THE FRANCO-GERMAN MONETARY PARTNERSHIP AND THE FUTURE OF EUROPEAN MONETARY UNION

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1 INTRODUCTION: THE FRANCO-GERMAN MONETARY AXIS

The vision of European Monetary Union (EMU) is of long standing and, as I argue, is based squarely on the Franco-German monetary axis. A brief survey of the development of closer European monetary relations over the last twenty-five years inevitably focuses one's attention on the Franco-German partnership. From the push in the late 1960's and early 1970's for a more independent European monetary policy, the ill-fated "snake" proposals and the development of the institutions of the European Monetary System (EMS), to the movement through the 1980's to adjust the EMS to reflect changes within Europe and the international monetary system culminating in the Maastricht Treaty of 1991, France and Germany have been on the forefront of such action. Today, some disagreements and political paralysis over the future framework of European Union exist. However, German and French monetary authorities are working closely on plans for EMU as they head toward the intergovernmental conference (IGC) in 1996.1. "Banque de France and Bundesbank einig wie noch nie," Frankfurter Allgemeine Zeitung, 3-26-94;[1]

The overarching research question to this article inquires, "What explains the process and relative success of European monetary integration? While recognizing the current pessimistic mood in Europe concerning EMU as well as the most recent bout of currency turmoil within the EMS, this study argues that the pattern and processes of European monetary integration suggests that scholars reexamine and reevaluate the Franco-German monetary axis and its relationship to the larger structure of the international monetary system. This study hypothesizes that the Franco-German monetary axis -- encapsulated within the larger U.S.-dominated international monetary governance structure2. The international monetary governance structure will hereafter be referred to as the G-7. See Andrews (1994) for a strong theoretical analysis of the international monetary structure.[2] -- has in large part determined the direction and success of European monetary integration. While recognizing the importance of the economic motives behind integration (Delors, 1990), the framework of the institutions of the European Community that may shape actor's interests and facilitate cooperation (Martin, 1993; Sandholtz, 1993), I contend that an analytical model linking the Franco-German bilateral axis to the international monetary structure more fully captures the powerful driving forces behind European monetary integration.

In order to understand the nature and degree of monetary integration, I focus on explaining the bargaining strategies of German monetary authorities (the Bundesbank and Federal Government in this model) toward European monetary integration and the G-7. These bargaining strategies and the outcomes of European monetary agreements such as the Nyborg and Maastricht arrangements are shaped by what I call the strategic bargaining environment. Specifically, I develop a model of German monetary policy that explicitly links Germany's strategic setting with the trade off German monetary authorities face between domestic monetary autonomy and exchange rate stability.3. Monetary policy is defined broadly to include the actions of the Bundesbank and Federal Government to affect monetary and other financial conditions both within Germany and abroad. For example, a realignment within the EMS, a Bundesbank move on the discount rate, intervention to support another currency, or a larger more formal agreement such as Nyborg are all considered monetary policies.[3] The basic proposition of this study suggests that the varying concern for monetary autonomy or exchange rate stability indicated in the bargaining strategies of German monetary authorities is determined by the strategic bargaining environment -- defined as the nature of the Franco-German monetary relationship and its association to G-7 monetary policies. While many analyses of European monetary cooperation and integration emphasize the degree to which other EMS members, in particular the French, have sacrificed monetary autonomy for exchange rate stability, this paper suggests that German monetary cooperation was no less significant and, more importantly, key to preserving the institutional integrity of the EMS and the path toward EMU.

Divided into three basic parts, the first part of this paper analyzes the Franco-German bilateral relationship in more detail and suggests some particular contours of the relationship -- including its relationship to the larger international monetary structure -- that are central for understanding the nature and degree of policy cooperation between France and Germany. The second part of the study briefly develops some basic components of the link between the strategic environment and Germany's concern with the trade off between monetary autonomy and exchange rate stability and what that means for monetary cooperation in Europe. The third part of this study focuses on three particular cases of European monetary interaction (the Nyborg agreement, the Maastricht Treaty, and the tensions within the EMS during the year-long monetary crisis of 1992-1993). Particular emphasis is placed on the bargaining strategies of German monetary authorities and their willingness to sacrifice monetary autonomy for exchange rate stability in Europe.

PART I: The Franco-German Bilateral Monetary Axis: the Strategic Bargaining Environment

On a general level, the Franco-German relationship is shaped by long term continuities such as geopolitical forces, medium-term variables expressed in the movement toward European integration and the political institutions within France and Germany and of the European Community, and short-term factors such as political leadership and the political assumptions of each countries' leaders (Simonian, 1985; Bulmer and Paterson, 1987). The desire to end centuries of cross-border conflict between the two countries as well as the particular geographical constraints (the division of Germany and Europe) on the Federal Republic often led to (the sometimes clumsy) German efforts to enhance Franco-German cooperation at the expense of Germany's Atlanticist ties. The French faced fewer geographical constraints on their external policy which allowed the French opportunities to develop the Franco-German relationship with the goal of a French led Europe from the "Atlantic to the Urals." Moreover, within Europe, the ideas and institutions of the European Community have helped bridge some of the geographical divergences in German and French foreign policy. Finally, the individual efforts and desires of French (Monnet, Schumann, Giscard d'Estaing and Mitterand) and German (Adenauer, Brandt, Schmidt and Kohl) leaders have further solidified the ideological and institutional bridges built between the two countries. These long, medium, and short-term factors have all led over the decades to a convergence of interests and efforts to minimize the impact of their policies upon the other.

Despite such factors, it should be noted that interests have not always converged, including monetary affairs. Dissimilarities of interest have at times characterized the relationship between the two. The Franco-German relationship is based on a careful calculus of national interests and, at times, uncompromising bargaining positions. What is unusual, however, is the extent to which accommodation has characterized the Franco-German monetary relationship. On numerous occasions, often critical to the long term credibility of European integration and monetary union, French and German monetary authorities, including the influential and largely independent Bundesbank, have sought to adjust their policies to reflect bottom-line commonalities of interest. Simonian (1985, p. 2) summarizes cogently the logic of common interest:

"... the continuing importance of Franco-German accord for wider progress in the Community was a theme constantly in evidence. Both the first and second enlargements of the Community depended on a similarity of French and German views. In the economic and monetary fields, the EEC's original and ill-fated steps towards a full Economic and Monetary Union (and its later creation of the successful European Monetary System) were firmly based on a convergence of French and German interests."

The questions addressed by Simonian on EU enlargement and institutional advancement (the deepening vs. widening debate) are nothing new to the policy leaders of France and Germany. More importantly, it has been the Franco-German alliance that has provided the impetus and political momentum necessary for such advancement, for example, movement on the Single European Act (SEA) in the mid-1980's and the Maastricht Treaty. The Franco-German relationship remains the most consequential factor for the future of European integration.

Specifically, the political motives of European integration centered primarily upon the Franco-German bilateral relationship. Roger Morgan succinctly states the nature of this bilateral relationship:

"The Franco-German relationship in today's Europe is characterized by intensive and highly structured communication, provided for in the Elys‚e Treaty of 1963; it is also marked by a powerful and durable political determination, extending from the highest levels downwards, to overcome conflicts and to make Franco-German interdependence and cooperation - economic, diplomatic, strategic and cultural - a permanent reality in an uncertain world."4.
Roger Morgan, "Preface," in Partners and Rivals in Western Europe: Britain, France, and Germany, Roger Morgan and Caroline Bray, eds., (London: Gower, 1986), x-xi.[4]

Indeed, the highly evolved interdependent relationship -- a "permanent reality" or structure in German foreign policy -- between the two countries suggests a closer examination of the concept of bilateralism. The concept of bilateralism has been dealt with extensively elsewhere 5. See especially the analysis of Helen Wallace, "The Conduct of Bilateral Relationships by Governments," in Morgan and Bray, op. cit., pp. 136-155. The following account of bilateralism closely traces Wallace's examination of bilateralism.[5] but a few points must be noted in the framework of bargaining to be developed below. Essentially, bilateral relationships take the form of governments engaged in dialogue based on transactions that take place between them. Governments are "condemned to consult and cooperate because of the volume and complexity of transactions between the two countries" (Wallace, p. 137). Through a special privileged relationship set on institutionalized and formalized dealings, the two countries under consideration develop a core set of interests which form the nucleus of a binding partnership. Ultimately, in a strong from of bilateralism, movement on a diverse set of policy issues (economic, military, political, etc.) requires some form of mutual consultation.

