish No injected doubt into the markets about the degree of public support for Maastricht, and by implication, the viability of EMU. On June 2, despite the endorsement of the political establishment, industry, unions and the press, the Danes rejected the Maastricht treaty 50.7%

to 49.3% -- serving as a jolting indication to European leaders that progress in Europe would depend on wide-ranging public support for the goals of political and monetary union, and a concomitant willingness to bear costs to reach those goals.⁷⁶

The problems posed by the Danish referendum for the Maastricht ratification process quickly exposed the fragility of the British domestic consensus in favor of the ERM commitment -- which at least nominally included government and Labour, the Trades Union Congress and the Confederation of British Industry. But Major and Foreign Secretary Hurd, who were intent on using the British EC Council presidency beginning in July to find a way to bring Denmark back into negotiations, looked increasingly isolated in their support for the treaty and for the ERM. The Labour party's announcement that it would not support the Maastricht bill until the Danish question was resolved dashed the prime minister's hopes of getting it through Parliament during the autumn session. About 100 Tory backbenchers and their Euro-skeptic ministerial allies, emboldened by the Danish outcome, intensified their attacks on EMU and called for a referendum on ratification. Knowing that a British referendum would likely yield a No vote, Major denounced the idea in the Commons as "a device of dictators and demagogues." Nevertheless, the views of the backbenchers could not be ignored, since the election had cut Major's parliamentary majority to a slim 21 seats.

By July, Britain witnessed a growing public debate over its exchange rate and interest rate policy. The pound had dropped to DM 2.85, only seven pfennigs above its floor. While the Italian lira came under intense pressure as well, inducing the Bank of Italy to raise its discount rate to 13%, a potential political backlash from domestic constituencies precluded such an option for Britain. Early in the month, representatives from several major manufacturing companies held a meeting with Treasury officials to stress that high British rates were hindering an upturn in industrial production. On July 12, Norman Lamont, addressing concerns from industrialists, Conservatives, and academic economists that high interest rates were impeding a recovery from the longest recession since the Depression, argued that devaluation of the pound would only increase interest rates, that a revaluation of the mark was not on the agenda, and that no other members were willing to sacrifice their credibility by pursuing devaluation. The next day Major also ruled out a devaluation on the same grounds.⁷⁷ But on July 14, the Times published a letter by six prominent monetarists warning that the recession could continue into 1993 unless Britain left the ERM. A subsequent series of editorial attacks in the paper prompted the prime minister in August to lobby the Times for a 5-month economic truce, since the government believed that newspaper attacks on its policies were undermining the sterling's position in the ERM.⁷⁸ That same month pressure mounted on the government to boost the housing market, as several of Britain's largest mortgage lenders proposed tax relief for people purchasing homes. The government agreed to an interest rate cut on National Savings to ease pressure on building societies' mortgage rates.

In the last week of August, Major and Lamont returned early from summer vacations to confront a sterling crisis, as the pound slipped to DM 2.79, its lowest rate since joining the ERM. When the government announced that it would, if necessary, raise interest rates, the facade of consensus cracked. Critics roared that would exacerbate the recession, including the Confederation of British Industry, which had been initially enthusiastic about Major's effort to bring sterling into the ERM as Chancellor. Leading industrialists, such as the chairman of ICI, called on the government for a realignment. Additionally, in anticipation of the Conservative party conference on October 6, several small business associations had already tabled critical motions calling for interest rate reductions, with some calling for devaluation or withdrawal from the ERM.

Labour was also thrown into disarray over Europe. No sooner had Labour leader John Smith and Gordon Brown, shadow chancellor, insisted that the party would stick by the ERM than a number of their colleagues disagreed, including Bryan Gould, national heritage spokesman, and John Prescott, transport spokesman. On September 8 several union leaders at the TUC Congress in Blackpool called for a devaluation of the pound, led by John Edmonds, head of the GMB general union, one of the largest Labour-affiliated unions. The GMB move was joined by several other unions, including the general TGWU, the public service union Nalگو and the white-collar union MSF.⁷⁹