In terms of the Franco-German bilateral relationship, geographical contiguity, the movement of people, goods, capital and services, historical, cultural and ideological affinities, and membership in similar multilateral organizations suggest a strong version of a bilateral relationship. Moreover, the Elys‚e Treaty, the Franco-German Economic Council created in 1988, as well as the meetings through the EU institutionalize a formalized, structured and systematic process of meetings and bargaining. Timetables, formal and binding explicit commitments, review procedures, agenda setting and public collaboration structure the Franco-German bilateralism. Interviews conducted by the author at the Bundesbank revealed the close institutional and personal ties between the bank and their French counterparts in discussing EMU and the operation of the fledgling European Monetary Institute (EMI). As such the Franco-German relationship is "special" due to the sustained investment and careful evaluation of the costs and benefits of partnership in terms of particular achievements and broader international interests. It involves the strategic assessment of objectives, longer-term timescales for results, and a capacity to define broadly the balance-sheet of the relationship. Importantly, a special bilateral relationship requires independence from domestic constraints -- a "strong state" in other words, for which German monetary institutions comply.6. In this sense, my analysis differs with Huelshoff (1994) who argues that the German "state" should be considered weak when analyzing bargaining models.[6]

In addition, the special Franco-German monetary bilateral relationship reveals other important aspects of EU policy-making. As Helen Wallace argues cogently, if the Germans and French reach a mutually agreed upon cooperative arrangement, the other European participants will generally fall in line (Italy) or fall off the European path (Britain).7. Helen Wallace, "Bilateral, Trilateral, and Multilateral Negotiations in the European Community," in R. Morgan and C. Bray, eds., op. cit., especially p. 162.[7] The converse is also likely. If France and Germany seek to halt movement on particular policy, there is a significant likelihood that it will not be adopted. The British or Danes can opt out of any arrangement, but the original agreement will proceed if the French and Germans secure their support for the plan. I do not contend that the other nations do not matter in negotiations surrounding Community issues, but that the monetary arrangement typically reflects a compromise between German and French preferences. Furthermore, with monetary integration acting as a lever for European integration in general, Franco-German monetary bilateralism can set the overall tone and direction of European movement on integration. A "Two-Speed Europe" requires two engines to propel integration -- namely Germany and France.

Importantly, and crucial to understanding the strength and endurance of the Franco-German partnership, bilateral relationships should not be separated from the larger international environment within which the Franco-German monetary partnership developed. The G-7, in particular, presents the Franco-German bilateral relationship with constraints that limit options and opportunities for state action but also offer new avenues for cooperation. Such is the case for the French and Germans who must operate within both the G-7 and the EU. G-7, in particular U.S. led efforts at macroeconomic monetary coordination complicated European efforts at closer monetary cooperation while at the same time provide a definite incentive for Europe to foster closer monetary integration in order to counter U.S. pressures. As Henning succinctly argues, the European incentive for monetary integration as been a result of response of the Europeans to conflict with successive U.S. administrations (Henning, 1993, p. 3) The strategic aim to enhance the zone of monetary stability w/thin Europe and to increase Europe's regional monetary balance within the global monetary order rests on the lengthy history of monetary tension between Europe and the U.S. The goal of a zone of monetary stability is also driven by structural factors such as the nature of global financial transactions.

Specifically, the weakening of U.S. monetary leadership and the inability of the U.S. to manage its worsening balance of payments problems in the late 1960's and early 1970's promoted an united French and German response and initiative to create a European zone of monetary stability and increase their monetary independence vis-…-vis the United States. The initiation of the Werner committee and subsequent report and ultimately the snake in 1972 were built on the Franco-German partnership. De Gaulle in particular aimed to shore up monetary stability within Europe and prod Germany to adopt a more international oriented monetary policy. The strategy met with some success, including the 1978 G-7 Bonn summit which saw the U.S. committing for the first time to adjustment policies. Furthermore, the primary motivation of Schmidt and Giscard d'Estaing in developing the EMS in 1978-79 was with the inadequacies of the Carter administration's monetary policy and the speculative attacks against the franc and D-mark that resulted from this policy.

In 1981, Jacques Delors, at the time the French Minister of Economics and Finance, blamed the U.S. for the pressure on the franc to devalue. The Germans were less vocal but no less interested in securing monetary. stability. Following the unilateralist monetary policies of the Reagan administration, the same incentives encouraged the renewed efforts at European integration with monetary union as the lever of such integration during the mid and late 1980's leading up to the Maastricht Treaty. More recently, similar arguments were heard from the French during the August 1993 EMS crisis when "Anglo-Saxon" speculators sought to derail EMU and drive the franc from the EMS. The French believed, and, in part, justifiably so 8. See the most recent analysis and comments of former U.S. Treasury Secretary James Baker, "Clinton's Search for a Foreign Economic Policy," Los Angeles Times, 7-31-94, M2. Baker suggests that movement on EMU "complicated policy coordination between the U.S. and major European economies..."[8], accounts of U.S. efforts to frustrate the creation of the ECU that might rival the dollar. The desire to strengthen Franco-German monetary cooperation and enhance regional monetary stability vis-…-vis the U.S. will continue to motivate both countries' interests in solidifying Franco-German monetary collaboration and accommodation. Even the most recent monetary turmoil in the EMS (the devaluation of the Spanish Peseta and Portuguese Escudo in March 1995) was induced by dollar weaknesses and corresponding D-Mark strengths. The EMS, and as I contend, the Franco-German relationship are caught in the middle. Therefore, understanding the Franco-German monetary axis cannot and should not be isolated from the developments within the larger international distribution of monetary power.

The importance of the Franco-German bilateral relationship and commonality of interests both towards each other and vis-…-vis the U.S should not, however, suggest a symmetry in monetary influence or leadership. Beginning, one can argue, at the Bonn currency conference of November 1968, Germany sought to emerge from its role as a secondary power in monetary affairs. In this sense, movement on European integration and monetary union since 1968, in addition to the operation of the EMS as a DM zone, has reflected the asymmetrical monetary power relationship between France and

Germany within Europe 9. See the analysis of Edward Gardner and William Perraudin, "Asymmetry in the ERM: a Case Study of French and German Interest Rates before and after Unification," International Monetary Fund Staff Papers, Vol. 40, No. 2, June 1993; See also Bill Jaretski and Gaff Schares, "A Partnership of Unequals: the Economic Alliance of France and Germany," Business Week, October 12, 1992.[9] As Neustadt (1970, p. 5) suggests and as French leaders need not be reminded, "reality is not bilateral." More importantly, asymmetric power relationships alter the bargaining game between the two partners. Tsebelis (I990) suggests that a hierarchy of commitments exists where leaders (Germany) define the rules of the game, the terms and conditions of international agreements, and the penalties for noncompliant behavior. Indeed, Germany has set the ground rules for monetary behavior and cooperation within Europe and has driven a hard bargain on Maastricht and Community monetary policy. Germany, however, has also bowed to the concerns of the French as well on a number of monetary issues (to be examined below) which suggest an additional level of commitment by the Germans to sustain the Franco-German monetary relationship.

In sum, the bilateral and structured monetary and political relationship between France and Germany firmly establish each actor's identity and goals and their interaction is prescribed by established rules of engagement. The structure of the enduring historical pattern and process of interaction shape the goals, norms, strategies that each actor carries with it to the bargaining arena. With increased information provided by structured bilateral interaction and the iterative learning process attached to such interaction, the behavior of French and German monetary authorities often reflects clear options, information, and strong assessments of the consequences of particular policy choices. Bilateralism can be a powerful force for cooperation. Finally, this driving force for cooperation is enhanced, if the bilateral relationship confronts a common external or structural milieu such as the G-7. Therefore, an important condition for cooperation at the bilateral level is a common external strategic environment (the G-7) which encourages a commonality of interests between Germany and France in the monetary arena.

PART II: Cooperation as a Choice Between Exchange Rate Stability and Domestic Autonomy

Recognizing that a special bilateral relationship exists between France and Germany is not enough for fully understanding EMU. The Franco-German bilateral relationship suggests a possible pattern for examining the processes of European monetary cooperation and integration. As discussed above, a number of authors have examined the larger pattern of Franco-German relations and the importance of the relationship for European integration. I argue that such approaches remain incomplete, primarily because they do not principally incorporate either the Franco-German bilateral relationship into their analyses or how this relationship is shaped by the larger G-7 international monetary structure. This paper offers a unique conceptualization of monetary cooperation and then suggests a relationship between Germany's willingness to cooperate and Germany's bargaining strategies toward the French within the EMS and U.S. dominated G-7.

Cooperation has traditionally been defined as the process of mutual adjustment on the part of the government (Keohane, 1984; Putnam, 1988; Webb, 1991). This definition focuses intently on the processes of negotiation and examines whether national policies were different as a result of an international agreement (formal or informal) than they would otherwise have been. Both the French and Germans have adjusted their monetary policies, for example, through ERM realignments, interest rate policy, or through the institutional intervention requirements of Nyborg, that suggest an unprecedented level of monetary cooperation in order to sustain EU integration. The cooperation that has been forthcoming from German monetary authorities has not, however, come easily. The desire by the Bundesbank to prevent any measure of imported inflation either through unsterilized intervention obligations, EMS realignments, or through pressure from other countries to see Germany stimulate domestic demand through monetary policy, focuses in on the central dilemma in the international monetary system: the trade off between national monetary autonomy and exchange rate stability.10. The trade off between monetary policy autonomy and exchange rate stability is of course complicated by the third leg of the "Unholy Trinity," namely private capital mobility. Specifically, there exists an intrinsic incompatibility of these three key economic desiderata. I do not seek to underestimate or neglect the influence and power of the capital mobility. However, in so far as the primary core of monetary debates in Germany focuses on the tradeoffs between monetary stability and exchange rate stability, these two variables will be highlighted. The concept of the "Unholy Trinity" is from Benjamin J. Cohen, "The Triad and the Unholy Trinity:. Lessons for the Pacific Region," in Richard Higgot, Richard Leaver, and John Ravenhill; eds., Pacific Economic Relations in the 1990's: Cooperation or Conflict? (London: Allen and Unwin, 1993).[10] As stated succinctly by Cohen,

"...in an environment of formally or informally pegged rates and effective integration of financial markets, any attempt to pursue independent monetary objectives is almost certain, sooner or later, to result in significant balance of payments disequilibrium, and hence provoke potentially destabilizing flows of speculative capital."11. Cohen, p. 147. My examination draws heavily from this analysis and the following pages in Cohen, pp. 147-152.[11]

For example, if the German government wanted to stabilize its exchange rate relationships within the European policy arena, the government would be compelled to restrict the ability of the Bundesbank to pursue an independent and autonomous policy. This relationship exists as well in the international arena. Moreover, if the Bundesbank should resist such pressure -- a definite likelihood given the bank's strongly independent position within the political economy of Germany -- the objective of exchange rate stability might have to be put on hold or compromised altogether.

One can conceptualize the relationship between monetary autonomy and exchange rate stability in terms of a continuum representing the varying degrees of monetary policy cooperation (see Figure 1.1). At one extreme lies the alternative of full monetary integration and a common currency, an extreme visualized in the articles of the Maastricht Treaty of 1991. Ideally, this would require full German monetary cooperation. At the other extreme lies the alternative of absolute monetary independence where governments and central banks sacrifice exchange rate stability for the benefits of securing domestic autonomy. As an example, following the collapse of Bretton Woods in 1973, German monetary authorities finally felt free to autonomously secure domestic policy objectives, unhindered by the monetary shackles of a fixed exchange rate system. Since the end of Bretton Woods, Germany has often still found itself under pressure, primarily from the U.S., to adjust German monetary policy to meet G-7 efforts at macroeconomic coordination. Within the EMS, Germany often finds itself pressured to adjust its monetary policies to meet the requirements of the institutionalized and adjustable pegged rate system of the EMS. In both the EMS and within the G-7, sacrificing monetary autonomy for exchange rate stability has been interpreted by German monetary authorities as "cooperation."12. Interviews conducted by the author at the Bundesbank in Frankfurt confirm this view.[12]

In whatever the case, any agreement that moves German monetary policy toward exchange rate stability requires, by definition, German monetary cooperation. To illustrate, in order to bring exchange rate stability to the EMS, German has often been called on to lower interest rates, intervene on foreign exchange markets, or face a revaluation of the Deutsche-Mark in the Exchange Rate Mechanism of the EMS. All of these actions would have a significant impact on Germany's monetary supply 113. Foreign exchange interventions could, of course, be sterilized (withdrawing liquidity from the system, usually by issuing government debt). However, as often the case, such interventions in EMS currencies have mounted to billions of DM's within a short period of time. As a result, sterilization has been practically impossible in every situation.[13] and the Bundesbank's autonomous ability to pursue its primary objective of price stability. In other words, reacting to these external events, Germany's domestic monetary policies were often different than normally would have been. Moreover, the extent of monetary cooperation depends systematically on the economic and political calculus of the Bundesbank and federal government toward exchange rate stability and domestic monetary autonomy within specific negotiating arenas. As we shall see, this calculus is central to understanding the degree and extent of German monetary cooperation toward the French in the EMS and toward the U.S. within the G-7.

On the domestic front, the Bundesbank and Federal Government often disagree on the relative emphasis that German monetary policy should give toward exchange rate stability or domestic monetary autonomy. There exists a definitive struggle for control over the extent to which German monetary authorities should sacrifice domestic monetary autonomy for exchange rate stability. For instance, analyzing the relative political position of the Bundesbank within the domestic political-economy of Germany as well as its attempts to maintain it independent policy-making capability, we can conclude that the Bundesbank would prefer maintaining monetary autonomy. Nevertheless, even though the Bundesbank must always regard its function of being the guardian of the currency as laid down in the Bundesbank Act as its primary task, it is also obliged to support the Government's general macroeconomic objectives. Therefore, the government's powers over the economy mean that the Bundesbank often finds itself reacting to the financial policies of the government. Domestically, even with its renowned political, financial and personal independence, the Bundesbank must be considered one of two major monetary players within Germany. Still, the Bundesbank's legally mandated responsibility to "safeguard the value of the currency" provides the bank with a forceful institutional platform to espouse its convictions. In the end, both the Bundesbank and federal government must solicit active support, participation and cooperation from each other and ultimately balance each other's preferences with what they both perceive to be in Germany's monetary interest.

Moreover, externally, a decision by the European Council of Finance Ministers (ECOFIN) to formally realign EMS currencies or a G-7 move to coordinate exchange rate intervention is a political decision taken by finance ministers and governments. In Germany, the Bundesbank's role is to advise the government in this process but the bank does not determine the timing or rates of realignment. The bank's power instead lies in the strategy and tactics of market intervention to support or defend various EMS currencies or the D-Mark. However, as a result of securing exchange rate targets, intervention and realignments can influence the German domestic money supply - indicating a clear link between the Bundesbank's exposed external flank and internally oriented domestic money supply targets. In whatever the situation, domestically or internationally, the Bundesbank will stake out a strong position vis-…-vis the federal government in deciding who ultimately will determine the extent of German monetary cooperation based on the continuum between exchange rate stability and domestic monetary autonomy.

The Bargaining Strategies and Objectives of German Monetary Authorities

One method of examining explicitly the degree of German monetary cooperation is to survey the bargaining strategies of German monetary authorities toward their French EMS partners and the G-7. Restated, the willingness of German monetary authorities to sacrifice monetary autonomy for exchange rate stability can be revealed in the negotiating approach such actors take to the bargaining table. Theories of bargaining (Putnam, 1988, Tsebelis, 1990) suggest three principal factors that determine the bargaining strategies of monetary authorities. These are 1) the interplay of domestic institutional actors central to the negotiating process; 2) the strategic bargaining environment or context within which such institutional actors negotiate; and 3) the objectives of the domestic institutional actors within each strategic bargaining context. The first factor, the domestic interplay of the Bundesbank and Federal Government, has been detailed above and need not be elaborated further. However, the point that it is the Federal Government, in particular the Finance Ministry, that must formally represent German monetary interests at the bargaining table should be kept in the forefront of analysis. Second, the strategic bargaining environment has also been specified above. Again, the nature of the bilateral Franco-German monetary axis and its relationship to the international monetary governance structure should be noted.

The third and final factor determining the bargaining strategy of German monetary authorities is their particular monetary objectives within the Franco-German monetary axis and within the G-7 international monetary system. The objectives of each actor are revealed in order of priority in Table 1.1. and demonstrate the differences each actor has toward sacrificing monetary autonomy for exchange rate stability within each negotiating arena. First, it should be noted that the objectives of the Bundesbank and Federal Government toward the Franco-German monetary axis are quite similar, although, importantly, not identical. What this suggests is that there is some room for compromise between the two actors and toward the French. Second, the monetary objectives of the Bundesbank and Federal Government at the international level are quite similar. This suggests that the overall negotiating position of the Germans at the international level will be quite strong since both actors generally agree on the monetary objectives toward the G-7. Finally, the Bundesbank's emphasis on "convergence", shared for the most part by the government, is driven by economic theories of currency unions and the German price-stability model. According to the Bundesbank, exchange rate stability could only come about after a long period of "harmonization" of convergence of macroeconomic policies, especially monetary policy based on the Bundesbank standard: an independent central bank committed solely to safeguarding the value of the currency. While the government shares this view, it should be noted that the government may seek to bend this standard in order to achieve particular political objectives like bowing to French pressure on issues of European Union or during "severe" political, economic, or financial crises such as potential stock market panics of currency speculation. Political calculations on the part of the Federal Government may outweigh the economic considerations of the Bundesbank.

Given the objectives of and the interplay between the Bundesbank and Federal Government within the Franco-German monetary axis and the international G-7 governance structure, this article suggests that we should expect German bargaining strategies indicating a willingness to sacrifice monetary autonomy within the EMS than within the G-7. Due to the inordinate political commitment of the German government to supporting the Franco-German bilateral partnership, the distinct bargaining leverage that the government has over the Bundesbank within the institutionalized structure of the EMS, and the recognition among Bundesbank officials of the relative importance of exchange rate stability in Europe (both in terms of intra-European trade but also as zone of monetary stability vis-a-vis the U.s.), the likelihood of German monetary cooperation towards the French within the EMS -- as compared to the G-7 -- increases. Of course German monetary authorities weigh carefully the costs and benefits associated with the trade off between monetary autonomy and exchange rate stability. They also recognize that there are large domestic societal costs associated with sacrificing monetary autonomy. Nonetheless, the costs associated with Germany's external position, namely its commitment to the Franco-German bilateral relationship and the process of European integration also weigh heavily into the calculus of German monetary authorities. As a result, German monetary authorities have seen it beneficial at crucial historical junctures to pursue a negotiating strategy toward the French and EMS that demonstrates a convincing commitment to the process of European monetary integration. The same commitment to the G-7 cannot be seen.