Nevertheless, Major stood against the tide, citing his commitment to the pound as a return to "conviction politics." This conviction was partly personal: after nine months he had finally convinced Thatcher to join the ERM, after Lawson had left the cabinet on the same issue. He also believed that Britain's long term economic decline was due to poor inflation performance, citing most recently the recession wrought by the 1988 inflationary boom.⁸⁰ Thus he addressed the UK presidency conference

on September 7 and hailed Maastricht as "good for Britain and good for Europe",⁸¹ while rejecting further Tory calls for a referendum. On the 11th he backed Lamont's position, and staked his political authority on the refusal to devalue sterling in the ERM. "As the chancellor made crystal clear, there is going to be no devaluation, no realignment...The soft option, the devaluer's option, the inflationary option would be a betrayal of our future, and it is not the government's policy."⁸²

However, the government's commitment to sterling's exchange rate could hardly be considered credible, given the extent of domestic opposition to the "hard option," as well as the history of Britain's participation in the ERM, wherein interest rates had been lowered repeatedly since entry in October 1990, but never raised. The day after sterling was forced from the ERM on September 16, despite massive coordinated central bank intervention and a last-minute interest rate rise to 15%, Peter Norman of the Financial Times observed:

With hindsight, the chancellor may have avoided yesterday's painful moves by raising interest rates earlier and in smaller increments when pressure began to build. This ignores however the politicized nature of UK economic and monetary policymaking, which is a more high-profile activity than in countries where technocrats or independent central banks hold sway. Heightened public interest may reflect the frequent mess the UK has made over economic management since World War II...Concentration of policy in the Treasury makes the chancellor a central political figure, in a way that finance ministers elsewhere are not.⁸³

The acrimonious debate over interest rates and exchange rate policy in Britain stands in sharp contrast to France, where the long-established franc fort policy, which had exacted a high price in terms of chronic unemployment and low growth, was never challenged in the months up to referendum. The lack of a domestic coalition willing to bear costs for the government's policies may have been the decisive factor in the market speculation forcing Britain's exit from the system, as several economic studies suggested that Britain's economic "fundamentals" in September were not so clearly in arrears as those of Italy, which was also forced out of the system after a 7 percent devaluation failed to halt speculation against the lira, and the Spanish peseta, which was devalued 5 percent.⁸⁴ If economic divergence was not the main reason for speculation against the pound (in addition to stronger currencies such as the French franc, Danish krone, and Irish punt, which also came under attack after Black Wednesday) then one could argue that markets were taking bets against the willingness of EC governments to bear political costs in order to meet their European obligations -- maintaining interest rates at German levels in the short-term, and taking the painful measures necessary to meet the Maastricht criteria in the medium term. According to Lionel Barber and David Marsh of the Financial Times,

Europe's economy is beset by slow growth, high interest rates, and mounting unemployment, yet governments are trying to win support for a treaty on political and monetary union which seems likely to impose further economic sacrifices in pursuit of the goal of irrevocably fixed exchange rates by the end of the decade...All EC governments are trapped in an economic vicious circle under which faltering growth drives up budget deficits through reducing tax revenue and increasing social security outlays. The strict budget deficit targets laid down at Maastricht as conditions for EMU membership looked difficult to meet nine months ago for most EC countries. Now, with EC growth forecast this year by the Commission at only 1 1/4 percent, fulfilling the targets will be impossible unless the EC rediscovers 3 percent growth.⁸⁵

Clearly the Maastricht bargain of strict convergence criteria in the medium term-- stringent under any conditions, but, in the judgment of speculators, politically untenable in an economic downturn -- changed the terms of the debate in the EMS. When the smoke had cleared around the rubble surrounding the exchange rate mechanism, Norman Lamont blamed Germany for the crisis, and declared that from now on, British economic policy would serve British, not European interests. John Major concurred that there were "fault lines" in the EMS that needed to be repaired.⁸⁶ Certainly the Bonn government could be held accountable for high German interest rates. The Bundesbank was also at fault for imprudent comments in September which undermined sterling's position and fed expectations of a realignment. But ultimately, the failure of Major's government to convince its

constituencies and the electorate that European costs were worth bearing precluded a solution to the British crisis of credibility.