PART III. Three Cases: The EMS Reshaped, The EMS Transformed, the EMS Maintained

The following analysis builds on the above examination of policy cooperation by empirically examining the negotiating behavior of Germany during three significant points in the Franco-German monetary relationship. These cases highlight the formulation of German monetary objectives, the central and crucial bargain struck between the French and Germans and how that bargain reflected German concerns with G-7 monetary instability and U.S. pressures. The first case examines the case of the Basel-Nyborg arrangement. The second case involves the Franco-German bargain struck at Maastricht on EMU. The final case examines the approach of most recent bout of monetary turmoil in the EMS in 1992-1993. Each case illustrates a point at which German and French monetary authorities had a choice between enhancing and strengthening monetary cooperation or slowing down and weakening the commitment to European integration. In the face of a dollar instability, U.S. and French pressures on German monetary policy, and the resultant tensions within the EMS, German monetary 'authorities were confronted by the choice of reducing interest rates, intervening in the foreign exchange market, or appreciating the currency. Exactly how the Franco-German partnership dealt with these situations, specifically the bargaining strategies of German monetary authorities and the outcomes of particular EMS agreements, are examined below.

Reshaping the EMS: Strengthening Europe's position vis-a-vis the U.S

For many analysts, the Plaza Accord of September 1985 marked a high point in the history of post Bretton Woods international monetary governance. What Plaza in fact signaled was a new era in international monetary governance -- Germany's blueprint for EMS leadership and the decline of U.S. and G-7 dominance. The Germans were now determined pursue a new approach to U.S. pressure: resist U.S. influence and strengthen the institutional workings and foundations of the EMS. In particular, reliance on the Franco-German partnership would prove crucial to the success of the strategy. In part, as a result of French pressure and Germany's own desire to secure a regional zone of monetary stability, the Bundesbank and Federal government requested a meeting among the finance ministers of the EMS in September in Gleneagles Scotland. This meeting marked a pivotal shift in Germany's bargaining strategies as it signaled Germany's willingness to sacrifice some measure of monetary autonomy in order to enhance the zone of monetary stability in Europe. The EMS, especially the Franco-German partnership, would be accorded a higher priority in terms of German monetary calculations.

At the meeting, the European finance ministers endorsed a strong German bargaining position vis-a-vis the U.S. With Germany at the head, the Europeans would continue to resist U.S. calls to further stimulate domestic demand and that European central banks would pursue a joint effort to buttress the value of the dollar against the DM. In return, the Bundesbank would be more agreeable to intramarginal interventions to support EMS parities- a move that soon demanded the Bundesbank to fulfil its promise. Although Bundesbank officials were less than vocal in their public support of the strategy, it was acknowledged by German monetary authorities that the strategy was aimed at "speaking with one voice toward the U.S."114. Interview with German Finance Ministry official.[14] This strategy of according priority to the stability of the EMS in order to counter U.S. pressure would prove central to the developments that would occur over the following years. The strategy became central to concluding Maastricht and solidifying EMS institutions despite the pressures of unification.

1987 proved a fertile testing arena for this strategy. With discord developing continuing over the value of the dollar, in February of 1987, the G-5 met at the Louvre to try and ease the macroeconomic conflict and stabilize exchange rates. The Louvre accord asserted that currency values were now "broadly consistent with underlying economic fundamentals" and that the G-7 governments "agreed to cooperate closely to foster stability of exchange rates around current levels." While hailed as another significant step in policy cooperation, the Bundesbank saw the agreement as nothing more than an affirmation of its own interest in attaining stable exchange rates based on "economic fundamentals" and not on intervention in the currency markets. Specifically, the German pledge in the communique was that "monetary policy will be directed at improving the condition for sustained economic growth while maintaining price stability." Nowhere was it stated that the Kohl government or the Bundesbank would "coordinate" monetary policy or be obliged to intervene to maintain the range or reference zones discussed at the Louvre. While the Germans did agree to move up a planned tax cut, such a move easily proved consistent with Kohl's policies and would not seriously threaten the Bundesbank's money targets. From the Bundesbank's perspective, no active coordination was promised. With no mechanism for enforcement, Bundesbank officials derided the entire meeting as "staged theater." Moreover, the Louvre agreement was seen by the Bundesbank as strengthening its ability to enhance the stability of the EMS. On the European front, exchange rate stability received a higher priority than G-7 coordination.

Despite the new strategy designed by the Germans for the EMS, through the EMS realignments of 1986 and early 1987, the French recommenced their criticisms about the functioning of the EMS. The French, whose currency remained under constant pressure of devaluation, insisted that changes in the functioning of the Exchange Rate Mechanism (ERM) of the EMS be undertaken. The political and financial turmoil m the earlier part of 1987 within the EMS, including mutual recriminations between the Germans and French, and the displeasure among other EMS members (primarily the smaller EMS countries like Ireland) over the financing and intervention mechanisms of the ERM led to the Finance Minister (ECOFIN) meeting in Nyborg on September 11-13. At Nyborg, the finance ministers announced a plan for EMS intra-marginal interventions to accommodate the position of weak-currency countries.15. As compared to the earlier form of intervention "at the margins," intra-marginal interventions meant that central banks would intervene before a currency reached the upper or lower margins of the ERM. This important correction was seen as easing some of the strains that would develop when a currency had already reached the limits of the margins by intervening before there was no room for manoeuver.[15] Although borrowing mechanisms had always been possible under the EMS, the agreement specifically identified a renewed commitment to a financing system that allowed central banks whose currency came under pressure to borrow a strong currency from another central bank. In due time, this meant borrowing DM from the Bundesbank. In addition, short-term loans could be repaid in European Currency Units (ECU's) which allowed the borrower the privilege of not having to come up with hard-currency to repay the loans.

The Bundesbank was at first skeptical of any "automatic" or "obligatory" financing mechanisms and intramarginal interventions to stabilize exchange rates within the EMS, although it appears P”hl was initially in favor. In general, the Bundesbank felt that it was seldom useful to shore up a currency under severe market pressure and found the binding requirements of intra-marginal interventions a limitation to the bank's ability to pursue an autonomous monetary policy. Interventions would require the Bundesbank to buy up foreign currencies which then would be converted into DM's thereby increasing the domestic money supply. Moreover, the Bundesbank has consistently maintained that such interventions would only add to the speculative turbulence, not calm it once it started. The credibility of the central bank could possibly be damaged by unlimited intervention or financing mechanisms. For a majority of the Central Bank Council, increasing the convergence of its European partner's macroeconomic policies toward the Bundesbank price-stability standard was the only true method for dealing with market pressure. More importantly for the Bundesbank, the Nyborg arrangement could lead to a greater degree of automaticity and supranationality in European monetary relations which, for some Bundesbank officials, would mean an abdication of its responsibilities to the Bundesbank law.116. The Bundesbank's views on Nyborg are nicely summarized in "Im Zeichen von Nyborg," Frankfurter Allgemeine Zeitung, August 27, 1987.[16]

Despite Bundesbank concerns, the final agreement rested firmly on a Franco-German compromise and eased pressure within the EMS and provided the foundation for the movement on EMU to come in the next years. It included the following provisions: 1) the extension in time of the credit facilities of the EMCF; 2) member states admitted more openly the possibility of using the Very-Short Term Facility for financing intramarginal interventions within a cumulative amount similar to the revised size of debtor quotas in the Short-Term Facility; 3) the raising of the acceptance limit for settlements in official ecus from 50 to 100 percent, initially for a period of two years; and 4)the general recommendation to aim for a better balance between the three instruments for operating the EMS: exchange rate movements within the fluctuation margin, changes in interest rate differentials, and intervention. The four points reflected a judicious compromise which enabled both the Germans and French to claim major concessions by the other. As Gros and Thygessen have summarized, the French emphasized "the enlargement of the credit facilities and the recognition of intra-marginal interventions which had not been part of the original intentions (of) the EMS. (the Germans) stressed the strengthening of monetary policy coordination and more active use of interest rates."17. Daniel Gros and Niels Thygessen, European Monetary Integration, (Harlow: Longman Group, 1992), p. 95.[17]

In the end, the Bundesbank agreed to the proposal as long as the main precondition for intervention would be that "it does not threaten price stability."18. P”hl went on the public relations offensive to detail how the bank had not transferred any monetary authority. The French, of course, had deemed the provisions of Nyborg as "presumably automatic." See "Leichterer Griff zum Geldhahn," S   ddeutsche Zeitung, September 15, 1987.[18] With flexibility within the bands, the Bundesbank retained a measure of autonomy. More importantly, the Bundesbank felt that giving in to the government on this issue would protect the long term independence of the Bundesbank. Since the Bundesbank recognized that negotiations would soon be under way on a plan for full European monetary union, the bank felt that the government would owe the bank a favor for supporting Nyborg. A compromise was struck. As another key fact, the Bundesbank acceded to the concerns of the government as well as its own belief that the EMS continued to serve the important function of stabilizing the payments relations between the European nations and solidifying the regional zone of monetary stability which had been the primarily reason for establishing the EMS in the first place.19. Interview with retired Bundesbank Central Council Member.[19] At this time, fluctuations of currencies within the EMS were due in large part to the large volume of trade and service transactions, unlike the capital flows between the dollar and the DM which were more affected by political and psychological factors. With exports to the EC accounting for more than 50 percent of Germany's total exports (in addition to almost 70% if one includes the EFTA nations, many of which pegged their currencies to the DM), the Bundesbank was more inclined to achieving stability in the EMS - even with the potential that the intra-marginal interventions would compel the bank to cede a measured amount of policy autonomy.

More importantly, defending the integrity of the EMS and enhancing the measures of inter-Community coordination could only strengthen the insulating effects of the EMS to the volatility of the dollar. Such was the case at the end of October following the market crash as the tumbling dollar precipitated renewed turmoil in the EMS. The French were quick to skillfully exploit the recent changes in the EMS in its defense of the franc. The French were able to prevent their currency -- under heavy speculative attack -- from being forced to devalue by flexibly using intervention techniques and through significant support from the Bundesbank. The franc and the EMS survived the heavy turbulence created by the October stock market crash due in large part to the changes agreed upon in Nyborg and the new and successful strategies pursued by the Germans. Indeed, now it was the U.S. Treasury Secretary James Baker that flew to Frankfurt to seek the assistance of German monetary authorities in restoring international monetary stability after the crash.

The significance of the Nyborg agreement should not be underestimated and confirms many of the propositions set forth in terms of German monetary cooperation. The German government pressured the Bundesbank to go to great lengths to offer concessions on intervention and financing mechanisms within the EMS in return for enhanced regional monetary stability. The "gentlemen's agreement" at Nyborg indicated a significant amount of flexibility on the part of the Bundesbank and the Kohl government at a time that both were increasingly inflexible toward the U.S. The agreement implied at least a minor loss of the DM's traditional dominance over the EMS. Moreover, the decision to adhere closely to the Nyborg agreement can be seen as the price Bonn and Frankfurt were willing to pay and the concessions they were willing to offer for ensuring that France abolish capital controls, further proceed toward the goals outlined in the Single European Act of 1986, and continue to converge its macroeconomic policies more in line with the German political-economic model.20. The decision to shift some of the burden of adjustment away from weaker currencies to the DM would also make full EMS membership more palatable to the British government.[20] Importantly, the Germans were eager to solidify regional monetary independence in the face of the declining value of the dollar and pressure by the U.S. to coordinate German policies in line with U.S. demands. The Germans discounted to a noticeable degree concerns about domestic monetary autonomy in order to enhance the institutional make-up of the EMS proved an important stepping-stone and credibility enhancement as the Germans would move into the first stage of negotiations over European Monetary Union in 1988-1989. The agreement also demonstrated that the Bundesbank's vaunted independence could be constrained by external financial considerations, i.e. commitments to intramarginal interventions to stabilize EMS currencies, given the proper constellation of political and economic factors.

European Monetary Union and the Compromise of Maastricht (1991)

Four months after the Basel-Nyborg agreement, Balladur indicated that the French were interested in reconstructing the EMS even further. In the famous Balladur memorandum, the minister argued that:

"The discipline imposed by the exchange-rate mechanism may, for its part, have good effects when it serves to put a constraint on economic and monetary policies which are insufficiently rigorous. It produces an abnormal situation when its effect its to exempt any countries whose policies are too restrictive from the necessary adjustment... The asymmetry is one of the reasons for the present tendency of European currencies to rise against the dollar and currencies tied to it. This rise is contrary to the fundamental interest of Europe... We must therefore find a new system under which this problem cannot arise."21. Gros and Thygessen, p. 312. The original memorandum was dated January 8, 1988.[21]

The Germans, acting as the president of the EC through the first six-months of 1988, responded to the French concerns by recommending the creation of a European Currency Area and the creation of a European Central Bank. From that starting point, the following three and a half years would see the states of the EC negotiate, often tediously, under pressure, and with conflict, the details of EMU and political union. The Treaty of Maastricht would ultimately come to encompass the goals and objectives of the French and Germans on EMU. The participation and ratification of the treaty by the Germans and French were crucial for the final agreement.

Some analysts do argue that the Bundesbank's own domestic monetary policy was increasingly uncooperative during this period (steadily raising interest rates through 1988-91) furthering tensions within the EMS). In other words, Bundesbank policy was far from being oriented towards the bank's European partners. In some respect, this is true, but such a view solely looks at the domestic monetary policy of the Bundesbank and not the external monetary diplomacy of the federal government. Therefore, one singular overriding fact cannot be disputed: the German government secured the approval and consent of the Bundesbank to the Maastricht Treaty - a treaty that would effectively do away with the Bundesbank's sovereign control over German monetary policy. The Bundesbank did not grant its approval without hesitation or preconditions. In fact, the Maastricht Treaty reflects a number of the key concerns of the Bundesbank including guarantees of the European central bank's (ECB) political independence, the ECB's clearly specified objective of ensuring price stability, strict EMU entry requirements, as well as movement on political union. However, the Bundesbank had essentially consented to an agreement that no one thought possible -- a single European currency regulated by a supranational European Central Bank that would do away with the Deutsche-Mark (DM) in Germany. In terms of the objectives of exchange rate stability and domestic monetary sovereignty, the Germans had offered the greatest concession of all to Europe -- the D-Mark.

The final elements of bargain struck at Maastricht came into shape in the last hectic days of negotiating before the actual summit.22. That some agreement would be reached still remained in doubt in the weeks before Maastricht. See the analysis, "Eine Schicksalgemeinschaft - verstrickt im Grabenkampf," Berliner Zeitung, 11-29-91.[22] First, the idea of a full-fledged political union would have to be set aside and a more modest set of supposedly "irreversible" policy and institutional mechanisms would be accepted for the time being. Although a political union of the ideal form that Kohl had envisioned remained an elusive goal, it was enough to secure his support for EMU, where the details fit closely to many of the stricter requirements outlined by the Bundesbank. Instead of creating a powerful ECB on January 1, 1994, the EMI would have the task in Stage Two of EMU of guiding member states toward convergence in inflation, interest rates and budget deficits. The treaty specifically outlined the economic pre-conditions or criteria for EMU membership (which Germany, ironically, at the time did not fulfill):

* For one year prior to membership, an inflation rate that is less than 1.5% points higher than that of the three lowest national inflation rates in the Community
* For one year prior to membership, an inflation rate that is less that 2% points higher than those of the three countries with the lowest inflation rates.
* For two years prior to membership, no devaluations from within the narrow band of the ERM.
* A national budget deficit of less than 3% of GDP
* A public debt of less than 60% of GDP

The treaty also enshrined the idea of an independent ECB guided by the price stability standard. Moreover, other EC members would have to seek their own central bank independence as a precondition to EMU.

The key component of the Maastricht deal was the trade off between the strict requirements for entry that France agreed to in return for the timetable that was agreed to by the Germans. The timetable concept recognized in part the idea of a Two-Speed Europe since some members of the EC would undoubtedly not be able to meet the standards of entry and, thus, would probably be left behind by those countries able to meet the requirements. The key concession by the Germans to the French was the agreement on the ultimate end date for starting EMU - 1997 at the earliest and 1999 at the latest. The transition to EMU would begin at the beginning of 1997 when the Finance Ministers would decide, by qualified majority, which members met the convergence criteria. A summit would then decide, again by majority, whether at least seven countries were ready for EMU, and if so, whether and when it should start. If no date was set, another summit would meet before July 1998 to decide which members were now ready. Those countries would then choose whether to adopt the ECU as their single currency on January 1, 1999 with a European Central Bank responsible for monetary policy.

Despite the protestations of the Bundesbank, the decision to secure a treaty on EMU was a political calculation reached by the chancellor. The Bundesbank could only stand by and "advise" the chancellor as to what the bank saw was the best path to proceed. Many of the preferred provisions of the Bundesbank for EMU had, in fact, been met in the negotiations but a number had not. Strict convergence criteria as suggested by the Kr”nungstheorie, the independence of the ECB (in most respects), and the price stability goal characterized the overall EMU arrangements. Yet, a form of automatic timetable, an ill-defined exchange rate policy, and a weak enforcement mechanism for fiscal policy were also important terms of the agreement. Maastricht was a political document, not an economic theory. Perhaps worst of all, there were no guarantees that the stability monetary ideology in Germany existed throughout Europe. Whatever the interpretation, the formal, legally binding Maastricht document had committed Germany to full monetary cooperation in Europe -- the full and irrevocable fixing of exchange rates and a single currency.

What can account for the successful completion of the monetary agreements of Maastricht? The analysis set forth in this paper suggests two factors: the Franco-German bilateral axis and developments on the international monetary front. First, the highly institutionalized form of bargaining inherent in the Franco-German bilateral relationship built on the institutions of the EC, including rigid timetables, firm agendas, and the increased opportunities to link various negotiated issues into a larger framework on European Union, opened up the possibilities that made such an historic agreement possible. Second, the crucial impact of reunification exposed a weakness in the German position -- namely crucial French support for the German unification would come at the price for German support for Maastricht. As a result, the necessity of securing French support for reunification opened the door for Europeans (led by the French) to seek concessions from the Germans and their agreement on sacrificing domestic monetary autonomy for EMU. The German concessions on EMU were highly structured by the Franco-German bargain to build a European central bank and the political desire of Kohl and Mitterand to secure European Union. German unification altered the negotiating calculus of both the French and Germans - including the Bundesbank.