September 1992

Since the outcome of the September crisis is well-known, and the factors contributing to the EMS crisis -- asymmetry of the system and its evolution into a "hard-ERM", financial liberalization, and dollar/D-mark divergence -- as well as the causally decisive forces of a Maastricht compromise irreconcilable with domestic political priorities have been elaborated above, a brief account of the chronology of events is all that is needed here.⁸⁷

September 5: The Bath Meeting The failure of member states' Ministers of Finance and central bank Governors to agree to the Bundesbank's proposal for a general realignment, involving a change in the value of all EMS currencies vis-a-vis the D-mark; or a broad realignment, involving the pound, lira, peseta, escudo, krone and punt, in exchange for a German interest rate cut, can be considered the immediate cause of the September crisis. Ruud Lubbers, the Dutch prime minister, later remarked that the failure to agree to a realignment at Bath was a "black page in the book of 1992."⁸⁸ On the day before Black Wednesday, a London currency trader was quoted as saying, "Europe missed the opportunity for a much further-reaching realignment which would have provided the growth needed to fulfill the Maastricht targets," thus demonstrating the framing effects of the Maastricht criteria upon the markets. British Chancellor Norman Lamont and French Finance Minister Michel Sapin's refusal of this option is predictable in light of the analysis presented above -- Major's government had staked its authority on a policy of no devaluation; the franc fort was the economic cornerstone of Mitterand's presidency which could not be compromised lest it have adverse effects on the outcome of the referendum. Moreover, the evolution of the system into a hard ERM had buoyed the high-political goal of EMU, and, ironically, the governments' feared undermining this objective with a realignment. Instead, the French and British tried to pressure Bundesbank president Helmut Schlesinger into a unilateral interest rate cut, to no avail. At the end of the meeting, Schlesinger was angered by Lamont's public statement that the ministers had reaffirmed their commitment to the fixed exchange rates, and that the participants had secured a promise from the Bundesbank not to raise interest rates. Lamont was forced to retract the statement publicly following a meeting of central bank governors on September 8.

September 8: Turbulence on the Scandinavian Markets With interest rates at 14%, Finland abandoned its year-old peg to the ecu, precipitating a 12 1/2 percent decline in the markka that day. Speculators turned to neighboring Sweden's currency, and the Riksbank raised its marginal lending rate eight points to 24 percent and then 75 percent the next day. Uncertainty in the Scandinavian markets fed speculation in the ERM.

September 14: The Weekend Lira Devaluation After massive intervention by the Bundesbank and the Bank of Italy on Friday the 11th failed to sustain the lira above its D-mark floor of L765.4, Germany and Italy agreed over the weekend to a 7 percent devaluation of the lira in the EMS, to be followed by a small cut in the Bundesbank's discount rate by 0.5, to 8.25 percent, and its Lombard rate by 0.25, to 9.5 percent. The intervention, totalling about DM 24 billion (\$15 million) was far more than any previous currency crisis, and the Bundesbank feared its effects on the already swollen money supply. The lira had been under pressure since the Danish referendum, and it had intensified over the last two weeks due to uncertainty about the French referendum, as well as market fears that the Italian government would not take sufficiently tough measures to tackle the country's budget deficit, rising beyond 10.5% of GDP. The shadow cast back to Stage I by the Maastricht bargain is evident in the EC Monetary Committee communique regarding the Italian devaluation:

The Italian government, recognizing that the fundamental condition for stable exchange rates, low interest rates and stable prices is sound public finance, is aware of the importance of a full and quick implementation of the convergence program.⁸⁹ [emphasis added]

September 15: The Handelsblatt Interview After a brief respite following the lira devaluation and interest rate cut, the pound and lira faced renewed downward pressure. Market pressure on the two

currencies was exacerbated by reports that Bundesbank president Schlesinger had suggested that the weekend realignment of the lira had not gone far enough and that a wider realignment could have reduced pressure in currency markets. The comments were based on an interview given by Schlesinger to *Handelsblatt*, the German business newspaper, and the *Wall Street Journal*. As soon as the news reached London the pound fell to a new low of 2.78, only one-fifth of a pfennig above its floor, prompting anxious calls to Germany from the Treasury and the Bank of England for clarification. A Bundesbank spokesman said that the statement was not an authorized version of the interview.⁹⁰

September 16: Black Wednesday After two interest rate rises to 15% failed to stem massive speculation against the pound, the Major government suspended sterling's membership in the ERM, and announced the reversal of the second rate increase, as the two rate hikes had brought protests from business and the threat of open revolt by some Conservative MPs. During the day, the Bank of England spent approximately 15 billion pounds in support of sterling, representing roughly 50 percent of the total reserves available to it. Other central banks, particularly the Bundesbank and the Banque de France, bought an additional 5 billion pounds.⁹¹ For Major, sterling's suspension represented a tremendous political defeat undermining the central plank of the government's anti-inflationary strategy. Britain blamed the Bundesbank for the sterling crisis, charging that Bundesbank leaks suggesting that a realignment was necessary had undermined the position of the pound.⁹²

September 17: More victims The lira was withdrawn from the ERM after it fell below its new floor against the D-mark; the Spanish government agreed to devalue the peseta 5 percent. The franc, krone, and punt fell to their ERM floors.