The second factor explaining the willingness of the Germans to offer concessions on domestic monetary autonomy to their European partners was the opportunity to export monetary stability to the EU and develop a European zone of monetary power and influence in global monetary affairs. In this sense, a comprehensive account of the Maastricht treaty must include the international level factors that played a role in the negotiations surrounding Maastricht. Although the Germans were concerned about the loss of monetary autonomy, the loss of autonomy was overshadowed by the desire to secure an absolute sense of power (influence) in global monetary affairs. The Germans and the French could realize their desire to enhance the community's monetary influence in world politics by enhancing exchange rate stability in Europe. The period 1988-1991 was marked by relative stability in terms of dollar politics and international monetary stability -- at least when compared to the period from 1985-1987. However, G-7 monetary coordination remained in abeyance. Officially, each member sought to pursue their own domestic monetary policies. As we have seen, while this may have been the formal stand of the G-7, Germany, France, and the rest of the EMS members were actively pursuing a strategy of cooperating at a supranational level. It is clear now that the German strategy was to disregard, at least as much as feasible, G-7 efforts to stabilize exchange rates while simultaneously negotiating the demise of the D-Mark. In short, Maastricht was a complex political bargain shaped by domestic, bilateral Franco-German, and international level factors.

Turmoil in the EMS: Testing the Limits of the Franco-German Partnership (1992-93)

The period 1992-93 marked another period of heavy monetary turmoil both within the G-7 and EMS. The Bundesbank's monetary policy was caught in a triple bind: confronting the government's ill-defined financing plans for reunification and the developing economic slowdown in Germany on the domestic front; confronting its EMS intervention commitments as well as the powerful driving forces of monetary integration surrounding Maastricht; and confronting an indifferent U.S. dollar policy caught up in election year imperatives and a resurrected weak dollar policy to fight mounting trade deficits with Japan. Not surprisingly, when caught in this triangular squeeze, the Bundesbank turned to its most potent political resource: its legally mandated duty to "safeguard the value of the currency." Without the viable option to pursue a realignment within the EMS and little if any control over the U.S.'s dollar policy, the Bundesbank had only one course of action, namely to raise interest rates. Moreover the tensions that developed in the EMS were to be expected as well. Given the rigidity of the system and divergent national interests and priorities, it was only a matter of time before market speculation, political indecisiveness and the not-so-subtle monetary diplomacy of the U.S. and some EMS members triggered the crises.

The crisis of 1992 and the continued turmoil was undoubtedly the result of Bundesbank policy. However, what is often forgotten is the international dimension to the monetary crisis. Through the summer of 1992, the dollar reached historic lows against the dollar. In August 1992, the dollar dropped briefly below 1.40DM for the first time since the end of WWII. The upward pressure on the DM brought about by the weak dollar policies of the U.S. and the high interest rate policy of the Bundesbank strained the EMS currency bands. For its part, the Bush administration was not in any credible position to pursue policies at home that would have fundamentally changed the direction of the dollar. With G-7 monetary governance continuing the pattern developed during the period 1988-

1991, it should have been clear that the G-7 or the U.S. would not be in any position to resolve international monetary disturbances. The dollar generated instability merely reinforced German desires to continue the policy of enhancing European exchange rate stability, even if that meant a leaner "hard core" of EU nations. Most importantly, this hard core would have to include the French or else any strategy designed to enhance European cooperation would fail.

Franc fort Under Pressure

Following the destructive events of Black September23. See the account of Peter Ludlow. I choose not to highlight the September crisis, not out of concern that the actions of German monetary authorities disproves my thesis, but rather because of the greater importance of the period from September 1992-August 1993 to the Franco-German partnership and the future of EMU. In fact, I would argue that the approach of German monetary authorities toward the crisis, although not in all accounts defensible, can be described as flexible - especially towards the French and support of the franc.[23] in which the British (along with the Italians) were ejected from the EMS, the Bundesbank spelled out through a series of speeches and interviews its vision of Europe's future - a vision that amounted to a monetary survival of the fittest.24. See the analysis in "The Bundesbank begins to make its voice heard," and "Schlesinger gives warning on common currency rules," Financial Times, 12-2-92. The tough talk also represents a decidedly conservative swing on the Bank's council over the last years. See the discussion in "Conservatives Hold Sway at Bundesbank," Wall Street Journal, 11-29-92[24] While the Bundesbank expressed public support for the goals of economic and monetary union in accordance with Maastricht, they expressed doubt about the effectiveness of the economic convergence criteria in the treaty. The Bank also cited the lack of clarity about the treaty's weak provisions on political union - a union that might provide a democratic foundation of support for the goals of a single European currency and central bank. Rejecting the hope that all members of the EU could proceed together toward EMU, Schlesinger insisted that there would be no compromise in Europe with the bank's domestic objective of achieving price stability. Countries were welcome to try and fix their currencies to the D-Mark, but it is up to them to make the "right choice" among various economic policies in order to ensure their economic fundamentals - inflation, international competitiveness and public finances - were in order.

The Bundesbank's tough talk was backed up with tough policy. When the Spanish peseta and the Portuguese escudo were both devalued by 6% on November 22, 1992, the Bundesbank resisted further pressure to cut interest rates and refused to compromise its strict anti-inflationary monetary policy. Even with a slight easing of German interest rates throughout the winter and spring of 1993, the EMS experienced continuing credibility problems heightened by the upcoming French parliamentary elections in March. The Irish punt was devalued by 10% on the first of February, 1993 and the Spanish Peseta was devalued another 8% and the escudo another 6.5% on May 14th 1993. The Bundesbank offered only limited intervention support for these currencies. As a result, countries perceived to be outside a developing "hard core" of the ERM faced an uncertain and darwinistic monetary and exchange rate environment.

Instead, the link between the franc and the DM became the central focal point for ERM relations and the overall survival of the EMS between September 1992 and August 1993. Following the crisis in September, a franc devaluation would have been seen as an even larger blow to the political prestige of President Mitterand and to the Prime Minister Pierre Beregovoy, who made the franc fort the center of his economic policy. Bundesbank President Schlesinger sought to verbally support the franc by suggesting that the franc was "a candidate for appreciation."25. The Financial Times, 9-18-92.[25] Moreover, a franc devaluation would also have demonstrated that the ERM was operating perversely by creating the conditions for the depreciation of a currency - the franc - which in terms of current economic fundamentals deserved to be stronger than the DM. The first major test of the link was the intense speculative attack on the franc following the weak "Oui" in the September 20 French referendum to the Maastricht Treaty. In spite of sound economic fundamentals, such as low inflation, stronger growth and healthier government finances than those of Germany, the Bundesbank and the Bank of France had to buy FFr 160 billion in concerted intervention to curb the first post-Black September speculative wave.

That initial attempt to support the franc indicated a significant turning point in Bundesbank policy. Although the Bundesbank appeared reluctant, even outright adamant, in its opposition to any largescale intervention efforts that might influence German money supply, the bank and the Federal Government were extremely willing to commit substantial political and financial support to the French. The two central banks coordinated their policies closely, for example, the Bundesbank provided the French with a generous swap line. While the Irish, Danish, Norwegians and Swedes experienced similar pressure, the Bundesbank was not willing to extend its generous French package to them. In fact, after the crisis, a great deal of conjecture surfaced on the motives behind the tight Franco-German monetary axis. Most of this conjecture focused on the possibility of a rapid acceleration of monetary union centered on a quick jump to Stage 3 of the Maastricht Treaty.26. See the discussion in "High Speed to EMU begins to gather steam," Financial Times, 9-27-93; "ERM upheaval seen hastening two-speed Europe," Peter Norman, Financial Times, 11-25-92; See also "Europa nach dem Sturm," Die Zeit, Udo Perina and Nikolaus Piper, 9-21-92; "France in der Falle," Ludwig Siegele, Die Zeit, 10-1-92.[26] Such speculation was supported by a private meeting between Kohl and Mitterand two days after the French vote on Maastricht. The conjecture was concretely supported, as stated, by the close cooperation between the Bank of France and the Bundesbank in propping up the franc.

How did the French gain the needed monetary and political support of the Germans? The French government's economic objectives since Mitterand's macroeconomic "volt face" in 1983 and the governments rigid support of the franc fort policy was launched primarily to put an end to soaring budget and trade deficits, rising inflation, and repeated devaluations. This policy soon worked and became the centerpiece of France's gradual conversion to market economics in the official political and economic establishment. The franc fort policy also became the official starting point for all subsequent French goals concerning the future of the EC. With the success of the franc fort policy, French politicians, supported by broad public support and consensus for the policy, could more easily move forward with such far-reaching agreements as the 1985 program for a Single European Market (codified in the Single European Act of 1986) as well as proposing large sections of the plan for economic and monetary union incorporated into the Maastricht Treaty. The problem, however, for the French was that the franc fort policy became more than a economic policy decision. It soon became a political symbol of French energy and fortitude. If the franc were forced to exit the ERM or face a large devaluation, the damage to the public support for Maastricht would be incalculable and would also raise the possibility of. a collapse in the French government.