September 18-23: The successful Franco-German defense of the franc With the outcome of the French referendum in doubt, the franc fell to within one centime of its floor against the D-mark and devaluation seemed imminent. But the tide was reversed by vocal and public support for the franc by the Bundesbank -- "the franc is in no way at risk. The franc is a very strong currency which has achieved inherent stability. On the contrary, it is a candidate for appreciation" ⁹³-- and an unprecedented coordinated intervention effort. It was later revealed that the Banque de France spent 160 billion francs (\$33.5 billion) of foreign currency in defense of the franc in late September;⁹⁴ the Bundesbank was reported to have spent somewhere between 10 to 30 billion marks (\$6.7 to \$20 billion).⁹⁵ The commitment of the Bundesbank's reserves and reputation to the maintenance of the French currency is perhaps the result of a long history of monetary cooperation between the two countries and the special nature of their relationship on issues pertaining to Europe.

Theoretical considerations

In this paper I have asserted a causal relationship between the Maastricht bargain and the September crisis, with domestic politics as an intervening variable which accounts for the variation in outcomes -- a successful defense of the franc and continued French membership in the system, versus the exit of sterling from the ERM and the indefinite "suspension" of British membership. Now I would like to briefly turn to the implications of this analysis for theories of European integration.

A historical review of the initiatives for European monetary cooperation in 1970 with the Werner report, in 1979 with the EMS, and in 1988 with the Balladur initiative for EMU indicates that heads of government and their direct representatives have been instrumental to progress in this policy sphere, and that such initiatives have traditionally been imbued with high political significance in regard to the long-term process of European integration. But while national governments remain the most important actors, interaction has not been characterized by lowest common denominator bargaining or assiduous protection of national sovereignty, elements normally associated with an intergovernmentalist interpretation of integration.⁹⁶ Indeed, the goal of monetary union by definition would preclude the exercise of national independent monetary policies. That prior coordination in Europe on monetary issues and the momentum of the Single Market seemed to have created the preconditions for a discussion of EMU has revived interest in functional explanations of integration, which fell into discredit with "Eurosclerosis" and the failed attempts at cooperation in the 1970s.

The early Functionalists, such as Jean Monnet and David Mitrany, denounced the artificial territorial boundaries of the nation-state and argued that the welfare of society can best be managed by technicians performing discrete functional tasks free from territorial referents. An ever-widening mesh of task oriented welfare agencies would come to pre-empt some of the work done now by governments, as the integrative lessons learned in one context become applied in other areas. The effective

performance of functions would gradually shift people's loyalty from the nation-state to a new center, creating a community of common sentiment which is the psychological prerequisite for political federation.⁹⁷

Neo-functionalists such as Ernst Haas concurred in the idea that "earlier decisions spill-over into new functional contexts, involve more and more people, call for more and more interbureaucratic contact and consultations, meeting the new problems which grow out of the earlier compromises."⁹⁸ However, the early functionalists are faulted for postulating the existence of a natural harmony of interests among actors. Haas contends that an articulate theory of interest politics must be included to accommodate the fact that individuals, groups, and elites engage in political pursuits to advance their own interests. "A Functionalist theory of converging but separate purposes, partaking of some general notion of welfare individually conceived and elaborate, would ring truer than a utopian vision of technocratic progress based on identical interests." Whereas Functionalists were more concerned with changes in popular attitudes as the test of effective integration, the Neofunctionalists identified the changing behavior of elites within institutional structures as the main motor of integration, as elites developed a procedural consensus and agreed upon a framework through which to pursue their interests.