More importantly, perhaps, the Bundesbank's generous support of the French was based on the belief that the French had made a credible commitment to the so-called coronation theory of EMU. According to the coronation theory, EMU would result after a long process of convergence of national economic and monetary policies. By attaching the franc closely to the value of the DM and the Bundesbank's monetary policies, the French soon became a credible member of the convergence club. As the tensions mounted in 1992-1993, the Bundesbank did not have the resources to provide unlimited support to all EMS currencies - only those members who belonged to the ERM core. In addition, the French were not only important monetarily but politically as well, since France's participation in EMU was tantamount to the entire process of European integration. As some analysts have suggested, Germany may have seen the opportunity in September to "purge" the EMS' hard core of uncommitted or other "soft currencies."27. See Barry Eichengreen and Charles Wyplosz, "The Unstable EMS," Brookings Papers on Economic Activity, No. 1, 1993, p. 112.[27] The Bundesbank could finally create a monetary union more in line with its own coronation model.

However, as tensions in the EMS again resurfaced in the spring and summer of 1993, there were increased calls to fundamentally alter the operating of the EMS or disband it all together. An influential group of economists argued that the turmoil in the currency markets and the broader crisis of unemployment in Europe (12.5% in France, 22% in Spain, over 3 million unemployed in Germany) provided enough evidence that the EMS had become profoundly counterproductive.28. "Why the EMS deserves an early burial," Oliver Branchard, Rudiger Dombusch, Stanley Fisher, Franco Modigliano, Paul A. Samuelson and Robert Solow, Financial Times, 7-29-1993.[28] Even with the Italians and British out of the system, the rigid adherence to the DM by the French and others and the continued high interest rate-policy of the Bundesbank, the inflexible EMS mechanism of intervention persisted unaltered. There was even serious discussion concerning the replacement of the DM by the franc as the anchor currency in the ERM as a series of interest rate reductions led by the French pushed French short-term interest rates below the Germans.29. See the discussion in "Zeitgespr„ch: Die Leitw„hrungsrolle der D-Mark im EWS," Otmar Issing, Peter Bofinger und Karl Friedrich/A. Unterberg, Wirtschaftsdienst, No. 73, 1993.[29]

Such speculation over the role of the franc as the "new" anchor currency of the EMS never caught up with actual events. With money supply figures in Germany still running over 7%, above the Bundesbank's 4.5% 6.5% target for 1993, and with inflation running at an annual rate of 4.3% through July, the Bundesbank could not have been expected to save the EMS with an interest rate cut at the last meeting before the bank's summer pause. On July 30, the Bundesbank did cut the Lombard rate by a half a point from 8.25 to 7.75% but as some analysts stated, the cut was "purely symbolic" and would only cause, "irritation at best."30. "Frankfurt dives for cover from flak," Financial Times, Weekend, July 31/August 1, 1993.[30] The narrow easing of rates, including the small reduction of the securities repurchase (repo) rate to 6.95%, did not save the system but helped trigger a renewed crisis. The markets were looking for more. Following the Bundesbank's decision on Thursday morning, the rest of Thursday and Friday saw continuous strains as European central banks spent an estimated DM 75 billion ($43bn) propping up weak currencies. The Bundesbank alone, it was estimated, spent up to 60DM billion on ERM intervention for the week, although efforts were made to sterilize the impact of the extra liquidity.31. Sterilization occurs when monetary authorities offset extra domestic liquidity created through foreign exchange operations by withdrawing liquidity from the system, usually by issuing government debt.[31]

In the absence of a realignment of exchange rates, the stubborn refusal of the Bundesbank to lower rates32. The Bundesbank had sparked additional rumors that a discount rate cut would be forthcoming after cutting the repo rate almost to the discount rate floor on the Wednesday before the Council meeting. This action was met with no public explanation which, in turn, fueled the frenetic instability of the markets.[32] produced the subsequent high-powered ministerial meeting which produced, in the words of Mr. Wire Kok, Dutch Finance Minister, "the worst but one solution."333. The events that transpired at the meeting on August 1 are captured accurately in "How the Ministers Agreed: ERM Bands produce sort of Harmony," Financial Times, 8-3-93.[3] The minimum point of agreement was that the ERM and its central parity grid had to be preserved. The main difficulty, though, was France's absolute refusal to accept a devaluation of the franc and the Bundesbank's (supported by the Kohl government) absolute insistence that it could not be expected to provide unlimited intervention. At one point, the Germans and French appeared to have achieved a compromise solution in which the Germans, who preferred to see the margins of fluctuation widened, agreed to leave the ERM.34. Such an argument was made in the editorial section of the Financial Times, "Bleak Summer for the ERM", which suggested that a realignment at that point in time offered no realistic prospect for relief. "A better solution might be for Germany to recognize that it - not France or Denmark - is the country with structural problems and so needs, temporarily, to leave the ERM." 7-30-93. On the point of the German offer to leave the ERM, the German Finance Minister Waigel stated in later interviews that there had been no suggestion that they leave the ERM.[34] As soon as the Netherlands, as well as Denmark, Belgium and Luxembourg found out about the plan, they balked and stated their intentions to pull out of the ERM as well despite the immense French pressure placed on the Dutch to break their link to the DM. However, with Delors personally opposing the German exit - which would have been seen as a fatal blow to Maastricht - and the Dutch holding firm, the talks returned to a widening of the bands. Moreover, all participants could not picture a future credible EMS with France sitting all alone in the ERM with Spain and Portugal.

In order to break the logiam, Germany offered that the French widen their fluctuation bands to 6% with an implicit promise, made more credible by the appearance of Schlesinger and the Bundesbank Vice President Hans Tietmeyer at the bargaining table, that the Germans cut their interest rates. The French refused the offer, interpreting it as a defacto devaluation of the franc and placing it among the EMS's second tier - Spain and Portugal. In addition, the French were extremely hesitant to test the margins at 6%. Finally, after numerous variations on currency bands and particular currencies, a solution was found: a fluctuation band of plus or minus 15 percent for all currencies except the DM and the Dutch guilder.35. The communique read: "This measure of limited duration is in response to speculative movements, which are exceptional in amount as well as in nature... the ministers and governors therefore reaffurm support for the current parities and are confident that the market rates will soon approach these parities again."[35] The aim was to disguise a de facto French devaluation as well as the defacto suspension of the system. Nevertheless, the institutions of the EMS had been maintained due to the strength of the Franco-German couple. Even with a widening of the trading margins of the ERM; a credible system of exchange rate management soon returned.

The German and French efforts to sustain the franc fort policy indicated the lengths both countries were willing to go in order to maintain progress on EMU. Since both the Germans and French could not envision EMU without each other, both countries sought a strategy that would save some face for each side. For their part, German monetary authorities did go to great lengths during the EMS turmoil of 1992-93 to minimize the impact of their policies on the European Union either through a realignment (which would have hurt the already depressed German business community), central bank intervention (which did throw off the Bundesbank's domestic monetary supply), or, as the Bundesbank points out, their lowering of interest rates throughout 1993. Cooperation in the form of sacrifices on monetary autonomy at the European level was forthcoming from the Germans. Arguably, without the Franco-German parmership, the future of EMU would have been forever destroyed. The built-up pressures within Germany following reunification, the inflexible and rigid preferences of European actors (including the Germans), and the structural and global disruptions associated with the decline of the dollar ultimately overwhelmed many of the steps that were taken to counteract these pressures.

CONCLUSION

This paper has argued that EMU can best be explained by the structural context of the EMS Franco-German bilateral relationship and its connection to global monetary structures. This relationship has two important implications for understanding the bargaining strategies of German monetary authorities toward monetary cooperation. First, both French and German monetary authorities have displayed a sustained willingness to accommodate their monetary policies in order to underpin integration and monetary union. The choice between exchange rate stability and domestic monetary autonomy examined in the cases above suggests that the Germans, counter to many scholarly and journalistic accounts, are willing to sacrifice domestic monetary autonomy if such a choice furthers the goals of the Franco-German alliance under the umbrella framework of the EMS. Second, and closely related, the willingness of German monetary authorities to cooperate on sensitive monetary questions with the French is also driven by the imperatives of counterbalancing U.S. pressure and influence upon European monetary affairs. In fact, the bargaining strategy pursued by German monetary authorities did indicate that the Germans differentiated their bargaining approach toward monetary cooperation within the G-7 and the Franco-German EMS partnership.

This paper does not suggest that EMU will occur by 1997 or even 1999. In fact, the author remains rather pessimistic, especially given the most recent bout of monetary turmoil in the EMS. However, I do argue that whatever progress is made toward that goal will depend on the strength of the Franco-German alliance and developments within the global system of monetary governance. Moreover, crises within the EMS driven by dollar crises have often led to renewed efforts on furthering European monetary integration. As this paper has demonstrated, German monetary authorities have on critical occasions seen it in their interest to pursue the goal of EMU. Despite the tremendous changes within Europe and Germany, a powerful element of continuity pervades the German approach toward EMU. It remains to be seen whether this pattern will continue.

ENDNOTES

1. "Banque de France and Bundesbank einig wie noch nie," Frankfurter Allgemeine Zeitung, 3-26-94; See also the analysis of Allan Saunderson, "Remember EMU?", International Economy, March/April 1994.
2. The international monetary governance structure will hereafter be referred to as the G-7. See Andrews (1994) for a strong theoretical analysis of the international monetary structure.
3. Monetary policy is defined broadly to include the actions of the Bundesbank and Federal Government to affect monetary and other financial conditions both within Germany and abroad. For example, a realignment within the EMS, a Bundesbank move on the discount rate, intervention to support another currency, or a larger more formal agreement such as Nyborg are all considered monetary policies.

4. Roger Morgan, "Preface," in Partners and Rivals in Western Europe: Britain, France, and Germany, Roger Morgan and Caroline Bray, eds., (London: Gower, 1986), x-xi.
5. See especially the analysis of Helen Wallace, "The Conduct of Bilateral Relationships by Governments," in Morgan and Bray, op. cit., pp. 136-155. The following account of bilateralism closely traces Wallace's examination of bilateralism.
6. In this sense, my analysis differs with Huelshoff (1994) who argues that the German "state" should be considered weak when analyzing bargaining models.
7. Helen Wallace, "Bilateral, Trilateral, and Multilateral Negotiations in the European Community," in R. Morgan and C. Bray, eds., op. cit., especially p. 162.
8. See the most recent analysis and comments of former U.S. Treasury Secretary James Baker, "Clinton's Search for a Foreign Economic Policy," Los Angeles Times, 7-31-94, M2. Baker suggests that movement on EMU "complicated policy coordination between the U.S. and major European economies..."
9. See the analysis of Edward Gardner and William Perraudin, "Asymmetry in the ERM: a Case Study of French and German Interest Rates before and after Unification," International Monetary Fund Staff Papers, Vol. 40, No. 2, June 1993; See also Bill Jaretski and Gaff Schares, "A Partnership of Unequals: the Economic Alliance of France and Germany," Business Week, October 12, 1992.
10. The tradeoff between monetary policy autonomy and exchange rate stability is of course complicated by the third leg of the "Unholy Trinity," namely private capital mobility. Specifically, there exists an intrinsic incompatibility of these three key economic desiderata. I do not seek to underestimate or neglect the influence and power of the capital mobility. However, in so far as the primary core of monetary debates in Germany focuses on the tradeoffs between monetary stability and exchange rate stability, these two variables will be highlighted. The concept of the "Unholy Trinity" is from Benjamin J. Cohen, "The Triad and the Unholy Trinity:. Lessons for the Pacific Region," in Richard Higgot, Richard Leaver, and John Ravenhill; eds., Pacific Economic Relations in the 1990's: Cooperation or Conflict? (London: Allen and Unwin, 1993).
11. Cohen, p. 147. My examination draws heavily from this analysis and the following pages in Cohen, pp. 147-152.
12. Interviews conducted by the author at the Bundesbank in Frankfurt confirm this view.
13. Foreign exchange interventions could, of course, be sterilized (withdrawing liquidity from the system, usually by issuing government debt). However, as often the case, such interventions in EMS currencies have mounted to billions of DM's within a short period of time. As a result, sterilization has been practically impossible in every situation.
14. Interview with German Finance Ministry official.
15. As compared to the earlier form of intervention "at the margins," intra-marginal interventions meant that central banks would intervene before a currency reached the upper or lower margins of the ERM. This important correction was seen as easing some of the strains that would develop when a currency had already reached the limits of the margins by intervening before there was no room for manoeuver.
16. The Bundesbank's views on Nyborg are nicely summarized in "Im Zeichen von Nyborg," Frankfurter Allgemeine Zeitung, August 27, 1987.
17. Daniel Gros and Niels Thygessen, European Monetary Integration, (Harlow: Longman Group, 1992), p. 95.
18. P”hl went on the public relations offensive to detail how the bank had not transferred any monetary authority. The French, of course, had deemed the provisions of Nyborg as "presumably automatic." See "Leichterer Griff zum Geldhahn," S ddeutsche Zeitung, September 15, 1987.
19. Interview with retired Bundesbank Central Council Member.
20. The decision to shift some of the burden of adjustment away from weaker currencies to the DM would also make full EMS membership more palatable to the British government.
21. Gros and Thygesen, p. 312. The original memorandum was dated January 8, 1988.
22. That some agreement would be reached still remained in doubt in the weeks before Maastricht. See the analysis, "Eine Schicksalgemeinschaft - verstrickt im Grabenkampf," Berliner Zeitung, 11-29-91.
23. See the account of Peter Ludlow. I choose not to highlight the September crisis, not out of concern that the actions of German monetary authorities disproves my thesis, but rather because of the greater importance of the period from September 1992-August 1993 to the Franco-German partnership and the future of EMU. In fact, I would argue that the approach of German monetary authorities toward the

crisis, although not in all accounts defensible, can be described as flexible - especially towards the French and support of the franc.
24. See the analysis in "The Bundesbank begins to make its voice heard," and "Schlesinger gives warning on common currency rules," Financial Times, 12-2-92. The tough talk also represents a decidedly conservative swing on the Bank's council over the last years. See the discussion in "Conservatives Hold Sway at Bundesbank," Wall Street Journal, 11-29-92
25. The Financial Times, 9-18-92.
26. See the discussion in "High Speed to EMU begins to gather steam," Financial Times, 9-27-93; "ERM upheaval seen hastening two-speed Europe," Peter Norman, Financial Times, 11-25-92; See also "Europa nach dem Sturm," Die Zeit, Udo Perina and Nikolaus Piper, 9-21-92; "France in der Falle," Ludwig Siegele, Die Zeit, 10-1-92.
27. See Barry Eichengreen and Charles Wyplosz, "The Unstable EMS," Brookings Papers on Economic Activity, No. 1, 1993, p. 112.
28. "Why the EMS deserves an early burial," Oliver Branchard, Rudiger Dombusch, Stanley Fisher, Franco Modigliano, Paul A. Samuelson and Robert Solow, Financial Times, 7-29-1993.
29. See the discussion in "Zeitgespr„ch: Die Leitw„hrungsrolle der D-Mark im EWS," Otmar Issing, Peter Bofinger und Karl Friedrich/A. Unterberg, Wirtschaftsdienst, No. 73, 1993.
30. "Frankfurt dives for cover from flak," Financial Times, Weekend, July 31/August 1, 1993.
31. Sterilization occurs when monetary authorities offset extra domestic liquidity created through foreign exchange operations by withdrawing liquidity from the system, usually by issuing government debt.
32. The Bundesbank had sparked additional rumors that a discount rate cut would be forthcoming after cutting the repo rate almost to the discount rate floor on the Wednesday before the Council meeting. This action was met with no public explanation which, in turn, fueled the frenetic instability of the markets.
33. The events that transpired at the meeting on August 1 are captured accurately in "How the Ministers Agreed: ERM Bands produce sort of Harmony," Financial Times, 8-3-93.
34. Such an argument was made in the editorial section of the Financial Times, "Bleak Summer for the ERM", which suggested that a realignment at that point in time offered no realistic prospect for relief. "A better solution might be for Germany to recognize that it - not France or Denmark - is the country with structural problems and so needs, temporarily, to leave the ERM." 7-30-93. On the point of the German offer to leave the ERM, the German Finance Minister Waigel stated in later interviews that there had been no suggestion that they leave the ERM.
35. The communique read: "This measure of limited duration is in response to speculative movements, which are exceptional in amount as well as in nature... the ministers and governors therefore reaffurm support for the current parities and are confident that the market rates will soon approach these parities again."

FIGURE 1.1
THE RELATIONSHIP BETWEEN DOMESTIC MONETARY AUTONOMY, EXCHANGE RATE STABILITY AND INTERNATIONAL COOPERATION*
ERS———————————————————————— DMA
(Cooperation) Non-Cooperation)
* Cooperation measured in terms of a continuum of policy choices between Exchange Rate Stability (ERS) at one extreme and maintaining maximum domestic monetary autonomy (DMA) at the other extreme.

TABLE 1.1
Monetary Objectives of German Monetary Authorities in Terms of a Continuum between Exchange Rate Stability (ERS) and Domestic Monetary Autonomy (DMA)*

The Franco-German EMS Monetary Axis	G-7 International System
* zone of monetary stability vis-a-vis the U.S.	* Convergence toward ERS
* Convergence toward ERS	* No strengthening of G-7
* Minor Institutional Changes in the EMS (but	Governance Structures

none that limit DMA or price stability)	* Limits on DMA resisted
* zone of monetary stability vis-a-vis the U.S. * Convergence toward ERS * Strengthening of EMS as lever of integration * Long-term goal of Federal Europe (Europe	* Convergence toward ERS * No strengthening of G-7 Governance Structure * Limits to DMA resisted Union) unless "severe" political crisis

* Objectives based on interviews with Bundesbank, Finance Ministry and Government officials, source material from the Bundesbank, and secondary sources.

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