Recently, Robert Keohane and Stanley Hoffmann have attempted to reconcile the fact that governments dominate the integration process with the apparent salience of neofunctionalist observations.⁹⁹ They argue that supranationality in the functionalist sense has suffered grievous misinterpretation over the years, coming to be associated with federalism or domination of national governments by Community institutions. Instead, they remind us that Haas emphasized supranationality as a style of decisionmaking through which political interests would be realized, not a depoliticized form of technical deliberation; in Haas' words, supranationality refers to "a cumulative pattern of accommodation in which the participants refrain from unconditionally vetoing proposals and instead seek to attain agreement by means of compromises upgrading common interests."¹⁰⁰ At the same time, according to Hoffmann and Keohane, while the process of policy-making in the EC is supranational, negotiation and coalition-building at the European level takes place in the context of agreements between governments. The authors argue that "successful spillover requires prior programmatic agreement among governments, expressed in an intergovernmental bargain...these interstate bargains remain the necessary conditions for European integration."¹⁰¹

This theoretical framework seems particularly relevant to the Maastricht bargain on Stage II, wherein both monetarist and economist positions had to be accommodated in order to obtain the assent of the major European governments, particularly Germany and France, to the goal of EMU. Compromise between national governments based upon an "upgrading of interests" was also evident in the negotiations for the Werner Report and the EMS, where progress in monetary integration was achieved not through lowest common denominator bargaining and tenacious defense of sovereign prerogatives in monetary policy, but rather a balancing of the interests and concerns of the major actors in the design of institutions. Unfortunately, the effects of a supranational bargaining style upon schemes for institutional change are not always beneficial, or even benign. On the contrary, I have argued that the accommodation and inclusion of competing economic philosophies resulting from differing national interests had destabilizing consequences for both the snake and the EMS, manifested perhaps most dramatically by the September crisis which shook the foundations of the ERM and opened the way for further exchange rate turbulence in recent months.

At the same time, the causes of the September crisis demonstrate that neofunctional variables emphasizing spillover from Community institutions and processes coupled with intergovernmental bargaining provide an incomplete framework for understanding progress in European monetary integration. Andrews locates the decisive causes of the Maastricht agreement on EMU outside Europe at the international level, arising primarily from the constraining effects of heightened capital mobility upon national monetary policies, and from changes in the international security environment in 1989-90. Drawing upon the insights of Woolley, I argue that the successful implementation of the Maastricht bargain requires strong domestic-level coalitions willing to bear costs in support of national politicians' European commitments. But these coalitions are not static; they may need to be rebuilt, reinforced, or widened to embrace greater segments of the population, especially if policymakers' substantive objectives change. The Maastricht treaty's plan for EMU and its provisions for wider European social and defense capacities would impose far-reaching changes on the lives of ordinary citizens, but the implications of these changes or even their desirability were not generally subjected to public debate

during the IGC negotiations leading to the Maastricht summit. The price of national politicians' neglect in this regard was the public backlash during the ratification process, demonstrated most dramatically by the ability of some 21,000 Danes, the margin of difference between the Yes and No votes, to threaten to derail the entire European integration process. The mixed feelings of the French electorate towards Maastricht, the refusal of the British public to tolerate higher interest rates in support of European commitments, and the unwillingness of German voters to shoulder greater financial burdens and exercise wage restraint in order to avoid a beggar-thy-neighbor monetary policy all illustrate the failure of political elites to clearly define the European agenda and win adequate support for their supranational political and economic goals. This analysis suggests that further integration in Europe, that is, the successful implementation of agreements reached through intergovernmental bargaining, will increasingly depend upon successful negotiation with domestic-level coalitions. Toward this end, Robert Putnam proposes a logic of two-level games which recognizes the fact that national political leaders must concern themselves with the demands of domestic actors (Level II) as well as the negotiation of an agreement acceptable to its international partners (Level I). He argues that the key theoretical link between the two levels is that any Level I agreement must, in the end, be ratified at Level II, whether it be by formal parliamentary procedure, or by the informal cooperation of bureaucratic agencies, interest groups, social classes, or even "public opinion."¹⁰² In this context, the message of the grass-roots anti-Maastricht forces marshaled in the run-up to the September crisis was that elite deals among politicians and technocrats can no longer be the sufficient motor of integration in Europe, and that publics demand consultation on changes which could profoundly affect their lives and that require significant sacrifices. The incorporation of two-level games into theories of European integration refocuses attention on the importance of popular attitudes (emphasized by the early Functionalists) and domestic coalition-building for "ratification" of the integration process, thus promising a fruitful avenue for future research.

Conclusions

Monetary cooperation in Europe is an unfolding historical process which has proceeded in fits and starts since the days of the Werner Report, advancing when the international environment was permissive and the national preferences of the major member states converged, suffering setbacks when the global political economy placed strains on the system and members' economic policies diverged. In explaining the causes of the September crisis, I have attempted to challenge the conventional wisdom prevailing at the time that turbulence in the ERM was due to an unfortunate confluence of unrelated events -- the Danish and French referenda, a British debt-driven recession, the "asymmetric exogenous shock" of German unification --and instead have sought to place these events in a coherent framework which incorporates domestic politics as well as the long-term evolution of the EMU debate among national governments. Because a uncausal explanation of such a complex phenomenon is likely to be unsatisfactory, I have identified several other factors which contributed to the ERM crisis: the evolution of the EMS from a system of fixed but adjustable rates to a de facto fixed rate system, despite a growing disparity in member states' economic fundamentals; the asymmetrical operation of the system, which implied a dependence upon the anchor currency country, Germany, to maintain a non-inflationary fiscal policy in order to preserve an acceptable floor for interest rates; greater financial liberalization and a concomitant rise in the potential for speculative capital flows; and the weakening dollar which exacerbated the strength of the deutsche mark vis-a-vis the other EMS currencies.

Together these factors created the permissive conditions for crisis in the system. The deteriorating balance of trade in the non-German states of Europe, especially after the Plaza Accord, refocused political attention on the long-simmering dissatisfaction with the asymmetry of the adjustment burden and German dominance of monetary policy in the EMS, prompting the Balladur initiative of 1988. However, efforts to redress these concerns would have likely focused on reform of the EMS rather than movement to full currency union, had it not been for the cataclysmic change in bipolar security arrangements in 1989-90. Prior EC cooperation in monetary affairs and integration efforts in a vast array of other policy areas since the 1950s placed EMU within the realm of the politically feasible, but it was the prospect of German reunification which provided the sense of political urgency within the

Federal Republic and among its major EC partners for a dramatic acceleration of the integration process. Council meetings of heads of government and their direct representatives provided the impetus for this acceleration, as they have historically done, and the Delors Committee of EC commissioners and central bankers was authorized to propose a plan for monetary union by stages. The Delors Report expressly sought to avoid the "religious wars" between the monetarist and economist camps which precipitated the failure of the Werner Plan, and recommended a course of action decidedly in favor of the economist position, emphasizing strict convergence criteria and no set timetables for passage to successive stages. However, this formulation proved unacceptable to the historically weaker currency countries of France and Italy, and through a bargaining process during the IGC which might be characterized as "refraining from an unconditional veto of proposals" and compromising in the spirit of "upgrading the common interest", both monetarist and economist agendas were accommodated in the final Maastricht agreement on EMU.

But this intergovernmental bargain on Stage II, reflecting the differing national preferences of France and Germany in particular, introduced an entirely new and destabilizing element into the EMS. To begin with, the objective of a single currency itself, codified at Maastricht, reinforced the "hard ERM" and governments' refusal to consider a realignment, even when one was warranted by economic fundamentals. At the time of reunification and again in the summer of 1992, the Bundesbank proposed an upward revaluation of the deutsche mark against the other ERM currencies in order to tighten monetary conditions in Germany and perhaps allow for a lowering of interest rates, but this was resisted by the other countries not wishing to jeopardize the highly politicized goal of EMU. Failure to agree to a general realignment in the weeks up to September is widely considered to be the immediate cause of the crisis.

But the more important structural flaw in the EMS introduced by the Maastricht compromise was the mating of demanding economic convergence criteria with a rigid timetable for their fulfillment in the medium term, all within a potentially chaotic environment of divided institutional responsibility between the EMI and national monetary authorities. This characterization of the Stage II bargain as a destabilizing element is contrary to the conventional belief that the Maastricht criteria and timetables constituted an external commitment which would effectively tie the hands of governments and force monetary and fiscal responsibility in their countries. According to the conventional wisdom, markets' fear that a No vote on Maastricht and hence on EMU would remove this external constraint led to speculation against weaker currencies. But this explanation cannot account for the fact that fundamentally sound currencies came under attack in the days before the French referendum and in the months afterward. I have argued instead that the Maastricht criteria cast a shadow back to Stage I through framing effects which highlighted the costs of the loss of monetary sovereignty. Specific reference numbers for debt and deficit ratios and relative inflation and interest rate targets emphasized economic divergence in countries with clearly overvalued currencies -- such as the lira and peseta -- but also drew attention to the political capacity of governments to impose costs on their electorates, in terms of interest rates at German levels in the shorter term and fiscal austerity in a recessionary environment for the medium term. Markets bet against sterling not so much on the basis of economic fundamentals, as many analysts agree that the pound was nearly correctly valued within its ERM band in September, but rather on the political ability of the Major government to keep its European commitments given strong domestic opposition. Similarly, the core currency of the franc came under speculative attack as the French electorate leaned towards a No vote, although for reasons apparently unrelated to its support for EMU.

Thus, I have argued that the Stage II commitment by national governments to speedy convergence did not contain any inherent credibility; changes in the internal politics of the member countries consistent with these policy objectives was required. Domestic coalitions must be reinforced, widened or even rebuilt by national-level politicians to accommodate new and expanded policy tasks. But the uncertainty surrounding the Danish and French referenda reflected the reluctance of electorates to bear costs associated with the Maastricht agreement, in terms of diminished national sovereignty and jeopardization of cherished cultural values, as well as economic sacrifice. Likewise, indebted British homeowners' and industry and labor's resistance to timely interest rate hikes indicated the preeminence of domestic over European priorities; German taxpayers' and wage earners' inflationary demands further spoke to the failure of elites to win support for the Maastricht objectives.

Hence, while the realization of Community goals requires the maintenance of long-term political momentum, much of Europe's failure is political, as national leaders have neglected to rally their

publics to the European cause. The implications of this analysis of the September crisis for theories of European integration indicate a need to refocus attention upon popular sentiment and domestic coalition-building, perhaps through the incorporation of two-level game analysis. For 40 years the building of Europe has been conducted by politicians and technocrats in forums far removed from the surveillance of ordinary citizens, as the Community's work since the 1950's has focused mainly on economic issues which directly affected only small segments of the population, such as farmers, fishermen, and steelworkers. By the late 1980's the activities of the EC touched a wider range of people: industrialists and bankers stood to gain from the single market, students and scientists received Community-sponsored funds. Then national and transnational elites negotiated the Maastricht treaty on political and economic union. No real public debate was held in Germany, the Benelux countries, or the southern European countries, since their political elites were largely in favor of the Maastricht provisions. In France and Britain the main parties were divided over the treaty, which merely led party leaders to avoid the subject; the future of Europe was hardly mentioned during the British general election. But the Danish No vote jolted European governments and galvanized grass-roots anti-Maastricht forces in Britain, France, and Germany opposing the treaty for many and diverse reasons. The public backlash in 1992 which precipitated the September crisis may mark a watershed in the ongoing process of European integration, as electorates demand greater voice, consultation, and accountability from their representatives on the issues which profoundly affect their lives and communities. This "democratic deficit" must be redressed not only in policy, but in theory, through analytic attention to domestic "ratification" of intergovernmental initiatives for further integration. Domestic actors' formal or informal ratification may now become the precondition for progress in Europe and the successful implementation of national governments' supranational objectives. Further research on this issue, with respect to the ERM crisis in July-August 1993 and political leaders' ongoing efforts to salvage the Maastricht treaty on EMU, would reveal the utility of this avenue of inquiry.

TABLE I.
Economic Indicators for the EC Countries, 1990

Country	Inflation Rate	Interest Rate	Fiscal	Public Deficit	Debt
Belgium	3.0	10.1		-5.7	127.3
Denmark	2.3	11.0		-1.5	66.4
France		2.7	9.9		-1.7
46.6					
Germany	3.4	8.9		-1.9	43.6
Greece		18.2	n/a		-20.4
93.7					
Ireland		1.6	10.1		-3.6
103.0					
Italy		7.5	13.4		-10.6
98.6					
Netherlands	2.8	9.0		-5.3	78.5
Portugal	15.0	16.8		-5.8	68.2
Spain		7.3	14.7		-4.0
44.5					
UK	8.4	11.1		-0.7	42.8

Source: EC Commission. Reprinted from Peter Kenen (1992).

Inflation rates are based on GDP deflators, not Consumer Prices Indexes as required by the Maastricht protocol. Interest rates are yields on long-term government bonds. Fiscal deficits and public debts are percentages of GDP. The German data pertain to West Germany.

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